Dec. 30, 2004

Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington D.C. 20549
By Email to rule-comments@sec.gov

Proposed Rule: Regulation NMS, File No. S7-10-04

To the Commissioners:

I write this letter concerning the Commission's above-captioned rule proposal to adopt Regulation NMS and the Commission's efforts to restructure the U.S. securities markets. I am a partner at the law firm of Bingham McCutchen LLP, where I represent broker-dealers, investment advisers and investment companies, and other participants in the securities markets. I was previously the Commission's Assistant General Counsel for Market Regulation, and later I was General Counsel for a major national broker-dealer. I submit this comment letter solely on my on behalf, and not on behalf of any current or former clients, my law firm, or any partners or associates at my law firm. I previously submitted a comment letter on the original version of the Commission's proposal,[1] and rather than repeat those comments in their entirety I ask that they be incorporated by reference. There are two aspects of the Commission's re-proposal on which I wish to comment further: market data, and the trade-through rule.

The Commission Should Make Better Quality Market Data Available to Retail Investors

The Commission's re-proposal concerning market data is seriously flawed and should not be adopted as proposed. The re-proposing release begins its discussion of market data by stating that "investors of all types - large and small - have access to a comprehensive, accurate, reliable source of information for the prices of any NMS stock at any time during the trading day." Sadly, this fundamental premise of the Commission's re-proposal is false. Institutional and professional investors do have access to very high quality market data: constantly updated real-time streaming market data showing depth-of-book trading interest on both sides of the markets.[2] However, retail investors do not have access to similar quality market data. Rather, retail investors receive only a static "snapshot" consisting of the best bid, best offer (together, the

[1] See http://www.sec.gov/rules/proposed/s71004/whcallcott0506704.pdf

[2] Some types of market data, such as the NYSE's OpenBook and Liquidity Quote, are only available to institutional and professional investors - no comparable retail product is offered at all. As a practical matter, the cost of streaming and depth-of-book market data products (hundreds of dollars per year for each of the three equity "tapes") precludes retail investors from purchasing them. Institutional investors typically get streaming depth-of-book market data products without any cost to themselves, by using their customers' assets (in the form of soft dollar commissions) to pay for them - perhaps the subject for a comment letter on another day.

"NBBO"), and last sale transaction for a security. Between the time that a retail investor receives that "snapshot" and the time they submit a trade, the market is likely to change substantially - but because the retail investor does not receive real-time streaming data, the retail investor will be unaware of those changes. And because the retail investor does not receive depth-of-book quote information, the retail investor never sees trading interest outside the NBBO.

Ten years ago, when most U.S. stocks were traded in one-quarter or one-eighth point increments, static "snapshot" quotes did not put retail investors at a substantial informational disadvantage. Retail investors' market orders were likely to be executed at the quotes they saw, because those quotes typically represented significant depth. Today, in decimalized markets, there is often little depth at the inside quotes, and those quotes change far more quickly than did fractional quotes. As a result, the likelihood is that even for a thousand-share order in a liquid stock, some or all of a retail investor's market order will not be executed at the "snapshot" quote he or she saw before submitting the order. An institutional or professional investor who receives real-time streaming, depth-of-book quotes has much more information about where their orders are likely to be executed. A market data regime (driven entirely by the Commission's Display Rule) - which may have been adequate ten years ago - is no longer adequate today, because of the changes the Commission has driven in the markets during that time.

Similarly, because a retail investor today cannot see depth-of-book quote information, the retail investor has no idea where to place a limit order. The retail investor does not know whether a limit order three cents outside the NBBO is one hundred shares away from being executed (and thus very likely to be executed), or ten thousand shares away (and thus very unlikely to be executed). With a static quote, the retail investor cannot see if the market is moving toward his or her limit order (and thus is likely to be executed) or is moving away (and thus is not likely to be executed). By contrast, an institutional or professional investor has a very good idea exactly where to place a limit order to maximize its chances of execution.

The whole premise of Commission's proposed expansion of the trade-through rule is to encourage investors to post limit orders, because investor limit orders are the ultimate source of long-term liquidity in the markets. I agree with the premise of encouraging investor limit orders (although as discussed below, the Commission's proposed trade-through rule is unlikely to achieve that goal). **The Commission could do far more to achieve the goal of encouraging retail customer limit orders by giving retail customers real-time streaming depth-of-book market data than by expanding the trade-through rule.**[3] And the Commission could do so without any change to the

[3] I must note that I made this point in my original comment letter on Reg NMS(see supra n.1), and the re-proposing release entirely ignored it. It is hard to understand how ignoring this argument is consistent with the Commission's obligations under the Administrative Procedure Act when adopting a rule to "consider a[ll] important aspect[s] of the problem," to address all relevant comments submitted, and to consider all major alternatives suggested. *See Motor Vehicles Mfrs. Ass'n. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983).

revenues of the SROs, simply by expanding the definition of what is required to be provided in the Display Rule, at the current prices for NBBO data. It doesn't cost any more money for the SROs to produce this streaming, depth-of-book data for all investors than it does to provide it to the current sub-set of institutional and professional investors.[4]

The Commission's depth-of-book trade-through proposal would make the existing market data disparities between retail investors and institutional investors even worse. That proposal would allow investors to "sweep" the books of participating markets, both at their inside price and at other prices away from the NBBO. But of course this "sweep" alternative is meaningless for retail investors unless they get enough market data to see prices outside the NBBO. It is often true today that the NBBO will be good for as few as a hundred shares - much less than the desired order size for many retail investors. Many retail investors desire the speed and certainty of immediate execution - to know, for example, exactly what their proceeds are from a sale, so that they can reinvest those proceeds in another security (the price of which may be moving, too). The Commission's proposal would have the practical effect of making the "sweep" alternative available only to institutional and professional investors.

The Commission's failure to make at least some streaming, depth-of-book market data equally available to all investors is directly contrary to the Commission's mandate in Section 11A of the Exchange Act. The Commission's failure means that retail investors do not have available "information with respect to the quotations for and transactions in securities" as required by Section 11A(a)(1)(C)(iii). The Commission's failure prevents fair competition among different classes of investors, as required by Section 11A(a)(1)(C)(ii). The Commission's failure prevents retail investors from obtaining economically efficient execution of their transactions, and it prevents them from ensuring that their brokers have executed their transactions in the best markets, as required by Sections 11A(a)(1)(C)(i) and (iv). Most significantly, while the Commission's trade through proposals purport to encourage "orders to be executed without the participation of a dealer" (in other words, limit orders), as required by Section 11A(a)(1)(C)(v), the Commission's failure to provide retail investors with real-time, streaming information about depth-of-book trading interest is the most important deterrent to those investors who might be willing to provide liquidity by placing limit orders.

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[4] The re-proposing release urges that comments about the absolute level of market data fees be postponed to the concept release on self-regulation, because market data revenues are used (in part) to fund SROs' regulatory functions. Fair enough; I will comment in that forum, although I cannot help but note that the Commission and its staff have done nothing but postpone action on this issue for the large majority of the nearly 30 years Congress has given the Commission the duty to regulate prices for this government-granted monopoly. Because the depth-of-book information that would be relevant to retail investors (perhaps the first five price points outside the NBBO) is less than that relevant to institutional and professional investors, the SROs would be able to maintain a healthy revenue stream for the larger universe of market data even if all ordinary retail investors received some streaming depth-of-book market data.

I have perhaps made this point in comment letters before: the Commission has permitted the creation of a two-tiered market for the most basic information about securities. Institutional and professional investors receive high-quality, real-time streaming, depth-of-book market data, while retail investors receive static (and therefore quickly out-of-date) NBBO quotes without the depth-of-book information necessary to predict where their orders actually will be executed. This disparity is flatly inconsistent with the Exchange Act, and with the Commission's primary mandate to protect small investors. In the 1990s, the Commission sanctioned Nasdaq for a less glaring failure to carry out its regulatory responsibility to protect small investors. Changing the allocation of market data, without addressing the fundamental disparity in the availability of market data, would be arbitrary and capricious and contrary to the Exchange Act. Even more to the point, adopting a trade-through rule that depends on depth-of-book market data, but then refusing to provide that data to retail investors, would make the existing disparity worse. Retail investors are smart enough not to go to a visibly crooked casino - yet the Commission's re-proposal will make the floors lean more, not less.

The Commission Should Provide Representatives of the Investing Public with a Majority Vote on the Committees which Administer Market Data

In my previous comment letter on Regulation NMS, I argued that a non-voting advisory committee provided insufficient protection for the interests of retail investors, and did not sufficiently mitigate the inherent conflict of interest in having SROs vote to set monopoly rates for which they are the prime beneficiaries.[5] The re-proposing release states that "the Commission agrees with the concerns expressed by commenters on the administration of the plans." Yet, remarkably, the re-proposal does nothing to change its suggested rules in response. Even more remarkably, not even one month prior to the re-proposal, the Commission issued a release suggesting a series of comprehensive changes to SRO governance. These changes would require a majority of public governors on all SRO boards of directors, and that certain standing committees where the possibility of conflicts of interest are most acute (Regulatory Oversight, Audit, Compensation, Nominating and Governance) be comprised *exclusively* of public governors. The Commission proposed these governance changes to address the significant conflicts of interest it (accurately) perceives may exist within SROs. The re-proposing release here concedes that exactly the same kind of conflicts exist within the committees that administer market data. Yet the re-proposing release would allow SROs to have *all* of the voting power on the market data committees, with only a non-voting advisory committee to represent the public interest.

[5] The re-proposing release (at n.311) at least acknowledged this comment (in contrast to my comments on the disparity between the quality of the market data provided to retail and institutional investors), which gives me some comfort that someone actually did read my original letter.

The Administrative Procedure Act allows federal agencies to change their minds. It allows agencies to address a problem one step at a time. But it does not allow agencies to do what the Commission has proposed here: to take directly inconsistent positions on the same issue at the same time, without any rational explanation for the disparity. To be consistent with the SRO proposal, at a minimum, the Commission should require that the market data administration committees contain a majority of public governors. To do anything less would be the definition of "arbitrary and capricious".

The Commission Should Not Adopt Either of Its Proposed Trade-Through Alternatives

The re-proposal suggests two alternative trade-through rules. One would expand the current NYSE-only rule to the Nasdaq market and eliminate current exceptions for block trades and 100-share quotes. The other would expand the trade-through rule to cover some quotes outside the NBBO. Both rules are a solution in search of a problem.

The U.S. securities markets have subsisted quite effectively for years without a market-wide trade-through rule. The closest the Commission can come to economic evidence in support of a trade-through rule is the argument that Nasdaq-listed stocks have somewhat greater intra-day volatility than similar NYSE-listed stocks. Yet there are many differences between the NYSE and Nasdaq markets, and the Commission points to nothing that can link this particular difference to the trade-through rule. Perhaps it has something to do with the NYSE specialists' enhanced duty (compared to Nasdaq market makers) to keep a fair and orderly market. Perhaps the Commission's and the NASD's regulation of Nasdaq market makers has made them less willing than NYSE specialists to commit their own capital to orders. Perhaps the NYSE market (with its greater delays in executing or posting orders) has a greater level of un-displayed trading interest.[6]

Equally to the point, even if the presence of a trade-through rule did explain the lower intra-day volatility on the NYSE market, this does not explain why the Commission should mandate that all markets have the same rule. The NYSE and Nasdaq compete vigorously for listings. If the cost of capital is lower on the NYSE, we could expect issuers to gravitate to the NYSE market (as indeed some do). Having diverse markets with different rules enables competition, and allows issuers and investors to choose which market structures work best for which securities. Many large Nasdaq companies eligible for NYSE listing have chosen to stay on Nasdaq, because they perceive benefits for themselves and their investors in doing so. The Commission should facilitate this competition for the best market structure; it should not mandate a one-size-fits-all approach.

[6] Indeed, the fact that trade-through rates are virtually identical in the Nasdaq and NYSE markets strongly suggests that something other than the difference in trade-through rules explains the difference in intra-day volatility between the two markets. It is hard to understand how the difference in intra-day volatility could be caused by the difference in trade-through rules, when in fact the two markets have nearly identical trade-through rates.

The Commission states that the purpose of its trade-through proposals is to encourage investor limit orders. But, as discussed above, the Commission could do far more to encourage limit orders if it made streaming depth-of-book quote information available to all investors, so they could see where best to place those limit orders. Moreover, the Commission provides no data concerning whether the quotes being traded through actually represent investor limit orders at all - many may simply represent the proprietary quotes of market makers and specialists (who are required by regulation to maintain two-sided quotes at all times). The Commission has not provided the data to distinguish the two.[7] And to the extent quotes traded through do represent investor limit orders, the Commission's statistics do not indicate how many of these orders fail to receive executions at all. Most trade-throughs mean only that the limit order at the NBBO will receive its execution price at a slightly later time. By definition, investors who place limit orders are more price-sensitive and less time-sensitive - they are willing to endure slight time delays to receive their target price. If (as I believe to be the case) the vast majority of limit orders traded through do receive their desired execution price within a short time, then once again the Commission's proposal is seeking to ameliorate a harm where none exists. The Commission's data does not support imposing a market-wide trade through rule.

Further, the re-proposal ignores the important effects of the order-execution quality guarantees prevalent throughout the US securities markets. To comply with their best execution obligations, most brokerage firms, market makers and specialists guarantee they will match or beat the best prices available elsewhere in the markets. Otherwise, those market centers could not attract order flow (and they would be highly vulnerable to regulatory scrutiny). Therefore, these firms have a very strong interest in "taking out" (executing) any limit order in another market that requires them to trade at a disadvantageous price. It is not necessary to direct all order flow to the best-priced quote anywhere in the market to create an incentive for that NBBO quote to be executed against - the duty of best execution and the economic self-interest of market participants already amply provides that incentive.

The US securities markets trade in tremendous and ever-increasing volume. The markets function well because for almost any given security, there are multiple different

[7] Nor do the Commission's data or its rationales support removing the existing trade-through exceptions for 100-share orders and block trades. Block trades (for example, by mutual funds) often represent the interests of many small investors, and the Commission has no business preferring the interests of small investors who trade individually over those who trade in groups through mutual funds or other collective investment vehicles. The 100-share exception exists to minimize the systems burdens of switching order flow to capture a very small NBBO, especially one which is likely to be generated by a market-maker's or specialist's proprietary auto-quote rather than to represent an investor's limit order. Once again, the Commission has not demonstrated that it has a better idea than the markets that have actual experience with a trade-through rule.

markets trading that security at almost all times. For most securities, no single market (not even the NYSE) could easily handle all the volume. Forbidding trade-throughs will force the entire fire-hose of orders to go to a single market (the one with the best price at that moment). Forcing the entire fire-hose into a single market increases the risk that the market will not be able to handle the resulting volume. Moreover, forcing the entire fire-hose to switch from market to market on a second's notice (depending on which market has the best flickering quote) increases the risk of system-wide failures that will harm all markets and all investors.[8] Experiments in market structure are risky and can have unintended consequences. They should only be undertaken when the data clearly supports them, which it does not here. The current market structure guarantees investors best execution, and it provides strong economic incentives for the prompt execution of investor limit orders setting the NBBO. The Commission's trade-through proposals create new systems risks without any evidence that they will provide anyone with better quality executions.

Investors in the US markets have benefited tremendously from competition among market centers. Single-priced openings for Nasdaq stocks, immediate electronic executions, electronic access to depth-of-book quotes - all were pioneered by allowing different markets to experiment with different market structure rules. The Commission has not demonstrated that the federal government has a better idea than the markets with respect to trade through rules. The Commission should continue to allow our markets to compete to create the optimal sets of market structure rules.

I appreciate the opportunity to comment on these important issues.[9] I would be happy to discuss these comments further or provide any other assistance the Commission or its staff may desire.

Sincerely,

W. Hardy Callcott

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[8] And of course we are actually talking about thousands of fire-hoses of orders switching from market to market on a second-by-second basis - one for each NMS security - for each one of which the Commission's proposals create an enhanced risk of system-wide failure. Moreover, the cost of creating such second-by-second order-routing engines at every market and every clearing brokerage will be enormous, creating new barriers to entry both for brokerage firms and market centers.

[9] I note that granting the public only 30 days to comment on a controversial 371-page release, over the end-of-year holidays, at a time when the Commission has several other long and important releases out for comment, bespeaks more of a desire to use an evanescent Commission majority to ram through an unpopular proposal, rather than an honest desire to receive and thoughtfully consider public comments.