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Jonathan Katz, Secretary
Securities and Exchange Commission
450 Fifth Street NW
Washington, DC
May 24, 2004

RE: S7-10-04

Dear Mr. Katz;

In addition to the Market Data System proposal, commented on in my May 16 & 17, 2004 letters, the subject release (The Release) proposes rules regulating trade-throughs across markets, market access fees, and the use of sub-pennies in quotations and last sale prices.

My background as a former Chief Economist and Senior Economic Advisor for the SEC (1969-1982), former Chief Economist for NASD (1983-1995), a former outside Director on the Boards of Ameritrade Holding Corporation and Knight Trading Group and as a proponent of the direct investing individual investor motivates me to also comment on The Release's proposals to adopt new NMS rules.

With respect to each of the rule proposals (including the market data proposal) The Release identifies anti-competitive practices or related regulations that are identified as causes of the NMS problems being addressed. Any such rules and practices should be eliminated, without regard to other elements of this Release. Indeed the Commission should be searching for such rules as the first step in any market structure proceeding.

In particular, The Release fails to review the small order best execution requirement to search for un-displayed bids and offers i.e. potential price improvement. It is a major regulatory factor affecting the NBBO and institutional quotes display problems referred to in The Release.

Similarly, some of the problems of concern in The Release, namely institutional liquidity, ATS business model viability and impacts on viability of SRO market centers of eliminating inequitable and/or anti-competitive practices, are not really a proper focus of Commission regulation. Rather they are matters of economic competitiveness and their resolution should be left to competition to resolve.

In short The Commission's NMS regulation appears to be attempting to regulate market structure economics, instead of focusing its regulatory efforts on equity, fairness, and the maintenance of a fair field of competition between and among participants, as Congress intended.

Best Execution Regulation

The most serious problem, hardly considered in The Release is the effect of best execution regulation on market distortions and inefficiencies that the proposals are intended to correct.

Through "price improvement" regulation applied aggressively to the routing of small investor orderflow, the SEC attempts to force much of the liquidity, spread, information and market data value of that orderflow to be transferred, free of competitive costs, to other market participants. This is done under the banners of “best execution” and “meeting of public orders without the intervention of a dealer”

In the process market transparency, the efficiency of the execution of small investor orders, and indeed the market’s fairness are reduced. Price improvement is only possible where unexposed bids/offers exist in a market center. If a market’s price improvement record is high, its quotation price quality (i.e. transparency of resident bids and offers in the NBBO) is low.

The Release emphasizes the NMS transparency and efficiency goals of the SEC; but best execution price improvement regulation of small orderflows works against those goals and against the interests of small investors.

Regulation is forcing small market order customers to grant free options to unexposed bidders/offerors often in un-automated processes. The option to “lay in the weeds” in a market center facility and either execute or not execute against incoming market orders in front of published bids/offers has a value that regulation is transferring from small customers to large customers.

Ironically, the market center with the most unexposed bids and offers is rewarded with greater order flow, not by competition, but by best execution enforcement. Regulation removes the competitive pressure on unexposed bidders/offerors to publish their bids and offers to attract interest, and indeed to automate their execution processes, reducing NBBO competition. This reduces the quality of the NBBO affecting all investors.

Regulating Market Structure Economics

The Commission is attempting to regulate economic efficiency, not the equity and fairness of the market. For example,

The Release states:

“Institutional investors have indicated that they need more effective ways to interact directly with large size trading interest on the other side of the market. Nevertheless, these costs appear to have risen substantially during the same time period that smaller order execution costs have dropped dramatically. Given the troubling nature of this trend, we cannot afford to be satisfied with the status quo as regards the efficiency of the NMS. A critically important goal of the proposals is to enhance opportunities for the direct interaction of investor buying and selling interest and to improve the depth of public price discovery.”

The Release would impose regulations that would raise the transactions’ costs of small individual investors whose bids and offers are displayed in the NBBO; but it does not consider modifying the best execution interpretation and allowing competing participants to ignore un-displayed interests.

The Release itself notes that:

"…little incentive is offered for the public display of customer orders - particularly the large orders of institutional investors."

Why would institutional brokers display pricing interest if they can persuade the SEC to require online brokers to route their orderflow for "potential price improvement"?

The best way for the Commission to improve prices for the benefit of all participants and improve the quality of the NBBO is to allow competition to incent the economic display of institutional pricing interest by allowing other investor automated orderflows to ignore un-displayed interests as they execute in completely automated, efficient, low cost, virtually instantaneous, trade execution processes.

Unequal Competition

The Release states that more regulations are needed to increase the "direct" interaction of "investor" buying and selling interests, because small order costs are so low and large order costs are so high.

In other words the intermediary dealers who execute small investors' market orders in 3to 5 seconds should be replaced with agency processes that have slower, less flexible execution abilities, and/or market centers that decline to have efficient automatic execution mechanisms and encourage the non-display of bid and offers.

Small investors' do not need more regulations to further reduce the ability of their brokers and dealers to keep their costs low, especially, rules that require them to absorb access fees to preserve ATS viability, trade-through rules that permit large investors to opt out, and/or rules that shift market data surpluses, extracted from small investors, to markets that serve large investors.

The Commission needs to focus more on equity and fairness and less on the welfare of inefficient participants threatened by competition.

Also, the Commission needs to read their own release. Congress did not say force the meeting of public orders, require the meeting of public orders, or even maximize the meeting of public orders. They said facilitate the meeting of public orders consistent with the efficient execution of transactions and with equitable and fair competition among participants.

The Commission should not adopt any rules that increase the costs of handling and executing small investor orders simply to reduce the transactions costs of other investors or to protect market centers that are otherwise not economically viable.

Trade-throughs and an imperfect NBBO will continue irrespective of Commission actions applied to small investor, and the brokers and marketmakers that serve them, if regulations continue to cause the shifting of trading costs from the less efficient to the more efficient market participants.

Trade Throughs

The new trade-through proposal appears to extend broker and dealer execution obligations to include protecting the other side of the market and competitors' quotes, irrespective of costs and failures of some market centers to display pricing interest in completely automated execution systems.

The Commission should not even consider rewarding foot draggers, trying to used regulation to save on technology costs or otherwise obtain some competitive advantage in interacting with orderflow. Any quote not automatically executable should be deleted instantaneously from the NBBO by the exclusive processors and reviewed. Similarly any trade reports at inferior prices should be screened from the last sale stream and reviewed.

The Release did not quantify the trades at inferior prices broken down by cause. The Release notes that there are several purely statistical time anomalies and some trade throughs that are unavoidable. However the statistical significance of these disparities is not clear.

Coverage of the Market Data System

Commission regulation assumes that investors need to see every trade report and every quotation for the market to be fair and for allocational and mechanical efficiency to be achieved. That leaves no room for error and requires much more detailed and costly self-regulation and investment in equivalent processes. The true costs of regulation, hidden in commissions and spreads, have become a large part of investor transactions costs.

The Market Data System need not include every trade and every quotation regardless of their quality and relevance to the market. At some point there is a cost of regulation that is not acceptable relative to the value of the information to investors.

Indeed, trade throughs, about which nothing can be done, must be analyzed by regulators and market operators; and that knowledge contributes to investor understanding of market imperfections. However, while disconcerting, they are of questionable pricing value to investors whose orders cannot reach those bids/offers. They add no useful actionable information.

Conversely, price reports that result in trade throughs of the NBBO may be of great value to the market center and investors executing the trades because they need “tape prints” to make their trades within the market. Such disparity in incentives argues that the Commission should not regulate trade throughs by extensive regulations and regulatory costs imposed upon the order routing of small investors’ orders. Rather the Commission should require that the reporting of trades outside the NBBO should be for regulatory purposes only and such trade reports screened from NBBO displays.

By screening quotations and trade reports that do not meet minimum standards from the exclusive processor displays, the Commission can set standards applicable to all participants equitably and avoid much of the unequal economic impacts of regulation on competing participants.

Small investors can function effectively without 100 percent of real-time market data. This is demonstrated by the ability of many small online investors to manage to keep their trading costs low despite having to rely on Yahoo real-time market data that include only about 20 or 30 percent of the total real-time trades and quotations information.

Moreover, an executing broker should not be obligated to route orders outside of automated systems; nor should they be required to give to competitors the priority and size that they provide to customers.

Requirements to deal with competitors negate competition between market centers, a result never intended by Congress. The NBBO mixes gross (agency) and dealer (net) prices and retail (investor) and wholesale (dealer) quotations and trade prices. Moreover unregistered limit order traders compete with registered dealers for quotation spreads paid by market order investors.

The Commission needs to pull back from regulatory attempts to make participants give the same service to competitors that they give to their best clients. Commission rules should not restrict artificially the services that marketmakers and ECN's extend to small investor clients. Rather the Commission should leave to competition the determination of mutual arrangements to deal among competing participants.

Access Fees

Similarly, the Commission should not require market competitors to pay access fees that cause the NBBO prices to be misleading.

What is clear is that the integrity of NBBO prices can only be maintained if the Commission either rejects the inclusion of access fees in the NBBO or fixes such fees so that they are equivalent to both sides. The latter would appear to require rate hearings and utility type regulatory procedures; and such fees would force investors to pay costs that are uneconomic.

Fees for liquidity Providers

A very highly respected economist, Fisher Black, once said at a SEC seminar that; "There is no such thing as liquidity, only the right price and the right quantity."

What he meant was that liquidity is always 100 percent for both sides at the agreed upon price and quantity. The only way that regulation can cause executions of large size to occur at small size prices is to transfer pricing ("liquidity") value from small traders probably at some increase in time-risk and other order handling execution costs of those small orders.

If small trader costs are going down and large trader costs are going up, then maybe small traders, helped by automation and SEC display rules, have found a way to avoid the subsidization process referred to above. In any event small investor experience demonstrates that institutions can also reduce trading costs by automating further their trading processes. It is much easier, and more competitively neutral, to make little orders out of big ones than it is to make large orders out of little ones.

Also, it is economic nonsense, as Fisher Black suggested, to argue that a market order is a liquidity taker from limit orders because published limit orders provide free options. That argument fails to recognize that limit orders are inflexible on price and when executed at that price they capture one-half the real spread from the market order. Upon execution both orders market and limit have 100% liquidity at the agreed upon price.

It is probably rare, excluding pre-arranged crosses, for market orders to arrive at the market within the 1 or 2 seconds that automated execution of small orders requires. Therefore the competition between limit orders and proprietary traders must be kept fair and neutral. The

Commission’s determination to increase the use of limit orders arbitrarily through market data subsidies and order handling rules applied to the handling of small market orders threatens the fairness of that competition and does not protect small investors.

Competition has proven to be the small investor's best friend. It should be the Commission's also.

Thank you for your consideration of these comments.

Sincerely yours,

Gene Finn