795

MEMORANDUM

RECEIVED
APR 08 2005
OFFICE OF THE SECRETARY

TO: File No. S7-10-04

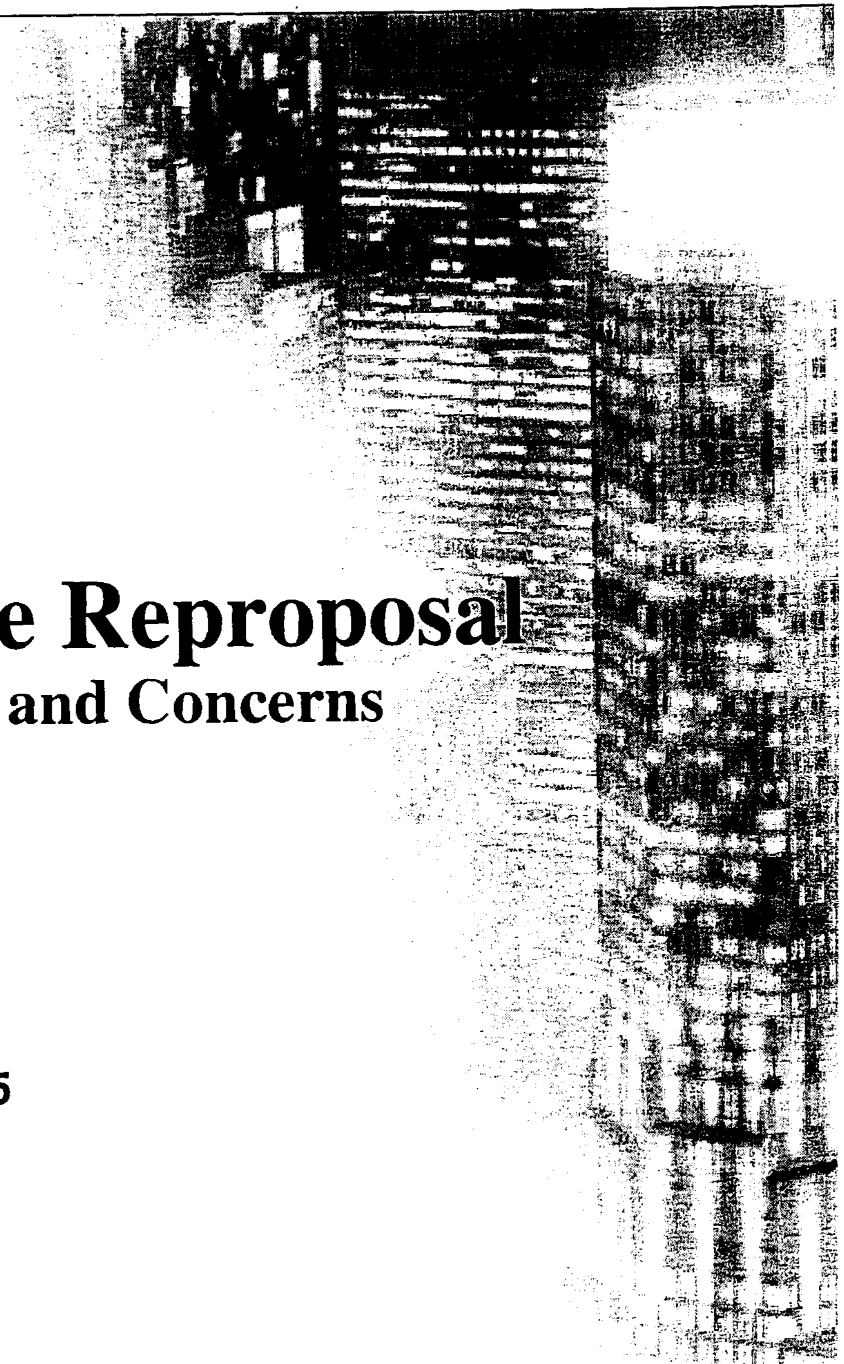
FROM: Dan Gray
Division of Market Regulation

DATE: April 5, 2005

RE: Meeting with Bear Stearns & Co.

On February 2, 2005, Division of Market Regulation staff met with Daniel B. Coleman, Brett Redfearn, James P. Davidowitz, Gary N. Distell, Mary Lynn O'Neill, and Bill Nichols of Bear Stearns & Co. They discussed their views on reproposed Regulation NMS as set forth in the document attached hereto.

BEAR STEARNS



Regulation NMS – the Reproposal

Bear Stearns & Co: Issues and Concerns

February 2, 2005

BEAR STEARNS

Institutional Equities

Key Areas of Concern

Trade Through Reform

- Of the two proposals presented, the Market BBO alternative, if properly modified, could bring tangible benefits to the U.S. equity markets, whereas Depth of Book (DOB) protection would do more harm than good.

Stopped Order Exemption

- Rule 611 should provide an exception for 'Stopped' orders, given the frequency with which 'stopped' orders are printed without any direct relationship to the quoted price of a stock at the time of execution.

Arbitrage Exemption

- Rule 611 should provide an explicit "Arbitrage Exception" covering various forms of index, merger arbitrage, and derivative hedging transactions.

Manual Protected Quotes

- Under Rule 600(b)(57), the definition of "protected bid" or "protected offer" should be modified to include "manual quotations" as defined by Rule 600(b)(37) when applied to designated "illiquid securities."

Comments on Reg NMS - the Reproposal

Trade Through Protection

We Support the Market BBO Alternative

- The most appropriate level of trade through protection requires intelligent and controlled government regulation balanced by consideration of competitive market forces.
- Top of book (TOB) protection accomplishes the right balance for trade through protection because it encourages competitive quoting behavior both within and among markets, without imposing excessive routing obligations and related costs on receiving trading centers.

We Oppose Depth of Book Protection

- DOB is a value-added proposition best driven by competitive forces and best execution considerations
- Imposes excessive routing obligations and related costs on receiving trading centers.
- Intermarket depth protection could delay the NYSE's Hybrid.
- Would not effectively achieve its stated objective of protecting displayed limit orders.
- Intermarket depth protection will largely become a reality despite regulation.

BEAR STEARNS

Need for an Exemption for "Stopped" Orders

Stopped orders are an important part of the liquidity provision process for institutional customers.

- **Enables institutional customers to get a guaranteed fill for large orders**
  - Stop price based on prevailing market, which includes current NBBO but also often takes into consideration recent trading ranges and volume weighted average prices
- **Stops do not "ignore" the National Market System, but often print outside of the NBBO**
  - In executing a stop, the BD is directly accessing the national market system in the course of executing the customer's order; and
  - The stop price, at the time it is printed, is usually away from the prevailing NBBO quote.
    - ☞This is largely a result of a time lag between the time the "stop" was priced and the completion of the order being worked/executed in the marketplace.
- **The "stop exception" should apply to all "stops" in which**
  - the full contra-side to the customer order is filled via trading in the national market system, and
  - the prevailing NBBO price varies from the stop price at the time of the customer's print.

BEAR STEARNS

Need for an Arbitrage Exception

There are a number of transaction types which trade to a "spread" relationship between two assets rather than absolute prices of either. Investors implementing this type of strategy are interested in the best execution for and liquidity of *the package* rather than its components. This exception should apply:

- **To convertible securities and "exchangeable" securities, that is, securities exchangeable for securities of a different issuer.**
  - A well-developed market exists for spread orders and executions in a wide range of convertible securities with common stock hedges simultaneously executed. The relationship is known and specified at the time of the order, and the relationship stands regardless of the prevailing price at the time of execution. In practice, adhering to the terms of such a contingent trade can result in each component of the spread being away from the price of each constituent.

- **To merger arbitrage strategies which involve the simultaneous purchase (sale) of a target company's stock and sale (purchase) of an acquirer company's stock.**
  - The price relationship between these two securities is known as the "spread", and involves an exchange ratio (or exchange ratio formula). Spread trades are based on the relationship between these two company's stock prices. As with contingent trades, the relationship is known and specified at the time of the order, and the relationship stands regardless of the prevailing price at the time of execution. In practice, adhering to the terms of such a spread trade can result in each component of the spread being away from the price of each constituent.

- **To the unwinding or establishing of an arbitrage between a derivative or an exchange-traded fund (an "ETF")**
  - Such as the "QQQQ" ETF, and a portfolio consisting of all, or a representative sample, of the stocks underlying the derivative or ETF.

Comments on Reg NMS - the Reproposal

Manual Quotations should be "protected" for *illiquid* securities

- Illiquid stocks trade much differently than liquid securities
  - Concrete empirical evidence has consistently shown that illiquid stocks have superior market quality in non-fully electronic (i.e., manual) environments.
- We understand the potential complexities of carving out a segment of securities for the purposes of this rule. However, we remain convinced that the quality of trading for illiquid stocks is not enhanced by mandating 'automated quotes' and 'automated markets.'
- For the more than 2,150 (approximately 60%) NYSE listed securities that have an average daily trading volume of less than 100,000 shares (that "trade by appointment"), a requirement for 'fast' markets and 'fast' quotes is misplaced.
- For illiquid stocks, time and negotiation are two key ingredients in the liquidity formation process, and the Reproposal does not reflect this reality. In addition, given the slow frequency of quote updates, the firm quote rule should effectively ensure "certainty" of execution.