THE FINANCIAL SERVICES ROUNDTABLE

1001 PENNSYLVANIA AVENUE, NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-289-1903

E-Mail rich@fsround.org
www.fsround.org

**RICHARD M. WHITING**
EXECUTIVE DIRECTOR AND
GENERAL COUNSEL

June 30, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: "Proposed Rule: Regulation NMS,"
SEC Rel. No. 34-49325, File No. S7-10-04

Dear Mr. Katz:

The Financial Services Roundtable[1] is pleased to offer its comments on the above-captioned proposal by the Securities and Exchange Commission (the "Commission" or the "SEC"). The Roundtable appreciates the opportunity to share its views on proposed Regulation NMS and broader market structure issues. Its diverse membership, including issuers, intermediaries, and institutional investors, makes the Roundtable uniquely qualified to comment on securities market structure issues.

In Regulation NMS, the Commission is addressing a number of important and complicated issues. The Roundtable commends the Commission for recognizing the need to modernize market structure. The Roundtable shares the Commission's view that market structure must be reviewed in light of the evolution of the marketplace. It is advisable periodically to review market structure, to evaluate whether it continues to promote competition to the greatest extent possible while fostering investor protection, or whether developments in technology, market practices or other areas suggest that market structure has become outmoded. Developments in recent years, including decimalization, the rise of electronic trading, and the entry of new trading venues, make this reexamination particularly timely.

<u>Principles That Should Govern Market Structure</u>

Before commenting on the specific elements of proposed Regulation NMS, the Roundtable would like to share its views on market structure in general and the principles that should govern market structure. The existing structure of the U.S. capital markets is fundamentally sound. U.S. capital markets remain the deepest, most liquid in the world.

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[1] The Financial Services Roundtable unifies the leadership of large integrated financial services companies. Its membership includes nearly 100 firms from the banking, securities, investment and insurance sectors. In addition to communicating the benefits of integrated financial services to the American public, the Roundtable is a forum in which financial services industry leaders address critical public policy issues.

The Roundtable believes that competition, including competition for orders on the basis of price, has played and continues to play an essential role in creating such markets.

Congress has long recognized the role of competition in strong and effective markets. In the Securities Act Amendments of 1975, Congress granted the Securities and Exchange Commission ("SEC") authority to "facilitate the establishment of a national market system for securities"[2] and told the SEC to promote "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."[3]

As an overarching principle, the Roundtable supports the introduction of greater competition and flexibility in U.S. securities market structure. As identified back in 1975, competition has the potential to advance the other goals of our national market system: efficiency, transparency, innovation and so on. To the greatest extent possible, Roundtable members believe that competition, rather than regulation, should determine the structure of U.S. markets. Consistent with investor protection and fiduciary responsibilities, investors and intermediaries should have the greatest choice possible in implementing their trading strategies.

Trade-Through Proposal

Modern technology has dramatically improved the efficiency and speed of executing trades for investors. Accordingly, the Roundtable supports reform of the trade-through rule. The Roundtable supports reform of the "trade-through" rule in the Intermarket Trading System ("ITS"). The current rule, approved in 1981, generally requires ITS Plan participants (the exchanges and the NASD) to require their members to avoid trade-throughs (transactions on an ITS participant market at a price inferior to that displayed at the time on another ITS participants market). The rules provide procedures for "satisfying" an order that is traded-through. The trade-through rules do not distinguish based on the speed or characteristics of the various markets, or on order sizes greater than 100 shares, nor on the difference in price between two markets.

The Roundtable believes this "one size fits all" approach of the ITS trade-through rules may no longer serve the marketplace well. The Roundtable agrees with the Commission that the current rule creates tensions in its operation, as automated markets now trade NYSE- and Amex-listed stocks in competition with manual markets. Market centers compete based on a wide range of factors that are important to investors, including efficiency, reliability, transparency, fairness, innovation and cost. These factors all bear upon best overall prices for investors and hence "best execution."

Institutional investors would appreciate greater scope for this competition to flourish in order to reduce trading costs, which the Commission has noted have increased in recent years. Many market participants would appreciate a greater ability to prioritize factors such as speed and size over "best price." In addition, in today's marketplace the

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2 Securities Exchange Act Sec. 11A(a)(2), 15 U.S.C. 78k-1(a)(2).
3 Securities Exchange Act Sec. 11A(a)(1)(C)(i).

"best price" may be just one cent better than the "next best price," rather than 12.5 cents better as was the case when the rule was adopted. Many investors would prefer a fast, certain execution to a slower, uncertain execution priced just one cent per share better. In fact, it often is better for investors to trade their equities in larger blocks at slightly higher prices than to suffer a no trade or many smaller trades at slightly lower prices. Smaller and less efficient trading increases investors' costs.

The Roundtable believes the overall approach taken by proposed Regulation NMS, to allow customers to distinguish between electronic and manual markets and to "opt out" of the trade-through rule, is intended to strike this balance. The Roundtable supports the Commission's proposal to allow an automated order execution facility to trade through a non-automated order execution facility. This is an appropriate step to account for the elements of speed and certainty of execution in the obligation of best execution.

The proposal's distinction between fast and slow markets and the opt-out exception would encourage market centers to continue to compete with each other on the basis of their technology. The Roundtable believes there should be a greater role for competition with regard to the operation of exchanges. The proposal would allow the marketplace greater ability to determine whether actively traded stocks and small orders are better suited to a matching process than to the traditional mode of trading with a specialist or market maker. The Roundtable notes that the New York Stock Exchange has announced plans to offer its customers the choice of trading via an electronic order matching system, alongside its specialist system.[4]

The Roundtable notes that some market participants have suggested that it may be possible to designate individual quotes, rather than markets, as "automated" or "manual."[5] The Roundtable cannot yet opine on the technological feasibility of this approach or its implications for market data system capacity. However, we urge the Commission to review this possibility thoroughly, as it has the potential to provide investors with the greatest flexibility to choose the trading parameter priorities that are most important to them.

The Roundtable also strongly supports the notion of allowing investors to opt-out of the trade through rule, particularly if the rule is extended to the Nasdaq market. Roundtable members believe the Commission has correctly identified that certain investors pursue trading strategies that prioritize immediacy of execution over pricing at the NBBO. An opt-out would enable these investors to implement strategies that best fit their needs. It would allow professional investment managers greater flexibility in seeking to achieve best execution for the accounts under their management. Indeed, the Roundtable believes that sophisticated investors should be able to make a "blanket"

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[4] See "NYSE Approves Expansion of Automatic Trading; Exchange Will Propose to Broaden Access to Speed and Certainty of NYSE Direct+," New York Stock Exchange Press Release, February 5, 2004.
[5] See SEC Rel. No. 34-49749, "Proposed Rule: Regulation NMS, Extension of Comment Period and Supplemental Request for Comment," May 20, 2004 ("Supplemental Request"), at Section II.A.

decision, rather than an order-by-order decision, to opt out of the rule's protections. All investors will benefit from the increased liquidity likely to result.

At the same time, the Roundtable shares the Commission's concern as to whether retail investors will understand the protections afforded by the trade-through rule and the implications of opting out of the rule. Roundtable members believe that the proposed requirements to obtain informed consent on an order-by-order basis and to provide disclosure of the NBBO would be impractical, confusing, and costly. In order for investors to retain confidence that the market treats them fairly, retail orders must not only continue to receive best execution but be perceived as receiving the utmost care by brokers. For these reasons, the Roundtable suggests that the opt-out be limited to sophisticated investors.

Our members are concerned about the responsibilities that under the SEC's proposal would be placed on broker-dealers, as distinguished from the SEC or self-regulatory organizations, to enforce compliance with trade-through rules. Under the current trade-through rule, the self-regulatory organizations that are members of the ITS Plan have rules requiring their members to avoid trade-throughs. The Commission is proposing to adopt its own trade-through rule, to ensure a uniform market-wide price protection regime. The Commission and the self-regulatory organizations will have the same duty and authority to enforce this rule as they do with regard to every other rule adopted by the Commission.

For that reason, the Roundtable is concerned that the rule proposes that every specialist, market maker, and broker-dealer that internalizes orders must have its own policies and procedures specifically designed to prevent trade-throughs. This would seem to require a duplicative and costly compliance regime. As the Commission notes, broker-dealers remain subject to the duty to achieve best execution of customer orders and must regularly review their order routing policies in order as part of their review of their best execution policies. Given this broad responsibility, it would be more appropriate to rely on enforcement of the trade-through rule by the SEC and the self-regulatory organizations.

Provided it included both the exception based on the distinction between fast and slow markets and the opt out provision, the Roundtable would support application of a uniform trade-through rule to trading in Nasdaq as well as NYSE- and Amex-listed stocks.

Market Access Proposal

On the issue of access, the Roundtable believes there should be more flexibility and greater scope for the marketplace to determine how linkages work and the technology used. "Soft linkages," such as the model implemented by the NASD Display Facility, should be considered as an alternative to the current model of mandated "hard linkages." It allows the marketplace a greater role to determine technology. The Roundtable is therefore pleased that the overall thrust of the SEC's proposal is to set the standards of access that market participants must meet and to avoid government-imposed linkages. These standards should help ensure that market participants have effective access without the need for direct linkages. However, the proposed automatic execution requirements would seem to run counter to this general direction – as the Commission itself notes, it could be drawn into determining performance standards that could quickly become inflexible and antiquated.

Turning to specific access proposals, the Roundtable supports the Commission's proposal to allow all broker-dealers, not just ECNs, to charge a de minimis access charge. Not only will this help ensure that investors have reasonable access to quotes, it will also help ensure that they will enjoy that access on standardized terms at all market centers. The Roundtable also supports the proposal to make the fair access requirements of Regulation ATS apply when a trading system accounts for 5%, rather than 20%, of the trading in a particular security. Again, this will promote greater and more standardized access for investors.

The Commission has requested comment on whether it should impose a single accumulated fee limitation on all types of market centers.[6] The Roundtable opposes such an exercise of regulatory authority. While it may be appropriate for the SEC to limit the level of access fees that a market center may charge to in order to promote fair access, it does not follow that it is appropriate to limit execution fees as well. Marketplace competition, rather than regulation, should determine the level of fees charged by market centers.

The Roundtable suggests that the Commission consider whether the governance of the ITS plan should include a voting or advisory role for market participants other than the exchanges. As discussed below, the Roundtable supports the SEC's proposal to diversify participation in the market data plans. Just as that proposal would help ensure that the market data plans better serve investors' needs, broader participation in ITS would help align this trading plan with investors' interests. In addition, the Commission should consider eliminating the "veto" that each exchange has over changes to the operation of ITS. While it is important to ensure that a majority of ITS plan members do not seek to disadvantage a minority of members in some way, this feature of the operation of ITS may unnecessarily thwart competition and hinder innovation, to the detriment of the marketplace as a whole. Requiring that decisions be made by supermajority vote, rather than unanimously as currently, may strike a better balance between the needs of exchanges and investors.

<u>Sub-Penny Pricing Proposal</u>

The Roundtable supports the restrictions on quoting in sub-pennies proposed by the Commission. The Commission has identified significant concerns that arise from quoting sub-pennies. First, quoting in sub-pennies allows market participants to gain an execution priority over others' limit orders without a commensurately significant

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[6] Supplement Request at Section III.A.2.

economic difference.[7] Quoting in sub-pennies is typically accompanied by rapidly changing quotes and difficulty in achieving best execution. The combination of these factors could discourage investors from placing limit orders, which would reduce liquidity.

In addition, sub-penny quotes on those markets displaying them are not readily visible to and accessible to many investors today. Many retail investors are not able to view or capture the rapid quote updates associated with sub-penny pricing. The growth of sub-penny pricing would therefore reduce transparency for some investors while creating a parallel market for those investors equipped with computerized systems that can capture and evaluate such information.

An industry-wide shift to quoting in sub-pennies would thus do little to promote more efficient markets, require additional investments in systems capacity by those who can afford them, and potentially disadvantage those investors who cannot. The Roundtable supports the proposed prohibition on quoting in sub-pennies.

Market Data Proposal

The Roundtable commends the Commission for making specific market data proposal in proposed Regulation NMS and for seeking comment on the reasonableness of market data fees and the Commission's review of such fees.[8] New technologies, new trading venues, and the introduction of decimal pricing of securities have combined to produce significant increases in volumes of market data. Many market participants also feel that decimalization has reduced the economic value of the data disseminated as the "national best bid and offer," or "NBBO." In addition, some market participants have expressed concerns about the lack of competition in the current system for collecting and disseminating market data and the impact of that lack of competition on the current fee levels.

With regard to the specific market data proposals, the Roundtable supports the proposal to allow broker-dealers greater freedom to make information available outside of their self-regulatory organizations. Not only will this allow firms to seek to realize the economic value of their proprietary information, such as depth of order book information, it likely will lead to the introduction of new information products and to the availability of greater information to investors at lower cost. Requiring broker-dealers to make information available on terms that are fair and reasonable and not unreasonably discriminatory seems to strike a reasonable balance between allowing firms to operate with different business models and ensuring that valuable information is available to investors.

The Roundtable also supports the proposal to increase the participation of market participants in the market data plans. Securing the input of broker-dealers, vendors and

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[7] The fact that sub-penny trades tend to cluster to \$0.001 and \$0.009 is strong evidence that sub-penny quoting is used to gain trading priority.

[8] Supplemental Request at Section IV.A.

investors through advisory committees to the national market system plans, as the SEC has proposed,[9] would help increase the likelihood that the plans operate to serve the needs of investors in a cost-effective way. The Roundtable suggests that the Commission consider whether representation of these constituencies directly on the plan operating committees would not go even further to promote a more cost-effective system of market data consolidation that serves investors' interests.

While supporting these specific proposals, the Roundtable notes that the Commission has not proposed fundamental change to the current system. Under proposed Regulation NMS, the provision of consolidated market data would remain the exclusive province of monopoly consortia consisting solely of self-regulatory organizations. Proposed Regulation NMS would not increase the transparency of how the costs of collecting and disseminating market data are calculated by the national market system plans and how the market data fees are set, nor would it change the Commission's exercise of its authority to review the reasonableness of those fees.

At a minimum, the Roundtable suggests that the Commission consider requiring the market data plans to adopt standardized accounting systems for the cost of producing consolidated market data, subject to independent audit and publication. This transparency would help ensure that only appropriate costs are passed along to investors in the form of market data fees, providing investors and the Commission with greater confidence that investors are not subsidizing markets improperly. It would help ensure that market data is priced in relation to its economic value, which is difficult to assess under the current opaque system. Finally, it might obviate the need for the Commission to engage in the sort of "rate regulation" that other regulatory agencies exercise over monopoly providers, such as energy utilities. Requiring the market data plans to publish standardized, audited accounts could help the Commission assess the reasonableness of market data fees without devoting scarce agency resources to protracted rate reviews.

## Conclusion

The Commission has addressed a number of important issues in Proposed Regulation NMS. The Roundtable appreciates the Commission's efforts, not just to review market structure issues but to propose solutions as well. We look forward to discussing our comments and the Commission's proposals further with the Commissioners and staff. If you have any further questions or comments on this matter, please do not hesitate to contact me or John Beccia at (202) 289-4322.

Sincerely,

Richard M. Whiting

Richard M. Whiting
Executive Director and General Counsel

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[9] Proposing Release at Section VI.D.