Dark Pool Comment Letter
File No. S7-27-09
From Steve Wunsch
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January 14, 2010

Elizabeth M. Murphy, Secretary,
Securities and Exchange Commission,
100 F Street, NE., Washington, DC
20549-1090

Dear Ms. Murphy:

I welcome this opportunity to comment on dark pools. I am Steve Wunsch, the principal inventor of two SEC-regulated stock exchanges, the Arizona Stock Exchange "AZX" (originally called Wunsch Auction Systems, Inc. "WASI") and the ISE Stock Exchange, both of which include dark pools. In fact, both of them, like all modern stock exchanges, have both lit and dark components and, thus, have provided me with potentially useful perspective on the dark pool question and on transparency in general. I will focus heavily on the latter, for it is impossible to understand the dark pool issues raised without understanding the value of transparency or, if improperly applied, the lack thereof. The AZX experience was, I believe, particularly instructive in this regard. Its highly transparent call market structure, combined with its unique regulatory status as a "low volume exempt" exchange, enabled me to see transparency and the role of regulation in promoting it from a perspective that I don't believe anyone else has.

SUMMARY

The mandatory transparency of the national market system (NMS), from which the dark pool proposals derive their justification, is and always has been flawed. But its flaws have gone largely unnoted by the Commission and, due to its guidance on the issue, the general public. Consequently, attempts to impose transparency by rule have been unconstrained by any doubts as to its efficacy. Many in the block trading community, of course, both institutions on the buy side and dealers on the sell side, as well as the markets of which they were members, did express doubts. But their concerns were easily overridden as being merely motivated by commercial interests that were opposed to the public interest in transparency. And, given the SEC's life or

death power over them, it is not surprising that they toned down their criticisms as much as they could in order to survive the transparency dictates.

Because the Commission has had a virtually unobstructed ability to impose a flawed transparency on the stock market for over three decades, in many respects what appears to be good is bad and what appears to be bad is good. Among other pernicious effects, mandating transparency based on this flawed theory is actually harming transparency, which is not only the principal value the NMS is designed to promote, but is the lynchpin on which all the other values depend. As a consequence, although "the [dark pool] proposals are intended to promote the Exchange Act goals of transparency, fairness and efficiency," they will not promote any of these goals.

By reining in dark pools, the proposed rules would hasten the ongoing transformation of the lit market into what is effectively becoming a giant, highly fragmented dark pool, characterized primarily by algorithmically shredded institutional blocks and high frequency market making. While this activity results in lower trading costs for everyone, it is less transparent than the block negotiations it is replacing, which benefited from honest disclosure of true information to those who needed to know it in order to discover correct prices. Those block prints anchored transparency to prices that were more likely to be correct, less likely to be distorted by deliberate attempts to muddy the waters, and easier to understand.

Today, no one is disclosing anything honestly to anyone and the anchoring blocks are disappearing. In fact, the main purpose of the algos is to mislead, and they work. The result is a wildly wandering thin stream of tiny prints executed at a multiplicity of dispersed venues of multifarious character, some of which print where they trade while others print somewhere else, sometimes after being routed and rerouted like hot potatoes to satisfy "best execution" regulations. None of the tiny trades mean anything by themselves and in aggregate are even more confusing, flashing by at a speed that only sophisticated computers can capture and decipher. Like strobe lights, they can be more blinding than illuminating and, thus, better suited to hiding activity than presenting it fairly to the public.

This transformation of light into dark has been and remains the principal consequence of all of the transparency initiatives since 1997's Order Handling rules. In addition to harming transparency, this result is demonstrably unfair, as it creates wide gaps between multiple tiers of information quality and access, where what you see is highly dependent on how much proximity and computing power you can afford. And, while it may be efficient in the narrow sense of lower trading costs, it is harming the efficiency of far more important values, like price discovery, exchange organization and capital formation. These values grew with the institutionalization of the marketplace, perhaps the greatest efficiency of all, in that it brought the economies of scale to investing and capital formation that made us the envy of the world. But behind the curtain, NMS's transparency policies have undermined all of these efficiencies, because they rest on a deinstitutionalization ethic, and I do mean ethic. From the beginning, NMS has targeted institutions as if there were a moral imperative to dismantle block trading and replace it with "democratized" electronic screens. Even if there were any moral value in this goal, which there isn't, as I will describe, it is clearly inefficient. It is transforming a market structure that had been well organized through free competition into one that is becoming increasingly disorganized as a consequence of being forcibly deinstitutionalized.

All of these problems are caused because NMS's underlying transparency theory is burdened with a fatal flaw, which my AZX viewpoint enabled me to spot quite clearly two decades ago. AZX was based on the ultra-transparent concept of "preannounced trading" or "sunshine trading." Unlike the displayed order books of today's exchanges, which seldom show significant size, AZX originally envisioned the pre-trade display of large blocks. Admittedly, this was naïve in its original formulation, which, like NMS's similar error, contemplated its application in continuous trading. But I soon figured out that, in order to make sunshine trading work, it was necessary to fix the time of the auction. I did not at first know the academic terms for this structure, such as "call market" or "single price auction," nor was I aware of any of its historical precedents or the academic literature on the subject. Rather, I was merely trying to solve the practical problem of how to manage a sunshine trade if multiple parties wanted to compete for the liquidity opportunity, or, equally challenging, if multiple parties wanted to conduct sunshine preannouncements. As it happens, conducting an electronic single price auction solves both problems.

I won't rehash here the benefits of calls, except as necessary to illustrate what I discovered about the hidden misconceptions that many have regarding the benefits of transparency. In a nutshell, they believe that transparent electronic trading, by itself, will automatically eliminate intermediation costs, even if applied in continuous trading, which they assume is the only way to trade. This is not because they have thought about it and come to this conclusion, but rather because they have not thought about it. They certainly have not realized that, when it comes to transparency, it is necessary to make the distinction between continuous and fixed time trading. In contrast, as I learned in designing AZX, it is difficult to even make transparency work in a fixed time call auction; many conditions need to be satisfied to produce the requisite competition that makes an auction work. But transparency never works in continuous trading, either as trading strategy or market structure. Without the fixed point in time on which to focus competition, it will always be dangerous to be the first discloser, i.e., the transparent one. And if transparency in continuous trading is always a dumb and dangerous strategy, how can it be good public policy to mandate it?

While all of this became clear to me as I focused on the AZX call market, I discovered that such distinctions were not at all obvious to most people. Over the decade and a half that I spent articulating and debating the potential benefits of transparency in a call market, I had hundreds of opportunities to observe how embedded this flawed transparency thinking is in many, perhaps most, market participants, academics and regulators. They have, in short, bought, hook, line and sinker, the SEC's view of transparency.

The primary market structure problem we face today is that this naïve, untested and incorrect transparency theory is the foundation of the national market system. As a result, NMS cannot produce its intended benefits, but does produce many unintended consequences. These non-benefits and unintended consequences are causing all of today's controversial market structure issues. Worse still, there appears to be no way out of the corner we have been painted into. The Commission apparently believes as strongly in transparency today as it did in 1975 when, based on this incorrect theory, it convinced Congress to grant the Commission its NMS authority.

Thus, although the official embrace of the transparency error is the primary reason the wheels seem to be coming off the stock market, the proposed solution to every problem is to up the ante with more of the same. Dark pools, actionable IOIs, flash trading and the like are treated as if they were surprising aberrations that must be suppressed and thereby pushed into the lit market, when in fact they are only the natural consequences of NMS policy. The reality is that today's lit market has none of the values the Commission ascribes to it and therefore should not be favored, while the dark pools and their cousins are beneficial to some and neutral to everyone else. They are not harmful, either to those who use them or to those who do not use them. And any concern over unfairness, two-tiered markets or undermining the value of lit quotes is misplaced, because the lit market is far more misleading, unfair and dark than these supposed aberrations are.

Because of this, I would recommend placing all further action on hold until the Commission has had a chance to reexamine NMS's transparency theories. Ratcheting up the rulemaking pace or, worse still, responding to those urgent calls from Congress for immediate emergency action to impose more transparency or fairness, will only double down on previous errors. The Commission has, after all, been doing nothing but imposing transparency and fairness for three and a half decades, and it clearly isn't working. At least it's not working if one judges by the rationales put forth in the instant proposals, which imply that non-transparency and unfairness are, again, spinning out of control. So why continue to do more of it? Until a better understanding of these issues is in hand, there is a great danger that more rulemaking will only further convince investors that the SEC, too, is at sea amidst the sea changes it has created.

DISCUSSION

Investors are Frightened and Angry, With Good Reason

The recent proliferation of dark pools is but one among many suddenly frightening features of the fragmenting landscape, including high frequency trading, flash orders, co-location and sponsored access. Although these features are certainly new, unfamiliar and frightening to most people, this is not the alien invasion implied by the urgent rule proposals and calls for public comment. Each and every one of these gremlins emerged in response to the electronic transparency of NMS, which has been in the works since 1975. Market participants are merely behaving rationally and reasonably to avoid transparency, as they have been for years. There should be no surprise here, although each upward ratchet in transparency rules naturally engenders some creativity in response. But the picture is the same: the SEC tries to force transparency on a market that doesn't want it or need it, so participants come up with ways to avoid it. But the cause of these responses is always the same: NMS's transparency rules.

Perhaps the most sudden and dramatic increase in transparency in the NMS campaign occurred when the latest Reg NMS rolled out in 2006 and 2007, which finally forced the NYSE to go electronic. Nasdaq had been hit with a similar transparency bomb ten years earlier with the Order Handling rules. Both bombs had the same effects. First, they unwound the dominant market shares of their targets' primary markets, as fragmenting competition flooded in. Second, they destroyed the business models of the block trading dealers who had supplied liquidity to institutions. Third, they atomized trading into zillions of tiny little pieces, as institutions, whose blocks used to be handled confidentially by the disappearing dealers, began to hide them in the lit market by algorithmically shredding them and randomizing their dispersal amongst the fragmented primarily lit books. Fourth, the algorithmic shredding of blocks led to the emergence of high frequency traders acting as a new form of market makers for both shredded institutional blocks and the retail orders that shredding effectively mimicked.

These developments should have produced no surprise, at least not this time around. Nor should it have surprised anyone that the minor practices around the edges of the block world, such as dark pools and IOIs, would be carried over and expanded where possible, as institutions struggled to cope with NMS, whose main target is and always has been block trading. Since the Institutional Investor Study of the 'Seventies, which the SEC produced to lobby Congress for its NMS authority, the SEC has viewed institutions and the block dealers who served them with great suspicion and alarm, as enemies, really, whose secretive practices must be snuffed out on behalf of leveling the playing field for individual investors. Block traders, of course, are the aforementioned commercial interests, whose understandably timid objections to being attacked by the SEC were overwhelmed. I will come back to show that, because of the fatal flaw in the SEC's transparency theory, the block trading community was right and the SEC was wrong. But for now, I want to emphasize that no one who understands anything about markets or trading should have been surprised at the appearance, continuation or expansion of things like algorithmic shredding, dark pools, IOIs or high frequency trading. They were all baked into the NMS cake.

Rather than scapegoat the gremlins, I would urge the Commission to conduct an honest appraisal of its own role in creating these practices. Continuing to attempt to escape blame by alleging a need to "keep pace with market developments" or "address the inequities of flash orders and dark pools," to pick two examples from the Commission's PR playbook, would be disingenuous and cynical. Such rabble-rousing serves only the Commission's interest in self-preservation and mission extension at the expense of the public interest in markets that investors can understand and trust.

Eliminating Dark Pools Is Pointless

Playing transparency whack-a-mole against dark pools, IOIs, flash orders etc. will have little practical effect and may actually backfire on its transparency-promoting intent, even if it successfully pushes some dark orders into the lit market. That is because all of the dark pools plus all of their extensions combined, from flash orders to actionable IOIs, are but a ten percent sideshow in the evading-transparency circus. The main event is in the lit market itself, where the furious interactions between algorithmic shredding and high frequency trading produce so much "transparency," over a million messages per second and doubling every year, that no one sees anything anyway. That is why institutions are using the lit market as a giant dark pool to hide in. This is the big picture. This is the forest to the dark pool trees. Even if all those little dark pools could be wiped out completely, that would only hasten the full transformation of the lit market into a scary house of mirrors, where the public tape is always behind the private feeds, where high frequency traders know what's about to happen and the public doesn't, and where the co-lo box seats are unaffordable by normal investors. So what is the point of moving dark pool orders into it?

Furthermore, dark matching of block orders has no damaging consequences. Whether we're talking about old forms of it, like specialists on the floor and upstairs dealers, or new forms of it, like dark pools or algorithmic shredding, block matching has always been beneficial to the efficient price discovery and stability of the market, including the lit market. All that happens is that size is matched if the lit market is at or moves to an acceptable price. That's it. Not only does this not undermine the efficiency of price discovery, as is often alleged, it improves it, as well as its stability, by satisfying size that, if thrown into the lit market, would cause unnecessary turmoil and volatility.

It is true that there has been a rapid decrease in the old non-anonymous dark methods, i.e., block trading, and a consequent increase in the new ones, such as actionable IOIs, flash orders, algorithmic shredding, high frequency trading and the like. The first thing to recognize about this transformation is that it was and is entirely driven by transparency mandates, which have succeeded in killing off the old block methods, if not quite entirely yet, then soon. The Nasdaq block market was put into intensive care as a result of the Order Handling rules of 1997 and related transparency-justified reforms, notably decimalization in 2001. NYSE block dealing is similarly in the process of being killed off now by Reg NMS. But the need of institutions to trade blocks did not go away, much less were any of them ever convinced to use transparent screens to show blocks as the NMS vision expected them to. Instead they have desperately sought out other means of getting the job done electronically, as NMS encouraged them to. So the first thing to recognize is that each and every one of the new gremlins is the result of the naïve attempt to force block trading onto transparent screens. The fact that that strategy didn't work is no excuse for trying to eliminate what did.

Transparency Can Be Very Dangerous

The 70-year old uptick rule on the NYSE may or may not have been wise policy to begin with, but both buyers and sellers had become used to it and their activities had reached an accommodative balance based on its presence. Its removal, therefore, entailed enormous risk, because it would help sellers become more aggressive without similarly helping buyers. It took great faith in the transparency- and efficiency-based arguments that were used to justify removal to believe that the balance between buyers and sellers would not be upset to the downside when the uptick rule went away in 2007. Such faith appears in retrospect to have been misplaced, as evidence shows that short sellers did indeed become significantly more aggressive in their order pricing and placement behavior after the uptick rule's removal.

And there were at roughly the same time two other transparency- and efficiency-justified changes to long-established practices that may have been similarly unwise: financial firms were required to mark their securities and derivatives inventories to market, and Big Board trading was required via Reg NMS to go from being mostly manual to being mostly electronic. Again, regardless of their theoretical merits, these three changes – uptick removal, mark-to-market, and a suddenly electronic NYSE – were so dramatic, especially for the stocks of the major financial firms, which were mostly NYSE-listed, that they may have constituted a perfect storm whose selling started in late 2007 and accelerated into March, 2009, when mark-to-market was relaxed and there was talk of restoring the uptick rule. This is not to minimize the roles of many other culprits in setting the market up for a fall. But why did it fall when it did? What were the proximate causes? Since all of the other culprits were the result of long-standing practices or policies, like housing, ratings, CDSs etc., they don't really answer the question of why it fell when it did. But this trio could answer that question. Each one individually was a drastic shift toward greater transparency and either singly or in combination could have initially triggered and then accelerated the bear market.

They might even have caused the credit crisis. Many in the equity trading community these days are fond of bragging about how their market stood up to the test of the credit crisis: "You might not have liked the prices, but at least we stayed open and liquid!" According to them, transparent and efficient markets were driving the banks' and brokers' stocks toward zero, because that was all they were worth. Maybe so. But there is an alternative hypothesis that better fits the facts.

Maybe transparency and efficiency are not as capable as their advocates assume of always producing correct prices, particularly if the mechanisms by which they operate are sharply altered. It just may be that the suddenly electronic NYSE, stripped of its uptick rule, faced more efficiency than it could handle. In this unfamiliar and volatile environment, what if you could artificially push a bank's stock down to, say, half of what it was really worth, perhaps using aggressive short sales coupled with the steady purchase of CDS insurance against the bank's bonds, the rising price of which would signal that the bank was in trouble, and then deliver the knockout punch by floating rumors that the bank's hedge fund clients were fleeing or that its counterparties were demanding more collateral? (This scenario closely parallels what the heads of the biggest investment banks reportedly alleged in emergency calls to the SEC in the fall of 2008 as they begged for short-selling bans, which were, in the end, granted.)

And what if, due to mark-to-market, the targeted bank had to suddenly treat assets that were never expected to trade, and for which there was historically no market, as if they could be traded every day? This would suddenly turn assets that once had value in the bank's business model into something worth zero as valued by the transparency hounds. To meet capital requirements, this could force the bank to sell artificially cheap company stock, thereby turning a liquidity problem into a solvency issue, causing lower marks, more sales, lower marks, more sales, etc. The possibility that such a positive feedback loop could doom a company or an industry is religiously denied by transparency and efficiency believers, who simply say, in circular fashion, that whatever price prints is, de facto, the correct price, even if it is zero.

But these people are wrong. It is possible to have wildly incorrect prices for extended periods. Plenty of examples have been seen in the real world, where obvious arbitrage opportunities have persisted for far longer than efficiency would have allowed, if it were operating with as much certainty as its believers expect it to. And experimental-markets academics have demonstrated conclusively that bubbles and crashes, both representing prices far away from theoretical equilibrium, occur with surprising frequency. Transparency, if poorly applied, not only cannot prevent incorrect prices, it can itself become their principal cause. If the prices that banks and brokers fell to last winter were artificial and incorrect, then it is also possible that the consensus on causation has it backwards. It may not be that the credit crisis caused the bear market, but that the bear market itself was at least a major contributor to if not the primary cause of the credit crisis. Staying open and liquid and printing trades is not necessarily a good thing if the prices printed are incorrectly low and misleading, much less if they are triggering positive feedback loops and further sales.

It is clear that transparency has brought us very far into The Land Of Unintended Consequences and that we'd best be careful from here on out. Before mandating equities-style transparency for CDSs or fixed income, for example, as many at the SEC and in Congress have advocated, someone should ask if we really want to see dark pools, high frequency trading, flash orders, co-location, etc. spring up in these markets, too. They, too, are largely upstairs block trading markets, whose price discovery is accomplished via non-anonymous human negotiation, just like equities were before NMS's electronic transparency transformed them. It is likely, therefore, that applying the same transparency theories to them will produce many of the same results.

Short Sales

In order to avoid further man-made disasters, I would include in the effective moratorium, not only all dark pool-related rule proposals, but also those on short sales. Whatever value the old uptick rule had, it existed in support of a market making system that no longer exists, having been wiped out by NMS. And however frightening the electronic market making system that has replaced it appears at first blush, the new system seems to be working pretty well and will no doubt improve if participants are allowed time to get used to it. While I believe that removing the uptick rule may have been one of the SEC's worst errors, I fear that the Commission may be about to top it, either by restoring it or adding another set of new and unfamiliar restrictions in a misguided attempt to resurrect its spirit.

The old rule operated during a time when trading moved much more slowly. Participants of all stripes could tell when they were long or short and what effect a new buy or sell order would have on that position. It was not difficult to correctly mark a new order as a short sale order if it would initiate or add to a short position. With correct marks, it was relatively simple to monitor and enforce restrictions such as the uptick rule. Moreover, if any market makers needed exemptions and such exemptions were allowed, it was relatively easy to identify them, since they were all registered on the markets where they filled their roles.

Not one of these conditions pertains today. Market making has been taken over by high frequency traders, who are rapidly becoming the only liquidity providers both to those algorithmically shredded institutional block orders and to retail orders. The good news is that the cost of liquidity has gone down dramatically for everyone. Liquidity is cheap, it is immediate and it is reliable. The bad news is that it is impossible to capture and record the new market makers' activity on anything like the old model. Their positions may change back and forth from long to short several times per minute or per second. They may have thousands of buy and sell orders "in flight" at a time and expect to cancel the majority within seconds and get fills on only a small percentage of the remainder. These high frequency traders often have no idea whether they will land in the next second or two in a net long or net short position. Any attempt to force them to mark their sell orders long or short, as if they were still standing around on a floor, will be extraordinarily expensive from a programming perspective and will result in failure on several fronts, including, ironically, the public interest in a transparent and correct picture of short selling activity.

The picture will be inaccurate and will grossly exaggerate the amount of short selling as participants mark almost everything questionable a short sale to avoid getting caught underreporting. SEC staff guidance OK'd such expedient deception previously, but almost certainly did not understand that the modern result of that guidance would not be just a few hundred shares here or there incorrectly marked short, but millions, perhaps billions of extra short sale shares being reported. In addition, if the extra short sale marks are also tying up the supply of stock that can be located for borrowing and selling short, the effect may be a severe restriction on or elimination of borrowable shares. Thus, either requiring pre-trade marks of short sale orders or continuing to allow the once-little deception of over-marking some orders as short sales in order to comply with the marking requirement could result in a back-door ban on short selling, which in turn could have the effect of banning the only remaining source of immediate liquidity for all investors: high frequency trading.

But even if correct short sale marking were possible, there is another problem that is worse: exemptions will be impossible to administer to the right people. There is no practical way to decide who gets an exemption other than whether a given trader is a registered market maker or not. But many, perhaps most, of the new market makers are not registered as such and, practically speaking, probably never can be. The old model gave benefits to market makers in return for their acceptance of certain liquidity-provision and market-stabilization obligations, which were specific to the particular exchange where they were registered members. The new market makers may or may not be registered members of any exchanges and, in any case, trade on all of them and many non-exchanges besides, and have no obligations or responsibilities. I have heard that some large old members are recommending a new registration regime built around co-location, which would treat co-lo as a privilege that comes with responsibilities. But that is a strategy to fight the last war. Granting exemptions only to the dinosaurs might kill off the newfound liquidity. Apart from cleaning up the remaining fail-to-deliver problem, there is no observable harm in the market coming from short selling now, and it should be left alone.

Freaking Over High Frequency

In 2004, "immediate" was defined as within one second in Reg NMS. The one-second standard sounded reasonable, as it would give the NYSE time to catch up to the modern markets that at that time were already quicker than one tenth of a second. By 2007, when Reg NMS fully rolled out, leading edge markets were faster than one one-hundredth of a second. By late 2009, the whole pack was there, several were faster than one one-thousandth of a second and the leading edge was nearing one ten-thousandth of a second. Now that everyone has figured out that speed is the key to pleasing high frequency traders and thus garnering the liquidity that enables a modern exchange to survive, the leaders are predicting 2010 speeds of one one-hundred-thousandth of a second and speculating about when one millionth of a second will be reached. And not to forget how all this speed translates into actual high frequency, exchanges regularly boast now of being able to handle a million transactions per second, and at least one is planning to hit one hundred million transactions per second.

Ordinary investors and seasoned professionals alike are naturally put off by this frantic focus on speed. But few recognize that such speed and frequency are the inevitable results of NMS's mandated transparency, which has harmed real transparency by emphasizing its quantity rather than its quality. Not only is the quantity harming the quality, but it is the quantity of transparency that is confusing investors and making them feel like second class traders. Beating the market used to be a trade that outperformed over a period of years, months or weeks. So why on earth would anyone care about a one-second time frame, much less any of these tinier and tinier fractions of a second?

They care, of course, because high frequency trading and its supposedly nefarious cousins are in the news, and always with a slant that emphasizes the lack of a level playing field. The reality, though, is that investing and trading have never been cheaper or easier. What investors are supposedly missing are the irrelevantly fleeting and tiny opportunities that would only show up when viewing the high frequency landscape the SEC has created through an electron microscope. No one should care. But they do, thanks to the populist rhetoric that emphasizes equality, however irrelevantly microscopic its parameters are.

Several people at the SEC and in Congress are already prominent among those calling for action. Consequently, there is a good chance that something very foolish will be done. The real danger of the moment comes from the possibility that the SEC or Congress might lash out at high frequency trading with, say, a back door way of shutting it down via something like new short sale restrictions, or a more direct attack, such as a transaction tax. The SEC seems bent on pandering to the angry rabble, piling on with its own suspicions of how high frequency traders may be taking away opportunities that legitimate investors deserve to have, and would have, if only there were a level playing field that did not favor "short term traders" over "long term investors." The fact that the Commission would accept and further fan the flames of such mischaracterizations demonstrates that it does not understand how market making functions in a market. This misunderstanding is another manifestation of the same theoretical flaw that is causing the transparency error.

The Transparency Error

In my AZX days I came across many people who believed that, on a truly level playing field, market making would be unnecessary and would disappear as investors provided liquidity directly to each other. And most of them believed that the electronic trading screens of NMS would create such a level playing field. Consequently, they became fervent believers in the Commission's NMS mission. They were inspired by its plan to use "new data processing and communications techniques" to promote "fair competition," find "the best market" and provide an opportunity “for investors’ orders to be executed without the participation of a dealer.” They knew this was revolutionary and that intermediaries would try to block it. So they were zealous in their support of having Congress grant the Commission whatever authority it needed to prevent those greedy, anticompetitive intermediaries from standing in the way of progress toward NMS.

It didn’t take long when considering the issue while designing a call auction to realize that NMS was based on a false premise. It is only in a fixed time trade that such Nirvana is possible. In a perfectly ideal call auction, all buyers and all sellers would simultaneously trade directly against each other at an equilibrium midpoint price, thereby eliminating the need for intermediaries and their compensation at that point in time. The level playing field is a necessary condition, but not a sufficient condition, for Nirvana to occur. Without the competition at the known, fixed time, even on a perfectly level electronic playing field, there would still be some who were faster than others at processing the information on the screen or would somehow find relevant information that wasn’t on the screen. A continuous market, therefore, cannot eliminate intermediation, no matter how level the playing field is, and no matter how powerful Congress makes the SEC.

Believers in NMS thought that by forcing trading onto screens, all those secret-hording block traders would have to come out of the dark onto the transparent level playing field, and that, just because they did so, intermediation would disappear. But institutional block traders were never so naïve. What they did instead was to algorithmically shred their orders so that they could stand the glare of transparency without running up huge trading costs. And a new professional class of intermediaries emerged to make money off their shredded flows, called high frequency traders.

The reality is that all continuous trading is bound to sprout intermediation behavior, regardless of how fair or level or democratized it is. But the SEC did not understand that in 1975 and does not understand it now, as evidenced by the apparent belief that there is something to be gained by putting long term investors on a level playing field with those high frequency intermediaries.

It might help to recognize that all market making involves front running. I don’t mean this in the pejorative sense, and certainly not in a way that implies legal culpability. Rather, I make the simple observation that, like a grocer stocking shelves, all successful market making involves prepositioning of inventory so that its unwinding is profitable. The only way this can occur is if, somehow or other, the dealer can figure out what is more likely to happen next so as to position himself to profit from it. Figuring out “what is more likely to happen next” could be as simple as your customer following through on what he told you he was thinking of by buying or selling stock, or as complicated as the whole market, based on your simultaneous computerized reading of multiple market direct feeds and many other sources of information, seeming more likely to stay still or move down a tick than to move up in the next half second so that you can risk a more aggressive sell order so as to hopefully earn a rebate and cover at the same price you sold at within a half second.

In the old block trading days, such information was gleaned primarily from an exceedingly complex ecosystem built up over decades that gave both dealers and institutions a reputation interest in dealing honestly and fairly with each other and the trading community in general. The securities traders' motto, Dictum Meum Pactum, my word is my bond, embodies, in addition to its literal meaning, a sort of Golden Rule among traders to not abuse confidential information disclosed in the process of trading in a way that would hurt a customer who disclosed it. Similarly, it involved a commitment on the part of the institution to respect the dealer's interest in not being bagged by incomplete or inaccurate information disclosed by the customer. The net effect of this was a price discovery and liquidity provision network that benefited from the honest disclosure of necessary information on a need-to-know basis so that dealers would be able to supply liquidity at reasonable cost to institutions. Although front running occurred as a matter of course, its effects were contained within bounds that were deemed by the community to be reasonable in the context of the need to get a block done. Violators of this honor code would be "put in the penalty box," shunned, stunted in their careers or permanently ostracized.

The Commission's error was in believing that, by wiping out this ecosystem, all those blocks would be forced onto NMS's transparent screens and thereby eliminate front running. It turns out that, while block trading is on the way out, NMS didn't eliminate front running; it only speeded it up. High frequency trading operates on none of the bases of the old ecosystem, but it has developed its own means of staying ahead of the flow. Intermediation by professional traders who can stay ahead of the flow still remains in our market, in spite of the Commission's belief that it could be eliminated and in spite of the Commission's attempts to eliminate it. The reality remains that no blocks were or ever will be put up on transparent continuous screens.

WHAT WAS LOST

The fact that markets have been able to adapt and evolve in spite of the Commission's errors should not be taken as an "all clear," or as a signal that more of the same is called for. Even though high frequency market making, a rare positive unintended consequence of NMS's errors, is a cheaper form of market making than block trading was, that doesn't mean that we didn't lose something important when we lost block trading. I will briefly outline below four vitally important things that we may have lost. For all four, I would recommend that the Commission conduct an examination of whatever theories may or may not exist to support its policies. The perfunctory mention of the terms "price discovery" and "capital formation" in rule proposals, for example, is not the same thing as having done an appropriate analysis in these areas before adopting rules that could affect these functions profoundly.

Price Discovery

The accuracy of price discovery is difficult to assess in live markets. Nonetheless, it is frequently trotted out as a goal of transparency policies, such as when decimals were supposedly needed to show exactly where inside those old quarter point spreads the true price really was. The theory was that, although block traders knew the true price, they kept that information hidden by only showing prices in quarters. Decimals were needed, this argument went, so that the public, too, could see the true price down to the penny.

Underlying this line of thinking is an implicit assumption that all market prices are always correct and that, therefore, it only takes transparency to reveal them, which it can do down to the finest increments imaginable. Few have considered how unrealistic this assumption is. While most people believe that the correct equilibrium price of the market is always at or between the bid-offer spread, few have considered what a great burden finer increments place on the accuracy of the equilibrium setting mechanism and, therefore, on the implicit assumption underlying mandatory transparency. But in fact, the more you ponder this question, the more you are bound to question the validity of the assumption in the first place. Do we really think we have robust enough supply and demand equilibrating methods to tell us accurately what the price is to the penny? How about to the tenth of a penny? The hundredth of a penny? The millionth of a penny? Thinking about such extreme cases has made me doubt that we ever did have it calculated correctly even to the whole dollar, much less to quarters, eighths or pennies. If we didn't, then how could we justify decimals on transparency grounds? The real question is, if finer increments can undermine the assumption on which mandatory transparency is based, then why were finer increments mandated on transparency grounds in the first place?

But the price-is-always-right assumption underlying mandatory transparency has an even bigger hole, and that is that it also implies that market structure doesn't matter to the accuracy of price discovery. Under this apparent assumption, the Commission has made radical market structure changes without worrying whether price discovery might be harmed. The Commission has dealerized the auction market, auctionized the dealer market, turned both of them into electronic ECNs, changed increments from eighths and quarters to pennies, atomized block trading and created high frequency trading, to name a few. And I have never once seen the SEC consider if any of these changes might affect the quality of price discovery. Rather, the assumption appears to be that transparency is always beneficial and that, therefore, more of it will improve everything, including price discovery.

It is highly unlikely that market structure does not matter to the accuracy or reliability of price discovery. Just consider three types of market structure: call markets, block trading and the atomized continuous trading that we see today. It has long been felt that the multiparty calls at opens and closes are the most reliable prices in the market. For continuous trading, large block prints were the focal point.

This, too, was logical, because block negotiations produced a relatively stately procession of prices that were more likely to reflect a community consensus of where supply and demand balanced.

In contrast, the frenzied string of tiny, anonymous trades in today's continuous market cannot produce such a consensus. This is not just because there are no longer any reputation reasons to keep information honest and correct (although there aren't, since trading is anonymous), or that the main purpose of those shredding algos is to mislead the market (although it is, and they work). The main reason is that continuous electronic trading cannot by its process ever produce consensus, since each trade is only looking at the one just before it. And the more anonymous, disconnected, atomized and continuous it becomes, the less able it is to produce consensus.

Although it is difficult to assess whether price discovery is accurate in live trading, it is not so difficult for experimental-markets researchers to do so. Some experiments show that prices can be surprisingly accurate, while others show that, under other conditions or structures, prices go off into bubbles and crashes, either of which can exhibit prices that are wildly inaccurate when compared to what the experimenter knows the true equilibrium price is. The Commission should consider whether the transparency-induced atomization of trading, or the loss of block trading, or both, could be hindering reliable price discovery. If so, then the sheer volume and frequent repetition of quotes and prints in the new hyper-transparent world of trading may be contributing to the impression that bad prices are good and, thereby, leading the public into bubble-chasing behavior even as the disconnection of price from reality makes bubbles more likely.

In any case, I would recommend that the Commission ponder three questions: 1) Does market structure matter to price discovery? 2) If market structure does matter to price discovery, shouldn't the price discovery effects of any contemplated changes in market structure be carefully considered before they are undertaken? 3) If a market structure change proves to be harmful to price discovery, wouldn't that also mean that it is harmful to transparency?

Capital Formation

In 1997 as the Order Handling rules were unfolding, I warned in a speech that the reforms might kill off capital formation and with it, in sequence, America's high tech advantage, its productivity miracle, and its economic growth. My concern was that the Nasdaq market making system was also the human engine that launched all those IPOs and created the miracles. By stripping down block traders' incomes, a deliberate goal of the reforms, which goal was premised on the belief that their high incomes were the result of antitrust violations and therefore illegitimate, I was afraid that we would kill the goose that laid the golden egg.

I would recommend that the Commission study the possibility that we have done just that. We have certainly killed off the old market making system and, for whatever good the new high frequency traders are doing, they aren't likely to fill the IPO gap. At least one outside study makes a connection between the market structure reforms that began with the Order Handling rules and the severe decline of IPOs. According to the study, the current market structure cannot support IPOs like those that launched Microsoft, Intel, Cisco, Starbucks, Oracle and Amazon, and our economy may already be missing millions of jobs as a result. In any case, the dearth of IPOs has led to a collapse in the number of stocks listed on our markets.

Stock Exchanges

Stock exchanges, as that term is commonly understood, no longer exist. You could say that transparency killed them, or that competition or linkage killed them, or that decimals or screens or fragmentation killed them. But any way you cut it, they're gone. What remains is a bunch of electronic boxes, essentially ECNs and ECN-like exchanges fighting over high frequency traders with ever faster matching engines. There are no central markets, no primary markets, no strong organizer or overseer of the membership, no capital raising communities. Members have no loyalty to any exchanges and are more interested in starting up new competitor ECNs to flip them to their next owners or the public. Bottom line, there are no membership organizations, because all of them have demutualized. And this is troubling, because the membership organization, or mutual, form of stock exchange was the form that all major markets of the world took at inception.

Can "re-mutualization" help? Not likely. The much-touted re-mutualization movement is but a pale shadow, only capable of creating a little better chance of flipping those new startup ECNs profitably. It has none of the capital raising or organizing power of the old membership organizations. It's nice that some of the new ECN exchanges are talking of starting listing businesses. But, realistically, it will be decades, if ever, before US markets rebuild anything close to the capital raising power that the old exchanges organized. And why did the membership organizations disappear? Antitrust did it.

All of the NMS reforms, including transparency, rest on a foundation of antitrust. From the 19c-1, 19c-2 and 19c-3 rules in the mid to late 1970s that started the process of eliminating the off-board trading restrictions by which the NYSE had controlled its members and protected its listings, to the latest Reg NMS that finally brought down the Big Board by allowing every other exchange and ECN to take order flow away from it merely by letting high frequency traders match the NYSE's prices on their screens, the intent and effect of NMS has been to destroy the membership organization structure of the NYSE. (The similar attack on Nasdaq began later, with the 1997 Order Handling rules, but had the same intent and effect.) And, just as there was a presumed moral imperative to bringing institutions and block trading down onto transparent screens on behalf of the little guy, there was a righteous fervor behind dismantling the Big Board's anticompetitive membership structure.

It's true that the Commission may have had no choice but to enforce antitrust, in spite of the supposed antitrust exemption that regulation by the SEC conferred on the NYSE at the SEC's formation in 1934. But it is possible that stock exchanges would never have emerged in the first place under antitrust and also that they cannot survive now under it. So I would recommend that the Commission contemplate one simple question: Could any of the major US markets, or world markets for that matter, have gotten started in the first place, if antitrust laws had been around or enforced when those markets formed?

Start with the Buttonwood Agreement. Every dot and comma of that founding understanding of the NYSE is an antitrust violation. But it's not unique. Membership organizations were primarily formed in order to engage in anticompetitive behavior, or at least that's the way trustbusters would see it. So, again, the question: Could the NYSE have formed in the first place if antitrust had been around in 1792?

Dictum Meum Pactum

Earlier I said that the securities traders' motto above, which means, "My word is my bond," goes beyond its literal meaning and is sort of a Golden Rule. Thus, a dealer would not egregiously front run his customer, and an institutional trader would not mislead a dealer about his true size. But it goes far beyond that, too, encompassing all manner of ethical behavior that evolved naturally as the sell side competed to serve the buy side. Ultimately, Dictum Meum Pactum underpinned the service ethic model of Wall Street behavior, providing powerful incentives to conserve capital so it could be used efficiently in the service of institutional customers and companies taken public. The service ethic also provided powerful disincentives to wasting capital on speculation or paying bonuses based on speculation rather than service. Unfortunately, the NMS reforms have abrogated the natural means by which such behavior was enforced and thereby eliminated the beneficial competition to demonstrate character and honesty that had existed previously and had supported the natural growth of our capital markets. And one only has to read any newspaper to see how far the investment banking business model and its reward system have veered from what the public considers to be appropriate behavior.

In the paragraphs below, I offer a short synopsis of how Dictum Meum Pactum was lost and capital markets have come undone as a result.

Although the Order Handling rules were the most visible part of the reforms that followed the antitrust investigations of Nasdaq by the SEC and the Justice Department in the 1990s, the one that caught my attention was an effective Justice Department ban on dealers talking about order flow. Traders had to agree to random taping of conversations and potential surprise visits from Justice. Although the purpose was nominally to prevent more price fixing, the effect was basically silence. Thus, not only were the Order Handling rules designed to force Nasdaq trading onto transparent screens, but just to make sure they got the point, the old way of handling information ethically and honestly upstairs was also outlawed. So those boisterous old trading rooms went silent. Long before the proliferation of ECNs, long before decimals, the ethical treatment of information as block traders saw it had been banned. Thus, not only was anonymous, screen-based trading mandated, but non-anonymous trading, where reputations could be monitored, was also banned. Granted, this only hit Nasdaq trading directly at first, but the die was cast. These twin salvos started the rapid unwinding of the means by which Wall Street firms restrained unethical behavior as well as incented ethical service to their customers.

It is difficult to overstate the damage that eliminating the ethical ecosystem built around block trading has done to capital markets. Start with transparency. We used to have a system where true information about the large orders that mattered had been conveyed to the people who needed to have it in order to arrive at correct market prices so as to provide liquidity. Now we have a system where no significant information is conveyed to anybody and where the main purpose of the shredding algorithms that have replaced block trading is to actually mislead everyone about what the large block flows are. The public used to see block prints guiding community consensus price discovery, thus keeping continuous prices anchored to reality. Now they see zillions of tiny trades wandering wildly up and down as the algos attempt to confuse the market and prevent real information about block flows from emerging. Although it is not their direct intent, such algo-driven camouflage has the effect of preventing a price discovery consensus from forming. How could consensus form when the purpose of the automated orders generating all that frenzied activity is to hide the true information that used to be provided voluntarily to those who needed it to arrive at correct prices? That may be good in terms of lower trading costs, but it is a definite downtick for true transparency.

The downtick in transparency was bad enough, but the loss of block trader ethics has had much more far-reaching and damaging consequences. The loss of the ethical ecosystem is unwinding the investment banking customer service model, which was critical to capital formation. Moreover, now that they have been cut loose from their traditional roles of serving customers and raising capital, investment bankers have applied their capital and energies much more to speculating. This has drastically undermined public support for banking activities. And it has subjected the world banking system to a significant increase in systemic risk.

Consider how markets used to operate and how they operate now under NMS. Pay particular attention to the likely effectiveness of the two means of enforcing ethical behavior: the natural means that had evolved from block trader ethics versus the NMS combination of electronic trading and regulatory policing that has replaced it.

In the infinitely complex and varied Wall Street environment, temptations to abuse others were everywhere. Conflicts of interest abounded, yet somehow trading happened, the business grew and capital was raised. In fact, rather than harming markets, there appears to have been a direct connection between the potential for abuse and the success of our market even as it exhibited such potential. Which isn't to say that the potential resulted in unacceptable amounts of actual abuse. How could it, without destroying the participants' willingness to deal with each other, thereby short-circuiting both further abuse and further market growth? In any market that continues to grow, as our institutionalizing stock markets did vigorously prior to NMS, natural methods of dealing with the conflicts of interest and the potential for abuse are bound to evolve through competition. A backdrop of constant temptation enables character to be demonstrated and encourages competition to proceed on that basis as each sell side firm tries its best to show itself worthy of being engaged to serve the buy side and companies in need of capital. Among other things, this means that you wouldn't wantonly front run your customer and you wouldn't underwrite a company that you knew to be worthless. You would stand behind your underwritten companies in secondary trading and you would generally use your capital to serve customers. You would not leverage yourself to the hilt to engage in speculative activities unrelated to customer service. You would not reward your people with outlandish bonuses related to speculative success rather than customer service. You would not reward people for creating securities that were so complex that the customers you sold them to couldn't understand them so you could rip them off. And you wouldn't reward them for co-opting the ratings agencies' imprimaturs to help you sell your junk as triple A.

Since NMS, traditional customer service ethics have been breached with a frequency and to a degree that prevents any possibility of comparing the NMS era favorably to the past. I know that from the perspective of the SEC, it looks like there's still a lot of work to do eliminating conflicts of interest, creating transparency and level playing fields. But what I would like the Commission to consider is the possibility that it is those very efforts that may be causing Wall Street to come undone. If the means of applying reputation-based incentives to continue acting ethically are disrupted, as NMS has done, few would have expected ethical behavior to continue, and it hasn't. If trading is thrown onto anonymous screens, if Chinese walls and arm's length separations are put between every possible conflict of interest, how could a firm demonstrate its character to its customers? Why would it even try to compete on that basis? And if the firm's reputation for honest dealing isn't determined by whether fellow traders or customers catch you doing something bad (where getting caught was almost certain and punishment was severe), but whether regulators catch you (which is remote and usually entails comparatively mild punishment even if it happens), why wouldn't you go ahead and abandon customers and just roll the dice?

Even if regulators could catch bad guys, that would not motivate firms to engage in the customer service and capital raising functions that had been so critical to our growth in the past. Under traditional trader ethics, refraining from fraud and serving customers honestly and well were part of the same ethic. By focusing only on the fraud side, which is all that regulators can reasonably do, the more important customer service and capital raising functions will be left in the lurch. No matter how many bad guys the cops catch, they cannot motivate firms to pull their capital back from speculation to start serving customers again.

Which means that substituting NMS and regulatory police for Dictum Meum Pactum was a bad trade. That bad trade is causing the proliferation of many more bad guys than the SEC can possibly catch, because there are no longer any natural reputation-based governors on their creation. It is also causing a weird and indecipherable quantity-based approach to transparency to replace an understandable and reliable quality-based approach. It is causing investment banks to drop away from capital raising in order to focus on speculation, creating systemic risk and too-big-to-fail problems for the economy. And, with compensation so visibly tied to speculation rather than service, the traditional assumption that investment banking is a socially valuable activity is disintegrating. A bad trade, indeed. Not only are markets far less safe now, but the most important functions that markets used to serve are being abandoned, as the temptation to speculate has been cut loose from the ethical prudence that had heretofore restrained it.

TRANSPARENCY SOCIALISM AND THE TRANSPARENCY LIE

Although transparency is commonly advocated as if there were a rigorous academic theory backing it, I am not aware of any. At the very least, such backing would have to consider the difference between a continuous market application of transparency and a fixed time call market application. As I described earlier, almost no one who advocates transparency is even aware of the distinction, much less thought about it as it relates to transparency. If anyone did engage in such an analysis, I believe that they would conclude, as I have, that continuous transparency makes no sense, either as a trading strategy or as public policy. They would conclude that it does not promote efficiency, price discovery, capital formation or any of the other values that are often mentioned as being promoted by it. I believe that these values are actually harmed by continuous transparency. In any case, my point is that no one has even begun to think seriously about whether continuous transparency is beneficial, much less reached any rigorous conclusion that it is. Nonetheless, transparency is advocated over and over, and the national market system is built upon it. Why?

The answer lies in the leveling rhetoric in which the transparency case is always wrapped. Going back to the Institutional Investor Study that preceded and made the SEC's case for the NMS authority that Congress granted the Commission in 1975, there has been a constant drumbeat of suspicion that the rich and powerful, i.e., block trading institutions and dealers, aided and abetted by their exchanges, were illegitimately hording opportunities that the average retail investor deserved a crack at. Those big bad traders were standing in the way, using their anticompetitive tricks and exchange rules, blocking the obvious potential that modern telecommunications technology had to level the playing field and bring upstairs opportunities down to the little guy. The excitement, the fervor, the hope for a better future that NMS generated all came from the expectation that putting all trading onto the same public screens would level the playing field.

Although the Commission has persistently implied that there is value and presumed academic rigor behind its transparency theories, there isn't and the Commission has never attempted to provide any. This is disingenuous and self-serving, because it enables the Commission to pursue a leveling socialist agenda without ever having to explain why it is doing so or how socialism at the heart of capitalism makes sense. Instead, the Commission basks in the presumed moral righteousness of its leveling intentions, collecting political kudos and support for its reforms.

It is common in comment letters to praise the Commission and the work it is doing, complimenting its wisdom and courage for bringing up for discussion all the important and controversial issues of the day. It is also common to grant the Commission good intentions and to attribute any problems only to unintended consequences or to new technologies or to unanticipated economic developments. No one should take such letters seriously. Every time the SEC passes a rule or alters a structure, some fortunes rise and others fall. All of that praise in comment letters is designed for one purpose and one purpose only, namely, to gain the Commission's favor in the hope of getting rules and interpretations that will benefit the letter writers' businesses.

NMS has given the SEC control and effective ownership of the market structure, having confiscated it from the membership exchanges that created American capitalism. While NMS originally had hopes and dreams behind it, albeit naïve ones, the NMS enterprise today is nothing but a confiscate-and-redistribute one in which the primary recipient is the Commission, which exercises and extends control through perpetual re-allocation of the remaining spoils via rule changes.

AN AMERICAN OLIGARCHY

It is not in the Commission's interest to admit failures of policy, such as the ones I have described in this letter, and I have never seen it done. It was not in the Commission's interest to admit that Bernie Madoff was the SEC's most trusted and intimate confidante in formulating and selling transparency, electronic trading and the whole NMS concept to Wall Street, the public and Congress. His legitimate business was the epitome of the kind of transparent electronic competition that NMS's leveling policies were trying to create, and he occupied the most favored place of all industry advisors on policy and rules as NMS was being created. In a very real and literal sense, Madoff's legitimate business and NMS were made for each other. NMS cleared a path for the application of continuous transparency by new electronic competitors, very visibly led by Madoff, enabling him to become at one time the third largest market in the United States, even though he wasn't officially registered as anything but a broker-dealer.

Had the SEC not emasculated the rules by which the NYSE controlled its members, Madoff would never have happened. In the time before NMS, when the exchange had Rule 390 or the stronger Rule 394 before it, diverting orders away from the floor or selling them to Madoff would have been banned. But on antitrust principles, the SEC wanted to foster NYSE-busting competition in NMS, and Madoff became its Poster Boy for such competition. In order to make way for him, the SEC opened up a variety of loopholes that allowed orders to be diverted from NYSE to Madoff and printed on regionals like Cincinnati. Rules 19c-1, 19c-2 and 19c-3 were in this vein. There were perennial attempts by the NYSE to plug the loopholes and rein in the membership, but the SEC batted them all away, enabling Madoff to continually grow his business. Eventually, the NMS environment forced the NYSE to abandon Rule 394, then Rule 390 and ultimately its membership organization altogether when it demutualized. This was all very good for Madoff. And Madoff was very good for NMS, giving it industry cred far in excess of what this poorly articulated socialist leveling theory could have had without his support.

In spite of a 457-page SEC investigation into Madoff and how his Ponzi scheme was missed, the most obvious reasons were not considered, namely, that Madoff played a central role in helping the Commission design and sell NMS, and that NMS made him rich long before the Ponzi scheme. Most importantly, the credibility that the Commission's collaboration with Madoff on NMS conferred on him was the principal factor enabling him to bring in money for the Ponzi scheme. Although the investigation's report notes his credibility in the industry, it is mentioned as if it were just a fact of life and was already there. Not mentioned is that his superior access to the SEC and apparent influence over the Commission, both of which were implicitly proved by his ability to get rich on NMS, are the most important reasons that he had such extraordinary credibility in the industry. The truth is that the SEC made Madoff. He could not have existed as a threat to investors without the Commission's active and dedicated support over several decades.

CONCLUSION

I used to think that, while the SEC was doing serious damage to our market structure under its NMS authority granted in 1975, there was some value in the original 1934 Act role of protecting investors from fraud and abuse. I now see that even there the Commission is doing far more harm than good. Its position in both roles is killing off the far better protections that had developed naturally as reputation-enforced honesty grew with the institutionalization of the market. In addition, even if the investor protection role could be performed adequately, the primary effect would only be to accomplish the avowed goal of giving investors confidence. While that sounds good, and is touted often, what such confidence actually does is dissolve the natural skepticism that investors have about strategies and people whose stories sound too good to be true. Such skepticism, which the SEC's very existence undermines, provides far more effective protection against fraud than anything that could be added by catching bad guys. So, while I used to think that repealing Section 11A, which contains the 1975 NMS Amendments, was the appropriate remedy, now I see that repealing the 1934 Securities Exchange Act itself, as well as all the other laws granting the SEC authority, and eliminating the SEC in its entirety, is called for. If the SEC disappeared completely, all of the intractable market structure maladies would start to heal themselves. And without the SEC's existence implying that investing is safer than it is, natural skepticism would return and provide far better protection than policing possibly can.

Sincerely yours,

Steve Wunsch