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22 September 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20459

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

Dear Mr. Katz:

The U.S. Advocacy Committee (USAC) of CFA Institute[1] appreciates the opportunity to comment on the SEC's proposal on regulation NMS that is designed to modernize the structure of the U.S. equity markets. We support the efforts of the SEC, through this proposal, to address the current market structure with an eye to reforming it in light of the evolving technological advances that have been made over the years. We are mindful of the intricacies of this complex system and the balance that needs to be achieved in order to retain a stable system.

We believe that the current way of doing business has become a system permeated with trading practices that often obfuscate the manner in which best price is determined or how some limit orders are filled. Thus, we strongly support and urge reforms that will bring uniformity and transparency to the current system, ultimately leveling the playing field as much as possible among market participants.

To this end, we support a trade-through rule that applies to all securities. We believe that over time an efficient, inter-linked market will minimize the need for opt-out exceptions, and instead will allow investors the information to trade knowledgeably. In addition, while we support regulations that address how market centers may interact with each other, we do not support requirements that would dictate how a particular exchange or market center should be structured. We feel instead that as part of our free enterprise system, these entities should be afforded the right to determine their business structure, as long as their policies are disclosed to, and do not unfairly compromise, the interests of investors. Finally, we support the investor protections and transparency considerations identified in the sub-penny quoting proposal. We believe, however,

[1] With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research®) is a non-profit professional association of more than 70,000 financial analysts, portfolio managers, and other investment professionals in 119 countries of which more than 57,700 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 129 Member Societies and Chapters in 50 countries and territories.

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that additional issues must be addressed to maintain these as the markets move toward a system where sub-penny quoting becomes the norm.

All of these positions are discussed in more detail below.

Discussion

We appreciate the efforts expended by SEC staff to address this incredibly complex issue of market structure through the creation of this comprehensive proposal. Since the introduction of this proposal, this Committee has held numerous meetings with, and gained input from a variety of market participants and traders, as it has considered the multitude of questions posed by the SEC and the far reaching implications of the proposal's implementation. Through this process, we have also gained an even broader appreciation of the complexity of the market structures, their interplay, and the extent to which changes to one segment of the market can affect the overall scheme.

The assurance of anonymity and a transparent system was a central theme to our review and discussions of the current market system. Thus, we believe that the first and overriding goal of market reform measures must be to establish mechanisms by which price transparency can be achieved and maintained. Guaranteeing that all retail and institutional investors receive equal consideration and preserving the integrity of the financial markets, dictate that transparency of price disclosure must never be sacrificed in the name of any movement which promises change.

During the course of our extensive analysis and discussions, we pondered the impact that the markets' complexity and those areas lacking transparency have on its principle constituent--the average investor. In our view, even though the markets should give primary consideration to addressing their interests, we wondered whether the current system had been satisfactorily meeting its responsibility. For example, we were made aware of instances where an average retail investor will submit a market order to buy shares of a highly liquid security being quoted at a certain price only to later discover on receipt of the order confirmation that the price at which the trade was executed is materially above the price quoted at the time the trade was entered. While often surprising but always disturbing, to seek remedy is to undertake the nearly insurmountable challenges of not understanding the system which allows the disparity but also the reasons responsible for its creation.

Our cry for unfettered market transparency and anonymity will be heard whenever we believe consideration is being given to enacting regulations which do not result in further internalizing order flow or creating still more market segmentation. The discussion on several key components of this regulation which follows serves to provide an understanding of the perspective responsible for our reaching this conclusion.

I. Trade-Through Proposal

As proposed, an order execution facility, national securities exchange, and national securities associations would have to establish, maintain and enforce policies and procedures reasonably designed to prevent the execution of a trade through in its market, with two exceptions: customers and broker-dealers trading for their own accounts could choose to "opt-out"; and an automated market could trade through a non-automated market up to a certain amount away from the best bid or offer displayed by the non-automated market.

In response to questions posed by the SEC, we believe that any trade through rule that is implemented should apply to all securities. In creating a uniform and transparent inter-market trading system, it is important that all stocks be subject to basically the same trading regulations. Having said this, we believe that the current structure of the exchanges is inadequate to support the system envisioned by Regulation NMS. To function effectively, the NYSE, American Stock Exchange and Nasdaq must realize the importance of implementing whatever changes are necessary for ensuring that such inter-market trading is accommodated and standardized.

(a) Opt-Out Exception

We have certain reservations about the use of the opt-out exception to the trade-through rule. Theoretically, opt-out orders could allow in a large number of trade-throughs, thereby causing an equally large number of unexecuted limit orders. As a result, the use of limit orders may decrease over time. Moreover, opt-outs would clearly impact the principle of price priority, given that trades would no longer be required to be executed at best price. However, we believe that both effects related to the opt-out exception would be mitigated by the interplay of truly linked markets. In our view, the increased efficiency of inter-market linkages and thus readily accessible bids and offers instead would work to limit the need for and utility of opt outs and eliminate those concerns about the effect of obtaining opt-out consent on the trading system.

However, for purposes of fashioning regulations, we believe that if an opt-out exception is to be allowed, it should apply equally to all investors, regardless of their level of sophistication or manner in which they enter the market. For this, we assume that they all possess the level of understanding necessary to enable them to provide the affirmative consent to be required by Reg. NMS for triggering the opt-out exception. In our view, effective implementation of the opt-out exception is achieved when applied on an order-by-order, rather than trade-by-trade, basis as we believe the latter approach will lead to an overburdened and unreasonably slow trading system.

As proposed, a broker-dealer will have a month to inform customers who elect to opt-out what the national best bid and offer was at the time of execution for each transaction. Rather than mandating this disclosure, we would recommend that the broker confirm to the client that the opt-out was exercised, as requested, and that additional details, including a "quantitative assessment," are available upon request. In addition, we suggest that one month within which to provide this information is too long, and would render useless the utility of this information.

(b) Automated Market Exception

In general, we do not disagree with the concept of allowing an automated market to trade through a non-automated market despite that execution of the trade would be at an inferior price. We do, however, encourage the final rule to include the definition of the term "automated" for purposes of this exception. In particular, we encourage an approach that focuses on automated quotes, rather than on the particular exchange or market center.

II. Market Access Proposal

As proposed, new standards would govern access to quotations and the execution of orders for equity securities by (1) requiring market centers to permit all market participants access to their limit order books on a non-discriminatory basis (2) limiting any fees charged by market centers and broker-dealers for access to their quotations and (3) requiring SROs to establish rules to reduce the incidence of inter-market locked and crossed quotations.

We believe that questions raised under this proposal relating to whether the SEC should mandate automatic execution—requiring that quotes be fully and immediately accessible at their full size—as part of these standards, or whether an automatic execution requirement should be limited only to the best bids and offers of quoting market centers and quoting market participants focuses on a pivotal issue relating to the structure of the markets. We believe that it is appropriate for the SEC to establish rules governing how various markets will interact with each other, including whether and when an automated market may trade through a non-automated one.

However, we urge the SEC not to set requirements for how a particular market should be structured. We believe that this should remain within the province of the individual market center. Thus, we do not believe that it is appropriate to mandate automatic execution for any market.

III. Sub-Penny Quoting Proposal

In this proposal, the SEC expresses a concern that current practices of trading in sub-pennies (which are rounded to the nearest penny by markets and securities information processors, but are not included in the quotation data that is disseminated to the public) are essentially creating "hidden markets." In addition, quotations in sub-penny increments are undermining limit orders. As proposed, market participants would be prohibited from accepting, ranking or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny in any stock, other than those with a share price below $1.00.

We strongly support price transparency that provides the average investor with the same information available to broker-dealers, institutional investors, and all market participants. Preserving a two-tiered system of using sub-penny quotes, but without revealing that information to investors violates fundamental principles of market integrity by providing one group with information that is used to the disadvantage of another. Moreover, we agree with the proposal's reasoning that the current system has a detrimental effect on limit orders, by allowing orders quoted in sub-pennies to "jump over" limit orders quoted in penny increments.

Having recognized the unacceptability of the current system, we nonetheless have reservations about the long-term "fix" that requiring quotes in no less than penny increments will provide to this problem over time. We believe the natural advances in technology have created an environment where trading in sub-pennies is becoming an inevitability. Given this likelihood, we urge the SEC to consider what mechanisms can be implemented to ensure the transparency of quotations to investors, and the fair treatment of all market participants.

Conclusion

Within the parameters of our discussion above, we believe that Regulation NMS is a thoughtful attempt to address changes in the market system that challenge the current way of doing business. We commend this effort and urge consideration of our suggestions on various aspects of the proposal.

If we can provide additional information, please do not hesitate to contact Linda Rittenhouse at 434.951.5333, linda.rittenhouse@cfainstitute.org.

Sincerely,

/s/ James W. Vitalone, CFA

James W. Vitalone, CFA
Chair, U.S. Advocacy Committee

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
CFA Institute - Advocacy

cc: U.S. Advocacy Committee
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