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CFA

Consumer Federation of America

January 24, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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

Dear Secretary Katz:

I am writing to express the Consumer Federation of America's support for the trade-through provisions in the Commission's reproposal of Regulation NMS.[1] The decision to abandon the original proposal's opt-out provision in favor of an approach that limits trade-through protection to quotes that are immediately and automatically accessible is, in our view, the right one for investors. The tailored exceptions the Commission has added for inter-market sweep orders and to address flickering quotes and markets that fail to meet requirements for automatic response appear to strike a reasonable balance between advancing limit order protection and ensuring that the system is workable, including for the large trades of institutional investors.[2] Thus, regardless of which of the two alternative approaches to the trade-through rule the Commission chooses to implement, investors and the markets should benefit.

In our earlier comment letter, CFA encouraged the Commission to consider applying trade-through protection beyond the best bid and offer in each trading center. As we noted at the

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy. CFA has previously written in general support of the trade-through and access provisions of Regulation NMS. We have not commented on other aspects of the proposed rule. (See letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Jonathan G. Katz, June 18, 2004.)

[2] CFA believes making the system work for institutional investors is important to individual investors, since many participate in the markets primarily through mutual funds, pension funds, and the like.

time, we believe investors stand to benefit both directly, through further reduction in trade-throughs, and indirectly, through increased price transparency, from such an approach. We are therefore gratified that the Commission has included consideration of the Voluntary Depth Alternative as part of its reproposal. Furthermore, we believe the Commission is asking the right questions as part of that consideration. Will such an approach advance limit order protection, preserve market competition, and avoid practical implementation problems?

The answer to the first question, in our view, is clearly yes. Although the Voluntary Depth approach cannot guarantee the elimination of all trade-throughs, it seems certain that fewer trade-throughs would occur under this approach. The ability of the Voluntary Depth Alternative to eliminate trade-throughs could conceivably be limited by the degree to which trading centers decide to enter greater depth of book into the consolidated quote stream. Opponents of this approach seem to assume that all trading centers covered by the trade-through rules would immediately display their entire depth of book. But the reproposal certainly doesn't mandate that outcome. It leaves it to each market to decide how much of its order book to enter into the consolidated quote stream. Should the Commission choose to adopt this alternative, we would encourage you to determine to the best of your ability in advance how various trading centers would respond and factor that information into your implementation plans.

The example provided in the reproposal (pg. 67) illustrates another limitation of the Voluntary Depth Alternative – that the priority given to undisplayed orders over displayed orders at an inferior price in executing trades at electronic markets would inevitably result in some "protected" orders' being traded through. However, this example also shows the superiority of this alternative over the BBO Alternative in reducing trade-throughs. In the supplied example, a protected displayed order offering 2000 shares at $10.02 would end up being traded through under the Voluntary Depth Alternative, even though the rule had been complied with and an inter-market sweep order sufficient to take out all the protected displayed orders had been sent to the market. On the other hand, under the same scenario but using the BBO Alternative, both the 2000 shares at $10.01 and the 2000 shares at $10.02 would be traded through. Thus, while limit order protection is not perfected under the Voluntary Depth Approach, it would clearly seem to be advanced.

The answer to the second question – how would inter-market competition be affected – is more complicated. We have little question that markets would continue to compete for both limit orders and marketable orders under the Voluntary Depth Alternative. What is less clear is on what terms they would do so and whether that competition would benefit investors. Because few retail investors direct where their trades are to be executed, markets do not typically compete directly for their business. Instead, they compete for the business of the intermediaries who handle those trades, intermediaries whose interests are far from perfectly aligned with the interests of their customers. As a result, retail investors may actually be harmed, rather than helped, by some forms of inter-market competition.

Markets are also likely to compete for the large-volume business of institutional investors. This may serve to benefit retail investors indirectly, both because retail investors may be well served by some of the same attributes that markets adopt to compete for institutional investors and because many retail investors invest primarily through the very institutional investors for whose business markets compete. However, as the recent mutual fund trading scandals and related issues of directed brokerage and soft dollar practices make clear, there is no absolute assurance that institutional investors will make decisions about where to direct their trades on the basis of factors that serve their shareholders' interests rather than their own.

Ultimately, in assessing the effect of the proposal on inter-market competition, it is important to consider not just whether competition will persist, but whether it will be based on factors that benefit investors. Critics of the proposal have argued that the Voluntary Depth Alternative would leave execution costs as the only basis for competition among markets, with the result that markets would enter into a bidding war to purchase order flow.[3] CFA shares the view expressed by the NYSE in its recent comment letter that payment for order flow harms our markets, harms retail investors, and should be banned.[4] Should the Voluntary Depth Alternative further promote this practice, we would view that as a very serious flaw. On the other hand, we do not share the view expressed by the NYSE that the Voluntary Depth Alternative would eliminate all more pro-investor bases for competition. Speed of response, even in a fully automated system, would still likely be a factor, as would the ability to handle large, complex trades efficiently.

In light of all these factors, the only honest answer to the question of how inter-market competition would be affected is that we don't know. On the other hand, we are not convinced that inter-market competition is an *a priori* good that always and automatically serves the public interest. The goal of the Commission should not simply be to ensure that competition is preserved, but to ensure that the competition that exists is conducted on terms that benefit investors and the markets as a whole.

The third question – could this approach avoid practical implementation problems – is even more difficult to answer. Will it prove as easy as some experts have predicted to identify automated and manual quotes? Will the exceptions the Commission has designed for inter-market sweeps, flickering quotes, and non-responsive markets work effectively? Will the hybrid markets some exchanges are currently designing in response to Regulation NMS function as intended? Could auction markets – which some believe provide a better venue for trading in thinly traded stocks – survive under such an approach? How will brokers, given their unchanged obligation to provide best execution, respond to the new system that provides trade-through protection only to automated quotes? We simply do not feel equipped to answer those questions with any assurance of accuracy. That lack of certainty should lend a note of caution to the Commission's approach to this issue, but it should not stop the proposal dead in its tracks.

Were the Commission to adopt the Voluntary Depth Alternative, it would presumably provide sufficient lead-time for its implementation to give trading centers time to adapt. To

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[3] Letter from Mary Yeager, Assistant Secretary, New York Stock Exchange, Inc. to Jonathan G. Katz, Secretary, Securities and Exchange Commission, January 12, 2005 at pg. 5.

[4] Ibid., footnote 16.

assist that process, we would encourage the Commission to consider using a trial run, or even a series of trial runs, before full implementation to ensure that all the kinks are worked out of the system and that the technology is up to the increased strain that is likely to result. Even better, perhaps, would be to take a staged approach to implementation, starting with the BBO Alternative and moving gradually to extend trade-through protection to greater depth of book. Such an approach could ensure that this approach was adopted only after the markets had an opportunity to adapt to the new system and the new system had proven to be workable.

In conclusion, CFA congratulates the Commission for the thorough study and careful analysis that have gone into this rule. In developing its proposal, the Commission appears to have kept uppermost in mind that its job is not to protect or advantage any particular market model, but to ensure that the markets overall function well and serve the public interest. The general approach to trade-through outlined in this reproposal, in our view, meets that standard and will go a long way toward bringing regulation into line with dramatic changes that have transformed the markets since Congress first directed the agency to develop a national market system 30 years ago.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection