Rules-comment@sec.gov
Subject: NYSE SR-2004-05 Release: 34-50173
Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to Enhancements to the Exchange's Existing Automatic Execution Facility (NYSE Direct+)
From: Junius W. Peake

This e-mail presents my comments on the above-captioned proposed rule, and may also be considered as additional comments on Release 34-49325, proposed Regulation NMS.

It is interesting, to say the least, that there have only been four comment letters sent to the Commission on this proposal until today, September 22nd, considering that the comment period was extended from September 7th to September 22nd. Perhaps since today is the deadline, there will be others.

Three of the four comment letters were very critical of the proposed rule changes. The fourth one, from James L Rothenberg, addresses only one aspect of the proposed rule: short selling.

The latest of the four, from Telic Management LLC, says the following:

"*The proposal is written in vague language and does not spell out many of the details required to understand exactly how this hybrid market will function in practice and if it really will meet the needs of the investing public.*"

They also noted:

"In our opinion, this is a failed opportunity at meaningful market structure reform. In a real time/price priority market, all liquidity providers would compete on an equal footing."

The Interactive Brokers Group wrote, as follows:

"…the rule proposal as drafted does not provide the public with a sufficient basis to offer informed comment, nor do the proposed rules provide any assurance to the public or the Commission of exactly how the market would operate if approved."

Fidelity Investments wrote, as follows:

"We recommend that the Commission:
1. Direct the NYSE to re-file its proposal and to include as an attachment a "plain English" explanation."

The New York Stock Exchange ("NYSE") proposed amendments to their Direct+ system are the technological equivalent of attempting to strap a jet engine onto a World War I Sopwith Camel biplane, and declaring it now to be a "modern" airplane. They do nothing to further the development of a national market system. In fact they take it in a retrograde direction by adding almost unbelievable complexity.

As a consequence, the proposed amendments should not be approved.

One fact is that a securities market is a natural monopoly. Having a single system is not "anticompetitive." In fact, having all bids and offers able to interact instantly make for the ultimate in competition in the one area that needs to be made competitive: price.

As long ago as 1979, that fact was stated clearly in sworn testimony before the Subcommittees of Oversight and Investigation and Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce of the House of Representatives by Professor James Lorie of the University of Chicago and a member of the National Market Advisory Board of the Commission, as follows:

"I think we all should recognize that a security market is a natural monopoly. That is what we tacitly acknowledge when we say all the buy and sell orders should meet within the same system. There should be only one system and it is important that there be access to the system by all qualified brokers and dealers.

and,

Now picture such a system, Mr. Chairman (Representative Eckhardt), for just a moment. All the bids and offers with volume and prices are freely available to everyone in the system. All broker-dealers can see all the bids and all the offers, not the identity of the bidders and others, but volume and prices.

If a little broker-dealer in Tacoma, Wash., wanted to interject a superior bid or offer into the system, that little broker-dealer in Tacoma, Wash., would know that it would be first in line when the stock moved to that bid or offer.

Merrill Lynch with all its size ands all of its clout and all of its resources could never get ahead of them. The importance of price and time priority is that it places the little fellow in Tacoma, Wash. on the same footing as Merrill Lynch.

and,

Now, the cost of this system will be very, very cheap. It will be like making a phone call. It will be possible to inject a bid or offer into the system without a lot of capital."

The Commission agreed with Professor Lorie. Their proposal was the creation of a file for the consolidation and accessible display of all orders, known colloquially as a CLOB ("Composite Limit Order Book"). The CLOB was proposed as far back as 1975 by the

Commission. But four years later the idea of a CLOB as the ideal national market system structure was overwhelmed by NYSE and OTC dealer lobbying and objections, causing the Commission to drop the idea in 1979, at least for the time being. Here are the Commission's words:

1975

"c. Limit Order Protection. By 1975, the Commission already had taken some steps toward the creation of a mechanism to ensure nationwide protection for limit orders. In the Commission's opinion, such protection was achievable by using the advanced technology then available to provide for a computerized central limit order repository, or composite book ("CLOB"). As envisioned, the CLOB would incorporate both public (i.e., agency orders for persons other than brokers or dealers) and professional limit orders. Such a limit order book would permit the effective integration of existing exchange and third market makers by ensuring continuation and extension of the public's ability to obtain priority in competing for executions. The CLOB also would provide an efficient and practical means to protect all limit orders on a national basis."

(MARKET 2000 REPORT: Study I, Introduction and Historical Background, SECURITIES AND EXCHANGE COMMISSION, January, 1994)

"…it appears necessary at this time to promote rapid development of a central electronic depository for limited price orders (a "composite book ") to ensure integration of the markets in an environment of significantly enhanced competition among market makers nation-wide protection for limit orders and augmentation of existing opportunities for public orders to meet without the participation of a dealer."

(SECURITIES EXCHANGE ACT OF 1934, Release No. 11942, December 19, 1975)

1976

"The commission believes that there is a need for further modernization and improvement of our securities markets...Further, existing limit-order mechanisms are unable to provide nationwide limit-order protection, and thus cannot always provide the degree of protection for limit orders which hopefully could be furnished by a composite book.

"Finally, a composite book appears to be well-suited to assuring an opportunity for public orders to meet without the participation of a dealer."

and

"A composite book would permit the effective integration of existing market makers (both exchange and third market); in addition, such a book would provide brokers and dealers with an efficient and practical means by which all limit orders, regardless of origin, can be protected on a national basis."

and

"Accordingly, the Commission intends to utilize its authority under the Act (particularly Sections 2, 3, 6, 11, 11A, 15, 15A, 17, and 23 thereof) to facilitate the development of a composite book."

(Securities and Exchange Commission, Release No. 34-12159, March 2, 1976)

1977

"A. Fragmentation

In the December Release, the Commission indicated that is intended to devote further study to whether removal of off-board principal restrictions would contribute substantially to fragmentation of the markets, and, if so, whether Commission action to require development of a composite limit order book ("composite book ") or some other Commission regulatory initiative would be appropriate to ameliorate the effects of such increased fragmentation. Potential fragmentation resulting from removal of off-board principal restrictions was discussed in the December Release in several contexts in light of the likelihood that increased over-the-counter market making would divert order flow in listed securities from existing market centers (including, particularly, the primary exchanges). The Commission gave particular attention to (i) the possibility that such a diversion of order flow, combined with an increase in the number of over-the-counter market makers in listed securities, would impair pricing efficiency, and (ii) the possibility that the quality of brokerage services generally, in terms of brokers' ability to seek out and achieve "best execution" of customer orders, would be adversely affected by the proliferation of market centers to which orders might be directed."

and

"While the possibility of further fragmentation of the markets remains a matter of concern, it has not been demonstrated to the Commission's satisfaction that a significant increase in fragmentation is an unavoidable by-product of Commission action to free the trading markets of the burdens on competition represented by off-board principal restrictions. In addition, if a significant increase in fragmentation is indeed more than a mere theoretical possibility, the Commission does not yet perceive why, as discussed below, the adverse effects of any such increase would not be prevented or ameliorated as a natural consequence of competitive forces in the market place. Finally, if competitive forces alone (considered in light of evolving information and order routing systems) are insufficient to combat those effects, regulatory initiatives, such as rules imposing new duties on brokers and dealers or compelling development of a composite book, would presumably be adequate to address that problem."

(OFF-BOARD TRADING RESTRICTIONS SECURITIES AND EXCHANGE COMMISSION SECURITIES EXCHANGE ACT OF 1934 Release No. 13662, June 23, 1977)

1978

“The commission continues to believe that one of the basic principles upon which a national market system must be based is the assurance that all agency orders in qualified securities, regardless of location, receive the benefits of auction-type trading protections.

“To this end, the commission believes the several self-regulatory organizations should take joint action promptly to develop and implement a central limit-order file for public agency orders to buy and sell qualified securities in specified amounts at specified prices...

“The objectives of a central file are relatively simple: to make available a mechanism in which public limit orders can be entered and queued for execution in accordance with the auction-trading principles of price and time priority.”

(Securities and Exchange Commission, Release No. 34-14416, Jan. 26, 1978)

But in 1979, bowing to industry pressure because of feared financial consequences, they wrote:

“The commission received several proposals describing alternative means of achieving the goal of nationwide limit-order protection. The National Association of Securities Dealers submitted a "Technical Plan for the Development of a national market system," describing an electronic facility (based upon the technology and hardware of the existing Nasdaq system) functionally similar to the central file proposed by the commission.

“The technical plan contemplates that any qualified broker could enter limit orders into the facility for execution by qualified market makers based upon price and time priority within the system. The NASD's board of governors, however, expressly reserved judgment on the policy and regulatory issues associated with implementation of the facility described in the technical plan.

“Specifically, the NASD noted that further study was necessary to determine whether exclusion of non-public limit orders from the central file and whether protection of orders entered in the file against executions at the same price as well as executions at an inferior price would be appropriate.

“Most other self-regulatory organizations opposed creation of a central file...These commentators argued that the absolute time priority proposed to be afforded public limit orders entered in the central file would have significant deleterious effects on the exchange-trading process.”

(Securities and Exchange Commission, Release No. 34-15671, March 22, 1979)

Although the Commission has repeatedly stated they want competition among market centers trading the same securities at the same time, they have created the technological equivalent of having multiple, competing traffic controllers at the same airport: complicated, expensive, and dangerous.

It is far past time to revisit and dust off the Commission's original, brilliant idea of a real central market system," a CLOB. I am very aware that there are powerful political forces as well as industry players who will take every possible step to thwart the development and implementation of a fully-automated price-time priority system.

The pressure on the Commission must be tremendous to keep as much of the *status quo* as possible. I know it has been so in the past from personal experience. But now, at a crossroads in market structure design, it is important the Commission demonstrate its independent charter and do what is best for the investing public.

The year 2004 finds the Commission at a most important crossroads: It can either mandate a convoluted, expensive and relatively inefficient market structure, such as proposed by Regulation NMS, and complicated exponentially by the proposed amendments to the NYSE's Direct+ system, or finally cut through the political minefield which has prevented a true, modern, automated system that creates the national market system envisioned by both the Congress and the Commission when Section 11A of the Securities Exchange Act of 1934 was enacted in 1975.

The best way to do this is to create a CLOB pilot system, say for 250-500 securities—listed and OTC—and test this system against present systems.

The market structure that has evolved up until the present time still maintains three disparate elements that are cumbersome, slow, costly and ineffective: (a) a "consolidated quotation system" which displays quotations from the many disparate market centers, although many are unreachable, and there is no assurance that the quotations will be honored when an executable trade is entered; (b) the "Intermarket Trading System,"[1] where orders sent to one market center are bussed to another which shows an apparently better quotation; and (c) a separate "consolidated tape," which reports trades after they are made.[2]

[1] At the joint House hearings in 1979, the then president of Merrill Lynch, William Schreyer, testified under oath about the ITS system, as follows.:

"The Intermarket Trading System, or ITS, which links the New York with some of the regional exchanges, is a communications device, and nothing more. It is as far from the concept of an automated, efficient trading system as a tom-tom is from a communications satellite."

[2] An analogous system would be an automated bank teller system designed with three separate components: (a) a device that would permit the customer to determine his/her balances; (b) a device that would dispense the withdrawal; and (c) a device that would print out the transaction. At the joint House hearings in 1979, the then president of Merrill Lynch, William Schreyer, testified under oath about the ITS system, as follows:

Turning to the NYSE's most recent proposal, it still has not been able to develop a coherent, straightforward plan to allow electronic execution of orders. To give but one random example of the NYSE's obtuse language in its proposed new rule,

"Autoquote will not be available when the specialist has gapped the quotation in accordance with Exchange policies and procedures, when a liquidity replenishment point ("LRP") has been reached, or during the time a report of a transaction is being made through the book.

After the specialist has gapped the quotation, autoquote will resume with a manual transaction or the publication of a non-gapped quotation.

Autoquote will resume as soon as possible after a LRP has been reached, but in no more than five seconds where the auto ex order that reached the LRP is executed in full, or any unfilled balance of such order is not capable of trading at a price above (in the case of a buy order) or below (in the case of a sell order) the LRP. Where the unfilled balance can trade at a price above (below) the LRP, but does not create a locked or crossed market, autoquote will resume upon a manual transaction or the publication of a new quote by the specialist, but in any event in no more than 28 seconds. Where the unfilled balance can trade at a price above (below) the LRP and creates a locked or crossed market, autoquote will resume upon a manual transaction or the publication of a new quote by the specialist."

The NYSE's proposal is structured to maintain the privileged role of specialists. But in 2004, are specialists still needed, or would market work to the advantage of investors if they no longer existed?

Here's what the Commission has written about the role of specialists:

"…except for providing "continuity" (which is objectively measurable), specialists' other "affirmative obligations" to provide "liquidity" and "depth" (which are not objectively measurable) have not been demonstrated to force a specialist, as a general matter, to act against which he perceives to be his interest…"

(Securities and Exchange Commission, Release No. 34-12159, March 2, 1976)

According to the NYSE's web site, specialists perform the following four functions:

- ***Auctioneer***
  The specialist continually shows the best bids and offers throughout the trading day. These quotes are disseminated electronically through the NYSE quote and other market data systems that transmit the information instantly worldwide. The specialist maintains order in the crowd and interacts with agents representing customers.
- ***Agent***
  A specialist is the agent for all SuperDot® (electronically routed) orders. A floor

broker may also choose to leave an order with a specialist to represent it until it can be executed at a specified price. This frees brokers up to concentrate on other orders that require their immediate attention. As agent, a specialist assumes the same fiduciary responsibility as a broker.

- ***Catalyst***
  Unique to the agency-auction is the specialist as a conduit of order flow. The specialist knows who has been interested in a stock, and keeps track of all known interest. As all buyers and sellers aren't always represented in the crowd at the same time, the specialist can call in all interested parties to let them know what has become available in the market. By giving updates to a previously interested party, a specialist helps trades occur where they otherwise might not happen.
- ***Principal***
  Specialists, in order to fulfill their role, agree to several obligations. The first is to place and execute all customer orders ahead of their own. At the NYSE, three out of four transactions take place between customers, without the capital participation of the specialist.

There seems to be general agreement that the first two functions can be equally or better performed through a fully-electronic system.

The last two are set forth as the essential reasons for continuing the specialist system. But an examination of those two functions, Catalyst and Principal, demonstrate they are not necessary as set forth in NYSE rules.

As “catalyst,” the specialist has confidential, unique knowledge of the prospective intentions of many large traders. If the specialist knows, for example, that there will be a large seller coming into the market later in the trading day, this knowledge is very valuable. However, the specialist is also instructed to represent orders (in this case, buy orders) as though nothing will happen to cause the price to decline. When doing so, the specialist is the agent for the buyers, and owes them his fiduciary responsibility. Until the large sell order arrives, the specialist is supposed to operate as though it doesn’t exist, thus disadvantaging the buyers for whom he is their agent.

If learning about potential buying and selling interest is valuable—which it is—there is no reason that competitive forces cannot create and market “potential order” systems outside the trading arena. This would remove the monopolistic position of the specialist, and make the market fairer. Actually, very few traders—especially institutional traders would be willing to disclose their intentions. Traders would like to know what everyone else is planning, but to keep their own intentions secret.

As “principal,” recent events have all too plainly demonstrated that all seven of the NYSE’s specialist organizations have been delinquent in their duties, and have settled complaints to the tune of nearly a quarter of a billion dollars.

In addition, specialists (and other market makers) do not provide “market wide,” or “macro liquidity.” What they offer is “micro liquidity,” since the positions they take—long or short—they wish to reverse as quickly as possible.

The economic function performed by these specialists and other market makers is equivalent to that of used car dealers. Used car dealers buy unwanted inventory from retail and wholesale customers and immediately attempt to resell it to new customers at a profit.

In a fully-electronic market the spread between disclosed bids an offers would be visible to the entire marketplace. If any would-be market maker believed the spread were large enough to contain a potential profit the market maker could narrow the spread, hoping to buy “at wholesale” a position the market maker could then sell at “retail.” Only when a non-market maker takes the unwanted position is macro liquidity achieved.

One loudly trumpeted argument against a CLOB is that it would stifle competition. But competition for what? In fully-developed national market system every bid would be competing against every offer in that security. The only way this can be accomplished is through the features now capable because of electronics.

This point is well made in the comment letter sent to the Commission, written by George U. Sauter, the Managing Director of The Vanguard Group, Inc., on July 14th, 2004.

“We prefer a system of market linkages that provides immediate access to the NBBO, essentially functioning as a national CLOB. Opponents of this concept claim that there would be no incentive for innovation. However, we observe today that marketplaces compete even when they do not have the best bid or offer. They route to the best bid or offer on another market and attract orders by competing on price (commissions), better service and trading enhancements, as they become a portal into a larger market system. Innovations, such as a reserve book or other service, still provide a competitive advantage.”

and more:

“If there were only one marketplace, or a centralization of the marketplace in a Central Limit Order Book (CLOB), then there would be no need for a trade-through rule.”

Another claim made by the NYSE is that specialists are essential for maintaining a “fair and orderly market.”

Even ignoring the plain fact that most issues do not trade on a stock exchange with specialists, and seem to do so successfully, a fully-electronic, price-time priority would allow for total transparency of the supply-demand being shown. There would no longer be a need for a “market” order, as is required at the NYSE because of the lack of complete bid and offer information. With the full availability of the supply/demand schedule, liquidity will be as readily available as possible for each issue.

On March 23, 2003, Mr. Harold Bradley , Senior Vice-President of American Century Investment Management, made a PowerPoint presentation to an audience of institutional investors. One of the slides he presented was a PowerPoint slide I had made in February, 1995 for a TraderForum Conference in New York City to an audience of institutional traders. On the next page I have attached that slide, which lists the percentage of institutional traders at the conference who wanted certain defined characteristics. As an aside, you will note than in 1995, five years before decimalization started, three-quarters of those voting desired decimals. The rest of the desired characteristics speak for themselves.

Members of the Commission, it is more than timely that the Commission go “back to the future”, to allow the national market system envisioned by the Congress nearly three decades ago to be completed. Thank you for the opportunity to comment once again.

Very truly yours,

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Characteristics of an Investor's Trading System

	Yes	No	Don't Know	N.A.	Total	Yes
Order Anonymity	43	0	0	1	44	98%
Maximum Order Confluence	38	1	0	5	44	86%
Decimal Prices	33	10	0	1	44	75%
Time Priority of entered orders within price	38	2	4	0	44	86%
Single price auction at opening	31	8	2	3	44	70%
Full, but anonymous, disclosure of supply/demand schedule	40	1	0	3	44	91%
Free entry and exit by those offering micro liquidity	37	5	2	0	44	84%
Multilateral price negotiation capability	39	1	1	3	44	89%
Integration of price discovery, execution and transaction reporting	43	0	0	1	44	98%

Source: Trader Forum, February 2, 1995,
Junius Peake, University of Northern Colorado.