Consumer Federation of America

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OFFICE OF THE SECRETARY

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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

Dear Mr. Katz:

Consumer Federation of America[1] supports the overall intent, and many of the details, of the Commission's proposal to enhance and modernize the National Market System (NMS). We share the Commission's view that it no longer makes sense to have different standards for trading in listed and Nasdaq securities, and that NMS rules should be updated to reflect dramatic technological and other changes in the marketplace that have both contributed to greater fragmentation in the market and provided the means for a solution. For that reason, we agree that enhancing the ability of investor buying and selling interest to interact directly in an efficient manner and encouraging the public display of customer orders should be top priorities for Commission policy in this area.

In general, we believe the Commission proposals offer a thoughtful approach toward achieving those goals. In particular, we believe that extending the trade-through rule to the Nasdaq market and requiring market participants to provide non-discriminatory access to their quotes would benefit investors by encouraging the use of limit orders and by maximizing order interaction. We are concerned, however, that the proposed "opt-out" provision to the trade-through rule would seriously undermine that rule's potential benefits. We therefore urge the Commission to consider instead an approach that allows automated markets to trade-through non-automated markets, but preserves the principle of price protection where execution is comparable.

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

I. CFA supports requiring market centers to establish, maintain, and enforce policies reasonably designed to prevent "trade-throughs."

We believe investors are best served when there is a strong incentive to display orders and when those orders can interact efficiently and fairly. We further believe applying the trade-through rule to all displayed limit orders across all markets will help to achieve this goal. The lack of a trade-through rule in the Nasdaq market has unquestionably contributed significantly to fragmentation in that market, by allowing practices such as internalization and payment for order flow that prevent substantial pockets of orders from interacting with the broader market while leaving limit orders that set the best price unfilled. When limit orders go unfilled while transactions are conducted at an inferior price, or even at the same price against an order that entered the market later, it contributes to the perception that the markets are unfair, and it discourages investors from placing such orders and pricing aggressively. Thus, we believe a universal trade-through rule will not only benefit the investors who have their limit orders filled as a result, but also will benefit the market as a whole, through increased liquidity, improved price discovery, and tighter spreads.

Given the variety of business models that exist among market centers, we believe it would be difficult, if not impossible, to come up with one set of rules for preventing trade-throughs that would be equally appropriate for all market centers. Because it provides needed flexibility, we support the Commission's proposed approach of allowing individual market centers to decide for themselves how best to achieve the goal of preventing trade-throughs. With this flexibility comes the potential for abuse, however, in the form of inadequate and ineffective policies. It will be incumbent on the Commission to monitor implementation of the rule in order to ensure that the policies adopted to implement the rule are working as intended, preventing intentional trade-throughs and minimizing to the extent possible the number of accidental trade-throughs that are allowed to occur.

We are concerned that the benefits of the proposed rule are limited by its application only to best bids and best offers that are disseminated pursuant to an effective national market system plan. As a result, better priced limit orders that are not disseminated pursuant to an effective national market system plan could still be traded through. One solution would be to require quoting market centers to make available, and provide access to, their entire depth of book. We would encourage the Commission to further explore whether this is currently feasible or could be in the near future. If it determines that this is not the case, we would encourage the Commission to explore whether other alternatives might be feasible, such as requiring display and access to all bids and offers within a certain pricing increment of the best bid and offer or up to a certain volume of shares. In addition to encouraging the use of limit orders, such an approach would result in better price transparency and help to address complaints that decimal pricing has reduced price transparency because of the relatively thin volume of trading interest displayed in the best bid and offer.

We also encourage the Commission to continue to explore ways to provide not just price priority, but also time priority for limit orders across all markets. This would help to ensure that those who wish to step ahead of previously displayed trading interest in a particular security would at least have to improve the price, rather than simply match the best price, to do so. Without protections for those who get to the market first with the best price, the new regulations may not fully achieve the benefits they are intended to provide.

We recognize the challenge the Commission faces in crafting a trade-through rule that accommodates the variety of today's markets. Those who complain about the existing trade-through rule appear to have a legitimate gripe when they note that the "best price" is not really the best price if it is no longer available by the time the order is executed. We believe the proposed exemption allowing automated markets to trade through non-automated markets represents a reasonable effort on the part of the Commission to address this issue. And we are encouraged that existing manual markets appear to be moving in the direction of greater automation, a trend this rule should support. In defining the term automated market, we share the view of those roundtable panelists who identified the key element as an immediate automated response to the router of the incoming order stating that the order was executed in full, was executed in part, or could not be executed. To ensure that all markets that claim the "automated" designation offer a generally comparable level of service, we believe the Commission should set standards governing the timing and nature of that automated response.

II. CFA Opposes the Proposed Opt-out Exception.

While we support the bulk of the Commission's trade-through rule proposal, we strongly oppose the proposed opt-out exception, which takes away with one hand what the Commission has given with the other. Allowing an opt-out would enable those who wish to ignore the trade-through rule to do so, and would extend that ability to the market in listed securities where it has previously not existed. With its requirements for disclosure and prior consent, it would also add significantly to the costs of implementation without offering any legitimate benefits beyond those already offered by the proposed automated market exception.

We do not believe the rule's disclosure and consent requirements will ensure informed consent by retail investors. Instead, these disclosures are likely to resemble the license agreements for software or the documents presented at a mortgage closure that the vast majority of consumers sign off on without ever reading. Where the investor does pay attention to the disclosures, most are still unlikely to substitute their judgment for that of their broker, since few understand the complexities of order execution. Thus, we believe the rule's primary protection designed to ensure that the opt-out provision is not misused will be ineffective at best and meaningless at worst.

Even an opt-out limited to institutional investors would, in our view, be harmful. As issues that have arisen in the mutual fund scandals make clear (e.g., with regard to funds' directed brokerage and soft dollar practices), there is no assurance that institutions would always make order routing decisions based on their shareholders' best interests. Some might instead base those decisions on factors that benefit the fund or pension adviser more than they do the shareholder. Even where this is not the case, there remains the simple fact that their choices are not made in a vacuum. Every time they chose to ignore a better price, the investor who offered that better price would be affected by that decision, with no ability to influence that choice.

Those who support the opt-out exception, like those who favor repeal of the trade-through rule, tend to put their faith in the broker's duty of best execution and market competition to stem any possible ill effects. We believe, however, that the broker's duty of best execution is simply too vague to serve as an effective deterrent to abuse. It is too vague for the broker to know with certainty that it has satisfied its best execution obligation and too vague to be enforced consistently and effectively. In fact, one of the real benefits of the proposed trade-through rule is that it has the potential to simplify compliance with best execution rules. Adding an opt-out exception will minimize, if not eliminate, that benefit. As a result, the Commission would need to devote far more resources to enforcement of best execution obligations under the rule than would be necessary absent the opt-out provision.

Market competition is, in our view, equally unlikely to protect retail investors' interests. Because retail investors do not routinely determine where their orders will be executed, market centers do not generally compete for their business. Instead, they compete for the business of large institutional investors and the intermediaries retail investors rely on to execute their trades. Because there is a far from perfect alignment between the interests of retail investors and those of their intermediaries, there is no reason to believe markets will compete on terms that benefit retail investors. Experience in the Nasdaq market – where, for example, industry succeeded in ensuring that the SuperMontage was designed to accommodate internalization and payment for order flow – suggests just the opposite.

Because it would increase the difficulty and drive up the cost of both implementation and enforcement, and because it would seriously undermine the benefits otherwise afforded by a universal trade-through rule, we urge the Commission to abandon the proposed opt-out exception.

III. CFA supports requiring markets to provide non-discriminatory access to the best prices displayed by NMS market centers.

A universal trade-through rule will only be workable if market centers are required to provide non-discriminatory access to their best prices. We therefore strongly support this aspect of the Commission's proposal. We also support the approach the Commission has taken of requiring markets to provide non-discriminatory access without dictating the means by which that access must be provided. Providing this flexibility should avoid the pitfalls – e.g., outdated technology and an unworkable governance structure – that have prevented the Intermarket Trading System from working effectively to support a national market system. Furthermore, it should be "self-enforcing," since competitors are likely to complain loudly if they believe a market is not providing the requisite degree and fairness of access.

Consistent with our comments above, however, we believe the rule would be significantly strengthened if markets were required to provide access to more than just their best bid and best offer. If it is not feasible to require markets to provide non-discriminatory access to their entire depth of book, then the Commission should look at other alternatives, such as requiring markets to provide access to all orders within a certain pricing increment of the best bid and best offer or up to a certain volume of shares. Such an approach would improve price transparency and significantly decrease the likelihood that a better price that otherwise would have gone undisplayed would be traded through.

IV. Conclusion

As the Commission notes in the proposing release, when Congress set out to create a national market system, it envisioned "a market structure characterized by full transparency where competing markets are linked together to provide the ability to effectively and efficiently execute customer orders in the best available market." While considerable progress has been made since that legislation was adopted, the achievement of that vision continues to be hampered by less than full transparency, ineffective or non-existent market linkages, and fragmentation that prevents fair and efficient interaction of buying and selling interest. If amended to eliminate the opt-out exception, the Commission's proposed NMS regulations would bring that vision one step closer to reality by improving inter-market linkages and establishing a policy of price protection across all markets. We believe investors will benefit from the greater price transparency and increased interaction of orders that will result.

Respectfully submitted,

Barbara Roper
Director of Investor Protection