Statement for the Record

on

"Market Competitiveness under the Securities and Exchange Commission's Re-Proposed Regulation NMS"

before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

February 15, 2005

Introduction

Fidelity Investments commends Chairman Baker, Ranking Member Kanjorski and other distinguished Members of the Subcommittee for their review of securities market structure, and in particular the Securities and Exchange Commission's (SEC) re-proposed Regulation NMS. We are pleased to offer our views of the re-proposed Regulation NMS.

The Commission has invited comment on two versions of an inter-market trade-through rule: (1) one that would "protect" only the best bid and best offer displayed in each market center for any stock (the "Top of Book" rule) and (2) another that would "protect" additional bids and offers below each market center's top of book if the market center chooses to designate those additional limit orders for protection (the "Depth of Book" rule). At the Commission's open meeting last December, Commissioner Glassman urged her fellow Commissioners to seek public comment on a third approach: namely, that the Commission stay its hand and adopt no trade-through rule at all.

We concur with Commissioner Glassman's position and oppose any rule which would deprive informed investors of the freedom to choose among competing markets in carrying out decisions to buy or sell a security traded in more than one market:

- The SEC's trade-through rule would deny an investor the right to take into account other important factors that bear upon the choice of market and best execution – for example, market data costs, transaction costs, technological innovation, enforcement of trading rules, quality of market surveillance, protecting the anonymity of investors, and elimination of informational and trading privileges of floor members.

- So long as bids and offers are made available to investors on a timely and continuous basis, and investors have ready access to competing market centers, the government need not – and should not – deprive investors of the freedom to choose among markets. This is especially so for institutional investors who owe fiduciary duties to the funds or accounts under their management. With market transparency and accessibility, investors will reap the benefits of vigorous competition among markets.

- Accordingly, we urge this Committee to send a clear signal to the Commission to adopt no trade-through rule at all and we are gratified that TIAA-CREF, among others, has recently announced its position against a trade-through rule.

In the balance of our statement, we wish to bring three additional issues to the Committee's attention: (1) the sequence for Commission consideration of a trade-through rule and the NYSE's "hybrid market" proposal, (2) the re-proposed rule's dropping of the "opt-out" right for informed investors and (3) the flaws in the SEC's economic study that the Commission offers in support for a trade-through rule.

I. <u>**The NYSE's hybrid market proposal and the Commission's trade-through rule proposal**</u>

We have heard from many quarters that one important reason to support the Commission's trade-through rule proposal is to motivate the New York Stock Exchange to transform itself from a "slow" market to a "fast" one – a market that will allow for automated trading, including automated "sweeping" of its limit order book. If this view has merit, we suggest that the Commission need ***not adopt*** a trade-through rule to achieve the desired end. The NYSE has, in fact, proposed a hybrid market proposal that purports to allow for automated trading of orders, regardless of their size. We are encouraged by this step, although we have a number of concerns regarding the NYSE's proposal. For its part, the NYSE, through its representatives, has stated to us that its hybrid market proposal does ***not*** depend on the Commission's adoption of a trade-through rule.

It seems to us that the Commission should first take up the NYSE's hybrid market proposal for consideration before acting on its own proposed trade-through rule. Does the NYSE rule effectively respond to investors' needs? Will it transform the NYSE into a fast market? Should floor members and specialists be allowed to insert undisclosed orders into the NYSE's electronic limit order books? With regard to all trading on the NYSE, should the NYSE be required to grant time priority (as its rules currently do not do) to investors' orders entered in the specialist's limit order book over orders that are sent to floor brokers later in the trading day? These are issues concerning the NYSE's market that should be addressed by the Commission before it decides whether an ***inter-market*** trade-through rule is necessary or appropriate.

II. <u>**The "Opt-Out" Right**</u>

The re-proposed Regulation NMS proposes to drop the "opt-out" right that the Commission included in its initial trade-through rule proposal. We have urged the Commission to retain the opt-out right and do not believe that the Commission's rationale for dropping it is sound.

The Commission recognized in its initial proposed Regulation NMS that an informed investor may have legitimate reasons to send its order to a particular market center, even though another market center may be displaying opposite-side limit orders at a price superior to the price that the investor is willing to pay or receive in its market center of choice. This is particularly true for institutional investors, like the Fidelity funds, that typically trade in large blocks. The Commission observed (at p. 23) of its initial release:

> "Large traders may … 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."

"A further benefit of providing investors with the flexibility to choose whether their orders should trade through a better quote is that it might create market forces that would discipline markets that provided slow executions or inadequate access to their markets. If investors were not satisfied with the level of automation *or service provided by a market center*, they could choose to have their orders executed without regard to that market's quote, thus putting pressure on the market to improve its services." (Emphasis added)

In its re-proposed Regulation NMS, the Commission explains that a trade-through rule that applies only to markets with "fast" quotes obviates the need for an opt-out right for informed investors. We respectfully, and strongly, disagree for the following reasons:

- Even if markets are fast, the risk remains real, and substantial, that an institutional investor, seeking to acquire or dispose a large block of stock will be put to a distinct and unfair disadvantage if it is deprived of the ability to negotiate, at one time and at a specified price, an all-in price for its block trade with a dealer. It is not unusual for mutual funds to do block trades consist of tens of thousands and sometimes hundreds of thousands of shares. It cannot be assumed that the displayed liquidity across market centers under a trade-through rule will always – or typically -- be sufficient to satisfy even a significant portion of our funds' block trades. As a result, whether markets have fast quotes or not, the government's imposition of a trade through rule may often cause many mutual fund investors (consisting of small retail and pension plan investors) to receive an inferior price for their funds as the market moves away from the desired price.

- An opt-out right also motivates market centers to compete for order flow with innovative trading technologies, shareholder services and quality of market center regulation. Without choice of trading venues, the Commission will seriously impair the ability of an informed investor to "discipline" a market center for other legitimate reasons – for example,

    - high transaction fees,

    - high fees for viewing limit orders away from the best bid or offer,

    - unfair informational and trading advantages given to members solely by virtue of their presence on a trading floor,

  - leakage of information by floor members regarding the identity of a large investor seeking to trade in large quantities in a given stock on a given day,

  - abusive trading by specialists or floor members that are not promptly addressed by the market center's surveillance and enforcement arms,

  - the ability of floor members to reap the benefit of "free" puts and calls represented by investors' limit orders, a benefit that facilitates "penny jumping" by floor members – a practice that would survive a trade-through rule for the very reason that such trading takes place inside the spread, and

  - failure of a market to give time priority to limit orders over orders sent to floor brokers later in the trading day.

  We respectfully submit that it ill behooves the government to decide that the only legitimate interest that an informed investor may have in choosing among competing market centers is whether a market center has "fast" quotes that happen to meet the minimum threshold set by the government as to what constitutes "fast."

- In proposing to eliminate the opt-out right, the Commission, inappropriately, is choosing to confer advantages to some investors over others. As noted above, the ability to do block trades quickly, and at a specified price, is a legitimate interest of an institutional investor – an interest that bears directly on the ability of the institutional investor to obtain best execution at an "all-in" price. The Commission implicitly acknowledges this legitimate interest of the institutional investor in its re-proposing release (at p. 59), stating that "advocates of the opt-out exception have failed to consider the interests of <u>all</u> investors – both those who submit marketable limit orders and those who submit limit orders." For our mutual funds, our fiduciary duty is to consider the interests – **and only the interests** – of our fund shareholders not the interests of all other investors in the market. The government should not be in the business of tilting the scales against mutual fund investors to favor other market participants. We hasten to add that this is not a "big investor vs. small investor" issue. The average account of a shareholder in a Fidelity domestic equity fund is roughly $10,000. We suggest that this average account size is smaller than the account size of the typical individual investor maintaining an account at many, if not most, full service brokerage firms.

- The Commission advances as a reason for depriving institutional investors of an opt-out right that these investors "free ride" on prices established by retail-sized displayed limit orders. We along with TIAA-CREF seriously question the underlying economic assumptions of this position. The price-formation process in our equity markets reflects information stemming from all trading interests, large and small. Almost a third of the reported volume on the NYSE in 2004 was of block size, typically representing undisplayed institutional trading interest.[1] The Commission does not discuss in the re-proposing release the economic literature relating to the impact of block trades by institutional investors in the price discovery process. We believe that it is incumbent upon the Commission to address available economic studies if it proposes to eliminate its earlier proposed opt-out right for informed investors on the unproven hypothesis that institutional investors "free ride" on prices displayed by retail-sized limit orders.

In the place of an opt-out right, the Commission is proposing a "benchmark order" exception. This exception would allow a block trade in one market to "trade through" superior opposite-side quotes on another market if the benchmark order is executed "at a price that was not based, directly or indirectly, on the quoted price of the … stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made."

The example of a benchmark order offered in the re-proposing release (at p. 87) is a block trade of 100,000 shares to which a dealer commits at 9 a.m., at a price equal to the volume-weighted average price ("VWAP") from the opening until 1 p.m. The benchmark order exception would allow the dealer to execute the trade at 1 p.m. even though the VWAP would result in a trade-through, in the Commission's words, of "better-priced protected quotations at other trading centers."

- The Commission offers little explanation as to why this type of trade-through is acceptable, whereas trade-throughs at dollar-specific prices at the time of the commitment by a dealer to its customer somehow are not. We submit that no meaningful distinction can be – or should be – drawn between the two types of block trades.

1 For 2004, blocks (trades of 10,000 or more shares) on the NYSE as a percentage of aggregate NYSE reported trading volume were as follows:

January	38.5%	February	36.1%
March	33.9	April	33.2
May	29.2%	June	30.2
July	30.5	August	27.6
September	29.8	October	31.0
November	29.9	December	31.2

Source: NYSE Online Fact Book, available at:
http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=655&category=3

- We strongly urge the Commission to reconsider how it would allow for block trades to occur, if the Commission were to adopt a trade-through rule. A benchmark order exception, even one that allows for negotiations at price points better than VWAP (for example, a block trade in which an investor buys at VWAP minus 2 cents per share), introduces the very uncertainty over price that a mutual fund manager seeks to avoid by entering into a block trade in the first place. It is likely to be of little solace to a fund manager who directs the trading desk at 10 a.m. to lock an all-in price to buy one million shares of a stock, to learn at the end of the trading day that the desk was able to negotiate a benchmark order trade of VWAP minus 2 cents per share, if the VWAP for that stock is up 20% over the prior day's close.

III. The Commission's Economic Studies Regarding the Need for a Trade-Through Rule Are Flawed.

It is critical that such fundamental changes to our equity markets like those proposed by Regulation NMS be supported with well reasoned and thoughtful research. To this end, the Commission has posted the work of its Office of Economic Analysis relating to the need for a trade-through rule, including the extension of such a rule to the market for Nasdaq securities. However, we bring to the attention of this Committee that the Commission's analysis, as set forth in the OEA's study entitled, "Analysis of Trade-throughs in Nasdaq and NYSE Issues," dated December 15, 2004, is open to serious question and likely rests on serious methodological flaws. We have reviewed the comment letter filed by Professor James J. Angel. Associate Professor of Finance, Georgetown University and believe his criticisms of the OEA's analysis have substantial merit. (Fidelity did not engage Professor Angel to conduct his review, and we were not privy to any of his work in this regard prior to the filing of his comment letter.)

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 – hardly sufficient to justify the intervention of the federal government to deny investors the freedom to choose the market where their trades are to be executed. The overstatement of limit orders traded through in the OEA's analysis necessarily carries over to the OEA's estimate of the total dollar "loss" occasioned by trade throughs. Our preliminary estimate, even assuming the Commission's theory of "loss" arising from trade throughs, is in the minimal range of $16 million per year.

We expect that access fees, leading to locked and crossed markets, may have been a primary cause of many of the perceived trade-throughs, that "race conditions," resulting from attempts to sweep the market, may well have been responsible for others and the activation of reserve quantities for still others. In any event, it is not necessarily the case that a limit order placed in one market center that was traded through by another market center would have been executed at its limit price had it been presented in the second market. It may well have lost out to other orders presented to that market at or about the same time. As a result, the "benefits" to investors of preventing trade throughs are by no means clearly established. Without further, more detailed information on the actual trades themselves, we cannot be sure what the data in the Commission's trade-through study show.

In light of these serious questions regarding the OEA's findings and methodology, we urge this Committee to ask the Commission to direct OEA to conduct further evaluations of trade throughs, particularly purported trade throughs in the Nasdaq market **before it finalizes** Regulation NMS. Those further evaluations should look not only at the publicly available data filed under Securities Exchange Act Rule 11Ac1-5 but also the OATS data on trading in Nasdaq securities and the audit trail data the NYSE gathers. That further evaluation should consider whether the trade throughs the Commission believes it found during the period covered by the OEA study were in fact trade throughs or instead were false positives occasioned by locked and crossed markets, race conditions, and the impact of "reserve" and replenishment.

We appreciate this opportunity to present our views to the Committee.