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Jonathan G. Katz  
Secretary  
Securities & Exchange Commission  
450 Fifth Street  
Washington, DC 20549-0609

**Re: File # S7-10-04**

Dear Mr. Katz:

Thank you for the opportunity to comment on the re-proposed Regulation NMS, File #S7-10-04. I write as an academic researcher who studies the structure of securities markets. As a financial economist, I would like to focus the Commission on the main economic principles involved, especially concerning the re-proposed trade-through rule. I conclude that if the Commission decides to implement a trade-through prohibition, almost all of the benefits can be achieved by protecting only the top of each venue's book.

What is the market failure that necessitates a trade-through prohibition? The main problem is an agency problem between brokers and their customers. Investors do not always make the order-routing decision. Instead, they typically hire a broker as their agent, and this introduces the potential for moral hazard. The broker may have an incentive to deliver a low quality execution, and it may be very difficult for the customer to monitor execution quality. To put it another way, there is a conflict of interest between the two that is hard to resolve without outside help.

Interestingly, the discussion in the current proposal is not centered on this potential market failure. Instead, the re-proposed Regulation NMS now focuses squarely on the externalities associated with public limit orders. The idea is that such limit orders are sources of liquidity supply. Since liquidity supply is a public good, these orders should be encouraged. If public limit orders are traded through regularly, liquidity providers may be less willing to provide liquidity, which could worsen overall stock market liquidity.

Despite the proposal's focus on the public good aspects of liquidity provision, the fundamental market failure is the agency problem. Public limit orders will suffer inappropriate trade-throughs only if there is an agency problem. A broker acting in the

best interests of a liquidity demander should ordinarily execute against the best-priced order or orders, and trade-throughs should not occur. The broker acting in the best interests of the liquidity supplier should maximize a limit order's exposure by routing it to an easily accessible venue. Without an agency problem between brokers and customers, there is no reason to implement a trade-through prohibition.

This is not just an academic discussion. It has direct implications for which orders should be protected. If the main agency problem is between brokers and retail customers, then trade-through protection should apply to the part of the book that is relevant for retail customers. If there is enough depth at the inside to satisfy most retail market orders, then protecting the top of the book is sufficient.

In contrast, suppose that an institutional trader demands a larger amount of immediate liquidity. If an institutional trader can monitor her broker's performance, this eliminates the agency problem between the two. In that case, both the institutional trader and her broker should want to access the best-priced orders (perhaps using an intermarket sweep order), regardless of venue and regardless of location in the venue's book. Formal trade-through protection is not required further down the book; the liquidity demander's self-interest (and the open access and automation provisions of Regulation NMS) naturally ensure that the best-priced limit orders execute first.

If this accurately describes US stock markets, almost all of the benefits of a trade-through prohibition can be achieved by protecting only the top of each venue's book. I and other researchers have written elsewhere that the underlying agency problem could be addressed with a lighter regulatory touch (see the earlier comment letter by the Reg NMS Study Group), but if the Commission has determined that a trade-through prohibition is in order, I would strongly argue that the top-of-book alternative is far superior. The benefits of the depth-of-book alternative would be extremely modest relative to the significant direct and indirect costs of implementation.

I hope the Commission finds these comments helpful in its deliberations.

Sincerely yours,

Charles M. Jones