July 8, 2004

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

Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609
Attention: Jonathan G. Katz, Secretary

Dear Mr. Katz:

J.P. Morgan Securities Inc. ("JPMSI") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC") proposed Regulation NMS under the Securities Exchange Act of 1934 (the "Exchange Act"). JPMSI serves as a market maker for over 800 equities and is one of the U.S.'s largest broker-dealers serving institutional investors. JPMSI appreciates the SEC's commitment to protecting the investing public and enhancing the functioning of the markets. For this reason, JPMSI strongly supports the SEC's goals in proposed Regulation NMS to ensure that investors continue to receive the best prices on their securities trades, while respecting investors' trading preferences and recognizing that advances in trading technology have empowered investors and facilitated their ability to make informed trading decisions.

Executive Summary

JPMSI has reached the following conclusions regarding each of the SEC's four primary proposals in proposed Regulation NMS:

1. Trade Through Proposal. JPMSI supports a trade-through rule, subject to an automated markets exception, that provides protections to retail investors while allowing institutional investors to opt out of trade-through protections on either a global or order-by-order basis. Additionally, JPMSI supports a *de minimis* window of compliance when identifying trade-through violations. However, concerned that a NBBO disclosure requirement would be costly, unworkable, and more confusing than helpful to investors, JPMSI opposes such a requirement.

2. Market Access Proposal. JPMSI supports the market access proposal in Regulation NMS, including encouraging intermarket access through private initiatives, and the SEC's proposed *de minimis* access fees.

3. Sub-Penny Quoting Proposal. Concerned with the various adverse effects of sub-penny pricing (*e.g.*, stepping ahead, loss of depth, and decreased price clarity), JPMSI supports the proposed ban on sub-penny price quotations.

4. Market Data Proposal. JPMSI believes that market data fee calculation and revenue allocation formulas should be simply constructed with points given both for quotes that are hit or taken and for trades, weighted by the size of the accepted quote or trade, and with a mechanism to deter quotes that cause locked or crossed markets.

We elaborate on each of these recommendations in the discussion below.

I. Trade Through Proposal

In the national market system, investors should expect to receive the best price then genuinely available on their trade. We believe the trade-through rule provides a valuable protection to retail investors and adds liquidity to the markets by encouraging aggressive quoting.

Within the contours of this general rule, JPMSI applauds the SEC for recognizing that advancing technology and the specific goals of institutional investors may at times make it undesirable to pursue execution against the "national best bid or offer." Proposed Regulation NMS reflects an understanding that the benefits of increased speed and certainty associated with one substantial-sized transaction may offer an institutional investor a better value than a tiny trade transaction with a penny better price. As such, JPMSI supports the ability of institutional investors to voluntarily trade at prices other than the so-called "national best."

JPMSI supports a trade-through rule that allows automated markets to trade through non-automated markets and that provides protections to retail investors while allowing institutional investors to opt out of trade-through protections on either a global or order-by-order basis.

1. Automated Execution

JPMSI supports the automated markets exception to the trade-through protections. To the extent that an investor can obtain a better price for an equivalent trade on a different market, the trade-through rule rightly demands that the better price be supplied. However, where an investor seeks a trade on an automated market, and a better quote exists on a non-automated market, the quote with the better price is not equivalent if it is not genuinely available. The delay in attempting to move the trade from an automated to a non-automated market has the potential to waste the value the investor seeks to capture. For this reason, JPMSI supports an exception to the trade-through rule that recognize that, in today's markets, a non-automated quote is not one that can be said to be readily available.

To the extent that automated and non-automated markets may still be somewhat undefined, we believe the guiding principle should be immediacy of trade completion. Without specifying an exact time for trading, an automated market can be identified as one where there is no human involvement, *e.g.*, where trades are executed within sub-seconds based upon computer-to-computer communication. Those markets requiring human involvement in trade execution should be subject to being traded through for they do not provide immediate execution.

a. Trade Through Limit Amounts

The prohibition against trading through automated markets should be subject to a trade through limit amount, moreover. For example, an "intermarket sweep order," by which a market participant simultaneously routes orders to take out all best bids or offers displayed on other market centers, may initially return executions at prices inferior to the NBBO because of timing issues. Accordingly, allowing trade throughs up to a limited amount would address such problems raised by current market structures. Historically, a trade through limit amount of three cents in liquid securities has been sufficient to address this concern, though it could be a different number with respect to less liquid securities.

2. *De Minimis* Window of Compliance

Furthermore, JPMSI supports a *de minimis* window of compliance with the trade-through rule, as proposed by the Securities Industry Association in its comment letter to Regulation NMS.[1] Due to flickering quotes, delays in quotations, and other market practicalities, supposed trade throughs may actually have represented the selection of the best price available to a broker-dealer at the moment of execution. Accordingly, JPMSI recommends the creation of a plus-or-minus three second window to be applied to the trade-through rule. Within this *de minimis* window, trades that appear facially as trade throughs and that occur within three seconds of the posting of the better quotation would not be considered a violation of the regulation.

3. Opt-Out Orders

JPMSI believes that allowing an institutional investor to decide whether to opt out of the trade-through rule on either a global or order-by-order basis while shielding retail investors from having to make opt-out decisions is consistent with the principles behind the trade-through rule and practical. JPMSI does not believe

---

[1] See Letter from Securities Industry Association to Jonathan G. Katz, Secretary, SEC (June 30, 2004) (comment letter on Regulation NMS). Please note that this three-second window of compliance is not an "exception" to the trade-through rule because it does not permit avoidable trade-through violations, but recognizes that violations may inadvertently occur due to other circumstances.

that providing NBBO disclosure is a necessary, or practical, aspect of the opt-out exception.

An institutional investor may wish to forego trade-through protections and execute a trade, for example, to take advantage of large offers or bids in a given market, or to ensure execution within a certain guaranteed time frame. Institutional investors may execute trades to a benchmark (where trading is done at a price unrelated to the current market price), or in large share blocks, or for other reasons which would not necessarily make executing a portion of a trade at the nationally best available price significant in light of the overall trade or strategy. The ability of institutional investors to opt out, then, allows sophisticated investors freedom to trade according to their own priorities, while in no way infringing on protections provided to the retail investing public.

The need for the opt out is not significant, however, for retail investors, *e.g.*, those transactions covered under Exchange Act Rule 11Ac1-5. The burdens associated with providing an opt-out to such retail investors, including the cost and the potential for confusion and manipulation, arguably outweigh any benefit that retail investors would receive from such an option. Therefore, JPMSI does not support extending the ability to opt-out to retail investors.

a. Order-by-Order Consent

JPMSI is opposed to a requirement that eligible investors may only opt out on an order-by-order basis. The opt-out provision's intent is to grant investors informed flexibility. By forcing investors to opt out on an order-by-order basis, Regulation NMS proposes to restrict some of that flexibility by creating unnecessarily onerous and formalistic procedures.

An order-by-order consent requirement would either require the creation of an automated system for obtaining consent, which would limit the amount and kind of useful information that could be provided, or it would require a verbal communication system, which would slow the trading process and perhaps moot the benefit of opting out in some circumstances. Further, we note that broker-dealers are always bound by an agency duty to act in the best interests of their customers, even in the presence of an opt-out request. Allowing investors to opt out on a global basis, if they so choose, averts problems of implementing an order-by-order opt-out system, while limiting the global opt-out to institutional investors addresses concerns regarding potential lack of understanding.

b. Provision of "National Best Bid or Offer"

Additionally, JPMSI is opposed to the onerous disclosure component of the opt-out exception. The proposed rule would require broker-dealers, in cases of opt-outs, to later disclose the "national best bid or offer" ("NBBO") available on that trade. We appreciate the intent to further guarantee that investors have full knowledge of the consequences of having opted out of trade-through protections. However, for practical reasons, we feel such a disclosure requirement is unsound. For example, in the sale of a large block of stock, the NBBO could change throughout the transaction, and the best offer available for the first sub-block of shares may be different from that available from any other sub-block of shares. Here, disclosure of the supposed NBBO would not further inform an investor, but only lead to confusion.

In cases of large trades, the disclosure requirement could become very cumbersome, in some cases spanning many pages. This information would only weaken markets by creating unnecessary trading costs, including the construction of the technology necessary to manufacture the reports, and diluting otherwise useful disclosures. Furthermore, as long as opt outs are limited to institutional investors with a sophisticated *ex ante* understanding of the consequences of opting out, there is no reason to provide further information as to what could have happened had they traded with trade-through protections: Informed investors understand that the NBBO is not necessarily available, and thus the disclosure is not genuinely meaningful.

II. Market Access Proposal

1. Access to Published Bids and Offers

In today's trading environment, many different trading venues compete for order flow. This competition leads to market forces pushing trading venues to provide the best services for their customers. Unfortunately, discriminatory access, access fees, and incentives for locked and crossed markets all hamper the achievement of a truly competitive market for trading venue services. JPMSI supports the SEC's efforts to reduce these inefficiencies and the requirement that access be open to all, without discrimination.

Compliance with the trade-through rule requires efficient linkages between trading centers. Without efficient linkages, broker-dealers will be unable to effectively access the NBBO and provide the best price to their customers. JPMSI welcomes the SEC's recognition of this problem and in large part supports its proposed solution of inviting private initiatives to improve intermarket linkages. Market incentives will push the development of faster and more reliable intermarket links. In moving away from setting a fixed governmental standard for intermarket linkages, we feel Regulation NMS opens the door for technological advancements, spurred by market incentives.

Proposed Regulation NMS rightly extends this principle both to major markets and to alternative trading systems. Granting preferential treatment in access to trading venues only distorts the market for trading services, which in turn costs the investing public value.

a. Access to the NBBO

Since the market access prong of proposed Regulation NMS provides for greater inclusion of investors and trading venues in the national market system, it is worth clarifying the calculation of the NBBO under the regulation. JPMSI believes that the NBBO should continue to reflect the "top of the book," *i.e.*, the best price available for a security and the aggregate quantity available at such price.

2. Access Fees

JPMSI also supports the SEC's direction on standardizing access fees. While governmental rate setting is not preferable to market forces as a general rule, unregulated and undisclosed (*i.e.*, not shown in the quote) market access fees have the potential to destroy open access to trading venues and hence to cost the investing public money due to inefficiencies in the market for trading venue services. In this effort to ensure open markets, the SEC's proposed *de minimis* rates applicable to undisclosed fees seem fair and sensible.

JPMSI believes that with a modification, the market access fee proposal could also serve to deter other market distortions while ensuring open access (and the collection of necessary market fees). Proposed Regulation NMS properly attempts to deal with the problem of locked and crossed markets. JPMSI believes that it would be premature, and likely ill-advised, for the SEC to outlaw access fees. However, when a quote is responsible for locking or crossing a market, the quoting market should not be able to collect an access fee for that quote. To allow the collection of access fees for locks and crosses of the market would incentivize this outcome that Regulation NMS otherwise proposes to prevent.

III. Sub-Penny Quoting Proposal

JPMSI supports the ban on sub-penny price quotations. With decimal pricing already providing 100 price points within a dollar, there is no need for greater specificity in quotations. Further, sub-penny pricing reduces liquidity by reducing depth of shares available at any given price point. While execution at the sub-penny level should be allowed in any individual transaction, there is no need to permit sub-penny quoting.

IV. Market Data Proposal

Lastly, JPMSI appreciates the SEC's efforts to improve the current regime of market data fee calculation and revenue allocation. In this effort, proposed Regulation NMS properly premises allocation formulas on the size of a trade. That said, we are neither certain that the current proposal provides the necessary clarity in presenting a formula for market data fee calculation, nor that it allocates revenues in line with the appropriate priorities.

We believe that any market data structure should be simply constructed. Points should be given both for quotes that are hit or taken and for trades, weighted by the size of the accepted quote or trade. Additionally, fees should not be paid (or should be reduced) in respect of quotes which caused locked or crossed markets.

Overall, we appreciate the recognition that the current market data fee and revenue allocation regulations are in need of reform. JPMSI looks forward to working with all relevant parties to help adopt a fair and easily understood set of standards to govern this issue.

* * * *

JPMSI appreciates the opportunity to comment on these important and timely provisions proposed in Regulation NMS. We look forward to continuing to work with the SEC to develop and implement improvements to the U.S. markets in the months and years ahead. If you have any questions concerning these comments, or would like to discuss these comments further, please feel free to contact Julius Leiman-Carbia at (212) 622-6592 or myself at (212) 622-2778.

Very truly yours,

James T. Brett

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid