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Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re: File No. 4-657; Release No. 34-73511: *Proposed National Market System Plan to Implement a Tick Size Pilot Program on a One-Year Pilot Basis*

Dear Mr. Fields:

When US equity markets reduced their tick sizes from an eighth to a sixteenth to a penny a number of market participants and regulators felt that a benefit would be a reduction in the occurrence of payment for order flow and internalization. It was felt that these practices were hurting market quality. The coarse pricing grid imposed on stocks under the one-eighth and one-sixteenth regimes required stocks to be quoted with wider spreads than necessary. A stock that required a $0.08 spread for liquidity providers to earn a fair profit was forced to have a spread of $0.125 under both regimes. That allowed liquidity providers to earn $0.125 - $0.08 = $0.045 in excess profits on a round trip trade. The excess profits were large enough for liquidity providers to pay brokers say $0.01 a share to send them marketable orders. Liquidity providers still earned $0.045 - $0.02 = $0.025 in excess profits. Some brokers decided they could earn all of the $0.045 in excess profits by filling customer orders themselves. This became known as internalization.

When tick sizes were cut to $0.01 the quoted spread in the above example reduced to $0.08, excess profits were largely eliminated, and the profitability of payment for order flow and internalization was greatly reduced. This led to their curtailed occurrence. The impact of internalization on market quality is best illustrated by examining what happened in 1998 when the Toronto Stock Exchange enacted rules to make internalization less profitable. In that case (documented by academics) market quality improved. As it pertains to the proposed study in particular depth increased following the TSX rule change.

I believe that the current tick-size pilot program will bring about an increase in internalization and may actually reduce liquidity for pilot stocks instead of increase it. Under the proposed pilot study, ticks would be increased to \$0.05. A return to a coarse pricing grid will bring about the excess profits discussed above. Assume a stock has a \$0.06 spread under a penny-tick regime. A \$0.05 tick will cause that spread to increase to \$0.10 and earn an internalizer an excess profit of \$0.04 on a round trip trade. The proposal requires internalizers to provide price improvement of \$0.005 on retail trades. That only reduces excess profits to \$0.03 on a round trip trade - it does not eliminate them. Therefore internalization should increase.

The attractiveness of internalization, even after price improvement is paid, will lead to its increase. As the internalization of marketable orders increases, fewer orders will reach markets. Lower order flow will discourage the use of limit orders, which in turn could lead to a *lower* level of liquidity than existed under penny ticks. I strongly urge the Commission to require a more significant price improvement level for internalized trades. I also recommend that the Commission require that brokers report the number of shares internalized in pilot stocks.

For example, at a \$0.01 price improvement level, stocks with a \$0.06 or \$0.07 spread under penny ticks would be profitable to internalize under a \$0.05 tick, \$0.01 improvement regime. Similarly stocks with a \$0.08 or \$0.09 penny tick spread would be unprofitable to internalize. The Commission could then compare the changes in regime-induced liquidity for the two groups of stocks just mentioned. Coupled with reports of the number of shares internalized, the Commission could conduct a direct assessment of the impact of internalization on the program's stated goal of increasing liquidity in low price stocks. The logic and academic proof presented in this letter suggests that internalization will be an impediment to the goals of the program. Its impact should therefore be assessed. The changes to the program suggested above will allow for that assessment.

Sincerely;