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

Re. File No. S7-10-04 – Regulation NMS

Dear Mr. Katz:

Bear, Stearns & Co., Inc. would like to further comment on the Commission's Regulation NMS proposal¹ and process, given very significant – and somewhat surprising – recent developments. As per yesterday's *Wall Street Journal*,² we are aware that the final Regulation NMS proposal currently before the Commission includes a provision for some form of intermarket depth protection. We believe that this development is *highly* material and has not been subject to adequate public debate and vetting. We therefore respectfully request that the Commission either reject this portion of the proposal or publicly disclose detail on the proposal and allow additional time for public comment. Otherwise, we feel that the process for Regulation NMS rulemaking, which has to date, been open and fair, will, in the end, be unnecessarily flawed. While we have little information on the final proposal, we have outlined below concerns regarding this process and the issue of intermarket depth protection for your consideration.

The issue of intermarket depth protection has not yet been adequately described or publicly debated. The Supplemental Release suggested that, while the SEC was interested in exploring the issue of depth protection, the trade through protection being contemplated was limited to 'top-of-book' price protection. As stated in the Release: "the proposed rule would apply only to the best bid and best offer of any order execution facility that is disseminated pursuant to an effective national market system plan..."³ No specific proposal on this topic was included in either of the SEC's releases, except to request general comment on whether the Commission "should expand the scope of the proposed rule to include trade-through protection beyond the best-displayed bid and offer..."⁴ As a result, the industry has very little material information on how this proposed intermarket rule would work. The details behind such a proposal will be highly integral to the workings of the national market system.

¹ Securities Exchange Act Release No. 49325 (February 26, 2005) 69 FR 11126 (the "Proposing Release"); Securities Exchange Act Release No. 49749 (May 26, 2004) 69 FR 30142 (the "Supplemental Release").

² Kate Kelly and Deborah Solomon, "SEC Preps 'Best-Price' Overhaul," *Wall Street Journal*, November 22, 2004, p.C-1.

³ Following this, the Release adds: "To expand the price protection beyond the best bid and best offer for each market would entail the Commission requiring quoting market centers to make available, and provide access to, their entire depth of book to other markets. Although the Commission believes that from a policy viewpoint it would make sense to provide protection to any better-priced quote or order display in another quoting order execution facility not just the top-of-book of each quoting order execution facility, the Commission questions whether protecting all displayed limit order and quotes at this time would be feasible." Supplemental Release, pp. 20-21.

⁴ Supplemental Release, p.21.

Intermarket depth protection: for displayed orders only? Our presumption would be that any intermarket depth protection rule would be designed to benefit/protect publicly *displayed* orders. However, given that marketcenters' rules do not allow displayed orders to trade through better priced non-displayed orders, it is very possible that non-displayed reserve orders would benefit most from any proposed intermarket depth rule. This would be true unless marketcenters create the ability for other markets to 'sweep' displayed orders only. However, if we mandate intermarket depth protection and do not protect reserve orders, what are the policy implications of enabling marketcenters to trade through better priced non-displayed orders within their own order books? Are ECNs, Nasdaq and the NYSE prepared to change their order execution rules to enable sweeps that only execute against displayed orders? If so, is this the best public policy outcome, or would this result in less overall liquidity (more displayed liquidity offset by less undisplayed liquidity) residing on limit order books and in marketcenters?

Intermarket depth protection will largely become a reality despite regulation. We believe that intermarket depth protection will largely become a reality *de facto* (without a regulatory mandate) as a result of: (1) the widespread diffusion of smart order routing technologies; (2) best execution obligations of broker dealers; (3) competition forces among brokerage firms; and (4) the enhanced ability to electronically interact with the NYSE Hybrid market. Smart routing technologies, already standard in the Nasdaq marketplace, automatically seek out liquidity across market centers and are specifically designed to 'ping' for and take out orders on an intermarket basis. While these technologies could not be effectively deployed in a manual NYSE environment, they will be easily deployed in the Hybrid world. Brokerage firms and their customers will have to decide whether they are providing best possible execution if they do not attempt to execute at every displayed price point in all markets. Firms that are able to efficiently do this should have a competitive advantage over firms that cannot.

Intermarket depth protection could delay the NYSE's Hybrid. If intermarket depth protection is to become a policy mandate, this would appear to require a significant change to the NYSE's Hybrid Proposal.⁵ The 'sweep order,' Liquidity Replenishment Points (LRPs) and other fundamental features of the Hybrid may need to be revisited as they were specifically designed to take out top-of-book and then to sweep through the NYSE's depth of book. This redesign could delay the rollout of the Hybrid market. In our view, the NYSE has already made significant developments in this process of market structure evolution, and the NYSE, in its Hybrid proposal, provides the access and functionality necessary to access its book electronically. From this, brokerage firms will be able access the NYSE and other markets simultaneously to give customers best price. Frankly, we are not interested in utilizing the NYSE as our smart order router and do not believe that the Exchange should be mandated to play this role given the universally available smart routing technology available to brokers.

This proposal would appear to represent another significant move towards the 'commoditization' of the order execution business. Under the proposal, it appears that any displayed order in any market would get price (but not time) protection. For example, any new ECN could conceivably enter the ECN space and instantly have a high internal fill rate for posted limit orders. This could have a downward effect on transaction charges at markets and ECNs as the value of captured liquidity is eroded, which raises additional questions: With full intermarket depth protection, will competing marketcenters be fairly compensated for developing innovative features and capturing liquidity, given the significant drop in the value of captured liquidity for any existing market center? Could this result in a proliferation of new ECNs, e.g., internal ECNs at brokerage firms that enable firms to post limit orders while avoiding having to pay transaction charges on existing ECNs and markets? If this results in additional ECNs, will this ultimately contribute to -- or reduce-- market fragmentation?

⁵ Amendment No. 2 to File No. SR-NYSE-2004-05 Relating to Amendments to NYSE Direct Plus+, filed November 8, 2004 (referred to as "Hybrid 2"), which amends Amendment No. 1 to File No. SR-NYSE-2004-05, filed July 30, 2004 (referred to as "Hybrid 1").



At this point, we do not have answers to these questions. In part, this is because we do not have information on the specifics of the intermarket proposal; in part, this is because we did not know until very recently that intermarket depth protection was a possible outcome in the Regulation NMS rulemaking process. At a minimum, we believe that a policy change of this magnitude deserves adequate public disclosure and discussion before a vote is taken and rules are enacted.

We appreciate your consideration of our concerns and look forward to continuing a constructive dialogue on this issue.

Respectfully Submitted,

Bruce Lisman

Cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
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