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January 14, 2005

Mr. Paul S. Atkins, Commissioner
Securities and Exchange Commission
450 Fifth St., NE
Washington, DC 20459-0609

S7-10-04

Dear Commissioner:

I have read carefully your Remarks before the Commission's Open Meeting on December 15, 2004, in which you speak of internalization and the specter of a virtual CLOB. I agree that neither of these issues is adequately discussed in the Reproposal, or the initial proposal for that matter. This is a serious flaw in both Releases and I support your call for delay and further discussion before the Commission acts. At the same time, I don't agree with you that a CLOB would "nationalize" the market. Actually, it is just the opposite.

For decades the market in stocks listed on the NYSE had a virtual CLOB residing in the specialist's book. It worked well until trading began to move away from the NYSE floor. This "fragmentation" of the market was disturbing to many, and a move began to "re-centralize" the market. The result was an exciting and tension filled period beginning in the mid-sixties and running until 1979. It ended when the Commission abandoned the effort with the unusual argument that a CLOB "might have a disruptive effect on the market" [footnote #29, page 192, February Release].

It is a mystery why the Regulation NMS Release ignores this earlier history. By doing so, it ignores the Commission's position at that time and the attitude of non NYSE commenters who opposed monopolies, favored competition over regulation, and supported the public interest over the insider's. It was Jim Lorie, Professor of Finance at the University of Chicago's Graduate School of Business, who led the charge for a CLOB while he was a member of the National Market Advisory Board from 1975 through 1977.

Back in the fifties, the market in securities listed on the NYSE was still almost completely centralized at 11 Wall Street. Some trading took place on regional exchanges amounting to a few percent of total volume. In the late thirties an effort had been made by the NYSE to recapture even that small volume by prohibiting their members from acting as specialists on other exchanges. A rationale for this "anti-competitive" move was that priority to public orders on the New York book was being ignored. The Commission eventually ruled against the NYSE in the 1941 Multiple Trading Case. [The dilemma then posed to the Commission, "centrality vs. competition", was resolved in Congress's design for a national market system in 1975.

This was the situation until interest in listed stocks began to develop from non-member broker dealers and from institutions. Initially, the demand was from NASD brokers looking for a discount from the minimum commission charged by NYSE members executing their orders on the Exchange floor. Institutions, were interested in obtaining larger blocks of stock than the central auction market was able to supply. The result was the growth of the Third Market.

In the 1963 Special Study to the SEC the Third Market was described as a small group of non-member dealers who acted much like the Specialist did in making markets and providing short term capital. In 1963, their volume was 6% of NYSE volume. It had been growing steadily and appeared to perform a useful and competitive service.

As early as 1957 the NYSE reacted to this growth by including, in their newly revised rules, a prohibition on members using the Third Market. In 1965, this rule, Rule 394, was challenged and a SEC staff report called it a violation of the Sherman Antitrust Act. A compromise, negotiated by the SEC Chairman, resulted in little improvement in the anti-competitive effects of the rule.

Nevertheless, demand for the Third Market continued to grow with the effect that more and more trades were ignoring the public limit orders residing on the specialist's book. Regional exchange volume also began to grow as the mutual fund industry used them to reward non-member brokers and regional only brokers for selling its funds. These trends accelerated the effort of the NYSE to have the Commission deal with this growing "fragmentation" of their market.

"Poor Aunt Millie," they told the SEC, Congress and anyone else who would listen. "Trades are ignoring 'her order on our book.'" They said, "Trading was moving toward the least regulated markets, especially the Third Market, which did not publicly report its transactions. Fragmentation and secret transactions hurt the small investor and the Commission should do something about it."

In 1971, the Commission responded by holding hearings on market structure. At the same time the former Chairman of the Federal Reserve Board, William McChesney Martin, was asked by the NYSE to study the situation and make recommendations to the Commission. In the meantime, Congress had become concerned about several troublesome developments in the securities industry and instituted their own studies of market structure in the Senate and House Committees concerned with the securities industry.

Mr. Martin reported first. He called for a recentralization of all trading in NYSE listed stocks onto the New York floor, the elimination of the Third Market, and suggested that the Commission relegate to the regional exchanges the trading of non New York listings only. Comment critical of the Martin Report was almost universal.

The SEC Hearings, presided over by Chairman William Casey, pointedly rejected the Martin Report recommendations on market structure, reconfirmed Commission support of competition, especially as provided by off board market makers, and called for the eventual elimination of the fixed commission structure. The Commission also advocated a Central Market System in which competition would be encouraged, trade reporting would be consolidated and a central repository for limit orders would be established with time and price priority. These conclusions and recommendations by the Commission were reinforced in a speech before the Economic Club of New York by the new Chairman of the SEC, Brad Cook, and in subsequent Releases by the SEC through 1978.

Meanwhile, Congress's two studies were going ahead with hearings far exceeding in breadth and depth the hearings on Regulation NMS. The result was the passage of the Exchange Act Amendments of 1975. At the heart of Congress's call for a National Market System was the use of the new technology to recentralize the market while providing for competition among and between the centers providing liquidity. The liquidity providers were the exchange specialists and off board market makers. In Congress's view "recentralizing" required a consolidated tape showing last sale information from all market centers, a composite quotation system showing all public bids and offers, and the creation of an efficient linkage connecting all recognized market centers to enable brokers with public orders to have them executed wherever the best market existed. Congress recognized clearly the value of posted limit orders and dealer markets as providing liquidity and minimizing short-term volatility. At the same time Congress was emphatic in the need for public orders, as much as possible, to meet without the intervention of a dealer (i.e. no internalizing).

This is a good time to pause and provide a broader significance to these events.

From the very beginning, the establishment of a repository for public orders was both unique and fundamental to the market in stocks traded on the NYSE. It was one of two characteristics that distinguished the NYSE from other securities' markets. The other being real time publication of last sale information. Most other securities, such as fixed income, currency, options, derivatives, and even other equities, were for the longest time, and some even now, without a central location for trading and no priority for the public order over insiders. It was this unique centrality, protection of public orders and real time reporting of trade information that caused Congress and the SEC to become involved.

While the Commission's Hearings were confirming the value of competing markets [suppliers of short term liquidity], and Congress was studying what constitutes a central market, the industry was trying to figure out how all this would effect its bottom line. An accelerating increase in Third Market volume made it clear to the NYSE that the minimum commission had to go. The regional exchanges opened up their membership to institutions and large liquidity providers. And the Third Market accepted the growing pressure to accommodate time and price priority for public limit orders. These were not easy times for anyone as fully one hundred NYSE members merged or went out of business.

The NYSE, in particular, saw its monopoly like structure, built up carefully over many decades, undermined with the pressure for negotiated commissions and the sharing of their last sale reporting tape. Both changes took over five years to be implemented, with the consolidated tape requiring Congressional threats before the NYSE agreed to one that was fair and in the public interest.

In 1974 the NYSE argued successfully with Congress for the retention of Rule 394 and the creation of a National Market Advisory Board (NMAB) to help the Commission with the final details of a national market system. In 1975, Congress passed the Exchange Act Amendments, negotiated commissions arrived, the consolidated tape was operating and the industry was committed to a composite quotation system.

At this point progress toward a national market system began to bog down. The National Market Advisory Board became the focus of debate on what more was needed to implement Congress's vision. Remaining were only the details of a linkage connecting the various exchanges and over the counter market makers. The critical detail was how to handle limit orders.

The NMAB was divided. A majority voted to create a central repository for limit orders. The vote was unanimous among non-industry members, but with strong negative opinions from industry members. Soon after, a private system, with provision for limit order protection, was built and tested, with mixed reaction from the exchanges and the broker dealer community. Some were concerned about its effect on internalization and some feared the new technology would eliminate the need for their services altogether.

The NYSE then suggested a more modest step toward linking the markets, to be called the Inter-market Trading System (ITS). It would be operated and governed by the Consolidated Tape Association wherein all improvements to the system would be subject to NYSE veto. Provision for a central repository for limit orders (MCLOF) was promised by the NYSE for sometime in the future.

By 1979 the makeup of the Commissioners had changed, Congress's attention had waned, and negotiated rates had reversed the trend of volume going to the Third Market. No more changes were made. Under Chairman Williams the Commission decided that the time was not ripe for a CLOB and finally, in the early nineties, it abandoned further consideration of one. The idea was resurrected briefly during hearings in 2000, under Chairman Levitt, but was quickly abandoned because of opposition expressed from a number of sources.

A letter from Chairman Donaldson to me dated November 30, 2004 summarized those hearings. "While there was some support for a 'virtual' CLOB from institutional investors and others, a large number of commenters opposed a CLOB. Among other things, they believed that a CLOB would be anti-competitive, hinder innovation, and increase volatility." I must assume the Commission agreed.

In rereading the above carefully phrased explanation, the cynic in me wonders why institutions were specified in support, while no clue was given as to who constituted "the large number...opposed." My guess would be the exchanges, other interpositioners and sundry camp followers. As for the reasons cited, "None fit the shoe."

Take "anti-competitive". How so? Any student of the market knows that order flow is key to being competitive and profitable. Order flow begets order flow. In a publicly displayed market the largest accumulation of limit orders has the best chance of attracting market orders, the execution of which in turn attracts additional limit orders, which in turn.......and so on. Thus is created a natural monopoly. The NYSE knows this best and has protected their hold on this monopoly by successfully opposing a CLOB. Despite the high cost of doing business on the NYSE, their antiquated technology, a slow manual system for access and a certain attitude antagonistic to many of its users, it still does 80% of the trading volume. This is due to their attracting most of the limit orders. Transfer this role to a neutral venue, or just introduce time priority into the market place and, "voila", competition will explode.

"Hinder innovation?" I guess one can argue that an inefficient system, controlled by a single provider that sees little to gain from change and the use of new technology, encourages innovation by others. I pose the following question to you. "What if, in 1979, the Commission had insisted that the industry create something akin to a CLOB?" Not that awful government owned and operated thing you fear, but, rather, an industry operated system much like the CTA, but without a veto power built in. " Do you think we would be farther along toward a national market system, or not?"

"Increase market volatility?" This anti-CLOB argument is so absurd as to question the sanity of those using it. I assume we all agree that limit orders dampen volatility. Certainly, that is one of the main themes running through Regulation NMS. Those institutions, who have commented, say that time priority would increase their use of limit orders. And a level playing field for registered market makers would further aid the cause of increasing liquidity and reducing volatility.

Why is the Commission so reluctant to take the plunge? Our industry is suffering from lower volume, narrower spreads, and pressure on commissions and increasing layers of regulation and compliance. We do not need further half measures in market structure that complicate and confuse. Simplify the market. Use what's already there (ITS). Unshackle the listed market. Correct the half step taken thirty years ago.

Congress made it very clear back then what they had in mind. It wasn't a monopoly and it wasn't interpositioning. Yes, they advised the Commission not to implement something without obtaining input from the industry. But they certainly didn't want the Commission to be controlled by the industry when it came to carrying out their vision.

I have a number of other comments about Regulation NMS and the problems I see it creating, but those can be found in letters submitted back in April and June of 2004. I also wrote a series of short notes to your Chairman last fall, which I understand, can be found in the public record, as well as his reply letter to me dated November 30, 2004. As I have mentioned in previous letters on market structure issues, my comments are those of an individual and do not necessarily reflect the opinions of Weeden & Co. of which I am still affiliated with.

Sincerely,

BCC: William Donaldson
Chairman, SEC