

Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS

INTRODUCTION

As a result of our strong disagreement with the majority's adoption of Regulation NMS,¹ we write jointly to make clear the reasons for our dissent. We support Regulation NMS' overarching goal of enhancing the efficiency of our markets. We do not believe, however, that Regulation NMS will achieve this goal, and we are concerned about its detrimental impact on competition and innovation. In our view, Regulation NMS is at odds with Congress' goal, expressed in the Securities Acts Amendments of 1975 ("1975 Act Amendments"),² of protecting competition within the national market system.³ In

¹ Securities Exchange Act Release No. 51808 (June 9, 2005) ("Adopting Release"). Regulation NMS is composed of four substantive rules: a requirement that markets provide fair and non-discriminatory access to quotations, a prohibition on the display of quotations in pricing increments of less than a penny, amendments to the formulas currently used to allocate market data revenues to self-regulatory organizations ("SROs") under joint industry plans, and a trade-through rule applicable to both the listed and the Nasdaq markets. In the Adopting Release, the trade-through rule is renamed the "order protection rule." Adopting Release at note 2. This is a misnomer. An order displayed at the best price is not necessarily protected because it can be matched or an execution can occur at an inferior price by using an exception to the rule.

² Pub. L. No. 94-29, 89 Stat. 97 (1975).

³ As the Senate Banking Committee stated in its report on the bill that ultimately became the 1975 Act Amendments:

[T]he Commission's responsibility [is] to balance the perceived anti-competitive effects of the regulatory policy or decision at issue against the purposes of the Exchange Act that would be advanced thereby and the costs of doing so. Competition would not thereby become paramount to the great purposes of the Exchange Act, but the need for and effectiveness of regulatory actions in achieving those purposes would have to be weighed against any detrimental impact on competition.

Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975) ("Senate Report"), at 13-14. See also House Committee on Interstate and Foreign Commerce, H.R. Rep. 94-123, 94th Cong., 1st Sess. (1975), at 47 ("in the economic areas affecting the securities industry, competition, rather than regulation, should be the guiding force") (quoting Securities Industry Study, Report of the Subcomm. on Commerce and Finance of the Committee on Interstate and Foreign Commerce, H.R. Rep. No. 92-1519, 92d Cong., 2d Sess. (1972), at 1).

analyzing Regulation NMS and voting to dissent from its adoption, we have been guided by Congress' clear preference that competitive forces, rather than unnecessary regulation, guide the development of the national market system.⁴ With the adoption of Regulation NMS, the majority's arbitrary notions and unfounded assumptions about how markets and investors should interact have taken unwarranted precedence over the interplay of competitive forces within the marketplace.⁵ We believe that Regulation NMS turns back Commission policy regarding competition and innovation and sets up roadblocks for our markets.

The majority's statutory interpretations and policy changes are arbitrary, unreasonable and anticompetitive. They are not supported by substantial evidence that, notwithstanding their anti-competitive effect, they are necessary or appropriate to further the purposes of the Exchange Act. The impetus for the Commission's efforts to modernize the securities markets was the outdated Intermarket Trading System ("ITS") trade-through rule that impeded the ability of electronic trading centers to compete against floor-based exchanges in the listed market. It is ironic that the end result of this lengthy process is the imposition of even more complex trade-through restrictions, not only on the New York Stock Exchange, Inc. ("NYSE"), but on Nasdaq, a market in which competition is already robust.

We believe the wiser and more practical approach to improving the efficiency of U.S. markets for all investors would have been to improve access to quotations, enhance

⁴ See, e.g., H.R. Rep. No. 94-229, 94th Cong., 1st Sess. (1975) ("Conference Report"), at 92 ("It is the intent of the [House and Senate] conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed.").

⁵ See, e.g., Senate Report, *supra* note 3, at 12 ("This is not to suggest that under S. 249 the SEC would have either the responsibility or the power to operate as an 'economic czar' for the development of a national market system.") (citations omitted).

connectivity among markets and market participants, clarify the broker's duty of best execution, and reduce barriers to competition. In our view, these steps would improve market efficiency without exposing our markets to unforeseen consequences, redundant regulatory oversight and the concomitant compliance costs that will ultimately be borne by investors.⁶

For purposes of our dissent, we will focus principally on the trade-through rule. The issues raised in our dissent reflect the same concerns we made public at the open Commission meeting on April 6, 2005, at which we dissented from the adoption of Regulation NMS. Our specific concerns are set forth below.

⁶ Given the uncertainty about the impact of the trade-through rule and the clear determination of the majority to pursue its chosen policy direction, we believe that it would have been prudent for the majority to have considered alternatives that would have permitted the Commission to gain more experience with the rule before requiring its implementation on all markets. One alternative would have been to implement access standards first, and adopt a trade-through rule only if deemed necessary after access and connectivity had been improved. Another alternative would have been to phase in the implementation of the trade-through rule in successive stages, allowing for sufficient time between stages to permit the Commission to evaluate the impact of the rule before full implementation across all markets. Yet another alternative would have been to extend the de minimis pilot approved in August 2002 for certain exchange-traded funds. See Securities Exchange Act Release No. 46428 (Aug. 28, 2002), 67 FR 56607 (Sept. 4, 2002). The exemption, which the Commission extended twice, led to increased competition, narrowing of spreads, and a reduction in trade-through rates. See Securities Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) (“Proposing Release”), at 11134 note 50 (citing October 2002 Analysis of QQQ Trading Before and After De Minimis, Memorandum from the Commission’s Office of Economic Analysis to the File (Feb. 24, 2004) (available at: <http://www.sec.gov/rules/proposed/s71004/oeamemo022404.pdf>)). See also Comment Letter of C. Thomas Richardson, Managing Director, Citigroup Global Markets, Inc. (Jan. 26, 2005) (“Citigroup Reproposal Comment Letter”), at 2-3 (noting, with respect to trading in QQQs: “In its first six weeks of trading as a Nasdaq-listed product, the average consolidated effective spread on trades executed dropped by 34%, despite the lack of any trade-through protection. In addition, quoted spreads did not widen, but, in fact, decreased approximately 15% as measured by the average consolidated spread. What is so significant about this comparison is that before the QQQs began trading in Nasdaq’s electronic market, a \$0.03 de minimis exception to the Trade-Through Rule existed already and had narrowed spreads significantly.”) (citing economic research provided by NASDAQ). However, no such alternatives were given serious consideration.

I. THE MAJORITY MISCHARACTERIZES THE TRADE-THROUGH RULE AS NEEDED TO INCREASE MARKET DEPTH.

One of the original catalysts for Regulation NMS was the need to address market inefficiencies caused by the antiquated ITS trade-through rule. The Commission’s policy objectives for the trade-through rule have expanded, however, far beyond a cure for integrating automated and manual markets. During the rulemaking, rationales offered for the trade-through rule have been a moving target, morphing from the protection of limit orders, to the need to increase market depth and liquidity, to the reduction of transaction costs for long-term investors and issuers.

In February 2004, the Commission proposed a uniform trade-through rule as part of Regulation NMS, with the stated goals of encouraging limit orders and aggressive quoting.⁷ The proposed rule contained two major exceptions. The first exception provided an “opt-out” from the trade-through rule for informed customers,⁸ and the second permitted an automated order execution facility to trade through the quotations of non-automated markets.⁹ The opt-out proposal was intended to provide investors with flexibility in choosing where to route their orders and in determining whether their orders should trade-through better-priced quotes.¹⁰ The automated market exception was

⁷ See Proposing Release, supra note 6, at Section III.B.2 (“Intermarket Price Protection”).

⁸ See Proposing Release, supra note 6, at Section III.D.1 (“Opt-Out Orders”).

⁹ See Proposing Release, supra note 6, at Section III.D.2 (“Automated Order Execution Facility Exception”).

¹⁰ The opt-out exception “strives to preserve the usual customers’ expectation of having their orders executed at the best displayed price, but allows a choice for those investors whose trading strategies may benefit from an immediate execution priced outside the national best bid and offer (‘NBBO’).” Proposing Release, supra note 6, at 11138. “Large traders may also want the ability to execute a block immediately at a price outside the quotes, to avoid parceling the block out over time in a series of transactions that could cause the market to move to an inferior price.” Id.

intended to resolve problems of integrating automated and manual markets under the ITS trade-through rule by protecting only the quotations of automated markets.¹¹

Commenters on the Proposing and Supplemental Releases were split on the need for a trade-through rule to promote fair and efficient markets.¹² The floor-based exchanges and many institutional investors supported a trade-through rule and opposed an opt-out.¹³ Electronic markets, online retail broker-dealers, and Nasdaq market makers were generally opposed to a trade-through rule,¹⁴ although there was some support for a

¹¹ See generally Proposing Release, supra note 6, at Sections III.B.2. (“Intermarket Price Protection”) and III.D.2 (“Automated Order Execution Facility Exception”). In May 2004, the Commission solicited comment on whether individual automated quotations, rather than automated markets, should receive protection under the trade-through rule. Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) (“Supplemental Release”).

¹² See Adopting Release, supra note 1, at Section II.A.1 (“Need for Intermarket Trade-Through Rule”).

¹³ See, e.g., Comment Letter of Darla C. Stuckey, Corporate Secretary of the New York Stock Exchange, Inc. (July 2, 2004); Comment Letter of David Humphreville, President, Specialist Association (June 30, 2004); Comment Letter of Kenneth J. Polcari, President, Organization of Independent Floor Brokers (May 12, 2004); Comment Letter of Ari Burstein, Associate Counsel, Investment Company Institute (June 30, 2004); George U. Sauter, Managing Director, The Vanguard Group, Inc. (July 14, 2004).

¹⁴ See, e.g., Comment Letter of John H. Bluher, Executive Vice President and General Counsel, Knight Trading Group (July 2, 2004) (“Knight Proposal Comment Letter”); Comment Letter of Edward S. Knight, Executive Vice President and General Counsel, Nasdaq Stock Market, Inc. (July 2, 2004) (“Nasdaq Proposal Comment Letter”); Comment Letter of Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Co. (June 22, 2004), at 3-6; Comment Letter of Huw Jenkins, Managing Director, UBS Securities LLC (July 2, 2004) (“UBS Proposal Comment Letter”), at 3; Comment Letter of Kenneth Griffin, President and Chief Executive Officer, Citadel Investment Group, LLC (July 9, 2004) (“Citadel Proposal Comment Letter”); Comment Letter of Ellen L. S. Koplow, Executive Vice President and General Counsel, Ameritrade, Inc. (June 30, 2004), at 2-4; Comment Letter of Carrie E. Dwyer, General Counsel and Executive Vice President, Charles Schwab & Co., Inc. (June 30, 2004) (“Schwab Proposal Comment Letter”), at 13-16; Comment Letter of Kim Bang, President and Chief Executive Officer, Bloomberg Tradebook LLC (June 30, 2004), at 2 and 9-14.

rule, provided that it included an opt-out.¹⁵ Numerous commenters particularly opposed extending the trade-through rule to Nasdaq.¹⁶

In December 2004, the Commission voted to repropose Regulation NMS, over Commissioner Atkins' dissent.¹⁷ In the Reproposing Release, the Commission's prior emphasis on encouraging aggressive quoting was dropped, and concern about market depth became more prominent.¹⁸ The Commission noted that many commenters opposing a trade-through rule, particularly on Nasdaq, had pointed to Nasdaq's efficient functioning without a trade-through rule.¹⁹ In response to these comments regarding Nasdaq's market quality, the Commission's Office of Economic Analysis ("OEA") was

¹⁵ See, e.g., Comment Letter of Thomas N. McManus, Managing Director and Counsel, Morgan Stanley & Co., Inc. (Aug. 19, 2004); Comment Letter of Edward J. Nicoll, Instinet Group Inc. (June 30, 2004).

¹⁶ See, e.g., Comment Letter of Kevin O'Hara, General Counsel, Archipelago Holdings, Inc. (Sept. 24, 2004); Nasdaq Proposal Comment Letter, supra note 14; UBS Proposal Comment Letter, supra note 14, at 4; Citadel Proposal Comment Letter, supra note 14, at 6; Schwab Proposal Comment Letter, supra note 14, at 13 and 16; Knight Proposal Comment Letter, supra note 14.

¹⁷ Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) ("Reproposing Release"). The staff had recommended a final rule, including a trade-through rule covering full depth of book, which was scheduled for a Commission vote on December 15, 2004, without seeking further comment from the public. When details of the staff's final recommendation for a trade-through rule became public, however, the ensuing outcry led the Commission instead to repropose the rule. Leaving no doubt that there would be a trade-through rule in the final rule, the Commission solicited comment on whether the trade-through rule should apply to the "top of book" or to a voluntary "depth of book." At the December 15, 2004 open meeting at which Regulation NMS was repropose, Commissioner Glassman urged commenters not to accept the inevitability of a trade-through rule. She asked for comment on the need for any trade-through rule, not just whether the rule should offer "top of book" or "depth of book" protection. SEC Open Meeting on Regulation NMS (Dec. 15, 2004) (webcast available at: <http://www.sec.gov/news/openmeetings.shtml>).

¹⁸ Compare Proposing Release, supra note 6, 69 FR at 11134 with Reproposing Release, supra note 17, 69 FR at 77426.

¹⁹ Reproposing Release, supra note 17, 69 FR at 77427-28.

asked to conduct a study of trade-through rates on several markets.²⁰ The Division of Market Regulation also prepared an analysis of comparative execution quality statistics between Nasdaq and NYSE stocks.²¹

The divide among commenters on the need for a trade-through rule continued in response to the Reproposing Release. However, commenters who had originally opposed the rule as well as those whose support for a trade-through rule had been conditioned on a general opt-out provision, which was dropped from the reproposal, were united in their opposition to the repropose rule.²² They noted fallacies in the Commission’s rationale

²⁰ Analysis of Trade-throughs in Nasdaq and NYSE Issues, Memorandum from the Commission’s Office of Economic Analysis to the File (Dec. 15, 2004) (“OEA Study”) (available at: <http://www.sec.gov/spotlight/regnms/analysis121504.pdf>). As one commenter noted, the Proposing Release’s “complete lack of economic analysis supporting the trade-through provisions” was surprising. Comment Letter of W. Hardy Callcott (May 6, 2004), at 6.

²¹ Comparative Analysis of Rule 11Ac1-5 Statistics by S&P Index, Memorandum to File from the Commission’s Division of Market Regulation (Dec. 15, 2004) (“Market Regulation Study”) (available at: <http://www.sec.gov/rules/proposed/s71004/mrmemo121504.pdf>).

²² See, e.g., Comment Letter of Thomas N. McManus, Managing Director and Counsel, Morgan Stanley (Feb. 7, 2005) (“Morgan Stanley Reproposal Comment Letter”), at 5; Comment Letter of Bruce C. Turner, Managing Director, CIBC World Markets Corp. (Feb. 4, 2005) (“CIBC Reproposal Comment Letter”); Comment Letter of Michael J. Lynch, Managing Director, Merrill Lynch, Pierce, Fenner & Smith Inc. (Feb. 4, 2005) (“Merrill Lynch Reproposal Comment Letter”); Comment Letter of Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable (Feb. 4, 2005); Comment Letter of David Baker, Global Head of Cash Trading and Global Head of Portfolio Trading, Deutsche Bank Securities Inc. (Feb. 3, 2005) (“Deutsche Bank Reproposal Comment Letter”); Comment Letter of Jeffrey T. Brown, Senior Vice President, Charles Schwab (Feb. 1, 2005) (“Schwab Reproposal Comment Letter”); Comment Letter of James T. Brett, Managing Director, J.P. Morgan Securities, Inc. (Jan. 28, 2005) (“J.P. Morgan Reproposal Comment Letter”); Comment Letter of Stewart P. Greene, Chief Counsel, Securities Law, Teachers Insurance and Annuity Assoc. of America, College Retirement Equities Fund (Jan. 27, 2005) (“TIAA CREF Reproposal Comment Letter”); Citigroup Reproposal Comment Letter, *supra* note 6; Comment Letter of Minder Cheng, Managing Director, Barclays Global Investors (Jan. 26, 2005) (“Barclays Reproposal Comment Letter”); Edward S. Knight, Executive Vice President and General Counsel, Nasdaq Stock Market, Inc. (Jan. 26, 2005) (“Nasdaq Reproposal Comment Letter”); Comment Letter of Adam Cooper, Senior Managing Director and General Counsel, Citadel Investment Group, L.L.C. (Jan. 26, 2005); Comment Letter of Phylis M. Esposito, Executive Vice President and Chief Strategy Officer, Ameritrade, Inc. (Jan. 26, 2005) (“Ameritrade Reproposal Comment Letter”); Comment Letter of Steve Swanson, CEO & President, Automated Trading Desk, LLC (Jan. 26, 2005) (“Automated Trading Desk Reproposal Comment Letter”); Comment Letter of the Competitive

for protecting limit orders and pointed to flaws in the OEA Study.²³ They also stated that the Commission had significantly underestimated the costs of implementation.²⁴

Over our dissent, the majority voted to adopt Regulation NMS on April 6, 2005, approving a trade-through rule protecting quotations at the “top of book.” The rule contains several exceptions, but does not include a general opt-out provision.²⁵ In the Adopting Release, the goal of trade-through regulation is recast once again. Now, the goal is increasing market depth and liquidity in order to minimize the impact of large

Enterprise Institute (Jan. 26, 2005); Comment Letter of Edward J. Nicoll, Chief Executive Officer, Instinet Group Inc. (Jan. 26, 2005) (“Instinet Reproposal Comment Letter”); Comment Letter of Kevin J. P. O’Hara, Chief Administrative Officer & General Counsel, Archipelago Holdings, Inc. (Jan. 26, 2005) (“Archipelago Reproposal Comment Letter”); Comment Letter of Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Co. (Jan. 26, 2005) (“Fidelity Reproposal Comment Letter”); Comment Letter of Daniel Coleman, Managing Director, Head of Equities for the Americas, UBS Securities LLC (Jan. 25, 2005) (“UBS Reproposal Comment Letter”); Comment Letter of Thomas M. Joyce, CEO and President, Knight Trading Group, Inc. (Jan. 25, 2005) (“Knight Trading Reproposal Comment Letter”); Comment Letter of Kim Bang, Bloomberg L.P. (Jan. 25, 2005).

²³ See, e.g., Fidelity Reproposal Comment Letter, supra note 22, at 7-8 (“We caution that the Commission’s analysis, particularly as set forth in the OEA’s study . . . is open to serious question and likely rests on serious methodological flaws. . . . Our own preliminary review of the OEA’s study suggests that trade-throughs of displayed superior orders equal to or greater in size than the incoming “trading-through” order may amount to only 0.4% of Nasdaq volume, and perhaps only 0.22% of NYSE share volume”); Nasdaq Reproposal Comment Letter, supra note 22, Exhibit 1, at 5; Instinet Reproposal Comment Letter, supra note 22, at 6; Comment Letter of Kevin J. P. O’Hara, Chief Administrative Officer & General Counsel, Archipelago Reproposal Comment Letter, supra note 22, at 6; UBS Reproposal Comment Letter, supra note 22, at 4 (“[T]he OEA Study is based upon several improper assumptions, and thus results in a fundamentally flawed analysis.”). See generally Robert Battalio and Robert Jennings, Analysis of the Re-proposing Release of Reg NMS and the OEA’s Trade-through Study (Mar. 28, 2005) (“Battalio-Jennings Study”) (attachment to Comment Letter of Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Co. (Mar. 28, 2005)).

²⁴ See, e.g., Deutsche Bank Reproposal Comment Letter, supra note 22, at 4-5.

²⁵ See Adopting Release, supra note 1, at text following note 236. See generally Adopting Release, supra note 1, at Section II.A.4 (“Elimination of Proposed Opt-Out Exception”).

orders, while decreasing transitory volatility and transaction costs for the benefit of long-term investors and issuers.²⁶

II. THE MAJORITY HAS FAILED TO DEMONSTRATE THE TRADE-THROUGH RULE IS WARRANTED.

The Proposing Release set forth three broad objectives for a review of market structure: equalizing regulation of markets, updating antiquated rules and promoting greater order interaction.²⁷ Adopted Regulation NMS moves beyond these objectives to establish goals for a trade-through rule that allow the majority to construct its own view of optimal market structure. The majority focuses on two types of so-called market structure “problems” that it claims would be addressed by a trade-through rule: investor protection concerns evidenced by trade-through rates on Nasdaq and NYSE²⁸ and a lack of displayed depth on Nasdaq.²⁹ Neither “problem” has been substantiated. However, the majority has contrived “problems” in the Nasdaq market that conform with Congressional goals for the development of a national market system in order to advance its own market structure solutions.³⁰ To achieve this result, the majority portrays successful market-driven innovations as intractable market structure problems that can only be solved by government intervention.

²⁶ See generally Adopting Release, supra note 1, at Section I.B.2 (“Serving the Interests of Long-Term Investors and Listed Companies”) and text accompanying note 15.

²⁷ Proposing Release, supra note 6, 69 FR at 11128-29.

²⁸ See Adopting Release, supra note 1, at text accompanying notes 104 and 105.

²⁹ See Adopting Release, supra note 1, at text accompanying note 108.

³⁰ There are two paramount objectives in the development of a national market system. First, the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements. And second, the centralization of all buying and selling interest so that each investor will have the opportunity for the best possible execution of his order, regardless of where in the system it originates.

Senate Report, supra note 3, at 7.

A. The OEA Study Did Not Substantiate Investor Protection Concerns.

The majority has failed to establish that current trade-through rates indicate a significant investor protection problem. The majority has cherry-picked statistics from the results of the OEA Study that appear to justify the adoption of a trade-through rule, while ignoring data that call the need for the rule into question. We do not believe that current minimal trade-through rates indicate that investors are not obtaining best execution, that their orders are being unfairly treated, or that investors are otherwise suffering economic harm.

The Reproposing and Adopting Releases interpret the OEA Study as establishing a seemingly high rate of trade-throughs. The Reproposing Release claimed that 7.9% and 7.2% of the total share volume on Nasdaq and the NYSE, respectively, were traded through.³¹ The Reproposing Release failed to point out, however, that these trade-through rates were calculated, not on the basis of a quotation's displayed size, but on the size of the order. Thus, an order executed at an inferior price was considered to have been traded-through at its full size even if the order was for a larger number of shares than were available in the market.³²

The Adopting Release cites the same figures, but acknowledges that the trade-through rates for total share volume on Nasdaq and the NYSE drop dramatically from

³¹ Reproposing Release, supra note 17, 69 FR at 77433. The OEA Study suggests that the 7.9% and 7.2% trade-through rates cited above would be “useful in assessing the potential benefits of increased limit order display and liquidity that the proposed rule intends to promote,” but the majority views the statistic as evidence of significant trade-throughs. OEA Study, supra note 20, at 1-2.

³² To illustrate, suppose a broker received a 10,000 share customer order to buy and a 3,000 share offer is displayed in the market at a price of \$10. Under the OEA Study's methodology, executing any portion of the remaining 7,000 shares above \$10 would be considered a trade-through, regardless of the fact that only 3,000 shares were offered for sale in the market. OEA acknowledged that this was a very conservative approach with the practical effect of overstating the trade-through rates. See OEA Study, supra note 20, at 2.

7.9% and 7.2%, respectively, to 1.9% and 1.2%, when executions are measured against the displayed number of shares available.³³ This disclosure was made only after commenters faulted the Commission for its selective use of statistics.³⁴

Similarly, the majority relies on the NYSE's 7.2% trade-through rate to attempt to show a reduction in trade-through rates hoped to be achieved from the new rule, which does not include the block size or 100 share exceptions contained in the ITS trade-through rule.³⁵ Significantly, the Adopting Release admits that, after eliminating the effects of both of the ITS exceptions, the NYSE trade-through rate for total share volume is actually 2.3%.³⁶ Given the majority's concession that the NYSE trade-through rate is 1.2% when measured against displayed size,³⁷ its emphasis on a possible reduction in trade-throughs to 2.3% is disingenuous. The majority's selective interpretation of the OEA Study to justify the need for a trade-through rule is unreasonable and calls into question the basis of the rule.

An additional finding of the OEA Study was that the majority of trade-throughs occurred within a penny or two of a better bid or offer,³⁸ at an estimated total cost in 2003 of \$321 million.³⁹ These statistics overstate the agency/principal conflict because the

³³ See Adopting Release, supra note 1, at text accompanying note 68. See also OEA Study, supra note 20, at text following note 3.

³⁴ See, e.g., supra note 23 (citing comment letters).

³⁵ See Adopting Release, supra note 1, at text accompanying note 71.

³⁶ See Adopting Release, supra note 1, at text accompanying note 71.

³⁷ See OEA Study, supra note 20, at 2.

³⁸ OEA Study, supra note 20, at Tables 3 and 10.

³⁹ OEA Study, supra note 20, at note 5 and accompanying text.

OEA Study was not limited to investors owed a duty of best execution.⁴⁰ Furthermore, \$321 million is a mere rounding error compared to the dollar value of trading on both markets which totaled approximately \$16.8 trillion in 2003.⁴¹ As a percent of the total dollar value of trading, the \$321 million cost savings represents less than 1/100th of one percent. These percentages do not indicate a significant problem with trade-throughs or best execution.⁴²

Nor do we believe that the trade-through rates establish that investors' orders are being treated unfairly. The Reproposing and Adopting Releases cited statistics from the OEA Study indicating that in 2003, approximately 2.5% of all trades on Nasdaq and the

⁴⁰ The OEA Study used data from TAQ and Nastraq, neither of which distinguishes among different types of investors. See OEA Study, *supra* note 20, at 1.

⁴¹ See NYSE Reported Share And Dollar Volume, 2003, NYSE FACT BOOK ONLINE (available at: http://www.nyse.com/factbook/viewer_edition.asp?mode=table&key=2923&category=3) (reporting \$9.7 trillion in share trading on the NYSE in 2003); see also World Federation of Exchanges, Annual Report (2004) (available at: <http://www.world-exchanges.org/WFE/home.asp?menu=315&document=2174>) (reporting \$7.1 trillion in share trading on Nasdaq in 2003).

⁴² The majority asserts that:

[g]iven the large number of trades that fail to obtain the best displayed prices (e.g., approximately 1 in 40 trades for both Nasdaq and NYSE stocks), the Commission is concerned that many of the investors that ultimately received the inferior price in these trades may not be aware that their orders did not, in fact, obtain the best price.

Adopting Release, *supra* note 1, at text following note 150. The majority claims that:

investors (and particularly retail investors) often may have difficulty monitoring whether their orders receive the best available prices, given the rapid movement of quotations in many NMS stocks. The Commission believes that furthering the interests of these investors in obtaining best execution on an order-by-order basis is a vitally important objective that warrants adoption of the Order Protection Rule.

Adopting Release, *supra* note 1, at text following note 105. The majority fails to acknowledge that retail investors have access to consolidated information that allows them to monitor their executions. In fact, the majority argues for a single consolidator by noting investors need reliable consolidated information to monitor their executions. The majority states that “[t]he great strength of the current model is that it benefits investors, particularly retail investors, by enabling them to assess prices and evaluate the best execution of their orders by obtaining data from a single source that is highly reliable and comprehensive.” See Adopting Release, *supra* note 1, at text following note 565. In addition, the NASD and the SEC monitor brokers for compliance with their best execution obligations.

NYSE traded-through the market.⁴³ Notwithstanding these minimal trade-through rates, the majority found the rates “significant,” with customer orders being “routinely” traded-through.⁴⁴ Commenters identified possible flaws in the OEA Study, suggesting that trade-through rates were lower than OEA’s estimate.⁴⁵ They also stated that, while the OEA Study was based on 2003 data, data from 2004 reflected a decrease in trade-throughs on Nasdaq to 1.5% due to increased order routing, reduction in internalization rates, and consolidation.⁴⁶ The majority’s 2.5% trade-through rate is also overstated because it includes trades other than trades for retail customer accounts, including trades for institutions, sophisticated investors and intermediaries.⁴⁷

Based on the record before us, it appears that the trade-through rate on Nasdaq during 2004 was between 1% and 2%. It follows, therefore, that between 98% and 99% of all trades on both markets did not trade-through better-priced bids or offers. Given

⁴³ See Reproposing Release, supra note 17, 69 FR at 77433; Adopting Release, supra note 1, at text accompanying note 102.

⁴⁴ See Reproposing Release, supra note 17, 69 FR at 77428. The majority states that “the order protection rule will promote a more level playing field for retail investors that currently see their smaller displayed orders bypassed by block trades.” Adopting Release, supra note 1, at text following note 84. We question the majority’s basis for asserting that retail investors are not on the same playing field as other investors. The statement is also inconsistent with the majority’s previous assertion that investors have difficulty monitoring whether their orders receive best execution. See supra note 42.

⁴⁵ See, e.g., Fidelity Reproposal Comment Letter, supra note 22, at 8; Nasdaq Reproposal Comment Letter, supra note 22, at 5; Archipelago Reproposal Comment Letter, supra note 22, at 6; UBS Reproposal Comment Letter, supra note 22, at 4.

⁴⁶ See, e.g., Nasdaq Reproposal Comment Letter, supra note 22. The majority unreasonably credits impending regulation for the decrease in internalization rates in the Nasdaq market, rather than increased market efficiency. See Adopting Release, supra note 1, at text preceding note 80.

⁴⁷ It is important to note, however, that the OEA Study did not distinguish among different investor classes. Thus, the majority would have no basis for determining how many orders that traded through the market were owed a duty of best execution nor how many investors were unable to monitor their executions.

that the hypothetical cost of trade-throughs is less than 1/100th of 1%, the evidence does not indicate that investors' orders are treated unfairly.

In sum, we believe that the numbers speak for themselves. The minimal trade-through results reflected in the OEA Study do not support the conclusion that trade-throughs are a significant problem — certainly not one that justifies regulatory intervention on the scale of Regulation NMS.

B. There Is No Evidence of a Lack of Depth on Nasdaq.

Over the past eight years, the Nasdaq market has developed into a completely automated market that meets the objectives of Section 11A of the Exchange Act.⁴⁸ It provides economically efficient executions for investors, provides fair competition and equal access for all investors, provides depth of book information with respect to all quotations and transactions in securities, and allows investors to enter orders directly into the market without participating with a dealer. The Nasdaq market is connected by private linkages that allow both brokers and investors to execute transactions at the best price in the market they choose.⁴⁹ This has all been accomplished in the absence of a trade-through rule.

⁴⁸ 15 U.S.C. 78k-1. Section 11A(a)(1)(C) provides that “[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure”:

- (i) economically efficient execution of securities transactions;
- (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in, securities;
- (iv) the practicability of brokers executing investors' orders in the best market; and
- (v) an opportunity . . . for investors' orders to be executed without the participation of a dealer.

⁴⁹ In the Adopting Release the majority notes approvingly:

Congress did not mandate that the Commission go beyond the goals of Section 11A to design its own view of optimal market structure, yet this is what the majority seeks to accomplish.⁵⁰ The majority has offered no substantive basis for extending the trade-through rule to the Nasdaq market.⁵¹ To justify imposing the rule on Nasdaq, particularly in light of the minimal trade-through rates reflected in the OEA Study, the majority attempts to establish a lack of market depth. Defining Nasdaq’s “problem” as a lack of depth is critical for justifying the rule’s extension to Nasdaq because increasing market depth was one of Congress’ goals for the national market system.⁵² The majority relies on a staff study of comparative execution quality conducted by the lawyers in the Division of Market Regulation (not the economists in OEA),⁵³ anecdotal evidence,

[w]ith respect to Nasdaq stocks, connectivity among many trading centers already is established through private linkages. Routing out to other trading centers when necessary to obtain the best prices for Nasdaq stocks is an integral part of the business plan of many trading centers, even when not affirmatively required by best execution responsibilities or by Commission rule.

Adopting Release, supra note 1, at text following note 290.

⁵⁰ “[T]he fundamental goals of a national market system must include (1) providing an investor or his broker with the ability to be able to determine, at any given time, where a particular transaction can be effected at the most favorable price and (2) creating an incentive for multiple market makers to deal in depth on a continuous basis.” Senate Report, supra note 3, at 12 (emphasis added).

⁵¹ The Proposing Release, referring to a “disparity” of regulation on the listed and Nasdaq markets, simply asserted the need for a uniform trade-through rule. No rationale for why uniformity was important was offered. See Proposing Release, supra note 6, at Section II.A (“Promote Equal Regulation of Market Centers”), 69 FR at 11128-29. We would note that if uniformity of treatment were a valid goal, having no trade-through rule would accomplish this. In any event, uniformity was not a Congressional objective for the national market system:

This is not to say that it is the goal of the legislation to ignore or eliminate distinctions between exchange markets and over-the-counter markets or other inherent differences or variations in components of a national market system. Some present distinctions may tend to disappear in a national market system, but it is not the intention of the bill to force all markets for all securities into a single mold.

Senate Report, supra note 3, at 7.

⁵² See Senate Report, supra note 3, at 7.

⁵³ Market Regulation Study, supra note 21.

hypothetical cost savings and conjecture specifically related to low fill rates to attempt to show that, in addition to the investor protection problem, the Nasdaq market suffers from a lack of market depth. This is surprising, given the view of many commenters that the large number of limit orders in Nasdaq stocks signifies that sufficient incentives exist for the placement of such orders and that low fill rates do not represent a market weakness or cause investor harm.⁵⁴ We do not believe that there were complaints about a lack of depth in the Nasdaq market in the Commission’s roundtables on market structure or the comment letters. In fact, many broker-dealers representing retail investors and institutions objected to extending the trade-through rule to Nasdaq.⁵⁵

In the Reproposing Release, Nasdaq’s small average displayed share size and low fill rate for large marketable limit orders was characterized as evidencing a lack of displayed depth, a purported defect in its market structure that a trade-through rule on Nasdaq would address.⁵⁶ In the Adopting Release, the majority argues that the relatively low share volume of traded-through quotations evidences a shortage of quoted depth.⁵⁷ The Adopting Release concedes, however, that Nasdaq’s low fill rate is attributable to market participants’ liquidity probing activities, otherwise known as “pinging.” Generally speaking, institutional investors seeking liquidity may “ping” or search for

⁵⁴ See, e.g., Instinet Reproposal Comment Letter, supra note 22.

⁵⁵ See, e.g., Schwab Reproposal Comment Letter, supra note 22; Ameritrade Reproposal Comment Letter, supra note 22, at 4; Comment Letter of Lou Klobuchar Jr., President and Chief Brokerage Officer, E*TRADE Financial (June 30, 2004); Fidelity Reproposal Comment Letter, supra note 22.

⁵⁶ “Thus, low fill rates demonstrate that the total displayed and reserve liquidity available for Nasdaq stocks at any particular trading center typically is small compared to the demand for liquidity at the inside prices.” Adopting Release, supra note 1, at text following note 132.

⁵⁷ “[T]he share volume of quotations that currently are traded-through is a symptom of the problem that the Order Protection Rule is designed to address – a shortage of quoted depth” Adopting Release, supra note 1, at text accompanying note 108.

non-displayed limit orders in the Nasdaq market by sending electronic marketable limit orders for a number of shares greater than a market's displayed size.⁵⁸ If there is liquidity in reserve, institutional investors will receive an execution for a number of shares greater than the displayed size. If there is no liquidity in reserve, orders will receive a partial execution or be left unfilled, contributing to the purported low fill rate on Nasdaq. "Pinging" provides investors with an efficient and economical method for searching for liquidity on an anonymous basis. The practice is the electronic version of the search for liquidity on manual markets through the auction market system, without the possibility of information leakage that may create market impact costs for investors. It is a fundamental trait of any market that the knowledge of additional trading interest will likely affect prices. Yet the majority views this market-based solution for searching for liquidity as evidence of a regulatory "problem" with Nasdaq's market structure that a trade-through rule must address.⁵⁹

We believe that Nasdaq's low fill rate is evidence that investors are actively seeking liquidity in an efficient manner. Unless the majority forces all liquidity to be displayed in the market, investors will naturally continue to search for hidden liquidity to meet their demand. The Adopting Release appears to suggest that Nasdaq participants should change their aggressive order pricing behavior and instead expose their orders by

⁵⁸ See Adopting Release, supra note 1, at text preceding note 132.

⁵⁹ The majority states that the trade-through rule will increase displayed liquidity and "promote market efficiency by reducing the uncertainty and costs associated with the need for market participants to 'ping' electronic markets for liquidity that is held in reserve." Adopting Release, supra note 1, at text following note 132.

providing latent displayed liquidity.⁶⁰ In our view, however, the rule will not be successful in significantly modifying market participant behavior.⁶¹ There are legitimate reasons why market participants may not want to display their orders. For instance, concerns about market impact will still act to prevent market participants from displaying the full size of their orders, even with a trade-through rule.⁶²

In one respect, the majority is correct that the trade-through rule, as modified after its adoption on April 6, 2005, will alter market participant behavior. By amending the rule text to remove the reference to “size” from the definition of quotation, the majority has substantially altered the scope of protected liquidity. We do not believe a change of this magnitude to a major rule should be made without the benefit of the Commission’s usual notice and comment process. In our view, this change is not merely a technical amendment, but rather cuts to the heart of how the rule will operate.

The trade-through rule requires trading centers to establish and maintain written policies and procedures designed to prevent trade-throughs of protected quotations unless they fall within an applicable exception.⁶³ Prior to the amendment, the plain text of the

⁶⁰ The majority states “the Rule strengthens the incentive for the voluntary display of a greater proportion of latent trading interest by assuring that, when such interest is displayed, it is protected against most trade-throughs.” Adopting Release, supra note 1, at preceding note 152.

⁶¹ As we have previously noted, the 2-8% range for lower and upper limits of potential benefits of increased market depth assumes that demand will create its own supply. See supra text accompanying notes 32 and 33. There is no basis for OEA’s assumption.

⁶² J.P. Morgan Reproposal Comment Letter, supra note 22, at 4 (“For any particular trade, multiple factors may bear on the quality of execution, including speed, certainty of execution, liquidity and depth, opportunities for price improvement, anonymity, error rates, and the quality of a trading center’s program of self-regulation. These factors all relate to costs that are not captured by quoted prices, such as market access and transactional fees, market impact costs, costs of broken or erroneous trades, and indirect costs such as market data costs.”).

⁶³ New Rule 611 states:

(a) Reasonable policies and procedures.

definition of quotation clearly included both price and size. Therefore, trading centers could route an order to a protected quotation's full displayed size and simultaneously execute an order at an inferior price. This was consistent with the policy goal of increasing displayed size. Under the amended formulation, however, the critical component of size has been eliminated, thus expanding the scope of liquidity falling under the protected quotation umbrella. Thus, under the new definition of quotation, trading centers cannot trade-through a protected quotation's price, regardless of available liquidity, without an exception. The practical effect is that market participants must exhaust liquidity in reserve prior to moving to the next price level. Ironically, this seems to provide more incentive to maintain liquidity in reserve, rather than to display it publicly, a result that would be contrary to the majority's stated goals.

III. REGULATION NMS WILL NOT ACHIEVE ITS GOALS.

The majority asserts that a uniform trade-through rule will promote market efficiency. By encouraging the display of limit orders, it argues, the rule will increase liquidity and displayed depth and lower transaction costs for long-term investors and issuers. At the same time, the majority asserts that the rule will enhance best execution obligations. We firmly believe, however, that the hoped-for benefits of the trade-through rule will not materialize.

(1) A trading center shall establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks that do not fall within an exception set forth in paragraph (b) of this section and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception.

A. A Trade-Through Rule Is Not Needed as a Backstop to Best Execution.

The majority believes that the trade-through rule will further the objectives of the Exchange Act by providing a “backstop” to a broker’s best execution obligations and that it will “materially reduce the trade-through rates in both the market for Nasdaq stocks and the market for exchange-listed stocks.”⁶⁴ Its only response to arguments that current trade-through rates do not justify the need for regulatory action is to assert that the trade-through rates found in the OEA Study are not insignificant and to assert that the total number of trade-throughs is not the sole consideration in evaluating the need for the trade-through rule.⁶⁵

As stated above, we find these assertions unreasonable given the majority’s failure to establish a significant trade-through problem as well as its acknowledgement that trade-throughs will continue to occur following the rule’s adoption. We note that the Adopting Release does not contain an estimate of the reduction in trade-throughs. Moreover, consistent with the objectives of Section 11A, the Nasdaq market provides investors with the ability to determine where they can obtain the best price and provides linkages that allow them to obtain the best price available. Given the negative consequences of the rule, which we discuss below, we believe that any potential reduction in the already low rate of trade-throughs will be minimal, at best, and will be outweighed by the costs of the rule. Moreover, the majority’s “one size fits all” approach

⁶⁴ See Adopting Release, supra note 1, at text preceding note 63. Furthermore, the NASD and the Commission’s Office of Compliance, Inspections and Examinations routinely monitor execution quality and whether brokers are fulfilling their best execution obligations.

⁶⁵ See Adopting Release, supra note 1, at text following note 102.

to best execution will prevent many investors from obtaining the best execution for themselves and their fiduciaries.⁶⁶

B. Some Trade-Throughs Will Continue.

The final rule requires trading centers to establish, maintain and enforce written policies and procedures to prevent trade-throughs, but it does not prohibit trade-throughs. The rule contains numerous exceptions for, among others, intermarket sweeps, self-help, flickering quotes, volume weighted average priced (“VWAP”) trades, and stopped orders,⁶⁷ which means that trade-throughs will not be eliminated. In addition, commenters have suggested that there will be trade-throughs, even with a trade-through rule.⁶⁸ The minimal rate of trade-throughs in the current environment and the undoubted existence of trade-throughs even after the rule’s implementation call into question the likelihood that the rule will reduce trade-throughs to any significant degree.

C. The Trade-Through Rule Will Not Augment Market Depth Because It Provides Only Incomplete Protection of Limit Orders.

The majority states that the protection of limit orders, the foundation of market pricing, is one of its most important goals for market structure.⁶⁹ This goal may be worthy, but Regulation NMS will not achieve it because the adopted trade-through rule

⁶⁶ See, e.g., J.P. Morgan Reproposal Comment Letter, *supra* note 22, at 6 (“To disenfranchise institutional investors for whom best execution frequently diverges from best posted quotes by limiting their strategies for managing risk would be to create a burden that is both unfairly distributed and disproportionate to the limited benefits of trade-through protection.”).

⁶⁷ Rule 611(b).

⁶⁸ See, e.g., UBS Reproposal Comment Letter, *supra* note 22, at 5; Comment Letter of Reg NMS Study Group (May 23, 2004), at 4 (“Accidental trade-throughs may be common in a market with fleeting quotes and limit orders that persist for only a second or two, making it difficult to effectively identify and sanction deliberate trade-throughs.”); Comment Letter of David Cummings, Chief Executive Officer of Tradebot Systems, Inc. (Jan. 26, 2005) (“Tradebot Reproposal Comment Letter”), at 1.

⁶⁹ See Adopting Release, *supra* note 1, at text following note 29.

does not protect all limit orders. Under the voluntary “depth of book” alternative proposed in the Reproposing Release, trade-through protection would have been given to all quotations that a trading center voluntarily transmitted to a securities information processor (“SIP”), not just its best bid or offer. We recognize that the full depth of book alternative would create its own set of problems, particularly with respect to its implications for centralization, technological complications and the size of the market data revenue pie. It would also have been the death knell for floor-based exchange trading. However, the majority’s professed commitment to protecting limit orders is difficult to reconcile given its rejection of the full depth of book alternative.⁷⁰

The final rule claims to protect a market’s best bid or offer (“BBO”), but since market participants can match a trading center’s BBO, rather than route orders to it, the rule does not actually protect limit orders at each market’s BBO. The Adopting Release acknowledges that the BBO trade-through rule will not draw out every limit order, but asserts that it will provide investors with the appropriate incentives to post additional limit orders.⁷¹ This assertion is highly questionable. Given its decision to protect limit orders only at the top-of-book, the permissibility of internalization, and the numerous

⁷⁰ Commenters saw through this false claim. See, e.g., Morgan Stanley Reproposal Comment Letter, supra note 22, at 4 (“[W]e cannot agree with the SEC’s view that the single most important objective of the SEC’s trade-through rule alternatives is the protection of limit orders, as the only effective way to accomplish that objective would be to impose market-wide price/time priority”); Comment Letter of George U. Sauter, Managing Director, The Vanguard Group, Inc. (Jan. 27, 2005) (“Vanguard Reproposal Comment Letter”), at 4 (“If one believes that the trade-through rule is important for the protection of investors, which we do, there is no logical reason why price protection should not be extended to all displayed liquidity. In fact, protection for just the BBO actually codifies trade-throughs.”); Ameritrade Reproposal Comment Letter, supra note 22, at 5 (“The Market BBO Alternative would protect only the best priced limit orders, while all other limit orders are unprotected and can be traded through with impunity.”).

⁷¹ See Adopting Release, supra note 1, at text following note 110.

exceptions to the trade-through rule, the majority cannot credibly argue that the protection of limit orders is a high priority.⁷²

The majority is careful to characterize the trade-through rule's objective of increasing market depth as "modest," translating into a hypothetical \$755 million in cost savings in 2003 for long-term investors.⁷³ This amount is based upon a hypothetical 5% improvement in depth and liquidity or an average reduction of 1.87 basis points in price impact and liquidity search costs.⁷⁴ The majority provides no basis, however, for positing a 5% improvement in depth and liquidity, except to characterize it as the "current share volume of trade-through transactions that does not interact with displayed liquidity."⁷⁵ Although it is apparently intended to show an order of magnitude, there is no basis for the 5% estimate.

Further, the majority fails to provide an estimate of the expected reductions in trade-throughs or indicate specifically how the new displayed depth will be generated. It speculates that "greater displayed liquidity will at least lower the search costs associated with trying to find liquidity,"⁷⁶ and goes on to make unfounded assumptions claiming that

⁷² The trade-through rule will only apply during normal trading hours. Thus, market participants might game the system and avoid the trade-through rule by shifting liquidity to after-hours trading sessions.

⁷³ See Adopting Release, supra note 1, at 303. The majority explains:

The Rule is designed to increase the perceived benefits of order display, against which the negatives are balanced. As a result, the market participant that currently displays only 500 shares of its 50,000-share trading interest might be willing to display 1000 shares. The collective effect of many market participants reaching the same conclusion would be a material increase in the total displayed depth in the market, thereby improving the transparency of price discovery and reducing investor transaction costs.

Adopting Release, supra note 1, at text following note 110.

⁷⁴ See Adopting Release, supra note 1, at text following note 303.

⁷⁵ See Adopting Release, supra note 1, at text following note 303.

⁷⁶ See Adopting Release, supra note 1, at text following note 160.

“[i]ncreased liquidity, in turn, could lead market participants to interact more often with displayed orders, which would lead to greater use of limit orders, and thus begin the cycle again.”⁷⁷ The majority fails to address how internalization, free-riding or market impact costs will factor into the display of additional limit orders. Instead, it provides only a theoretical response to an extremely complex question.

IV. THE MAJORITY’S DISTINCTION BETWEEN LONG-TERM AND SHORT-TERM INVESTORS IS ARBITRARY AND UNREASONABLE.

Essential to the majority’s argument that a trade-through rule is necessary to augment market depth is its decision to favor the interests of long-term investors and issuers for purposes of market structure design.⁷⁸ The majority interprets Section 11A of the Exchange Act as requiring the Commission to facilitate the national market system – not for the protection of “investors,” but for the protection of “long-term investors.”⁷⁹

We find the majority’s parsing of the term “investor” arbitrary and unreasonable. In our

⁷⁷ See Adopting Release, supra note 1, at text following note 160.

⁷⁸ See Adopting Release, supra note 1, at Section I.B.2 (“Serving the Interests of Long-Term Investors and Listed Companies”). In the 1975 Act Amendments, Congress did not exhibit such favoritism:

The purpose of this title is to insure that our Nation’s capital markets continue to be the best in existence . . . by establishing a framework for a national market systems in which all qualified persons throughout our country may be linked together electronically so that they may compete and may bring to the marketplace their capital so as to make for broader, deeper and more liquid capital markets.

H.R. Rep. No. 94-123, supra note 3, at 90.

⁷⁹ See Adopting Release, supra note 1, at text preceding note 15; see generally Adopting Release, supra note 1, at Section I.B.2 (“Serving the Interests of Long-Term Investors and Listed Companies”). The majority cites the legislative history of the adoption of the Exchange Act in 1934 to support this position, but that history is not relevant. See Adopting Release, supra note 1, at text accompanying notes 20 and 23. The term “investor” as interpreted by the Commission was contained in Section 11A of the 1975 Act Amendments directing the Commission to facilitate the national market system. The legislation did not include a definition of the term.

view, all investors are entitled to efficient executions and access to the best markets. This is not the case, however, under Regulation NMS.⁸⁰

The majority characterizes short-term investors, or traders, as holding securities for a matter of seconds, minutes or hours.⁸¹ It concedes that short-term investors provide valuable liquidity to long-term investors,⁸² yet acknowledges that the rule may harm short-term investors and market intermediaries.⁸³ What the majority fails to recognize is that, by harming short term investors, the rule may also negatively affect long-term investors who may face increased spreads and decreased liquidity. Liquidity provided by short-term investors narrows spreads and gives long-term investors better executions. Because short-term investors are willing to take risks that strengthen the marketplace and benefit long-term investors, Congress clearly could not have intended for short-term investors to be harmed through the Commission's facilitation of the national market system. In fact, Congress prioritized the removal of barriers to competition to increase the participation of market makers and increase the competitive trading of securities.⁸⁴

⁸⁰ The Adopting Release does not credit commenters' claim that a trade-through rule is not needed on the Nasdaq market because that market is efficient. See Adopting Release, supra note 1, at text preceding note 61. The majority unreasonably views this claim as suspect "when market efficiency is examined from the perspective of transaction costs of long-term investors, as opposed to short-term traders." Adopting Release, supra note 1, at text following note 63.

⁸¹ See Adopting Release, supra note 1, at note 22 and accompanying text.

⁸² See Adopting Release, supra note 1, at text following note 19.

⁸³ See Adopting Release, supra note 1, at text following note 22.

⁸⁴ One of the fundamental purposes underlying the national market system contemplated by S. 249 is to enhance the competitive structure of the securities markets in order to foster the risk-taking function of market makers and thereby to provide free market incentives to active participation in the flow of orders. The competitive structure and incentives to participation thus provided should supplement, and ultimately may be able to replace, most affirmative requirements to deal imposed by regulation.

Senate Report, supra note 3, at 14. The trade-through rule creates comparable barriers to off-board trading restrictions, which were among the barriers Congress sought to remove.

The majority also fails to take into account that long-term and short-term investors are not mutually exclusive groups. Investors can be long-term and short-term investors at the same time or they may be a long-term investor one moment and, for a variety of reasons, become a short-term investor the next. The overlapping nature of these undefined categories highlights the arbitrary nature of the majority's distinction. The length of time an individual owns a stock or intends to own a stock at any particular moment is not a relevant factor in distinguishing among groups of investors.

The majority claims that the trade-through rule ensures that investors get the best price. We have indicated above why we believe this claim significantly overstates the problem the rule is intended to address. By making price the sole criterion for determining how and where orders will be executed, the trade-through rule also restricts investor choice and ability to obtain best execution. As one commenter explained:

Indeed, based on years of empirical evidence and substantial quantitative research into the components of transaction costs, it is our strong belief that price is just one element in overall execution quality. Institutional traders often need to trade off price for liquidity, speed of execution, likelihood of completion, and other attributes. We believe investors should have the choice over where to execute their orders, considering these other attributes, and that regulatory reform should continue to encourage market centers to compete in all these dimensions of execution quality.⁸⁵

The majority claims that the limitation on investor choice inherent in the trade-through rule is in the public interest and is needed to protect retail and long-term investors that may be harmed by trade-throughs. Before restricting investors' ability to obtain the best execution in a manner that satisfies their investment needs, the majority

⁸⁵ Barclays Reproposal Comment Letter, supra note 22, at 2-3.

should be required not only to show current harm, but to demonstrate the benefits provided by the trade-through rule.⁸⁶

The majority's distinction between the interests of long- and short-term investors simply provides a way for it to attempt to justify its policy choices, without any basis in fact, and it sets a dangerous precedent. Once codified, the concept may leach into other rulemakings and alter the basic ownership principles governing the market. Clearly, the interests of long- and short-term investors are inextricably linked. In the words of the Proposing Release: "A fair and efficient national market system must serve the interests of both types of investors."⁸⁷ In the absence of Regulation NMS, fair and efficient markets would develop to provide economically efficient execution of securities transactions for all investors, not just those favored by the Commission.⁸⁸

V. THE RULE WILL HAVE NEGATIVE REPERCUSSIONS.

We believe that, not only will the trade-through rule not achieve its purported benefits, it will have negative unintended consequences. The complexity of the rule structure invites exploitation that may create unforeseen market distortions. Commenters indicated that the BBO trade-through rule may introduce market inefficiencies, competitive barriers, and unnecessary costs, while stifling innovation.

⁸⁶ See Senate Report, supra note 3, at 12 ("In other words, in the national market system, investors should be able to obtain the best execution of their orders and be assured that because of open competition among market makers the total market for each security is as liquid and orderly as the characteristics of that security warrant.").

⁸⁷ Reproposing Release, supra note 17, 69 FR at 77439.

⁸⁸ The majority is selective in its reliance on the long- and short-term investor distinction. In rejecting the proposed opt-out, the majority claims that advocates of the opt-out "have failed to consider the interests of all investors -- both those who submit marketable orders and those who submit limit orders." Adopting Release, supra note 1, at text following note 247.

Market participants and academics warned the Commission of unintended consequences,⁸⁹ including: (i) decreased price discovery and quantity discovery,⁹⁰ (ii) increased gaming opportunities,⁹¹ (iii) the lowest common denominator problem,⁹² (iv) increased market fragmentation,⁹³ and (v) increased volatility.⁹⁴ The lack of consensus about the likely impact of Regulation NMS among industry participants, academics and investors provides further evidence of the risks attendant to the rule's

⁸⁹ See, e.g., Comment Letter of Marc E. Lackritz, President, Securities Industry Assoc. (Feb 1, 2005) (“SIA Reproposal Comment Letter”), at 10; Comment Letter of James A. Duncan, Chairman, and John C. Giese, President and Chief Executive Officer, Security Traders Assoc. (Jan. 19, 2005); J.P. Morgan Reproposal Comment Letter, supra note 22, at 7; Paul L. Davis and Robert A. Schwartz, Report, Comments on SEC Reg NMS (Jan. 26, 2005) (attachment to TIAA CREF Reproposal Comment Letter, supra note 22), at 7; Battalio-Jennings Study, supra note 34, at 5 (“[T]he proposed trade-through rule may have negative unintended consequences.”); Comment Letter of James J. Angel, Assoc. Professor of Finance, McDonough School of Business, Georgetown University (Jan. 25, 2005) (“Angel Reproposal Comment Letter”), at 1.

⁹⁰ See, e.g., TIAA CREF Reproposal Comment Letter, supra note 22, at 2 (expressing concern that “both of the proposed trade-through rules will compromise” price and quantity discovery).

⁹¹ See, e.g., J.P. Morgan Reproposal Comment Letter, supra note 22, at 11.

⁹² See, e.g., Instinet Reproposal Comment Letter, supra note 22, at 17; Merrill Lynch Reproposal Comment Letter, supra note 22, at 5.

⁹³ See, e.g., J.P. Morgan Reproposal Comment Letter, supra note 22, at 10 (“[T]he incentive structure created by the Top of Book Alternative could also lead to increased market fragmentation despite the SEC’s intent to the contrary.”); Citigroup Reproposal Comment Letter, supra note 6, at 5 (explaining that the top of the book alternative “could cause market participants to choose market centers for execution that are more likely to have less liquidity and order flow so that the market participant’s order has a greater probability of being at the top of the book (best bid/offer) and therefore receiving increased protection. . . . Ultimately, we feel this could result in increased fragmentation with each broker-dealer’s order flow being dispersed throughout the eleven ‘protected’ market centers.”); Tradebot Reproposal Comment Letter, supra note 68, at 2 (“It is not widely understood yet, but I think a trade through rule with automated quotes would . . . increas[e] market fragmentation . . .”).

⁹⁴ See, e.g., J.P. Morgan Reproposal Comment Letter, supra note 22, at 6 (“A trade-through rule that essentially forces investors to perform sweeps is likely to increase volatility in the marketplace, particularly for relatively illiquid securities.”); Vanguard Reproposal Comment Letter, supra note 70, at 4 (“The BBO alternative would produce greater volatility, as some executions would occur at inferior prices.”); Automated Trading Desk Reproposal Comment Letter, supra note 22, at 3 (“The proposed rule will create added market volatility due to behavioral changes by block positioners . . .”).

implementation. Our concerns about these negative consequences are aggravated by the rule's questionable enforceability.⁹⁵

A. The Rule Will Limit Competition and Stifle Innovation.

The majority speaks continually of the importance of encouraging two types of competition – competition among orders and competition among markets, and believes that the trade-through rule promotes competition on both scores. We find no mention of different types of competition in the language of Section 11A, the source of the Commission's authority in this area, and we believe the rule is anti-competitive.

1. Competition Among Markets.

In adopting the trade-through rule, the majority has opted for government-controlled competition over competitive market forces to determine the appropriate market structure. Section 11A plainly states, however, that a national market system should foster competition among broker-dealers and among markets. Today, broker-dealers, electronic communications networks (“ECNs”) and SROs compete in the Nasdaq market on the basis of technology, execution quality and cost. Competition among market makers increased significantly following the Commission's adoption of Rule

⁹⁵ OEA, in its study on trade-throughs, remarked on the complexity of identifying actual trade-throughs, a necessary predicate to the enforcement of the rule. OEA Study, supra note 20, at 1 (“While trade-through identification seems straightforward, in practice it is complicated by quickly changing quotes, system time lags, data limitations, and imperfect access to markets.”). See also UBS Reproposal Comment Letter, supra note 22, at 5 (“[E]nforceability will be unachievable (correctly noted by the OEA Study) due to the inability to accurately identify when, due to quotation changes, system imperfections and data discrepancies, a trade-through has even occurred.”); Morgan Stanley Reproposal Comment Letter, supra note 22, at 14 (“In order to monitor and enforce a trade-through rule, it is essential that the Commission promulgate standards for an intermarket clock. The existing clock synchronization standards, which differ by market, combined with penny trading increments, would render it virtually impossible to effectively monitor compliance with the proposed trade-through rule.”).

11Ac1-5, which required market centers to publish execution quality statistics.⁹⁶ This information permitted brokers to make more informed order routing decisions, consistent with their best execution obligations. At the same time, overall execution quality for retail customers improved as competition among executing broker-dealers on the basis of execution quality became a means of attracting retail order flow. Likewise, competition between markets and ECNs drove technological innovation as a means of attracting orders and liquidity to their markets.

Under the trade-through rule, competition among market makers may decrease. Given the rule's sole focus on price, incentives to improve execution quality above and beyond the trade-through rule's mandated execution methodology may be reduced. Further, by limiting order routing decisions to the price of protected quotations, the trade-through rule sacrifices competition among SROs and ECNs, which will have a negative impact on innovation. Instead of allowing markets to compete for order flow, the trade-through rule forces order flow to the SRO markets. The majority believes that competitive pressures will continue to drive change since orders may still be internalized, and priority for routing decisions can be made when SROs are displaying the same price. We believe, however, that the trade-through rule will restrict competitive forces and reduce markets to the lowest common denominator by dampening the incentives for markets to compete on the basis of improved technology and services and reduced costs. With the government managing all aspects of the competition, it is difficult to credit the majority's claim that the trade-through rule promotes competition. In our view, the trade-through rule limits competition among markets.

⁹⁶ See Securities Exchange Act Release No. 43590 (Nov. 17, 2000), 65 FR 43590 (Dec. 1, 2000).

Market share may well shift following implementation of the trade-through rule, but not because the rule promotes competition. To the extent that we observe shifting market share, it will be attributable to limit orders being redistributed among protected SRO quotations. Market participants may game the system by distributing orders to what might normally be their second-choice market, so that their orders will be protected as top-of-book at the second-choice market. To the extent that investors spread orders among the various SROs to obtain as much top-of-book protection as possible, any resulting shift in market share would occur, not as a result of increased market competition, but as a result of the Commission's attempt to engineer market structure by imposing a trade-through rule.⁹⁷

2. Competition Among Orders.

The majority believes that by protecting limit orders, that is, restricting pricing decisions, it will create the appropriate incentives for investors to display more of their interest to buy or sell, which will decrease volatility and implicit transaction costs. However, the trade-through rule restricts competition among orders by requiring a government-mandated method of trading. Disfavoring short-term investors could upset the market's liquidity equilibrium and decrease competition among orders because "short-term" investors provide much needed liquidity to the market through their willingness to buy and sell stock.⁹⁸

⁹⁷ See, e.g., J.P. Morgan Reproposal Comment Letter, *supra* note 22, at 10 ("The result likely would be that market participants would engage in an economically inefficient competition to develop costly computer systems that route and re-route limit orders to various markets based on the probability of achieving trade-through protection."); Citigroup Reproposal Comment Letter, *supra* note 6, at 5 ("[T]his type of market regulation may serve to support certain market centers that otherwise may be incapable of competing because of poor technology and inferior execution.").

⁹⁸ See *supra* Section IV.

Unrestricted market and order competition in the Nasdaq market has achieved several objectives under Section 11A, including increased direct order interaction, reduced execution costs and improved execution quality for all investors. In the absence of any valid justification for extending the trade-through rule to Nasdaq, the majority is forced to argue that Nasdaq's vigorous order competition reflects a weakness in market depth and liquidity that requires a trade-through rule. As discussed above, the use of electronic methods of price and size discovery on Nasdaq is evidence of a healthy, competitive market, not evidence of structural weakness.⁹⁹

By adopting a trade-through rule, the majority has shown itself willing to sacrifice competition among markets to attempt to increase competition among orders. If increasing order competition were its goal, however, then the majority should have afforded full protection of limit orders by imposing price-time priority. It is questionable how order competition will increase under a rule that applies a price priority structure that is rife with exceptions. The negligible protection afforded to limit orders under the trade-through rule simply does not square with the degree of increased order competition that the majority hopes will materialize. If anything, the rule's compromised approach favoring long-term investors may decrease liquidity, and thus decrease order competition.

⁹⁹ See supra Section II.B.

3. Barriers to Competition.

The trade-through rule creates barriers to competition.¹⁰⁰ We are concerned that these “regulatory restraints” will prevent new competitors from entering the market and place unnecessary burdens on existing trading centers.¹⁰¹ Under the rule, only SRO quotations are protected. Through the SRO registration process, the Commission controls the number of SROs in the national market system. This barrier to entry will likely increase if the Commission adopts proposed regulations that would place restrictions on SRO ownership and substantially increase regulatory burdens pertaining to SRO governance, reporting and recordkeeping requirements.¹⁰²

The Commission’s involvement in implementing the access and automated market provisions of Regulation NMS will create additional barriers to entry. The access provisions require that the Commission approve the application of each new participant

¹⁰⁰ See, e.g., SIA Reproposal Comment Letter, supra note 89, at 9 (“[T]he SEC’s two Alternatives err too far in the direction of ensuring intermarket interactions, thereby threatening intermarket competition, discouraging innovation, and limiting investor choice. As a result, we are concerned that the TOB and DOB Alternatives ultimately may cause significant harm to investors and imperil the preeminence of the U.S. markets. Specifically, we believe that the TOB and DOB Alternatives will drive the markets toward one uniform market model. Indeed, both proposals push the markets toward intermarket competition that is based solely on displayed price. . . . [B]oth Alternatives raise the specter of competition-stifling, micro-management of market structure by the government.”); J.P. Morgan Reproposal Comment Letter, supra note 22, at 7 (“However, such incentives would likely be stronger the greater the extent of the regulatory license provided by the trade-through rule.”); TIAA CREF Reproposal Comment Letter, supra note 22, at 8-9 and 11; Citigroup Reproposal Comment Letter, supra note 6, at 2 and 5; Comment Letter of Daniel M. Clifton, Executive Director, American Shareholders Assoc. (Jan. 26, 2005), at 2; Comment Letter of J. Greg Mills, Managing Director, Head of Global Equity Trading, RBC Capital Markets Corp. (Jan. 26, 2005) (“RBC Reproposal Comment Letter”), at 3; Instinet Reproposal Comment Letter, supra note 22, at 5; Archipelago Reproposal Comment Letter, supra note 22, at 9; UBS Reproposal Comment Letter, supra note 22, at 3.

¹⁰¹ See Senate Report, supra note 3, at 13 (“Unfortunately, because of excessive and unnecessary regulatory restraints, competition in the securities industry has not been as vigorous and as effective in advancing the public interest as it could be.”).

¹⁰² Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 FR 71126 (Dec. 8, 2004).

in the NASD's Automated Display Facility ("ADF"), outline the requirements of "substantially equivalent" access, and determine whether trading centers engage in unfairly discriminatory practices. The Commission will also be involved in determining which markets comply with the definition of an automated market, involving the Commission in highly technical and subjective judgments, which may neither be fair nor expedient.

We see troubling parallels between the barriers to entry that we foresee under the trade-through rule and the barriers to entry created by the Commission's criteria for recognition of credit rating agencies as nationally recognized statistical rating organizations ("NRSROs").¹⁰³ The delay in obtaining a no-action letter from the SEC staff by applicants for NRSRO status, a process that often takes several years, has raised barriers to entry for credit rating agencies. We are concerned that bureaucratic delay may create similar barriers to entry for market participants seeking to register as an SRO, new ADF participants and SROs seeking to make changes to their market operations.¹⁰⁴

4. Stifling Innovation

Innovation may be another casualty of the trade-through rule. Decreased competition and increased regulatory barriers create an environment that stifles innovation, depriving investors of the benefits of innovation, including efficiencies and cost savings. Unfortunately, as we saw in the listed market, where technology was antiquated and price discovery hampered, it is difficult to determine whether a regulatory regime impedes innovation until a marketplace is competitively disadvantaged.

¹⁰³ Securities Exchange Act Release No. 51572 (Apr. 19, 2005), 70 FR 21306 (Apr. 25, 2005).

¹⁰⁴ Nasdaq's application for exchange registration has been pending since March 15, 2001. Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001)

By requiring the Commission or its staff to approve changes to an SRO's market operations, Regulation NMS essentially codifies current technologies and methods of trading through the exceptions to the trade-through rule and controls future innovation.¹⁰⁵ Bureaucratic delay creates a competitive barrier that may impede the future development of trading and order routing systems. In other words, the future development of efficient and effective methods of committing capital and pricing securities may be inhibited.

What we find disturbing about the majority's policy determinations in Regulation NMS is that they are contrary to prior Commission statements regarding the importance of fostering innovation and competition. In Regulation ATS, for example, the Commission designed a regulatory framework for alternative trading systems ("ATs") that "encourage[d] market innovation while ensuring basic investor protections."¹⁰⁶ To help reduce competitive impediments to innovation by SROs, the Commission approved a temporary exemption permitting SROs to operate new trading systems without filing for approval under certain circumstances.¹⁰⁷

Likewise, in the order approving Nasdaq's SuperMontage, the Commission acknowledged that "competition and innovation are essential to the health of the securities markets. Indeed, competition is one of the hallmarks of the national market

¹⁰⁵ Schwab Reproposal Comment Letter, *supra* note 22, at 2 ("A centralized routing algorithm stifles innovation of new mechanisms for handling orders."); Archipelago Reproposal Comment Letter, *supra* note 22, at 5; Angel Reproposal Comment Letter, *supra* note 89, at 2.

¹⁰⁶ Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844, at 70847 (Dec. 22, 1998).

¹⁰⁷ *Id.* The Commission stated that the pilot was "to provide registered exchanges and national securities associations with a greater opportunity to compete with alternative trading systems registered as broker-dealers and with foreign markets." *Id.* at note 29.

system.”¹⁰⁸ It stated that the regulatory structure was designed to “provide all market centers with structural flexibility in order to enhance competition between market centers, while promoting market fairness, efficiency, and transparency.”¹⁰⁹ In analyzing the competitive issues involved in approving SuperMontage, the Commission stressed that:

Nasdaq and traditional exchanges must have the flexibility to rethink their structures to permit appropriate responses to the rapidly changing marketplace. Congress instructed the Commission to seek to “enhance competition and to allow economic forces, interacting with a fair regulatory field, to arrive at appropriate variation in practices and services.”¹¹⁰

The Commission found SuperMontage consistent with the goals of promoting “price discovery, best execution, liquidity, and market innovation, while continuing to preserve competition among market centers.”¹¹¹ Under this policy guidance, the markets automated and real competition emerged, due in large part to the explosive growth of the ECNs, which have been the greatest catalyst for increased competition and technological advances in the Nasdaq market. Under the trade-through rule, ECNs will be able to compete only if they display quotations through an SRO and offer substantially equivalent access. Moreover, the fact that dominant markets can match BBOs undercuts the majority’s argument that competition among markets will increase.

Unfortunately, the majority fails to use past experience as a guide. In adopting the trade-through rule, the majority has reversed Commission policy, opting for government-controlled competition, a failure under ITS, instead of unfettered competition, the more successful approach over time as evidenced by the Nasdaq market.

¹⁰⁸ Securities Exchange Act Release No. 43863 (Jan. 19, 2001), 66 FR 8020, at 8049 (Jan. 26, 2001).

¹⁰⁹ Id. at 8052.

¹¹⁰ Id. at note 471 and accompanying text (citing Senate Report, supra note 3).

¹¹¹ Id. at 8055.

The Nasdaq market has developed into an efficient, automated and highly competitive marketplace. Competition among markets trading Nasdaq securities has fulfilled the objectives of Section 11A by creating a fully automated and connected marketplace, decreasing execution costs, and increasing market data distribution. Efficiencies born of competition have benefited investors and issuers alike. The majority's adoption of the trade-through rule assists one market to step forward, while forcing other markets to take two giant steps backward.

B. Additional Regulation Is Needed to Address Problems Created by the Trade-Through Rule.

To have its trade-through rule, the majority has been compelled to engage in rulemaking that otherwise would have been unnecessary. The Commission has historically analyzed a broker's best execution obligation on the basis of several factors, including execution price, speed of execution, the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and the cost and difficulty associated with achieving an execution in a particular market center.¹¹² One of the consequences of limiting investor choice to the sole criterion of price is that the Commission must ensure that markets have comparable access to these prices. This has required the Commission to adopt a cap on access fees so that market participants are not held hostage by outlier markets displaying the best price, but charging excessive access fees.

¹¹² Newton v. Merrill Lynch, 135 F.3d 266, 270 n.2 (3d Cir. 1998) (citing Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934 (Oct. 13, 1993)).

As noted above, Regulation NMS will also require Commission involvement in implementation of access standards and approval for new ADF participants. Key standards under trade-through exceptions, including standards for automatic execution, will also require determinations by the Commission and its staff, many involving interpretation of subjective standards. The end result is a highly regulated and micromanaged market that limits competition and innovation. As one commenter observed:

[T]he rule will require lots of filings from SROs, and years of intense fighting over details. It is likely that the Commission staff will end up making numerous important decisions on the important micro-details of market structure with lots of unintended consequences that will take decades to understand and fix.¹¹³

Indeed, the majority concedes that a trade-through rule may “lessen the competitive discipline” because brokers will not be able to avoid markets that do not provide quality execution services.¹¹⁴ The majority would replace this competitive discipline with increased regulatory oversight. The Commission now must screen new entrants’ ability to meet access requirements and standards for automatic execution through the SRO registration process or the 19b-4 approval process for new ADF participants. The majority notes that the self-regulatory function will also be important in monitoring compliance with all Exchange Act and SRO rules, including compliance with the trade-through rule.¹¹⁵ Finally, the Adopting Release notes that “[e]ffective implementation of the Order Protection Rule also will depend on the Commission’s taking any action that is necessary and appropriate to address trading centers that fail to

¹¹³ Angel Reproposal Comment Letter, supra note 89, at 2.

¹¹⁴ See Adopting Release, supra note 1, at text following note 243.

¹¹⁵ See Adopting Release, supra note 1, at text following note 244.

meet fully their regulatory requirements.”¹¹⁶ This would include taking enforcement actions against trading centers that fail to meet regulatory requirements.

Instead of relying on competitive forces to discipline market access and execution services, Regulation NMS establishes a regulatory back-up plan for outlier SROs. We believe the better approach would have been to clarify best execution guidance, outlining the appropriate balancing of factors when routing orders. In any event, the trade-through rule, which does not provide protection to manual quotes, complicates the best execution analysis because manual quotations may not be disregarded. Furthermore, guidance on best execution will still be needed to assist brokers in fulfilling their obligations for assessing the depth of book and manual quotations.¹¹⁷

C. Implementation Will Be Costly.

The majority’s cost-benefit analysis underestimates the costs associated with implementation and compliance, while overestimating the benefits. Even by the majority’s own estimation, the benefits of Regulation NMS will likely be modest. But these modest benefits will come at a very high price. Some of the costs of Regulation NMS will be measured in terms of the dollars it will cost trading centers to modify their

¹¹⁶ Adopting Release, supra note 1, at text following note 244.

¹¹⁷ See, e.g., SIA Reproposal Comment Letter, supra note 89, at 15 (“[W]e are concerned that broker-dealers will be required, as a business and legal matter, to take account of the full depth-of-book as well as manual quotes in providing best execution to their customers. Although the SEC states only that best execution standards will not change, the SEC will have changed the entire market structure, which would appear to necessitate a re-evaluation of best execution standards. . . . [W]e are concerned that broker-dealers will be held liable by customers and regulatory examiners, far beyond the requirements of the trade-through rule, to a best execution standard based on manual quotes.”); Comment Letter of Bernard L. Madoff and Peter B. Madoff, Bernard L. Madoff Investment Securities LLC (Feb. 3, 2005), at 5 (“[W]e urge that the Commission clarify its position by providing specific guidance as to the interplay between the trade-through and the best execution requirement.”); RBC Reproposal Comment Letter, supra note 100, at 4; Merrill Lynch Reproposal Comment Letter, supra note 22, at 6; UBS Reproposal Comment Letter, supra note 22, at 2.

policies and procedures and internal systems and monitor compliance with the trade-through rule on an ongoing basis.¹¹⁸ The cost-benefit analysis estimates start-up costs at \$143.8 million, with average annual ongoing costs of approximately \$22 million.¹¹⁹ Market participants will also experience significant costs in terms of the time and effort they will spend negotiating with our staff on the numerous interpretive issues and in explaining to our examination staff that apparent trade-through violations are not really violations.¹²⁰ Thus, even if there are no trade-throughs, there will still be a burden on trading centers to prove the absence of trade-throughs.¹²¹

¹¹⁸ See, e.g., Deutsche Bank Reproposal Comment Letter, supra note 22, at 5 (“In sum, we are concerned that the adoption of Regulation NMS, unless carefully crafted with sensitivity to practical implementation difficulties and expenses, holds the potential to force upon broker-dealers complex challenges and burdensome costs, the scale of which may not be fully appreciated by the Commission.”); SIA Reproposal Comment Letter, supra note 89, at 11; Citigroup Reproposal Comment Letter, supra note 6, at 2; Knight Trading Reproposal Comment Letter, supra note 22, at 5.

¹¹⁹ See Adopting Release, supra note 1, at text following note 782.

¹²⁰ As UBS explained, the difficulties associated with inspecting for violations of the rule are likely to result in a shifting of the burden to firms to prove that they did not violate the rule:

[W]e foresee a process, not unlike many current “sweep” regulatory actions in which the SEC (or a SRO) will provide each firm with a list containing hundreds of “exceptions” for which the regulatory surveillance systems have detected a potential trade-through violation. In following current examination practice, a firm will be given an opportunity to demonstrate to the regulator why it believes that it did not trade through the best posted price (thus the firm will be deemed guilty of these violations unless it can satisfactorily demonstrate its innocence). Due to exceptions to the rule, technological limitations, and latency in delivery and receipt of market updates and quotations, there will be a substantial number of “false positives” that would have to be disproved. The likely end result of this review will be a justifiable reason for 98% of the exceptions, but firms such as UBS would, most likely, receive a regulatory sanction for their inability to demonstrate guilt or innocence for the remaining 2%.

UBS Reproposal Comment Letter, supra note 22, at 5. See also CIBC Reproposal Comment Letter, supra note 22, at 4 (“It will result in wasted resources sifting through market data to eliminate false trade-throughs, and trade-throughs for economically insignificant sums. We also believe that this task will be inordinately expensive, both in terms of the hard dollars required to build systems and pay for market data to do surveillance and the lost opportunity cost of resources that could be spent investigating execution quality in less liquid stocks.”).

¹²¹ One commenter cautioned against underestimating costs. See Deutsche Bank Reproposal Comment Letter, supra note 22, at 4 (“[W]hat in principle may appear to be a rather

VI. Market Data Reforms Do Not Address the Real Problem.

While the discussion above focuses on the trade-through rule, we also believe there are serious problems with the market data reforms included in Regulation NMS. The availability of market data is critical because market data provides transparency within the market and allows investors to evaluate the quality of their executions. Regulation NMS does not address the larger issues surrounding market data, and the majority has indicated that these issues will be addressed in a different forum.

We have concerns about the market data reforms in Regulation NMS, even though they are limited, and a particular concern with respect to the codification of the single consolidator model. By entrenching the single consolidator model, the majority grants a monopoly for the consolidation of market data, which erects another barrier to encouraging competitive solutions for market data consolidation. We intend to advocate a reconsideration of this decision by our colleagues when the Commission considers the market data issue in general.

We are also concerned about the majority's failure to address the level of market data fees. The size of market data revenues and lack of accountability for the use of these revenues by the SROs creates market distortions and inefficient allocation of resources.¹²²

straightforward measure, most assuredly involves significant changes to a broker-dealer's trading, technology, operations, supervisory and compliance platforms. . . . In our experience to date with Regulation SHO, which was a fairly incremental initiative that built upon existing SRO rules and adopted a fraction of the original Commission proposal, our costs (represented by hundreds of collective hours . . .) have been real and significant."

¹²² See, e.g., Hearing on Proposed Regulation NMS Before the Securities and Exchange Commission (Apr. 21, 2004) ("Regulation NMS Hearings"), at 223-24 (testimony of Robert Greifeld, President and Chief Executive Officer, Nasdaq Stock Market) ("Currently that cost [of market data] for professional investors is around \$20. . . . There was no great wisdom in that number, and we look at the number today, that number is too high. . . . With the current structure, then, data is not provided at a low enough cost and it [creates] unintended results and distortions in our market. The market centers today are the beneficiaries of that excessive rent. . . .");

By continuing to fail to address the reasonableness of the rates charged by the markets, the majority sidesteps serious questions about whether government-sponsored monopolies should be allowed to charge excessive rents to cross-subsidize other functional costs, and if so, how they should be held accountable for the appropriate use of such funds. What is needed is a heightened sense of accountability for the use of market data revenues and an incentive for the exchanges to increase efficiencies.

Supporters of the current pricing schedule indicate that the extra revenues are needed to fund the regulatory functions performed by exchanges. Even with the current high levels of market data fees, our enforcement docket does not demonstrate that higher funding has led to effective regulatory oversight by SROs.¹²³ Critics contend that the exchanges charge an excessive rate for consolidating and distributing market data. They note that the relative opaqueness of the market data pricing process inhibits public scrutiny on the current cost of consolidated market information.

It is difficult to argue that, in an era of heightened disclosure requirements, a virtual public utility should not be required to openly justify and account for the use of public funds. Moreover, having chosen to maintain the current single processor system,

Regulation NMS Hearings, at 229 (testimony of Jeffrey T. Brown, General Counsel, Schwab Soundview Capital Markets) (“[L]ast year, the market data cartels took in \$424 million in revenue and had expenses of \$38 million. . . . [T]hat’s a profit margin of over a thousand percent. . . . [T]hat excess revenue manifests itself in the types of practices that you’re concerned with, . . . tape shredding, market data rebates, excessive pay to executives. And there’s clearly a link . . . between market data revenue and these practices.”).

¹²³ See, e.g., Securities Exchange Act Release No. 51163 (Feb. 9, 2005) (Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 relating to violations by MarketXT, an NASD member, and registered broker-dealer, which were not adequately addressed by Nasdaq, as overseen by its parent, NASD); Securities Exchange Act Release No. 51524 (Apr. 12, 2005) and SEC Press Release 2005-53 (April 12, 2005) (instituting and simultaneously settling an enforcement action against the NYSE, finding that the NYSE, “over the course of nearly four years, failed to police specialists, who engaged in widespread and unlawful proprietary trading on the floor of the NYSE”).

the majority, if it is to accomplish its mission of promoting transparency and protecting investors, while allowing competition to flourish, must accept the responsibility for scrutinizing rates charged for market data and monitoring the heavy hand of monopoly power.¹²⁴

CONCLUSION

We do not believe that Regulation NMS is the appropriate policy choice. Instead of facilitating a national market system in which technology, competition and innovation will produce benefits for all investors, Regulation NMS saddles the marketplace with anachronistic regulation that reduces investor choice and raises investor costs. In the name of investor protection and uniformity, the majority has opted for greater regulation rather than competition to facilitate what it perceives to be fair treatment of customer orders and deep and liquid markets. However, the majority has failed to establish evidence of investor protection concerns, and the goal of uniformity could have been achieved by having no trade-through rule.

Since the Commission voted on Regulation NMS, mergers have been announced between the NYSE and Archipelago and between Nasdaq and The Instinet Group.¹²⁵ The timing of these announcements so soon after the adoption of the rule has led some to

¹²⁴ The Senate bill required SIPs which act as exclusive processors to register with the Commission and provided the Commission with the authority to require the registration of other categories of SIPs. The reference to exclusive processors did not constitute a mandate for a single securities information processor at any stage in the processing of quotation or transactional data, but merely recognized that where SROs utilize an exclusive processor, that processor takes on certain of the characteristics of a public utility and should be regulated accordingly.

Conference Report, supra note 4, at 93.

¹²⁵ See, e.g., Aaron Lucchetti et al., NYSE to Acquire Electronic Trader and Go Public, WALL ST. J., Apr. 21, 2005, at A1; Aaron Lucchetti, Nasdaq Chief Plays Hardball in Instinet Deal, WALL ST. J., Apr. 25, 2005, at C1.

credit Regulation NMS with enhancing competition and equalizing regulation among markets. We believe the timing can be more accurately explained by the markets' simple desire for closure with respect to Regulation NMS. Intensifying competitive pressures, combined with the Commission's focus on market structure, created an environment in which the markets' strategic business plans likely could not be finalized until the regulatory risk was resolved. In the end, it was not so much the substance of Regulation NMS that was important, but the fact that the regulation was final.

Unfortunately for the marketplace, this version of Regulation NMS that the majority has adopted is far from final. Imprecise definitions, the acknowledged need for future interpretations that the majority has seen fit to delegate to an opaque process of staff guidance, and uncertainty regarding future examination and enforcement standards combine to produce a regulatory framework that will keep market participants guessing and seeking clarification from our staff. From our experience with analogous situations, we fear that the inevitable delays in obtaining guidance, the attendant regulatory uncertainty, and concomitant costs will harm a competitive marketplace.

Far from enhancing competition, we believe that Regulation NMS will have anticompetitive effects. Increasing consolidation in the securities industry as a result of the proposed mergers and the increased barriers to entry created by the trade-through rule magnify our concerns about the competitive impact of Regulation NMS going forward.

For the reasons stated above, we respectfully dissent.

Cynthia A. Glassman, Commissioner

Paul S. Atkins, Commissioner

Dated: June 9, 2005