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United States Senate

WASHINGTON, DC 20510

February 9, 2004

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W. Room 6100
Washington, D.C. 20549-0100

Dear Chairman Donaldson:

I am writing to request additional background on the Securities & Exchange Commission's staff review of the "trade through rule." I am very concerned that the staff may be proposing changes that will drive our markets towards the least regulated areas, at the very time we are seeing the need for stronger regulation.

As you know, the trade through rule has served the markets well over the twenty years since it was first instituted in 1983. Some consider it the foundation of our national market system because it upholds the core principle linking our markets: the investor must always get the best price, no matter where it is to be found. By focusing on that principle the U.S. equity markets have thrived and become the envy of the world.

At times markets and technologies change, and a revision of core principles is needed. My concern is that the current direction of the SEC is not to update the "best price" standard but, in effect, to abandon it.

According to your staff, the SEC is considering a proposal that would allow firms trading on electronic markets to "opt out" of the trade through rule. That means they would be able to trade wherever they desire for whatever reasons they desire, not based on a principle – best price – but on various other factors that may have nothing to do with best price. For example, many large institutions would prefer to trade with as much "anonymity" as possible, and that has driven trading to less regulated vehicles, like ECNs.

Mr. Chairman, if these reports are true, it seems like an extraordinary move by the SEC, particularly given your mandate to protect the average investor and your strong regulatory interest in clear guidelines and transparency. Given the magnitude of the change, and its long term impact on our markets, I was very surprised that your staff could not answer the following questions; thus my letter to you.

First, if the staff-level proposed language is adopted, what will be the impact on further fragmentation of the market? Specifically, what percentage of trades do you estimate will shift to and from ECNs, NASDAQ, other exchanges, and the NYSE?

Second, if the best price standard is "opted out" what standard will govern how trades are conducted? Your staff indicated that the "best execution" standard is what would govern the markets. However, my understanding is that there is no official SEC language clearly defining what is or is not best execution. In my mind, best execution must mean getting the best price. But, as you are aware, many traders view "best execution" as the most secretive, least transparent execution. This rule change could push our markets further in that direction.

Third, without a clearly defined standard, who will regulate trading activity, and how will they regulate it? In the recent case of Corinthian Colleges, we saw a clear example of the lack of regulatory standards and lines of governance among the fragmented ECNs. Before instituting a change that will drive trading into electronic markets, shouldn't the SEC first ensure there is a clear set of rules governing these markets?

Fourth, while new electronic trading techniques offer many advantages and new ways of trading, the SEC has enforced standards so that principles drive the markets, not technology. For example, although technology allows stocks to easily be traded in fractions of a penny, the SEC only recently moved to trading done in penny increments – decimalization – and has resisted efforts to allow trades at fractions of a penny in the interests of an orderly market structure. Why then, would the SEC's staff consider a contrary logic in regard to best price?

It strikes me that the SEC staff is choosing technology-driven trading ("get the fastest price") over principle-driven trading ("get the best price"). By doing so, we could end up with a proliferation of small electronic markets that do, in fact, get investors the fastest price, but never check if a much better price was available in another market. I am reminded of the used car salesman who urges the customer to buy as quickly as possible, instead of leaving the lot to see what other dealers may be offering.

Mr. Chairman, I believe we share the same strong interest in ensuring investors have access to the broadest, deepest and most liquid markets. I believe we also share the view that the market works best when trading is transparent and open. I fear the changes your staff is considering go in the opposite direction of both of those goals. The best price standard as embodied in the trade through rule has served investors and our country well. I look forward to your response to my initial questions and an active dialogue with you before any changes, however preliminary, are proposed that would undermine its principles.

Sincerely,

Charles Schumer
United States Senator

cc: Commissioner Paul Atkins
Commissioner Roel Campos
Commisioner Cynthia Glassman
Commisioner Harvey Goldschmid