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**VIA FEDERAL EXPRESS AND ELECTRONIC MAIL**

January 26, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

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

Dear Mr. Katz:

Citigroup Global Markets, Inc. ("Citigroup")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") re-proposed Regulation NMS ("Reproposed Rule").[2] Citigroup applauds the Commission for the effort it has undertaken throughout this entire process, from the initial proposal, to the public hearings, to the open meeting on the Reproposed Rule, to this second comment period. However, as it was made clear at the recent open meeting held December 15, 2004, there remains a vast difference of opinion on the best way to advance the objectives of price transparency, efficiency, competition, and best execution. The proposals, involving a Trade-Through Rule, intermarket access, sub-penny pricing, and market data, have broad implications for the U.S. capital markets, and it is important to consider thoroughly the implications of the Reproposed Rule and other alternatives prior to implementing any new rules which could have unintended consequences.

[1] Citigroup is a global financial services firm that provides investment banking, securities and commodities trading, asset management, and advisory, research and brokerage services to customers. It is a registered market maker in approximately 4,000 Nasdaq, exchange-listed, bulletin board, and over-the-counter securities, is a member of the National Association of Securities Dealers, Inc. ("NASD"), the New York Stock Exchange, Inc. ("NYSE"), and a number of other national securities exchanges. Additionally, the firm has a substantial floor operation on the NYSE, and is one of the largest block positioners in approximately 2,500 listed securities. In addition, Citigroup, through Citigroup Asset Management, provides asset management services to institutional and individual investors, and in doing so acts as a buy-side firm accessing all market centers and participants.

[2] Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 ("Regulation NMS" or the "NMS Release"). Subsequently, the SEC issued a supplemental request for comment and extended the comment period. Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 ("Supplemental Release"). The Commission's reproposal of Regulation NMS is at Securities Exchange Act Release No. 34-50870 (December 16, 2004), 69 FR 77424.

Citigroup respectfully requests that the Commission not limit the discussion of a Trade-Through Rule to just two alternatives **--** market BBO (also known as Top of Book) versus voluntary depth of book **--** but consider all alternatives, including the need for any Trade-Through Rule at all. To be certain, Citigroup fully supports the goals associated with a Trade-Through Rule, but is concerned that additional regulation in this area may inhibit the competitive market forces and technological developments currently driving our markets. In formulating our response to both the original proposal and the Reproposed Rule, Citigroup has spent a great deal of time, both internally and externally by participating in various industry committees, analyzing the proposals, debating the issues, and anticipating potential unintended consequences for us, the market centers, and the investing public. We firmly believe that the benefits of fair and efficient markets, characterized by transparent prices, firm and accessible quotations, efficient linkages, and automated executions, accrue to all market participants, but most importantly to our customers whose interests are paramount. We believe that there is no demonstrated need for a Trade-Through Rule, particularly with respect to highly liquid securities.

## I. A Trade-Through Rule Should be Based Upon Liquidity

Citigroup does not support a universal Trade-Through Rule. As we stated in our first comment letter,[3] we believe that intermarket price protection exists when the best bids and best offers are firm and accessible across all market centers, executions are automatic for all Nasdaq and exchange-listed stocks, and market participants are bound by the duty of best execution. We understand the Commission's desire to encourage displayed limit orders and create uniformity and transparency for the equity markets. We do not believe, however, that a Trade-Through Rule accomplishes these goals with respect to the most liquid securities, but, instead, adds unnecessary technological, regulatory, compliance, and surveillance costs.[4] We therefore would propose a pilot Trade-Through Rule that would exempt the most liquid securities from regulatory trade-through protection (the "Liquidity Trade-Through Rule").

Our proposal is based upon the belief that the characteristics of how stocks trade should dictate the type of Trade-Through Rule is mandated. If the Commission believes that a Trade-Through Rule is necessary to create an incentive for posting limit orders, Citigroup respectfully suggests that it is only needed for less liquid stocks. We are not alone in our belief that highly liquid stocks trade very differently from illiquid stocks. The most liquid securities trade automatically with sufficient competition, creating little chance a better-priced quote goes unexecuted. There is no need for additional regulation to create incentives for market participants to post limit orders in securities such as Microsoft Corp. ("MSFT"), General Electric Inc. ("GE"), the S&P Depository Trust Receipts© ("SPY"), and the Nasdaq-100 Index© ("QQQQ"); competition and Best Execution obligations have already accomplished that. The recent trading in the QQQQs provides a good example. In its first six weeks of trading as a Nasdaq-listed product, the average

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[3] Letter from C. Thomas Richardson, Citigroup Global Markets, Inc., to Jonathan G. Katz dated July 20, 2004 ("First Comment Letter")

[4] We note that the implementation challenges are much greater than those faced by the industry in implementing Regulation SHO, which was delayed and implemented in parts.

consolidated effective spread on trades executed dropped by 34% despite the lack of any trade-through protection. In addition, quoted spreads did not widen, but, in fact, decreased approximately 15% as measured by the average consolidated spread.[5] What is so significant about this comparison is that before the QQQQs began trading in Nasdaq's electronic market, a $0.03 *de minimis* exception to the Trade-Through Rule existed already and had narrowed spreads significantly.

Clearly stocks like GE and MSFT trade similarly and one could argue that as long as the quotes in such stocks are automated and universally accessible, there is no need for a Trade-Through Rule. We concede that there could be merit to the argument that the best price in less liquid securities be protected with a universal Trade-Through Rule. We believe that it would be appropriate for the Commission to look at the liquidity characteristics of stocks as a basis for a Trade-Through Rule, which we would define as the frequency of NBBO quote updates. There is little need to encourage the posting of limit orders in securities that have frequent updates and a rigid rule applied to these securities would be difficult and costly to implement and enforce. In our analysis we discovered that approximately 250 stocks in the 500 most liquid securities have a NBBO quote update every two seconds or less.[6] Further, we discovered that 410 securities in the Russell 3000© index have an NBBO quote update every two seconds or less.[7] Stocks with an average quote update under two seconds over a calendar quarter should be exempt from any Trade-Through Rule. The list of exempt securities could be updated quarterly. Formulating the Trade-Through Rule like this would allow the Commission the ability to implement it uniformly across all markets for the majority of equity securities. To the extent the commission deems a Trade-Through Rule necessary, Citigroup would recommend NBBO trade-through protection for the balance of the securities, which we discuss below (*See* Section III.C., below.)

## II. Fair Access to Quotes is Key to Intermarket Price Protection

The Commission has included in the Reproposed Rule to cap access fees and to ensure fair access to market centers with substantial volume through private linkages. These rules ensure intermarket price protection.

### A. <u>Regulation ATS Fair Access</u>

We support the Commission's efforts to protect the fairness and efficiency of private linkages by its proposed amendment to Regulation ATS lowering the fair access requirements from 20% of the average daily trading volume to 5%. In the event that an intermarket Trade-Through Rule is enacted, market participants must have fair access, which encompasses non-discriminatory

[5] Economic research provided by NASDAQ.

[6] The universe for this analysis was the securities in the S&P 500 index©, the QQQQ, SPY, and the DIAMONDS© (DIA). The sample was 24 full trading days and a quote move was defined as a change in the NBBO price (bid or offer), a change to either the best bid or best offer quantity, or a change to any participant's quote that is either at the NBBO or becomes part of the NBBO.

[7] 214 are NASDAQ stocks and the balance of 196 exchange-listed securities. It would also exempt approximately ten Exchange Traded Funds.

access fees and connectivity to trade with the BBO of that ATS. The Reproposed Rule would require trading centers that display quotations in an SRO display-only facility (currently, the ADF) to be responsible for "establishing the necessary connections to afford fair and efficient access to its quotations." The nature and costs of connections would have to be equivalent to those of SRO trading facilities, and could not be unfairly discriminatory. We support this approach and believe that it is fair and appropriate.

B. Access Fees

As stated in our First Comment Letter, we believe that access fees are unnecessary and distort the quote because they are non-transparent. However, Citigroup recognizes that there are distinctly opposing views on this issue from the various market participants. Under the Reproposed Rule, all quoting trading centers and market participants displaying protected quotes would be permitted to impose an access fee of $0.003 per share.[8] We support the Commission's efforts to propose a cap that would create a level playing field among market participants and curb outlier markets from attracting liquidity providers by charging a higher fee and providing higher rebates. However, we feel that access should be limited to $0.001 so as to eliminate the incentive for rebates.[9] Liquidity providers should be attracted to the market that provides best execution, not rebates.

The Reproposed Rule would prohibit an SRO from imposing unfairly discriminatory fees that would prevent efficient access to all displayed quotes. It also will help to prevent behavior that distorts the market, like locking or crossing markets to receive rebates.[10] Finally, by standardizing the fees, the proposal would address, to some extent, the transparency concerns associated with access fees that are not apparent in an advertised quote.

However, because the Reproposed Rule limiting access fees only applies to quotations protected by the Trade-Through Rule (*e.g.*, the BBO of an Exchange, NASDAQ and the NASD's Alternative Display Facility ("ADF")), Citigroup believes the Reproposed Rule does not go far enough to promote equal access. All quotes, including protected quotes, displayed size and reserve should be subject to the cap. If there is a distinction to be made between displayed quotes and reserves, we would suggest that no access fee be permitted for reserves, thereby adding further incentives to display liquidity. In the alternative, Citigroup would support the Commission's original proposal on access fees.

## III. Trade-Through Rule Alternatives

The Commission has asked for comment on two Trade-Through Rule proposals. The first, the Market BBO Alternative -- or as it is more widely known, the Top of Book proposal -- would

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[8] For NMS stocks priced less than $1.00, the fee would be limited to 0.3% of the quotation price per share.

[9] We are more in favor of the original proposal on access fees limiting them to a maximum fee of $0.001 per share with total access fees subject to a $0.002 cap.

[10] The Reproposed Rule would, however, allow the display of automated quotations that lock or cross a manual quote. This is an extremely important exception that is necessary given the inaccessibility of manual quotes.

create a rule that would protect the best displayed automated quote of each of the exchange SROs, the Nasdaq Market Center, and the NASD's ADF. The second proposal, the Voluntary Depth of Book Alternative ("DOB Alternative"), would establish a mechanism for these markets, on a voluntary basis, to protect its designated depth of book quotations from trade-throughs.

Citigroup is not in favor of either of the two alternatives included in Reproposed Rule, for the reasons detailed below. If forced to choose one alternative, we believe Top of Book to be the lesser of two evils. Notwithstanding our belief that no Trade-Through Rule is warranted, Citigroup would suggest that there are other more compelling alternatives that should be examined, such as the Liquidity Trade-Through Rule we proposed herein, or the NBBO Trade-Through Rule discussed below.

A. Top of Book Alternative

The Top of Book proposal limits protection of the top bid or offer on the eleven designated exchanges and market centers. We feel that this type of market regulation may serve to support certain market centers that otherwise may be incapable of competing because of poor technology or inferior execution. Furthermore, the Top of Book proposal could end up protecting quotes in one market that are inferior to quotes in another market. We believe that this could cause market participants to choose market centers for execution that are more likely to have less liquidity and order flow so that the market participant's order has a greater probability of being at the top of the book (best bid/offer) and therefore receiving increased protection. In addition, it seems counterintuitive to Citigroup that in order to comply with its Best Execution obligations, a broker-dealer may ultimately design a routing system to send its order flow away from the largest liquidity pool so as to be at the top of the book of an outlier market center. This is especially troublesome where firms have come to rely on smart routers to seek out the best execution for an order. They will now have to route to each of the markets top of book rather than to the market that may have a better price on its book. This could result in a scenario where broker-dealers are constantly chasing the top of all the books. Ultimately, we feel this could result in increased fragmentation with each broker-dealer's order flow being dispersed throughout the eleven "protected" market centers. Citigroup believes that this proposal is not in the best interests of the markets.

B. DOB Alternative

The DOB Alternative is problematic for several reasons. First, the cost of implementing, monitoring and enforcing this rule would be prohibitive.[11] Second, the concept of reserve size renders the rule meaningless. Third, we believe this alternative inhibits innovation and competition. Lastly, we think it will be next to impossible for the NYSE's proposed Hybrid market to operate effectively in a depth of book world.

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[11] Citigroup understands that the Securities Industry Association, Inc. ("SIA") will address these costs in more detail in its comment letter.

The DOB Alternative would be extremely difficult to monitor and enforce. Market centers would need to establish a mechanism to identify quotes as protected, and each broker-dealer would have to develop complex systems to analyze a significantly higher level of market data than is used currently in their order management systems. For example, in MSFT, typical broker-dealer systems need to read and maintain only the best bid and offer data. Under the DOB Alternative, firms would need to analyze and maintain market data in multiples of what is being used currently, creating system capacity problems. Costs for market data will increase, as the number of quotes that must be monitored significantly increases. This proposal would also add to the regulatory cost of enforcing a Trade-Through Rule simply because of the numerous quotes that would have to be monitored. In addition, we believe that this proposal could actually decrease competition among markets, rendering the NYSE's recent Hybrid proposal inoperable.

Citigroup believes that the DOB Alternative will not promote the display of limit orders unless displayed quotes and size take precedence over reserves.[12] If not, an order that is routed to a market center to sweep displayed protected quotes could be filled by the reserve size behind the first one or two quotes, and the other protected quotes would receive no execution. Trade-Through protection is ineffectual if a limit order never receives an execution. Yet without the ability to have reserve size, institutional investors and other market participants with large orders to buy or sell may lose the incentive to post a quote. For these reasons, Citigroup does not believe the DOB Alternative is practicable.

### C. NBBO Trade-Through Rule

To the extent a Trade-Through Rule is deemed necessary, Citigroup would propose a rule that would protect quotations at the NBBO an exempt the most liquid securities. This alternative would protect quotes at the consolidated best price, thus providing incentive for aggressively priced limit orders. It would also eliminate the issue of protecting a Top of Book quote in one market center that is inferior to unprotected prices in other market centers, mitigate the problem of flickering quotes, and eliminate the reserve issue. The market participant would have to take out all the best displayed quotes in the market, and then could execute the remainder of the order in the manner it deems best for the customer, using smart router technology.

## IV. Proposed Exceptions to a Trade-Through Rule

Proposed Rule 611(b) sets forth the following exceptions to a Trade-Through Rule: (1) material delays or malfunctions; (2) transactions not "regular-way"; (3) openings, reopenings or closings by the trading center; (4) crossed markets; (5) intermarket sweep orders; (6) an execution or order not based on the current quoted price; and (7) flickering quotes in a one second window. We commend the Commission for listening to the numerous comment letters that stated the proposed "opt out" exception would not work and that, instead, the market needed specific narrowly tailored exceptions. However, as proposed, some of these exceptions could prove difficult to monitor and enforce.

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[12] To be clear, Citigroup is not advocating the elimination of reserves.

A. Material Delay Exception

We support the Commission's proposed exception due to a material delay or systems problem. However, we believe more discussion is needed to clearly define when this exception is applicable. For example, the Commission needs to mandate some mechanism whereby a market center notifies the rest of the market that it is experiencing a material delay. Can a market participant bypass the entire market center or just quotations in particular stocks? In addition, how long can the material delay exception last? While we agree that one occurrence of a failure to respond within one second may not justify the future bypassing of that market center's quotes, the suggestion that a trading center should "attempt to resolve the problem by contacting the other trading center that has failed to respond immediately" is not practical. It would be impossible during real-time trading to stop and contact a trading center that has not responded with immediate execution or rejection of an incoming order. With the advancement in technology, most order routing vendors (*e.g.*, aggregators and ECNs) know instantly whether a quote is in fact stale. We would propose that the Commission allow these advanced trading systems the ability to trade-through quotes they deem to be outdated or stale.

B. Stopped Orders Should be Excepted

Citigroup supports the proposed exception for benchmark orders.[13] We disagree, however, with the Commission's determination that stopped orders not be included in this exception from the Trade-Through Rule.[14] A stopped order is where a broker-dealer agrees to buy or sell a security on behalf of a customer at a specified price or better. In order to guarantee that price, the broker will employ their capital only if the stop price has been exceeded. The Commission has suggested that the execution price of a stopped order is based on the quoted price of a stock at the time of execution. Stops provided by broker-dealer firms provide a source of liquidity that otherwise does not exist in the market at the time the order is stopped **or** at the time the stop is executed. The final price of the execution often bears little or no relationship to the quoted market at the time of execution. If sufficient liquidity existed in the marketplace at the time of execution, the broker-dealer would not have to commit its capital and the stopped order would be executed in the market on an agency or riskless principal basis at the then-quoted price. We believe that stopped orders should be exempt from any Trade-Through Rule precisely because their price is unrelated to the current market price, protection of which is unnecessary. Of course, any executions for the customer before the stop is elected would be subject to Rule 611. We would suggest that trade reports of stops, like other benchmark trades, include a modifier (*e.g.*, .PRP, .W) to identify it to the market as a trade that is unrelated to the current quotes and not a trade-through. If the Commission is concerned that firms will use this exception to circumvent the Trade-Through Rule by stopping a customer and then printing with a trade

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[13] The Commission should consider including in the benchmark exception trades where the common stock side is related to a derivative or convertible security such that the price is determined by that relationship. In addition, Citigroup believes it is necessary to except risk arbitrage transactions that are priced based on the arbitrage spread between the two securities. We look forward to working with the Commission to craft these and other exceptions as appropriate.

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[14] *See* Reproposed Rule 69 FR at 77446, note 149.

modifier shortly thereafter, we suggest that this kind of behavior can be monitored to ensure that firms rely properly on the stop exception.

### C. "Reopening" Exception Should be More Clearly Defined

The final exception we would like to comment on is the one proposed for "reopenings." Citigroup urges the Commission to more clearly define the circumstances under which a market center may trade-through another market center's quotes because the first market center is executing after a reopening. We fear that, under the current rule proposal, a market center could halt trading due to a pending order imbalance. Subsequently, its first print of stock immediately thereafter could be unrelated to the quotations of other market centers that did not halt trading, allowing it an exemption to the Trade-Through Rule. This exemption has the appearance of being inconsistent with the price protection objectives of reproposed Rule 611, and could lead to a situation where a market center halts trading and reopens just to enable it to trade-through another market's quotes. The Commission needs to more clearly define what constitutes an imbalance and ensure that the definition is consistent across all market centers.

## V. Best Execution Should Not be Measured Against a Manual Quote

The Reproposed Rule does not include the elimination of slow or manual quotations from the NBBO, despite recognizing that manual quotations are often inaccessible and not firm for purposes of a Trade-Through Rule. Furthermore, manual quotations are excluded for purposes of allocating market data fees. Citigroup believes that broker-dealers should benchmark Best Execution statistics to firm and accessible quotes and base the NBBO solely on these quotes. The Commission is concerned that to do so would widen the spreads in many stocks, but Citigroup does not believe that this would happen because internalizers that ignore manual quotations with real liquidity will suffer in their Best Execution statistics. To elaborate, not all slow quotes are the same, and in some cases, a slow quote is merely a delayed quotation with no corresponding real liquidity and no relevance to the current market. In other cases, such as with the proposed NYSE Hybrid market, slow quotes are designed to decrease trading costs. Market centers that use slow quotes to decrease trading costs and improve price discovery may demonstrate superior execution quality. Broker-dealers will be compelled to internalize at the price of a manual quote that actually provides liquidity in order to comply with the duty of Best Execution.

In the end, the issue is that slow or manual quotes are often inaccessible and therefore represent an unfair standard of comparison when used for Best Execution analysis. In addition, slow quotes could be used to game Best Execution statistics without any consequence. Finally, including slow quotations in the NBBO creates a risk that non-professional investors who do not have access to the depth of market data could be misled as to the true state of the market.

## VI. Sub-Penny Quoting Proposal

As with the Original Release, Citigroup supports the Commission's Reproposed Rule prohibiting sub-penny quoting in NMS stocks priced at $1.00 or greater. Sub-penny quotations would be allowed to four decimal places only for those orders priced below $1.00. Citigroup believes this is a sensible approach to allow a limited sub-penny quote for these low-priced securities. We agree that executions in sub-penny increments that result from price improvement, mid-point or VWAP algorithms should not be prohibited.

The Commission is seeking comment on whether there should be a similar exemption for sub-penny quoting in the QQQQ and other actively traded ETFs. Citigroup believes that sub-penny quoting is not warranted for these securities that are often purchased by individual investors and that trade similarly to the stocks underlying them.

**VII. Market Data Proposal**

Citigroup commends the Commission for its reproposed market data rule, which we believe is simpler, more transparent and less open to gaming than what exists today. The proposal will reward automated quoting, not trade volume, and recognizes the value of a 20,000-share trade over a 100-share trade. We look forward, as well, to the review of market data fees and the funding of self-regulation in the Commission's SRO Governance and Transparency releases.[15] Because the Commission has decided to split the discussion of the level of market data fees and their allocation between the Reproposed Rule and these releases, it is difficult to fully support the market data proposal. Citigroup continues to believe that before the Commission can determine how market data revenues should be allocated, it must first address whether the present utilization of market data fees to cover regulatory and other costs beyond the actual cost of gathering and disseminating market data is consistent with the statutory purpose. We believe that market data fees should be used solely to cover the costs of disseminating and collecting market data. Limiting market data fees to the cost of collecting and distributing the data would have the effect of eliminating the practices the Commission's proposals seek to address (*e.g.*, tape shredding). We see no reason why a cost-based fee structure for market data would in any way undermine the funding for regulation.

We recognize that SROs must adequately fund their regulatory programs. Clearly, well-regulated markets and strong enforcement programs build integrity in our markets and ensure investor confidence in the markets. We suggest that SROs create regulatory fees that are separately approved, and earmarked for the funding of regulation. This would ensure that SROs receive adequate funding for regulatory programs while bringing transparency to the process.

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We thank the Commission for this opportunity to comment on the Reproposed Rule, and hope the dialogue on market structure continues, as we believe our markets will be strengthened

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15 Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) and Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004).

because of it. We look forward to an ongoing dialogue with the Commission and will continue to work with the industry on these complex and important issues. If you have any questions, please feel free to contact the undersigned at 212-723-4921 or Amy C. Reich, Assistant General Counsel, at 212-723-5781.

Very truly yours,

C. Thomas Richardson
Managing Director

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