May 6, 2004

Via Electronic Mail to Rule-Comments@sec.gov

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

Re: Proposed Rule: Regulation NMS, File No. S7-10-04

Dear Mr. Katz:

I submit this comment letter on the above-captioned rule proposal. I was formerly the Commission's Assistant General Counsel for Market Regulation, and also was formerly the general counsel of one of the nation's largest broker-dealers. I submit this comment letter solely on my own behalf and not on behalf of any current or former client, my law firm (Bingham McCutchen LLP), or any of my partners or associates.

Market Data

At the Commission's open meeting proposing these rules, Commissioner Atkins compared the proposals to repairing the upholstery on a 1975 AMC Gremlin rather than replacing the engine. Nowhere was his observation more justified than in the area of market data. The Commission can and should do much better.[1]

Currently, pursuant to the Commission's rules, ordinary retail investors receive a markedly inferior market data product - a static "snapshot" quote of the inside bid and offer price (the national best bid and offer, or "NBBO") and the price of the last reported transaction. Institutional investors receive a much richer market data product - continuously updated streaming market data including both the NBBO and "depth of book" information about supply and demand outside the NBBO. After decimalization, as the Commission itself has observed, the depth of quotes at the NBBO has fallen dramatically - often to only 100 shares on each side of the market, which is often much lower than the size of an order a retail investor may be considering. Moreover, post-decimalization, the NBBO changes much more rapidly. As a result, the static NBBO which retail investors currently receive has little utility. By the time an

[1] On July 26, 2001, I testified concerning market data before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. A copy of my testimony, which I incorporate by reference in this letter and will not repeat here, is available at http://financialservices.house.gov/media/pdf/072601hc.pdf.

investor is able to act on a quote, it is very likely that quote has become stale - a disadvantage which becomes even more acute in a rapidly moving market, when investors most need good information. And without access to depth-of-book information, a retail investor does not have sufficient information to judge at what price best to place a limit order, or where a market order (especially one larger than the size available at the NBBO) is likely to be executed.[2]

The current market data system is entirely a creation of the Commission's own rules. The Quote Rule, Rule 11Ac1-1, requires every broker-dealer to transmit all of its (and its customers') order and transaction information immediately, without any compensation, to the relevant SRO. The Display Rule, Rule 11Ac1-2, then requires every broker-dealer to repurchase exactly the same information back again from the relevant SRO, and display it to each customer transacting or contemplating an order for that security. There are three securities information processors ("SIPs") to which broker-dealers must provide this information and from which broker-dealers must then purchase the same information. Each of the SIPs has an absolute monopoly in its market: CTA for NYSE and Amex-listed securities, Nasdaq for OTC securities, and OPRA for exchange-traded options. Although there are several market data intermediaries (such as Bloomberg and Reuters), they must buy their raw market data from the SIPs, and are required by contract to pass on the same fees charged by the SIPs.[3] The only control on the monopoly prices set by these SIPs is the Commission's oversight. Yet the Commission has consistently refused to engage in the type of monopoly rate-setting contemplated by Congress in the 1975 Act Amendments, which first authorized the Commission to create these market data monopolies. As the Commission candidly admitted in its Market Data Concept Release, the Commission today does not even know what it costs the SIPs and their affiliated SROs to consolidate and distribute market data - the basis from which it should be judging the reasonableness of market data fees.

Broker-dealers provide the basic NBBO information to their customers for free, though large broker-dealers may pay tens of millions of dollars per year to the SIPS to obtain this data. The SIPs typically each charge on the order of $25 per subscriber per month for the enhanced market data discussed above - continuous streaming depth-of-book data. Obviously broker-dealers cannot absorb this additional cost for all of their ordinary retail customers, nor can the retail customers (who may trade only a few times a year) afford to pay such costs themselves. However, this amount is relatively trivial for institutional investors who trade multiple times a day (and who in any event often use "soft dollars" belonging to their clients to pay these market data fees). As a result, institutional investors have an enormous structural information advantage over ordinary retail investors. The Commission, by its own rules, has created a "two-tiered

[2] Last year, when selling 2000 shares of a technology stock, I received 15 separate executions - each for 100 or 200 shares of my order. Clearly the NBBO, which shows only the inside NBBO quote for as little as 100 shares, is often insufficient to give an individual investor such as myself enough information to predict whether, when and at what price an order will be executed.

[3] Market data vendors make their profits by charging additional fees (beyond what they pay to the SIPs) for enhancements they add to this market data - something of great use to institutional investors but priced far beyond the reach of ordinary retail investors.

market" in which ordinary retail investors are at a permanent, severe structural disadvantage compared to institutional investors and professional traders.[4] While not all individual investors are fully aware of this disparity, it certainly contributes to the general sense of many individual investors that they are on an uneven playing field when trading in the securities markets.

The SROs' market data revenues soared in the 1990s as all major US broker-dealers began to offer their clients online access to their accounts.[5] Formerly, some SROs claimed that they used this money to subsidize their regulatory operations (a claim that the Market Data Concept Release took at face value). Today, that claim has been exposed as false. Many SROs use market data revenues to fund market data rebate programs - they pay brokerage firms for executing orders in their market (because each executed order in turn generates market data revenue for that market). As a result of these rebate programs, the short-comings of the market data system are affecting market structure for all investors. This problem is so severe that some market participants have been sanctioned for conducting manipulative wash sales solely to obtain the resulting market data rebates.[6] Moreover, we now know that other SROs used their excess market data revenues to pay grotesquely excessive compensation to their senior executives. In short, SROs have been behaving as government-sponsored monopolies will - they have used their monopoly market data revenues to subsidize their activities in areas where they face competition (such as for trade executions). And the Commission, which is charged by Congress to prevent these abuses, has simply stood by ineffectually and watched.[7]

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[4] The Commission brought an enforcement action against the NASD for creating a "two-tiered" market in which market professionals were allowed a systematic advantage over retail investors. *See* Exchange Act Rel. No. 37538 (Aug. 8, 1996). In the market data arena, the Commission itself could not stand up to the same level of scrutiny it applied to the NASD in that case.

[5] The SIPs charge brokerage firms a monthly fee for each non-professional client at that brokerage firm who has electronic access even to the minimal NBBO quotes. Before the advent of widespread electronic access, brokerage firms satisfied their Display Rule obligations by giving customers quotes over the telephone or at in-person meetings, which did not trigger any additional market data payment beyond the monthly "professional" fee the brokerage firm pays for providing the quotes to the registered representatives themselves. By adding the non-professional fees for all the clients with online access, the SROs saw their market data revenues double or triple.

[6] The NASD brought an enforcement action against Swift Trade Securities USA, Inc., and its President Peter Beck for such conduct. *See* http://www.nasdr.com/news/pr2002/release_02_053.html.

[7] Beyond the excessive cost of market data, the SIPs have also used their monopoly power to impose inequitable and burdensome contract terms on market data vendors, broker-dealers and investors. The SEC has failed to require these form contracts to be submitted for Commission approval under Sections 11A and 19 of the Exchange Act. Unless the Commission is willing to dismantle the market data monopolies, it should immediately require these contracts (and all future amendments to these contracts) to be filed for public notice and comment and for Commission approval. *Cf. Bloomberg L.P.,* Exchange Act. Rel. No. 49076 (Jan. 14, 2004) (rejecting NYSE attempt to impose market data contract provisions not filed with Commission for approval).

The Commission's stated intention in changing the formula by which market data revenue is allocated, and in expanding the trade-through rule, and, is to encourage more aggressive use of limit orders. The single step the Commission could take which would most significantly advance this goal - far more than changes in the trade-through rule - would be to give retail investors cost-effective access to better quality market data. If retail investors can see where trading interest exists, they will submit more and better limit orders, and provide more liquidity to the markets.

The Commission's (in)action in the market data area has been flatly inconsistent with Section 11A of the Exchange Act, adopted as part of the National Market System amendments in 1975. Section 11A(a)(1)(C)(iii) explicitly makes market data transparency one of the primary goals of the National Market System: "the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities".[8] As definitively interpreted by the D.C. Circuit, this provision requires market data fees to be "cost-based."[9] Yet, as noted above, the Commission has conceded that it does not even know what the SIPs' and SROs' costs are to consolidate and distribute market data. As discussed above, the Commission has allowed the creation of a two-tiered market in which market professionals receive market data which is vastly superior to that received by ordinary retail investors. This inequity in turn affects all of the other National Market System goals - it impedes retail investors' ability to see which are the best markets, it impedes economically efficient execution of retail orders (because investors cannot make informed judgments about the price at which to place orders, or the market in which to place them), it impedes fair competition, and it impedes investors' ability to execute orders without participation of a dealer (again because investors cannot see and interact with each others' limit orders).

The Proposing Release would do nothing about the severe, structural market data problem that the Commission has created. The complicated formula proposed there would reallocate some market data revenue from markets that execute a large number of trades to markets that frequently quote at the NBBO. The Commission's stated intent is to reward market participants who quote more aggressively. But ultimately it is individual investors who are the bedrock providers of liquidity in our securities markets. If the Commission does not provide retail investors with sufficient information to place limit orders intelligently, its intent of encouraging more aggressive quoting (and the intended result of increased liquidity) will be completely frustrated. Truly the Proposing Release would tidy up the upholstery while, under the hood, the engine lurches and wheezes and belches black smoke.[10]

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[8] Note that Congress' Section 11A(a)(1)(C)(iii) goal is not limited to data about the NBBO.

[9] *National Ass'n of Securities Dealers, Inc. v. SEC,* 801 F.2d 1415, 1417-18 (D.C. Cir. 1986) ("*Instinet").*

[10] The Proposing Release suggests that non-voting advisory committees might somehow constrain the monopoly pricing behavior of SIPs. This suggestion is completely inadequate to constrain the SIPs behavior. SROs have an inherent financial conflict of interest in serving on the boards of SIPs. At a minimum, SIPs should have a self-perpetuating super-majority of public governors. This reform

Long term, the Commission should break down the current market data monopolies. If there were no Display Rule, and the SROs had to make all of their underlying raw data accessible to all parties on the same terms,[11] then the SEC could let competitive market forces set the amount of market data that investors receive, and the prices at which they receive it. The Commission should work towards such a market-based replacement for the current monopoly structure.

In the shorter term, I assume the Commission is not willing to repeal the Display Rule at this time. In that case, the Commission should: (a) devote the resources to exercise true ratemaking regulation to ensure that the SIPs are not able to extract monopoly rents and are allowed only (as the statute and as the *Instinet* case contemplate) to recover their legitimate costs; and (b) expand the Display Rule so that all investors receive data which ordinarily would be sufficient to predict how typical retail-sized orders (orders up to 1,000 shares) are likely to be executed. I suggest that this means every investor should receive, at a minimum, display of real-time, streaming data concerning the first five ticks of order interest on each side of the market. I note that there would be no incremental costs to the SIPs or the SROs to provide this data, since they already provide it to market data vendors and professional investors today.[12] There is no other single step the Commission could take that would provide more benefit to individual investors, or that would go further to restore confidence to the nation's securities markets.

Trade-Through Protection

The Proposing Release frames the trade-through issue as, fundamentally, a trade-off between receiving the best price and receiving the speediest trade executions. The Proposing Release recognizes that speed of execution is important to some investors, but assumes that most investors value price over speed.[13] I believe this portrayal seriously misrepresents the issues at

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would complement (but not replace) those discussed in the text. If the Commission believes that non-voting advisory committees are sufficient to address conflicts of interest, perhaps it should require mutual fund boards to appoint non-voting advisory committees, rather than requiring the mutual fund boards themselves to have a super-majority of independent directors (as the Commission in fact has proposed).

[11] An analogy would be to the market access provisions in the Proposing Release, which would mandate equality of access but do not set in stone a particular technical standard for access. I support that proposal as a good example of technology-neutral principle-based rulemaking. The alternative, mandating a particular inflexible system (there ITS), has served investors very poorly and has long deserved to be replaced.

[12] There would of course be incremental cost to brokerage firms to implement their display of this data to all customers. However, I believe that the increased trading interest brokerage firms would receive from their customers would substantially offset this cost.

[13] Speed is important to many investors. Two of the largest online broker-dealers currently advertise (respectively) two-second and five-second order execution guarantees (which, if the firms do not meet, then the firms do not charge their clients a commission). Clearly these firms believe that their

stake. Broker-dealers already have (and will continue to have) their basic best execution obligation: they must regularly and rigorously review the execution quality in the markets to which they direct client orders, and direct those orders to markets with the best execution quality. But once clients' orders are directed to a specific market, inevitably there will be some instances in which the best price appears in another market. If the Commission requires that the order be re-directed to that other market, not only will the investor's order be delayed. In a substantial percentage of cases, by the time the order makes it to that other market and then goes through the order queue in that other market, not only will the ephemeral better quote be gone, but the actual quote in that market will have moved against the client. In many of these cases, the quote also will have moved against the client in the market to which the order was originally sent. As a result, the client will receive a worse execution than if the order had simply been executed in the original market. In other words, the trade-off is not just between speed and better price. The trade-off is between (a) speed and price certainty, if the order is executed in the original market, and (b) delay and a substantial risk of a worse price, if the order is required to be re-routed to another market. I agree that most investors, given the choice, like to have the possibility of price improvement - if it comes without risk. However, faced with the possibility of price improvement but also a real risk of price deterioration, most investors opt for speed and certainty.[14] The Commission's proposal would default investors to a choice (delay and the possibility of price deterioration) that most would not voluntarily choose. For these reasons, I urge the Commission not to expand the inter-market trade-through rule, and indeed to seriously consider abolishing the rule (on an inter-market basis) where it now applies.[15]

One cannot help but note the complete lack of economic analysis supporting the trade-through provisions of the Proposing Release. In the U.S., we have a major equities market (Nasdaq) which does not have a trade-through rule, while the exchange-listed markets do have such a rule. In order to justify extending the trade-through rule to the Nasdaq market, the Commission ought to be able to offer some credible economic evidence that the listed markets offer better execution quality in some statistically meaningful way as a direct, provable result of the trade-through rule. The Proposing Release offers no such evidence, and indeed, no such evidence exists.[16] I suggest that this fact alone indicates that expanding the trade-through rule to cover Nasdaq securities would be arbitrary and capricious. Similarly, in the US we have a group of securities (the actively traded ETFs) for which the Commission has recently relaxed the trade-

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clients and potential clients value speed of execution; this preference for speed is not just something that lawyers have dreamed up as an excuse for internalization.

[14] A bird in the hand is better than two birds in the bush (when the risk is that, by going to the bush, the investor will end up with no birds at all).

[15] I have no objection to a market voluntarily applying an intra-market trade-through rule - as discussed below, such market-structure experimentation is in the long-term interests of all investors.

[16] By contrast, the Commission was able to point to ample economic evidence of a difference in market quality when it extended the limit order display rule to the Nasdaq market in the 1990s - a difference which disappeared after that rule change.

through rule (by granting a *de minimis* exception to the rule). If the trade-through rule were beneficial, the Proposing Release ought to be able to produce statistically meaningful economic evidence that execution quality in these securities deteriorated when the rule was relaxed. In fact, quite the opposite is true - execution quality did not deteriorate, and if anything may have improved.[17] Once again, to expand the trade-through rule in the absence of economic evidence (indeed, in the face of contrary economic evidence) would be arbitrary and capricious.

American investors benefit tremendously from competition among markets. Different markets should be allowed to have different market structures, in order to compete to best serve investors.[18] The trade-through proposal would mandate a particular market structure, and would hinder this process of competition and improvement. The Commission should only impose such a rule where there is compelling economic evidence that a particular market structure rule is necessary to protect the large majority of investors, the large majority of the time. No such economic evidence exists to support the trade-through proposal.

If the Commission determines to go forward with the trade-through proposal, it should do so only within strict limits. The trade-through proposal would be ameliorated by giving customers the ability to opt out of trade-through protection (as the Proposing Release suggests, but which some commentators including the NYSE vigorously oppose). For the reasons discussed above, I believe that most well-informed investors in fact should and would opt out of the trade-through rule. Given that reality, the Commission should give investors the choice to opt-out on a categorical basis (rather than requiring a cumbersome, time-consuming process of documenting opt-out on an order-by-order basis, as suggested in the Proposing Release). This choice should be available to all investors, not merely institutional investors.[19]

The trade-through proposal also would be ameliorated if it only applied to markets that offer immediate, automatic trade executions ("fast markets"). Such a limitation would decrease the risk that an investor would suffer both delay and price deterioration as a result of the trade-through rule. The Commission should require a very strict standard of immediacy in order to

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[17] The Proposing Release dismisses this evidence by arguing that the ETFs at issue are different from most other securities. While this may be true to some extent (query how different they are from the most actively traded individual equities), it doesn't explain why relaxing the trade-through rule would be beneficial for those securities but harmful for others. Nor does it help the Commission make a reasoned judgment about the universe of securities for which a trade-through rule is unnecessary.

[18] For this reason, I support the recognition in the Proposing Release that ECNs should be allowed to charge de minimis access fees. It is important to preserve the ECNs as competitors against the traditional markets. As the Proposing Release recognizes, access fees are important to the ECNs' business model.

[19] Also, at most, a market-wide trade-through rule should apply only to exchanges and national securities associations, not to every brokerage firm and ATS. There is neither precedent nor justification for treating every brokerage firm and ATS as if it were a market center subject to duties and obligations properly placed only on SROs - especially since brokerage firms and ATSs do not get the benefits of SRO status, such as sharing directly in market data revenue.

qualify as a fast market: immediate must mean immediate (and not five seconds later or thirty seconds later or allow market centers to disable their automatic execution capability or manually exempt some orders from automatic execution). In order to qualify as a fast market, the Commission also should require automatic executions not only a market's inside price and size but also through the market's displayed depth-of-book. Very few U.S. equities markets currently would qualify as fast markets under an appropriate standard. Even with these changes, a market-wide trade-through is at most a second-best alternative.

Sub-Penny Pricing

Ordinarily, I would oppose having the Commission set a minimum price increment as anti-competitive and contrary to the interest of allowing different markets and ECNs to experiment with different market structures. However, in this case the Commission has provided compelling economic evidence: sub-penny quotes cluster just inside the whole penny quotes in which almost all retail investors must transact.[20] This evidence suggests that market professionals are using sub-penny quotes primarily to step ahead of retail orders or avoid Manning obligations to retail orders. The strength of this economic evidence concerning abusive sub-penny quoting is in direct contrast to the lack of economic evidence adduced in support of the trade-through proposal. However, I would caution that once the Commission bans sub-penny quoting for a security, it will be very difficult ever to go back. Therefore I urge the Commission to examine whether a higher price threshold would be appropriate (e.g. securities priced under $2 or even $3 per share, rather than $1 per share as suggested in the Proposing Release), and whether there is any class of securities should be excluded (such as the most actively traded securities where the spread is often only 1-2 cents). Where sub-penny quoting may provide an economically significant benefit to the market, it should be permitted, with careful SEC and SRO monitoring to prevent abuse of retail investors.

Conclusion

For the reasons discussed above, market data reform - making better quality market data available to all investors - is the single most important market structure initiative the Commission could undertake. I urge the Commission to give this long-festering problem the highest priority of any of the issues identified in the Proposing Release. If you have any questions or would like to discuss any of these important issues further, please feel free to contact me.

Respectfully submitted,

W. Hardy Callcott

[20] Broker-dealer order entry screens for ordinary retail clients typically only permit orders to be submitted in round penny increments.