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BY ELECTRONIC MAIL AND U.S. MAIL

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

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

Dear Mr. Katz:

The American Stock Exchange LLC ("Amex") appreciates the opportunity to comment on the sweeping changes contained in the Securities and Exchange Commission's revised Regulation NMS proposal.

We support the Commission's efforts to modernize the national market system and recognize the Commission's desire to move forward as expeditiously as possible in effecting Regulation NMS. Nevertheless, we urge the Commission to give market participants reasonable time to make required changes to their technological and regulatory infrastructure. Some of the industry-wide challenges raised by implementing Regulation NMS, if adopted, include substantially increasing message capacity, making system changes to accommodate manual quotes, changing the role and function of the Intermarket Trading System, and facilitating sub-penny trading. At the same time, other challenges are more participant specific. At Amex, for example, we are making major changes to our trading rules and technology and regulatory infrastructure to support a hybrid market structure Each undertaking, all of which are substantial, will require a working partnership with the Commission and its staff along with the time to responsibly implement these changes.[1]

In our comment letter to the Commission, dated June 30, 2004, we described our position on each of the four inter-related proposals addressed by Regulation NMS. In

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[1] For example, to the extent that the Commission determines to permit sub-penny quoting and/or trading in some contexts, we ask that the Commission allow sufficient time for responsible implementation by markets, like the Amex, that do not currently accommodate this type of quoting and trading.

this letter, we limit our comments to addressing two issues raised in the Commission's revised Regulation NMS proposal: (1) why adopting the depth of book alternative could result in poor order execution quality and create the appearance of a disorderly and unfair market for investors and (2) why manual quotes provide price discovery and should receive a revenue allocation under any market data distribution formula.

I. Voluntary Depth Alternative

In its revised Regulation NMS proposal, the Commission seeks comment on two alternative means of protecting automated quotations for all national market system securities. One alternative would extend trade-through protection to automated quotations at the top of any away market's order book ("BBO Alternative"). The other alternative would extend trade-through protection to visible quotations throughout the depth of any away market's order book ("DOB Alternative"). The Amex supports the BBO Alternative, which provides incentives to place, and protection for, limit orders in a market place that encourages competing market structures. By contrast, Amex opposes the DOB Alternative because it will hurt investors, large and small, and will create the appearance of a disorderly and unfair market. Under the DOB Alternative, only displayed orders would receive price protection. And, as the Commission noted, within individual markets, partially-displayed orders would have priority over inferiorly-priced, displayed orders causing trade throughs of price points and investors receiving inferior executions.

For example (as depicted below), suppose an Amex specialist wanted to sell a block of 10,000 shares of ABC securities at a price of 4. Before doing so, the specialist would need to sweep down the collective displayed size of 2000 shares at BSE, ARCA and INET. That is, the specialist would trigger an inter-market sweep of (1) 500 shares at 8 to BSE, (2) 1000 at 6 to ARCA (which appears to be the aggregate of two displayed bids), and (3) 500 at 5 to INET. After sweeping down the market, the specialist could execute the remaining 8,000 shares at 4. However, because ARCA had a hidden reserve order that was priced better than a second displayed order, the order for 1000 shares sent to ARCA would trade at 7, because of the reserve size and no trade would occur at 6.

Center	**Displayed bid size**	**Bid price**
BSE	500	8
ARCA	500 *	7
ARCA	500	6
INET	500	5
AMEX	1000	4

*Reserve order for 10,000

Not only does this trading result in substantially complicated market surveillance, it creates the appearance of a disorderly and unfair market for investors. Three points are of note here. First, ARCA's customer with the reserve order at 7 was traded through by the Amex execution, although all regulatory obligations were fulfilled. Second, the

ARCA customer at 6 did not get filled despite being a fully-displayed, purportedly protected quotation. Third, the Amex customer did not receive an optimal execution. The fact that a price point within an individual market is bypassed due to a partially hidden order size already in existence will, in our view, rapidly result in a concentration of liquidity by investors in those trading venues where they may most likely ensure that they cannot be traded through. We believe that this will reduce natural competition in the market place. At the same time, we believe that institutional investors with larger sized orders will be less likely to put reserve sizes on markets, as they risk being traded through despite having a purported protected quote.

The Commission has always been careful to allow different market structures to compete. The DOB Alternative greatly hampers the price discovery function of auction-based markets. At the same time, the DOB Alternative propels individual investors towards homogenous liquidity pools in fewer trading venues, and institutional traders with large-sized orders to exclusive trading networks unavailable to individual investors. It is our view that competing markets should only disappear when they are no longer providing value, not because of regulatory fiat.

Finally, with regard to cost, Amex does not believe that the DOB Alternative could be implemented in a practical and cost-effective manner. Despite the Commission's suggestion of an accessible database of quotations, markets will in practice face the competitive need to take in full depth of book directly from one another in order to minimize trading latency. Due to the sheer number of extra price points that are protected under the DOB Alternative, we expect a meteoric rise in "empty" message traffic, as participants seek to fulfill their regulatory obligations and target the same quotations. While Amex supports a uniform trade-through rule, it is unclear whom depth of book protection is intended to benefit and what problem exists that requires such extensive and costly regulation.

II. Market Data Revenue and Manual Quotations

As we stated in our comment letter of June 30, 2004, we strongly support the Commission's initial proposed revisions to the market-data distribution formulas, with some minor adjustments, as a thoughtful, innovative mechanism to discourage deceptive and market-distorting trading practices while encouraging enhanced liquidity and price discovery. However, as presented in the Commission's modified proposal, we do not support the exclusion of manual quotations from those formulas for both policy and practical reasons.

First, especially for less- or inactively-traded securities, manual quotations can provide important—if not critical—price discovery information. For securities that trade less actively, manual quotations often ***establish*** the benchmark around which not only other quotes cluster, but also the price at internalized trades occur.[2] Under these

[2] As noted in the revised Regulation NMS release: "Markets that provide price discovery in less active stocks serve an extremely important function for investors in those stocks" by allowing them "to monitor the status of their investment" and "by offering them a ready

circumstances, excluding manual quotations from receiving any revenue allocation allows internalizers and opportunistic quoters to free-ride on the price discovery offered by the manual quotes. Second, at a time when the Commission, the industry, and investors are demanding more from self-regulatory organizations, totally and immediately eliminating manual quotations from market-data distribution formulas may seriously undermine the ability of auction-based markets, such as the Amex, to fund sweeping changes in market structure and related surveillance and regulatory requirements.

III. Conclusion

Thank you for giving us the opportunity to express our views on the Commission's revised Regulation NMS proposal. If the Commission or members of its staff have questions concerning any matters raised in this letter, please contact me at (212) 306-1000.

Sincerely,

cc: The Hon. William Donaldson, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Cynthia Glassman, Commissioner
The Hon. Harvey Goldschmid, Commissioner
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation

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opportunity to trade at any time at a fair price if they need to buy or sell a stock." Securities Exchange Act Release No. 50870, *Regulation NMS: Proposed Rules and Amendments to Joint Industry Plans*, 69 Fed. Reg. 77424, 77466 (Dec. 27, 2004).