May 21, 2004

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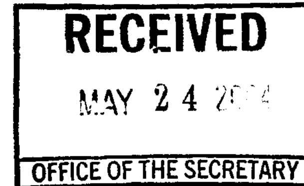
Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609



Re: File No. S7-10-04 / Regulation NMS

Dear Mr. Katz:

Please accept this letter on behalf of Vie Securities, LLC in response to the Commission's request for comment regarding proposed Regulation NMS. Overall we view the proposed new rules as outlined in Regulation NMS as an improvement over current industry standards and regulations. However, we feel compelled to point out what may be an unintended consequence, an increase in the ease and frequency of internalization of order flow. Ironically, an increase in internalization resulting from the new rules has the potential to counteract benefits otherwise derived from Regulation NMS and may serve to undermine the liquidity of US equity markets.

Internalization refers to the practice of brokers filling customer orders themselves or at an affiliated dealer, usually at the exchange-quoted price or, at most, one tick better. In today's world of high-frequency trading and fast moving markets, most customers, both retail and institutional, do not possess the ability to select the proper trading venue in real-time. They depend on their broker to safeguard their orders, and yet the guardian is allowed to execute those orders internally, rather than send their customers' orders to the market center displaying the best quote. This practice was particularly widespread in OTC trading in the 90s and contributed significantly to the wastefully high cost of trading on the old NASDAQ. Because dealers with the best quotes are not rewarded with an execution, no one had any incentive to compete on price. This resulted in artificially high and arbitrarily determined bid-ask spreads. The latter of these two characteristics was documented by Christie and Schultz in their seminal paper of 1994 and eventually led to the Commission's establishment of the Order Handling Rule. While the Order Handling Rule curbed many excesses, internalization continued to be common practice for several years until the nascent ECNs introduced unprecedented competitive pressure, lowering the bid-ask spreads to the degree where internalization became unprofitable. Today, internalization is almost a non-issue among the larger OTC stocks, and the OTC market is now characterized by fierce competition and continuous innovation.

On the listed side, the NYSE's specialist system remains human-driven. The specialists provide quote updates at relatively long intervals. In the meantime, electronic orders, floor orders and the specialists' own intention to trade can build up inside the bid-ask spread without being displayed instantly. Therefore, the quoted spreads are often much wider than the real ones. When virtually all the listed volume happened at the NYSE, this was not a problem, since traders would still meet at the middle or, as the exchange put it, receive price improvements. Yet, in the past year, as the exchange began to face a new wave of challenges, even some full-service brokers began internalizing their listed order flow. Consequently, unrealistically large bid-ask spreads provided the potential for excessive profits at the expense of the individual investor. The

customer misses the opportunity to meet non-displayed liquidity at the exchange. The liquidity providers with the best price lose out on the trades and are forced to reduce both the frequency and aggressiveness of their service to compensate for the increased adverse-selection risk. This reduction in liquidity results in a further increase in bid-ask spreads, making internalization even more profitable to the executing firm, again, at the expense of the individual investor.

While the financial industry debates the future direction of listed trading, we must not forget the lessons learned from the OTC market of the last decade. In both the OTC market then and the listed market now, structural issues lead to bid-ask spreads that are wider than the underlying liquidity could justify. Internalization becomes an easy way to make money with minimal risk. As the customer order flows get diverted away from the public marketplace, liquidity levels drop and the spreads become still wider. Those who control the order flow may have more incentive to abuse that control. Eventually, the markets risk becoming totally fragmented. Unlike the nominally fragmented ECNs which are actually fully integrated for all practical purposes, this fragmentation is real because every broker that internalizes is a segregated market center that neither accesses other market centers nor allows them to access local liquidity.

What ultimately remedied the potential for internalization abuses on the OTC side was a combination of regulatory and competitive pressures that forced the bid-ask spreads to narrow to unprofitable levels. In particular, the sub-penny pricing and the large liquidity rebates on certain ECNs drove the spreads on heavily traded stocks to well below one penny, too low a profit even for internalization. Even today, the spread on QQQ is often 0.1 or 0.2 cent on iNET with good depth. As a result, and to the benefit of the individual investor, few brokers bother to internalize this order flow.

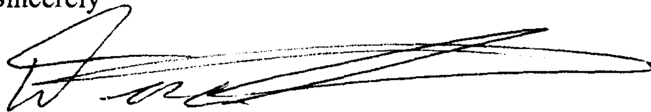
The proposed Regulation NMS makes it easier to trade listed stocks outside of the NYSE, allows trade-through, bans sub-penny pricing on most names and sets limits on the ECNs' liquidity charges. While these changes are aimed at promoting fair competition among the legitimate market centers, they also create a loophole that may subject individual investors to the same potential for internalization abuses once common in the OTC market. This may have a significant affect on the efficiency of US equity markets and should be taken into consideration by the Commission.

The most direct way to tackle the problem is to ban internalization of retail orders. While this approach looks straightforward, it is very tricky in practice as long as internalization is profitable. One can easily envision a whole new industry being born among lawyers and accountants to set up special "structures" in order to circumvent the ban. A much better route is to ensure the displayed quotes are as narrow as the intrinsic liquidity levels dictate, if not narrower. By having the narrowest possible spreads, the retail customers are in effect automatically protected from most abuses. The current proposal is therefore correct in allowing no trade-through of the "fast" markets, but the Commission will be well advised to require instantaneous display of at least the top-level liquidity as a prerequisite for qualifying as a fast market. This leads to the conclusion that there should be no price improvement on these markets. This may seem strange at first, but it actually makes sense. The fast markets are where price discovery takes place, and the regulators should encourage aggressive price competition by making sure that orders are executed against the best publicly displayed bid or offer. "Price Improvement" means traders who have not displayed their intention are stepping ahead of those who have done so publicly, consequently discouraging price competition. The key word here is public display. Since the trade-through rules ride on the best public prices, in our opinion, the Commission needs to do more to protect the interests of both the individual investor and liquidity providers by ensuring orders are executed against the best publicly displayed bid or offer first. By the same token, the Commission may want to consider banning hidden orders. Fortunately, among major

market centers in the US, only iNET allows hidden orders. Because it is an ECN, its rules are fairly flexible and it will not be difficult to make the change.

The Commission may also want to reconsider its position on the sub-penny issue. Again, looking at QQQ as an example, we see tens of thousands of shares offered at 0.1 cent apart on iNET most of the time. This is substantial liquidity that can be accessed easily and instantaneously. Because a smaller tick size reduces incentives for internalization, the market will benefit from a redefinition of the minimum tick to 0.1 cent, at least for the more liquid stocks or stocks with lower prices. The old Instinet policy seems a good starting point, where stocks under $10 per shares and a handful of very liquid names such as QQQ and SPY were traded at the 0.1-cent increments. The Commission should also take into consideration academic research results which have shown that the optimal price-to-tick ratio in electronic markets is roughly 2000:1, leading to the conclusion that all stocks under $20 should be traded at 0.1 cent increments, if not less. (e.g. Anshuman & Kalay) The same set of evidence had determined the optimal price-to-tick ratio in specialist markets to be 300:1, which would explain the various complaints against specialists' "pennying" shortly after decimalization, because the tick size was reduced by more than six fold overnight while the stock prices changed relatively very little. For the past three years, the price-to-tick ratio of listed stocks has been roughly 3000:1, far away from its optimal for a specialist market. Now that the Commission is reviewing regulations in anticipation of an electronic future, in our opinion, forcing the tick size to be at least 1 cent is an incorrect course of action and will likely prove a counterproductive anachronism because such a rule will unfairly handicap the electronic venues.

Sincerely



Dean G. Stamos
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