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Automated Trading Desk, LLC

June 30, 2004

Mr. Jonathan Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. **S7-10-04**

Dear Mr. Secretary:

Automated Trading Desk, LLC (ATD) appreciates this opportunity to comment on Regulation NMS. ATD is a technology firm that develops software and systems for the use of its brokerage subsidiaries to trade Nasdaq and listed equities on an automated basis. Since 1994, ATD has traded on its own behalf and for institutional clients through Automated Trading Desk Brokerage Services, LLC (ATDB). Since 2003, ATD has provided execution services for a broad spectrum of retail order sending firms through Automated Trading Desk Financial Services, LLC (AUTO). In May 2004, ATD accounted for approximately 5% of all Nasdaq daily trades and 3% of all NYSE daily trades through ATDB and AUTO. The vast majority of these orders were entered as passive limit orders entered via nearly every ECN and exchange possible. ATD firmly believes that automation provides solutions to many of the issues raised by proposed Regulation NMS.

Recommendations

Trade-Through

In today's environment, we are faced with two competing market structures: the Nasdaq market represents a competitive environment while the NYSE represents a controlled near-monopoly.

While the NYSE currently has a trade-through rule, the rule as it exists today does not promote the use of limit orders and competition. Instead it is largely a mechanism used against other competing market centers. Some will argue that the current trade-through helps foster limit orders. Quite to the contrary, it is used by the NYSE to eliminate competition from ATS participants (and therefore from other non-NYSE broker-dealers). Every day the NYSE specialists trade-through thousands of listed orders. The NYSE specialists recognize it is unlikely that firms placing orders onto ATS systems will go through the hassle of calling the ATS, that the ATS will then call the specialist, and that the specialist will then deliver the fill owed. This fact thwarts competition in the listed marketplace and keeps spreads artificially wide, both of which inevitably hurt the public investor.

It has been noted that trade-throughs also occur in the Nasdaq marketplace, but those trade-throughs occur for far less anti-competitive reasons. Typically a trade-though will occur either (1) by a participant who has poor sweeping technology or (2) by a participant who, in an effort to quickly take out liquidity over several price levels, runs past a reserve quantity order. In both cases the firm trading-through would have preferred to receive a better price. As technology improves, those cases will diminish.

One additional case of trade-through activity in NASDAQ must be discussed. This type of trade-through occurs against the quotes of manual market UTP participants such as the Amex. These organizations place thousands of irrelevant quotes into the Nasdaq market each day. Such participants' quotes are more like "indications of interest" rather than true liability quotes. Their antiquated systems provide little if any true liquidity to the Nasdaq marketplace. The existence of these quotes is at best disruptive, and at worst manipulative in a truly electronic marketplace.

The proposed trade-through rule in Reg NMS is very different from the current trade-through rules in that it prevents trade-throughs prior to execution. While this would likely improve the listed market place (if effectively enforced against the listed specialists), it would have negative ramifications for the Nasdaq marketplace. In the listed market, it would force the NYSE to pay attention to better quotes in the ITS system. This would encourage firms to place limit orders into ATS systems, thereby effectively narrowing the spread and improving the marketplace. While this would be a positive effect, it would still allow manual markets to block natural market moves.

In the Nasdaq market, firms would no longer be allowed to sweep up many levels, thereby ensuring they receive an execution at a predetermined price. Instead, they would have to take out the top of book from each participant and march an order up or down. This slow down will be detrimental to the sweeping firm in that some market participants will begin to compete with the sweeping firm for the same liquidity. Other market participants will withdraw their quotes as they see the sweeping firm slowly march towards their limit orders.

In addition, non-electronic participants would have significant negative effects in Nasdaq. Their nearly irrelevant quotes would be "protected" against being traded-through. In fact, the sweeping firm would be required to attempt to access the alleged liquidity quoted by the non-electronic participant. This would dramatically increase execution times, submit order sending firms to greater "information leakage", and in general decrease execution quality in the Nasdaq market. Such a result would have the effect of erasing much of the good that has been created in Nasdaq since the introduction of the Order Handling Rules.

ATD believes the market is better served if trade-through rules were eliminated in their entirety. The SEC should only enact regulation when market forces and competition are insufficient to address problems in market structure. We believe the market is already addressing the issues raised by the proposed new trade-through rule. Currently, market participants compete for order flow on the basis of the execution quality statistics. The requirement that these statistics be made public has been a strong force for improving execution quality. Moreover, the best execution obligation of broker dealers requires that they rigorously examine where they send the orders for execution. An executing firm that routinely trades through other market participants will have a severe degradation of their order execution quality statistics. In turn, order sending firms will route order flow to other destinations due to their best execution obligations. Enforcement of the rules as they currently exist should be sufficient to address the issues raised by the proposed trade through rule.[1]

If all quotes were automatically accessible, and all execution reports automatically generated, then competitive forces would dictate that there will be an extremely small incident of trade-throughs. Nonetheless, if the SEC determines there must be a trade-through rule, we strongly support the opt-out provisions against non-automated quotes or markets. Trading through such markets should not be limited to certain variances dependent upon the stock price. If a non-automated market's quotes are not immediately accessible, such a quote is irrelevant to the price obtained in the rest of the market. There is no value in limiting the amount by which a non-automated quote can be traded-through. We would also suggest that opt-outs be allowed for VWAP trades, average priced trades, and block transactions. ATD also supports an opt-out by investors/order sending firms. Such a provisions should be allowed either order-by-order, or by informed consent on an account-by-account basis. Again, the imposition of true automated quotes and reporting would obviate the need for a trade-through rule in its entirety.

[1] ATD strongly supports the position taken by the Securities Traders Association that non-electronic (non-automated) market quotes should be excluded from the definition of "national best bid and offer". Therefore, pursuant to proposed Rule 605 (current Rule 11Ac1-5), these quotes would be excluded from the statistical reports on order execution quality. ATD believes that only those quotes that are truly accessible should be included in these reports.

Access Fees

In recent years, access fees and rebates have led to a form of trading known as rebate trading. This trading occurs largely by proprietary traders who have no other economic incentive to trade other than to collect the rebates from the various ECNs. While the proposals of Reg NMS work to diminish this to some degree, it still leaves room for rebate trading.

As proposed, SRO execution facilities may charge $0.001 for a participant to access their liquidity. Broker-dealers that display an attributable quote through an SRO execution facility may also charge $0.001 to access their quote. An ATS that does not display its quote through a SRO execution facility may only charge $0.001 for a participant to access their liquidity. It appears that an ATS that does display its quote through a SRO execution facility may charge $0.002 for direct access to their quote, or $0.001 for access obtained through the SRO execution facility (if the SRO execution facility also charges $0.001). In Release No. 34-49749, the Commission notes that if an ATS is quoting through an SRO execution facility, and its quote was accessed directly (i.e. NOT through the SRO execution facility), then the ATS would likely charge $0.002 and rebate $0.001 to the broker dealer placing the order on the ATS.

At best, the proposed rules will eventually lead to a world of $0.002 charges to take liquidity and $0.001 rebates to add liquidity. While this reduces the rebates by a significant amount, it will not end rebate trading. It is uncertain whether these changes, especially in light of the proposed market data revenue changes, would also cause further distortion if a SRO decided to shift focus on profits from access fees to market data revenue.

For these reasons, ATD supports a $0.001 charge for taking liquidity. This would severely limit rebate trading, thus engendering more economic reality in the trading which does occur.

If the SEC decides to stay with the $0.002 charge/$0.001 rebate, we would suggest that firms that decide not to charge the $0.001 fee move to the front of the queue in terms of price/time priority. In other words, orders that have an access fee of $0.001 or less should be given price/time priority over orders with higher access fees. This would result in most market participants foregoing the additional $0.001 and moving the market away from pure rebate trading.

Locked-Crossed Markets

Hand-in-hand with access fees and rebate trading are locked markets. ATD believes that locked and crossed markets are disruptive to an orderly marketplace. Current economics encourage placement of orders to lock other market centers, and in extreme cases, to cross other markets, in order to both garner rebates and to eliminate access fees. ATD believes the Commission should adopt a rule prohibiting one automated market's quotation from locking or crossing the quotation of any other automated market. Clearly, non-automated markets quotations should be excluded from this prohibition.

Sub-Penny Pricing

ATD is in favor of the proposal in Reg NMS to ban sub-penny quoting in stocks priced above $1. ATD believes that the sub-penny system allows certain firms to price predatorily by jumping in front of displayed limit orders for insignificant economic amounts. So, for example, in a sub-penny environment, if an order is placed to buy stock for $10.00 and another order is placed at $10.0001, for the miniscule cost of one mil, the second order gains price priority over the $10.00 order. When an incoming sell order comes across, the more aggressively priced order gets the execution before the $10.00 order. Something is wrong with a system that gives tremendous advantage for such insignificant costs. Further, sub-penny pricing deters limit-order traders from placing orders on systems that trade in sub-pennies.

If limit orders can be easily price jumped by sub-pennies, there is less incentive to place such orders. Wider spreads result from such predatory pricing. Certainly smaller market orders and the orders of certain professional traders benefit in sub-pennies, but the market as a whole suffers from less liquidity and wider realized spreads. The big question that should be asked of sub-penny marketplace supporters is ‘Why stop at four places? Why not go out to 10 or 20? If you’re going to have sub-pennies, why not go all the way?’ The fact of the matter is that sub-penny quotes can and do have a negative effect, and it does harm the quality of the marketplace. The only losers associated with the sub-penny quote ban are those firms that price predatorily; oftentimes, the same firms that are heavily involved in rebate trading.

ATD strongly supports the SEC’s efforts to ban sub-penny pricing.

Data Revenue Proposal

ATD supports the position that market data revenues should be calculated so as to reward market participants who provide true, quality quotes that are automated and tradable, in particular those which better the NBBO. ATD is concerned that the Commission’s proposal on market data revenue will in fact reward market’s with manual, inaccessible quotes. Such markets should not receive market data revenue credit for their quotes. Rather, they should be limited to receiving market data revenue based solely upon transactions occurring in their market.

Conclusion

As noted above, automation is the cure for many of the ills highlighted by proposed Regulation NMS. ATD believes that market participants are moving (albeit some more slowly than others) towards a truly automated marketplace. Competitive forces are working in the market, driving market participants to become more automated and more efficient. There is always concern that large-scale regulation may invoke the law of unintended consequences. Who knows how the markets will react if new trade-through, access fees and market data proposals are enacted? Will these proposals interact and give rise to a whole new class of problems currently unforeseen? These issues point out the gravity of the task undertaken by the SEC.

ATD appreciates the careful consideration that the SEC has given to these important issues. Further, we fully understand that the SEC is seeking guidance from many different sectors throughout the marketplace, many of which have widely disparate viewpoints. ATD believes the US markets are the strongest in the world, and trusts the Commission will only adopt those proposals that will clearly benefit the market as a whole.

ATD appreciates the opportunity to submit its viewpoints on these matters, and we would be happy to discuss these issues further.

Sincerely,

Steve Swanson
CEO and President
Automated Trading Desk, LLC