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NYSE

January 12, 2005

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

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

Dear Mr. Katz:

We appreciate the opportunity to comment on the Securities and Exchange Commission's reproposal of Regulation NMS. For almost a year, the Commission and the industry have worked to hone this ambitious proposal to restructure our national market system ("NMS"). We are glad to see that this effort is close to bearing fruit, and believe that the process has focused on the relevant issues and that the Commission is largely headed for the correct results.

We agree with the Commission that Regulation NMS should benefit investors by facilitating a market structure in which they receive the best price on their transactions, while at the same time giving them the benefit of competition between the various markets trading stocks. It should also advance other important policy objectives that we identified in our July 1, 2004 comment letter and which the Commission reiterated in reproposing the rule. These include:

- promoting investors' ability to choose among alternative trading venues and order types,
- lowering costs to investors and to issuers raising capital by accommodating market models that minimize price volatility, and
- providing greater market transparency by offering investors widespread access to the market data of their choice.

For the most part, reproposed Regulation NMS is consistent with these three goals.

However, for one critical piece of its proposal, the trade-through rule, the Commission has proposed two alternatives, one of which is contrary to these goals. Under the first alternative, which we support, the best bid and offer in each market would be protected. This "Market BBO Alternative" will incent investors to become the best bid or offer in their markets of choice by providing them with the assurance that their best quotes will not be traded through. By encouraging markets and investors to quote aggressively, the Market BBO Alternative will lead to tighter spreads and greater liquidity.

In contrast, the second alternative, which mandates depth-of-book ("DOB") order routing, would effectively transform our competing markets into a homogenized government-mandated utility.

Until now, the Commission has successfully maintained the important balance between order competition and market competition that the 1934 Act requires. However, mandatory DOB routing eliminates intermarket competition by giving any limit order, regardless of where it was placed, the same protection. That would effectively transform the NMS into a virtual electronic Consolidated Limit Order Book, or CLOB. The Commission, after lengthy debate and careful deliberation, has wisely rejected this concept twice in the past and should similarly reject it now.

Intermarket competition has spurred innovation, leading to a variety of efficient trading choices for investors. Two of the most important ways in which markets compete are through price discovery efficiencies and order aggregation (i.e., providing market depth and liquidity by attracting multiple limit orders at each individual price point). Imposing a virtual CLOB on the U.S. capital market would stifle this intermarket competition, limit customer choice, discourage innovation and ultimately cause significant harm to investors.

Our concerns extend beyond the price-discovery role of the New York Stock Exchange to the overall competitiveness of the U.S. capital market and how our markets serve investors. One of the great competitive advantages of the U.S. capital market is that orders of institutional and individual investors interact, providing all investors, large and small, with equal access to the best price. In a virtual CLOB environment, where all orders must be disclosed in order to be covered by the rule and trading centers must break up trades in order to chase orders at multiple price points in multiple markets, large blocks of stock would become more difficult and costly to execute. Large orders can be expected to flee to private markets or overseas, where they will trade to the exclusion of retail orders. This market bifurcation would hurt all investors. Institutional investors will lose the valuable natural liquidity of retail limit orders, retail investors will lose the benefit of price improvement when a block trade occurs in a public market, and all investors will lose the pricing efficiency as a result of the bifurcation of orders between two markets.

Today, the preferences of investors and issuers, rather than regulation, determine which market models succeed. Investors in the U.S. capital market benefit from spreads that are among the tightest, and transaction costs that are among the lowest, in the world. They also benefit from the freedom to choose the place and type of execution that is right for their orders. Whether retail investors are purchasing 100 shares or institutions are purchasing 1,000,000 shares, investors have venue and execution options that enable them to receive the best price.

We applaud the Commission for the comprehensiveness and thoughtfulness of its reproposed Regulation NMS. As the Commission observed in its release, the need for change today arises out of the success, not the failure, of the NMS. Modernization and adjustment are necessary to synchronize the regulatory environment with changes in technology and trading strategies.

But the core concepts of the 1975 NMS legislation should continue to guide NMS policy considerations. The success of the NMS has largely been the result of competitive forces channeled by regulation that is practical while at the same time balances and promotes the benefits of order competition across markets and intermarket competition. We believe that the adoption of Regulation NMS with the Market BBO Alternative will continue and extend this collaboration between government and industry that has served the U.S. capital market so well for the last 30 years. We urge the Commission not to deviate from this path of success by forcing an unwieldy, untried and expensive system on markets where the risk of failure could significantly damage investor confidence, the functioning of our capital markets and our nation's economy.

Sincerely yours,

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth
Robert L. D. Colby

DETAILED COMMENTS

At the outset, we want to recognize the scope of the Commission's efforts in revisiting the core precepts of the national market system and to commend it for thoughtfully and carefully responding to the many diverse comments. With one important exception – mandatory depth-of-book ("DOB") routing – we believe that the revised Regulation NMS proposal presents reasonable approaches for dealing with difficult market structure issues, and will promote the core principles of the NMS. Those principles include best execution of investors' orders, efficient trading, reduced costs of trading for investors, reduced cost of capital for issuers, order competition and fair competition among markets. In particular, we believe that the proposal's enhancement of the current protection of best bids and offers represents an important step forward in the NMS.

Our July 1, 2004, comment letter on the Commission's initial proposal[1] describes our position on each of the four areas covered by Regulation NMS. Therefore, we will limit our comments in this letter to articulating why mandating DOB routing would undermine the competitive vibrancy of the U.S. capital market by creating a virtual Consolidated Limit Order Book (CLOB).[2]

The Commission has recognized that extending the trade-through rule to cover all NMS stocks could provide significant benefits to the U.S. capital market and to investors, and is proposing two alternatives. The Market BBO Alternative would provide price protection to the best bid or offer ("BBO") that each national securities exchange and national securities association disseminates for a NMS stock, provided that the quotation is immediately accessible for automated trading. The mandatory DOB routing alternative, in contrast, would require trading centers[3] to route orders to satisfy not only the BBO from each market, but also depth-of-book quotations that a market voluntarily displays pursuant to an effective national market system plan.

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[1] Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004). The Commission also issued a supplemental request for comments. Securities Exchange Act Release No. 49749 (May 20 26, 2004), 69 FR 30142 (May 26, 2004).

[2] Under separate cover, the NYSE will address the proposed market data allocation formula.

[3] The term "trading center" covers exchanges, exchange specialists, alternative trading systems, over-the-counter market makers and block positioners.

1. The Market BBO Alternative Will Be Consistent With The NMS Goals

In the Release reproposing Regulation NMS,[4] the Commission articulates four interrelated NMS goals. We briefly summarize the four goals here to facilitate our analysis of the two alternative versions of the trade-through rule.

The first goal is the interplay and balance between order competition and market competition. As the Commission states, "The NMS … incorporates two distinct types of competition – competition among individual markets and competition among individual orders – that together contribute to efficient markets."[5] Further, the Commission states that it

> has sought to avoid the extremes of (1) isolated markets that trade an NMS stock without regard to trading in other markets and thereby fragment competition among buyers and sellers in that stock, and (2) a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets.[6]

The second goal is to permit investors to choose between various market models without having the Commission mandate one specific type of model. The Commission states that Regulation NMS is "designed to strengthen and enhance the efficiency of linkages among the various competing markets, but without mandating any particular type of trading model." This will allow "[i]nvestor choice and competition" to "determine the relative success or failure of the various competing markets."[7] Today, in fact, investors may select the market model that best meets the standards they value from among a variety of choices, including electronic systems for investors seeking immediacy and floor-based venues for investors seeking price improvement opportunities through negotiated auctions.

The Commission recognizes as a third goal that any NMS proposal must "advance the principle of limit order protection while preserving intermarket competition and avoiding practical implementation problems."[8] Chairman Donaldson elaborated upon this principle when the Commission voted to repropose Regulation NMS for comment, stating that the Commission needs "to identify real problems, consider the practical consequences of the possible solutions, and then move pragmatically and incrementally towards the goals Congress staked out."[9]

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[4] Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004).

[5] 69 FR 77426.

[6] *Id*.

[7] *Id*.

[8] 69 FR 77427.

[9] "Opening Statements by SEC Chairman: December 15, 2004 Open Meeting" at 4.

Finally, as a fourth goal, the Commission recognizes that reducing trading costs for long-term investors is essential to reducing the cost of capital for listed companies "because the cost of capital of listed companies depends on the trading costs of those who are willing to accept the investment risk of holding corporate stock for an extended period."[10]

We believe the Market BBO Alternative will advance these four important public policy objectives.[11] By protecting the BBO of each market, the Market BBO Alternative will encourage aggressive quoting within markets and assure the interaction of orders across markets, while at the same time permitting markets to compete on the basis of costs, liquidity and other elements of service and market quality.[12] It will foster investor choice by avoiding the imposition of a single market model on investors.[13] It will be practical to implement without undue costs. In turn, these benefits will minimize trading costs for investors, reducing the cost of capital for listed companies.

2. <u>Mandatory DOB Routing Will Contravene NMS Goals</u>

The second alternative, mandatory DOB routing, is inconsistent with these four NMS goals. It will inevitably stifle intermarket competition and diminish order competition. It will eliminate investor choice by forcing markets into a virtual electronic CLOB. It will fail the test of practical implementation because it will be costly to implement, lead to order routing chaos that will ultimately isolate retail order execution from institutional execution and extinguish auction markets, including the NYSE's hybrid market model. Finally, because it will give rise to poorer executions and lead to the bifurcation of retail and institutional markets, it will increase rather than reduce trading costs for long-term investors. For these reasons, the Commission should reject the proposal to mandate DOB routing, just as it rejected similar proposals in 1978 and 2000.

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[10] 69 FR 77440.

[11] Moreover, the Market BBO Alternative will be far more effective in achieving these objectives than the suggestion offered by some that price protection should be limited to the NBBO. That suggested approach would only marginally promote order interaction across markets and would represent a step backwards for the markets for listed stocks where BBO protection has been in place for decades. In addition, it would be susceptible to gaming. For example, someone who wants to print a block outside better-priced quotes could fraudulently place a better-priced limit order for 100 shares in one market to avoid meaningful best price order protection, in contravention of the goals of the NMS.

[12] We recognize that quickly changing quotes could lead to a greater incidence of "false positive" reports of trade throughs. The benefits of requiring BBO protection far outweigh this risk, which can be managed by regulatory programs and the Commission's proposed "flickering quote" exemption.

[13] We agree that there is no need for a separate exception for the printing of elected "upstairs stops" priced away from the current market. Currently, any residual of those orders that misses the upstairs stop can be traded after the close and, for example, printed in our Crossing Session III (Guaranteed Price Orders).

A. The DOB Proposal Strikes A Suboptimal Balance Between Market Competition And Order Competition

In his opening remarks at the meeting that reproposed Regulation NMS, Chairman Donaldson reminded us that reconciling order competition across markets with market competition involves a trade-off:

> Congress asked the Commission to use its judgment to reconcile the twin goals of the national market system: to increase the display of orders and the number of buyers and sellers and thereby maximize liquidity, and at the same time to allow the forces of competition to drive the markets towards ever-increasing innovation and efficiency.[14]

At their extremes, order competition across markets and intermarket competition are mutually exclusive. To maximize intermarket order competition is to homogenize the markets and ultimately create a single, one-dimensional order-matching system. To maximize market competition is to create complete fragmentation.

Mandatory DOB routing skews the balance toward order competition at too great a cost to intermarket competition. It will virtually eliminate intermarket competition and, paradoxically, diminish order competition at the same time.

i. The DOB Proposal Will Virtually Eliminate Intermarket Competition

Markets compete in the three important ways:

1. The prices at which orders can be executed (efficient price discovery);
2. The depth and liquidity they can attract (order aggregation) to promote optimal pricing and accommodate large orders; and
3. The cost of executions.

Imposing DOB routing on the markets will eliminate the first two bases for competition. The ability for markets to compete on the basis of depth and liquidity will erode if all displayed orders can participate in the pricing of every trade.[15] This, in turn, will degrade the overall quality of prices that orders receive within each market, removing that consideration from the competitive equation as well. Instead, competition for limit orders would be based strictly on

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[14] "Opening Statements by SEC Chairman: December 15, 2004 Open Meeting" at 4.

[15] As a collateral matter, we are concerned that the DOB proposal will effectively nationalize each market's depth of book quotations, taking away important competitive incentives in terms of the revenue that markets may derive based on their ability to attract limit orders aggregated at multiple price points and their willingness to create innovative market data offerings. This will come about because a market would have to disseminate its order data through a national market system plan to include its depth of book, and under the current plan structure this means that a portion of the revenue derived from this data will be allocated to its competitors. This nationalization of DOB quotations is contrary to the Commission's separate proposal in Regulation NMS to permit markets to display their market data on an independent basis. It also prolongs the life of the market data consortia, which cause the various dysfunctional behaviors described in our July 1, 2004 comment letter.

execution costs and, in all probability, will push markets into a bidding war to purchase order flow, fueling a practice that harms our markets.[16] Limiting intermarket competition to a race to be the cheapest will also likely deprive markets of the resources they need to develop innovative new products and services, and to assure that their trading systems operate efficiently, securely and without disruption. As noted above, the end result is to homogenize the markets into a single, one-dimensional order-matching system.

ii. The DOB Proposal Will Diminish Order Competition

Mandatory DOB routing will diminish order competition by bifurcating the institutional and retail markets. Retail limit orders are a source of liquidity to institutional orders, and block crosses can often provide retail investors with better prices due to gap pricing. Yet, as described in Section C.i. below, institutions and their brokers will find it increasingly difficult to execute large orders in the electronic virtual CLOB that mandatory DOB routing will create.

Buy-side firms also do not typically want the full size of their buying or selling interest publicly disclosed for fear that doing so will reveal important trading information to other market participants, ultimately raising their execution costs. Protecting their orders against trade throughs through mandatory DOB routing will do nothing to reduce this risk; indeed, it would exacerbate it because it would tend to force the display of latent interest as limit orders.

Large institutional orders would likely migrate to private markets or “upstairs” trading desks to be executed and reported outside of market hours or in foreign venues. As a result, mandatory DOB routing would bifurcate the U. S. capital market into public retail markets operating within the NMS framework and private institutional markets operating outside the reach of the rule’s responsibilities.

The benefits that both types of orders enjoy when institutional and retail order flow interacts will be lost. Without large institutional investor participation in the NMS, spreads will widen, and execution quality for retail investors will deteriorate as liquidity evaporates in public markets.

B. The DOB Proposal Will Diminish Investor Choice

We agree with the Commission that the Regulation NMS framework should allow investor choice and competition to “determine the relative success or failure of the various competing markets” under a “framework within which competition among individual markets can flourish on terms that ultimately benefit investors.”[17] By virtually eliminating intermarket competition, mandatory DOB routing will diminish investor choice.

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[16] The NYSE continues to believe the Commission should ban payment for order flow, a practice fraught with conflicts of interest. Such payments interfere with the ability of retail orders to interact with each other and obtain the best execution price. In payment for order flow arrangements, individual investors rarely get the opportunity for an execution at the midpoint of the spread or better.

[17] 69 FR 77426.

Investors and issuers benefit from different types of market models that compete with one another by providing different order types and services. The Commission's statistics cited in the reproposing release show that our floor-based auction combined with the current trade-through rule provides lower price volatility and far greater certainty of execution for larger size orders.[18] We believe this is due to the value that auction markets create by aggregating liquidity at a single point of sale. If auction markets must implement mandatory DOB routing, they would be forced to provide uniform execution facilities that disperse this liquidity by chasing quotes that will often disappear almost immediately after they are posted.

Recognizing the disparity between fill rates, as well as the opportunity to access reserve liquidity, buy-side firms and their brokers have developed so-called smart routers that analyze the quotations disseminated by various markets and route orders to them in accordance with a number of factors. One factor is the likelihood that an order routed to that market will in fact be executed. Mandatory DOB routing would force these firms to abandon their intelligent routing systems in favor of uninformed government-mandated routing, which will invariably lead to worse executions.

C. The DOB Proposal Cannot Meet The Test Of Practical Implementation

Mandatory DOB routing will not meet the Commission's stated goal of practical implementation.[19] Consistent with Chairman Donaldson's remarks at the Commission's December 15th open meeting, the Commission should "consider the practical consequences of the possible solutions, and then move pragmatically and incrementally towards the goals Congress staked out."[20]

The practical consequences of mandatory DOB routing would be debilitating for the NMS. It would seriously damage the efficiency and fairness of the markets resulting in bad execution experiences for investors and render floor-based auction markets inoperable.

i. The DOB Proposal Will Create Market Inefficiencies And Unfairness Resulting In Bad Execution Experiences For Investors

As explained above, the DOB proposal will compel exchanges and broker-dealers on behalf of their customers to implement uninformed, government-mandated routing decisions that chase orders throughout the NMS. This would carry with it a high risk of obtaining worse execution prices when orders cannot be filled at the routed market, miss liquidity in the original market of choice and lose standing on their return. As a result, large orders would be splintered into tiny trades to pursue fragmented volume across several price points and several markets – volume that may well disappear within milliseconds of being displayed.

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[18] The SEC's analysis reveals that, compared to NYSE-listed stocks, Nasdaq-listed stocks experience higher price volatility and a higher percentage of trade throughs. See 69 FR 77431-33.

[19] 69 FR 77427.

[20] Opening Statements by SEC Chairman: December 15, 2004 Open Meeting, at 4.

While the risk of low fill-rates would also exist with the Market BBO Alternative, that risk will be confined to one price point at each market. As this principle of mandatory routing is extended up and down the depths of all markets' books, the benefit to investors declines as the quality of the execution experience is degraded.

ii. The DOB Proposal Will Not Achieve The Stated Objective

The DOB proposal will also cause a higher occurrence of trade throughs due to reserve size. As the Commission has pointed out, mandatory DOB routing would not even achieve its goal of protecting displayed limit orders.[21] Displayed limit orders could be traded through without protection, since markets are permitted to execute against reserve orders rather than allocate the routed shares to displayed orders. Therefore, displayed orders will be traded through to the extent that routed shares are executed against reserve interest.

iii. The DOB Proposal Will Render Floor-Based Auction Markets Inoperable

It will be virtually impossible for a floor-based auction market to effectively price block-size orders if it is necessary to track the entire depth of book in each market, especially when the quotations in those markets are constantly changing. Under the Market BBO Alternative, the market would have to integrate a single price point from up to nine other markets (seven exchanges, Nasdaq and the ADF) when pricing a block transaction. This entails a cost, but that cost is reasonable when compared to the benefits from protecting the most aggressively priced limit orders in the NMS. With mandatory DOB routing, the obligation to track quotes and route orders would rise dramatically, as well as the execution costs due to uneven fill rates. If a large order were priced 5¢ away from the NBBO, a market would have to track as many as 50 or 60 constantly changing quotations. This would lead to order routing chaos, as market centers attempt to access the same quotes simultaneously. The experience of investors accessing the market under these circumstances would be negative, and investors would hold market centers responsible for these adverse effects.

For the same reasons, the NYSE's proposed hybrid market model cannot co-exist with mandatory DOB routing. We designed the hybrid market to have as many quotations as possible available for automated execution, while providing for the interaction of institutional and retail order flow, negotiated price discovery and the opportunity for the price improvement of a floor-based auction. The structural changes associated with the hybrid market model are widely supported by our customers, who want to have the choice of representing orders in both electronic and auction platforms. They support the hybrid market as an innovative and promising initiative.

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[21] 69 FR 77411.

D. The DOB Proposal Will Increase Investors' Trading Costs And Issuers' Capital Costs

The DOB proposal will increase trading costs for investors as orders chase elusive quotes and by bifurcating order flow into retail markets and institutional markets. This will increase issuers' capital costs because, as the Commission has noted, "the cost of capital of listed companies depends on the trading costs of those who are willing to accept the investment risk of holding corporate stock for an extended period."[22]

All market participants ought to be concerned about the potential dissolution of the auction market model. Our market model – chosen for the execution of 80% of the listed volume executed today – could not exist in an environment of DOB routing. Yet, the Commission's own studies show that this model lowers trading costs for investors,[23] reduces volatility and, therefore, lowers the cost of capital for issuers.[24]

3. <u>The Costs To Implement The DOB Proposal Will Greatly Outweigh Any Possible Benefits</u>

The Commission has provided only a perfunctory cost benefit analysis of requiring DOB routing. We believe the proposal will impose significant implementation and operating costs on the markets and on market participants, layered on top of the substantial costs in terms of market degradation and harm to investors described in Section 2.C. These costs would inevitably be borne by investors. Moreover, as we have described, the DOB proposal fails to achieve the benefits that would justify these costs.

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The Commission quite rightly points out that the "NMS needs to be enhanced and modernized not because it has failed investors, but because it has been so successful." Just as Congress predicted, this success has largely been the result of competitive forces accompanied by practical regulation. We believe that the adoption of Regulation NMS with the Market BBO Alternative will enable market competition and quote competition to thrive within a regulatory framework that protects investors. That balance has served investors and issuers well for the last 30 years. We urge the Commission not to deviate from this path of success by forcing an unwieldy, untried and expensive system on markets where the risk of failure could significantly damage investor confidence, the functioning of the U.S. capital market and our nation's economy.

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[22] 69 FR 77440.

[23] 69 FR 77433.

[24] 69 FR 77433.