January 26, 2005

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

Re: Regulation NMS; SEC File Number S7-10-04

Dear Mr. Katz:

We are writing to respond to the Commission's request for comments regarding re-proposed Regulation NMS. RBC Capital Markets Corporation ("RBCCM") is a member of NASD and the New York Stock Exchange ("NYSE"). It is a diversified capital markets firm that is registered as a NASDAQ market maker in several hundred securities, has an active block trading and institutional facilitation business, and is one of the largest index arbitrage and program trading firms in the United States. We appreciate the opportunity to add our views to the ongoing dialogue in connection with the Commission's efforts to revise and reform the National Market System ("NMS") for the trading of equity securities.

Our comments focus on what we believe is the most significant and perhaps controversial component of Regulation NMS—the "Trade-Through Rule" (sometimes referred to herein as the "Rule"). The Trade-Through Rule (to be designated SEC Rule 611) will require, for all NMS stocks, intermarket protection against trade-throughs that occur when one "trading center" executes an order at a price that is inferior to the price of a protected quotation displayed by another trading center. Trading centers include NASD operated facilities such as the NASDAQ Stock Market Inc. ("NASDAQ"), national securities exchanges, alternative trading systems ("ATSs"), exchange and OTC market makers, and any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent. The Rule is designed to protect limit orders represented by displayed and automated quotations, and market and marketable limit orders, by requiring execution of orders at the best, immediately accessible prices, or routing of such orders to trading centers that display such prices. The Rule will protect only "automated quotations." This limitation is designed to avoid any potential advantage that manual (non-automated) markets may have under the current trade-through provisions of the Intermarket Trading System ("ITS") plan for exchange-listed securities, where such manual markets may show a better, but less accessible price.

I. The Trade-Through Rule Should Be Eliminated Under the Current Market Structure

Instead of extending the Trade-Through Rule to the NASDAQ market, RBCCM believes that under the current market structure, the Commission should eliminate the Rule altogether. Only in a truly open, transparent marketplace, where all quotes and orders, at all price and size levels, are completely visible and immediately accessible, can a trade-through rule properly exist. We also believe that under the current market structure, where fully electronic markets operate side-by-side with traditional exchanges, each offering certain unique attributes, the Rule is antiquated and places undue weight on one factor—price—to the virtual exclusion of other factors (for example, speed and certainty of execution) that many investors trading in such a structure may find equally or more important than price. Trade-through rules under the current market structure simply ignore the fact that many orders may be better served if the goal of seeking the best price is sublimated to other goals. In fact, "best execution" obligations serve many of the same objectives as the proposed Trade-Through Rule, but without being as inflexible or one-dimensional.

A. The Trade-Through Rule Can Work Only in a Completely Open and Transparent Marketplace

Under the current market structure, where many different types of trading centers operate side-by-side, each offering different advantages and disadvantages, the Trade-Through Rule does not work. Only in a marketplace that provides total transparency of quotes and orders, at all price and size levels, can market participants truly determine what the best available price is for any security, and only where all quotes and orders are completely and immediately accessible can a market participant trade in a manner that protects the interests of that market participant (or its customer) and the interests of those providing the liquidity reflected in those quotes and orders. In such a marketplace, RBCCM would support a Trade-Through Rule. However, where disparate variables are introduced into the equation, then a rule that focuses on only one such variable – price – is inappropriate and unworkable.

Unfortunately, the re-proposed Trade-Through Rule will exist in a marketplace where electronic markets, which offer immediate automated executions for certain orders, operate side-by-side with traditional floor-based markets that offer an opportunity for orders to be exposed to a more time-consuming auction process. Moreover, some traditional exchanges are now proposing "hybrid" models that are designed to provide automated, immediate executions for certain orders while subjecting other orders to the manual auction process. The Trade-Through Rule will apply only to those quotations on such markets that are deemed automated; however, each hybrid exchange will be permitted to develop its own standards regarding when its quotations are deemed automated or manual. In addition, even electronic trading centers may not necessarily make their entire depth-of-book ("DOB") transparent. Instead a "reserve size" function may be offered, which permits market participants to post additional *undisplayed* liquidity at various price levels. Even the Re-proposal itself offers two possible methods for providing protection of each market's quotes and orders, one of which would protect only the "top-of-book" quotations of each market, leaving other available liquidity of that market undisplayed even if it is at a price that is superior to the protected quotes of other markets.

We do not question the fact that a multiplicity of trading center models may present significant benefits to certain market participants. For example, the ability to post reserve size permits market participants to explore the marketplace without disclosing the full size of their orders, while floor-based auction markets may present significant advantages in the handling of certain large orders. Indeed, the hybrid model attempts to provide advantages of both types of markets and provide investors with choice. However, we strongly believe that a market structure that provides so may different options, and therefore introduces a number of variables other than price into the order routing equation, is not an appropriate candidate for a trade-through rule. So long as each trading center presents different variables to the order routing execution equation, similar variables may be subject to disparities, and such disparities are under even partial control by the individual trading centers, the Trade-Through Rule simply does not work and should be eliminated, not expanded.

B. Continuing and Expanding the Trade-Through Rule Under the Current Market Structure Will Stifle Competition

An analysis of the potential impact of the Rule under the current market structure must begin with a comparison of the market model that currently has such a rule, the ITS, and the model that doesn't, NASDAQ. In the past decade, NASDAQ has been subject to a number of changes and improvements, many of which are the result of competitive forces in the market. Indeed, it can be argued that the single most important factor leading to the need for revision of the NMS is the growth of fast, efficient electronic communication networks ("ECNs") and ATSs. They evolved in a NASDAQ market that was free of any "trade-through" rules or other undue focus on one component of the overall analysis of what constitutes "best execution." Indeed, it is questionable whether these ECNs and ATSs could have developed, or certainly achieved their current level of success, if the market for NASDAQ securities had been subject to a trade-through rule.

In the NASDAQ market, SEC Rules 11Ac1-1 (the "Quote Rule") and 11Ac1-4 (the "Limit Order Display Rule"), along with Rules 11Ac1-5 ("Disclosure of Order Execution Information") and 11Ac1-6 ("Disclosure of Order Routing Information"), have combined with the NASD trade reporting requirements to create an environment where market participants, including investors and their brokers, can evaluate various factors that contribute to an overall assessment of execution quality, including, of course, price, but also including speed, likelihood of execution (liquidity or minimum size commitments), ability to efficiently handle orders of a particular size or for a particular stock, and cost of execution. Indeed, each market must disclose its performance with regard to many such factors in the monthly reports made available to the public under Rule 11Ac1-5.

The requirements for broker-dealers to disclose "quality of execution" statistics, along with the open, transparent display of quotations and prices, has resulted in an open market where investors and their representatives can evaluate and compare market centers and, based on the factors that each market participant determines to be most important for each order or type of order, direct orders to the most appropriate venue. The bottom line, however, is choice. If the investor (or its representative) determines that other factors are more important than the best displayed price alone, the choice remains with the investor.

Trading in the ITS world provides much less freedom of choice. Each ITS exchange is subject to an existing trade-through rule that in many cases fails to reward factors other than best price, such as speed or certainty of execution, and reduces all routing decisions to a single factor – the best *displayed* price. However, because the exchange showing that "best price" has up to 30 seconds to respond, we have seen any number of cases where an order directed to such exchange is rejected (for example, because another market participant has accessed that quote) and, by the time this happens, a slightly inferior but available quote, which could have been accessed virtually instantaneously, is no longer available. The result is that the order ends up being executed at a worse price than if it originally had been directed to the faster market.

The Commission attempts to address this concern in Regulation NMS by protecting only automated quotes. It also proposes Rule 611(b)(1), which will address slow trading centers by exempting from trade-through protection quotations displayed by trading centers that are experiencing, among other things, material delays in responding to incoming orders. While this goes a long way to addressing the shortcomings of the current ITS trade-through rule, we continue to be concerned that there will be disparities in response time, quality of execution and other factors that may make another market a better choice for the execution of a particular order.

Moreover, as discussed further in Part II.C of this letter, the Rule as now proposed would permit a market, under Rule 600(b)(4), to "blink" in and out of status as an automated trading center, based on standards established by each such market. This poses a risk that orders will be routed to an exchange apparently providing automated executions that has reverted to manual status during order transmission. It also poses burdens on order entry firms to track continually the status of such markets to be certain as to when they are or are not operating in an automated manner. The Trade-Through Rule, even as re-proposed, thus has the potential to seriously undermine competition and freedom of investor choice without necessarily assuring that orders will be executed at the best available prices. (See discussion of the shortcomings of the "Market BBO Alternative" in Part II.B, below.)

C. The Re-Proposed Trade-Through Rule Will Interfere with the Duty of Best Execution

In the context of the current market structure, a Trade-Through Rule that puts best price above all other factors is simply unnecessary. As the SEC points out in the Re-proposal, adoption of the Rule "would in no way lessen a broker-dealer's duty of best execution. Broker-dealers still must seek the most advantageous terms reasonably available under the circumstances for their customer orders. They must carry out a regular and rigorous review of the quality of markets to which to route customer order flow." Thus broker-dealers, as well as others determining where investor orders should be routed (*e.g.*, investment advisers), have an obligation to determine the best place to send those orders. And, as stated above, several variables currently go into making that determination – not just best posted price. To mandate that an order (or even a portion of an order) be routed to a particular venue solely because it is showing the best price, takes the best execution decision away from the broker-dealer, other representatives or, indeed, an investor, who wishes to make the routing decision based on factors other than price.

The Re-proposal fails to give sufficient consideration to this point. An inherent weakness of the approach taken in the Rule is that it mandates one particular focus of execution quality in a marketplace with many variables, while purporting not to change the broker-dealer's duty of best execution. It forces the order to chase the "best price" even if other factors are considered more important in the context of the particular transaction, and provides protection to one side of the market (the market or market participant showing the "best" price) at the potential expense of the other side of the market that wishes to trade based on factors other than (or in addition to) price. With the information that is currently available, broker-dealers and others should be free to determine where to route orders, subject to their best execution obligations. If a broker-dealer can otherwise satisfy these obligations, its decision regarding where to route an order should not be turned into a regulatory violation because it did not focus solely on the best posted price, which would be the result under the Trade-Through Rule. In fact, the Commission clearly signals its intention to reduce the best execution analysis to a best price analysis when it states that "the re-proposed Trade-Through Rule would backstop a broker's duty of best execution by prohibiting the practice of executing orders at inferior prices, absent an applicable exception."

Moreover, the Rule forces a broker-dealer to circumscribe its duty to its customer, and to consider the interests of another party. The Re-proposal states that "even when . . . brokers act in the best interests of their customers, they may deliberately choose, for various reasons, to bypass (*i.e.*, not protect) limit orders with the best displayed prices. . . . Market participants that execute orders at inferior prices without protecting displayed limit orders are effectively 'free-riding' on the price discovery provided by those limit orders. Displayed limit orders' benefit all market participants by establishing the best prices, but, when bypassed, do not themselves receive a benefit, in the form of an execution, for providing this public good." The Commission seems to be saying that, rather than acting solely on behalf of its customer, the broker-dealer should act in the best interest of some other party because that party provides a "public good." Forcing the broker-dealer to send an order to a market to which it otherwise would not send the order, to protect the interests of the participant in that market who is responsible for the better priced quote, flies in the face of the broker's undivided duty of loyalty to its customer.

Furthermore, as noted in the opening paragraph of this letter, RBCCM engages in substantial index arbitrage and program trading. For such proprietary activity, the imposition of a trade-through obligation on our own order routing decisions is particularly inappropriate. This activity is highly competitive and driven solely by the economically rational objective of obtaining optimal execution of our orders based on a number of predetermined factors. Speed, reliability, depth of market (at the posted price or at price points immediately below the posted price) are all factors that could cause order routing decisions rationally to vary from the strict execution parameters the proposed Trade-Through Rule would dictate. To impose, by regulatory fiat, a requirement that we direct such orders to particular destinations when rational economic behavior would dictate otherwise, by definition introduces inefficiency into the market.

We believe that the last several years have not been an aberration, and that the speed and efficiency of the markets will continue to evolve and improve if all market participants are allowed to freely compete based on the public's perception of the value they bring to the table. If the best price is viewed as the single or predominant factor in executing a particular trade, then ensuring there is information regarding available prices, and free and open access to those prices, is the key to facilitating execution of the order. However, under the present market structure, where concerns other than best price often predominate in the handling of a particular order, an investor, its broker or other representative, should be free to pursue an execution that satisfies those concerns. In the end, we firmly believe that competition will drive the continual development and improvement of systems and linkages, and lead to more competitive, indeed aggressive quoting of prices, all of which will better serve the interests of all investors.

II. If a Trade-Through Rule is Adopted Under the Current Market Structure, It Should Initially Cover Only the Best Bids and Offers of Each Market

The SEC is proposing two alternatives for protecting quotations. The first (the "Market BBO Alternative") would protect only the best bids and offers ("BBOs") of each national securities exchange and NASDAQ, in a manner comparable to coverage under the current ITS rules. The second alternative (the "Voluntary Depth Alternative") would protect the BBO and also permit a market voluntarily to protect its depth of book ("DOB") quotations at prices away from its best bid or offer. The SEC is requesting comment regarding which of the two alternatives furthers the objectives of the NMS in a practical and workable manner.

A. The Market BBO Alternative Will Be More Cost Effective to Implement

While we believe that the Trade-Through Rule is inappropriate and unnecessary under the current market structure, we believe that if the Commission adopts such a rule, it should adopt, at least initially, the "Market BBO Alternative." The Market BBO Alternative will operate similarly to the current ITS trade-through rule, with the exception that NASDAQ securities will be included as well. Under this alternative, protected bids and offers would be limited to quotations in NMS stocks that are displayed by an automated trading center, disseminated pursuant to an effective national market system plan, and are automated quotations that represent the best bid or best offer of a national securities exchange, NASDAQ, or a national securities association.

Because most firms that route orders in exchange-listed securities, and the vendors that provide market information and execution services to them, already have developed systems to address the current ITS trade-through rule, we believe that adapting those systems to include NASDAQ securities would be far simpler than trying to accommodate an untried system of protecting the entire depth of each market's order book. While, as discussed below, it may be determined ultimately that the Voluntary Depth Alternative is a preferable approach to the operation of the Rule, we do not believe that the significant expenditures of time and money that would be required to accommodate DOB protection is warranted as an initial matter.

B. A Voluntary Depth Alternative Pilot Program Nevertheless Should be Explored

Despite our view that any Trade-Through Rule, as adopted initially, should be limited to the top of the book of each trading center, we believe that there may be significant long term benefits to the Voluntary Depth Alternative. We are sensitive to the concerns that gave rise to the Voluntary Depth Alternative, and we certainly recognize that there are serious limitations of providing only top-of-book protection. For example, while designed ostensibly to lead to orders being executed at the best price, the Market BBO Alternative may in fact result in orders being executed at the best displayed quotes of the various markets, but nevertheless not at the best price available. For example, if Market A is looking to buy 5,000 shares of XYZ and Market B is showing a best offer of 1,000 shares of XYZ at $10.00, along with 2,000 shares at $10.01, and 2000 shares at $10.02, while Market C is showing a best offer of 2,000 shares at $10.03 and Market D is showing a best offer of 2,000 shares at $10.04, if Market A's order is handled in accordance with a top-of-book approach, the offers at Market B at a better price than those of Markets C and D (*i.e.*, the offers at $10.01 and 10.02) would go unexecuted in favor of the inferior offers at Markets C and D.

We are also uncertain of the structure that DOB protection would take, and the effects it could have on the marketplace. For example, many trading centers offer investors a reserve size function that permits them to bid for or offer undisplayed size at various price levels in addition to the size they display. Thus, a market that displays a best offer of a certain number of shares at $10.00, along with offers at $10.01, $10.02, etc. may also have reserve size -- additional shares offered but not displayed -- at $10.00, $10.01, etc. If only the displayed offers of $10.00, $10.01, and $10.02 are protected, another market would be prevented from executing a trade at $10.03 unless it simultaneously routed an order to execute the same size against the accumulated *displayed* size of the protected quotations at the first market. This would be done by routing an order to buy with a limit price of $10.02 for the total number of shares displayed at $10.02 or better. However, as stated in the Re-proposal, reserve size (where offered) generally has priority over displayed size at inferior prices. Thus, the trading algorithm at the market receiving such an order would execute it against the better priced reserve size (at $10.00 and $10.01 above) before executing anything at $10.02. Moreover, if the order was satisfied at 10.00 and $10.01, the offer at 10.02 would not be lifted, and the market executing the trade at $10.03 would appear to have traded through the still displayed quote at $10.02. We believe that this could cause significant confusion. It appears to us that the only effective way to relieve such confusion would be to have all interest at each price level disclosed, effectively eliminating (or significantly altering) the reserve function.

We are also concerned that implementation of the Voluntary Depth Alternative may be operationally difficult. As the Re-proposal points out, each trading center "would need to monitor a significantly larger number of quotations displayed by other markets and route orders to execute against such quotations." Each trading center also would be required to establish a mechanism to collect their DOB quotations, have them designated as protected, disseminated publicly, and made available and accessible on fair and reasonable terms. Furthermore, protection of DOB quotations would not be feasible unless market participants have a source of information that clearly identifies all quotations to be protected, that information is available on fair and reasonable terms, and market participants have fair and efficient access to the protected quotations without paying exorbitant access fees. Finally, regulatory authorities will need to develop resources to permit them to monitor and enforce compliance with the Rule as so constructed, including an objective, uniform source to identify the protected quotations at any particular time.

The Voluntary Depth Alternative will also require broker-dealers, investors, regulators and others to implement significant changes to their systems for monitoring market information, routing orders and evaluating best execution. Even if the necessary systems modifications are implemented by participants at all levels, potentially significant practical issues, in particular "flickering" quotes in actively traded securities, would have to be addressed. We simply do not believe that all market participants should be forced to undertake such a massive technological undertaking without significant empirical evidence showing that the benefits of this alternative over the Market BBO Alternative (or, indeed, no trade-through rule at all) outweigh these costs.

Therefore, before adopting a DOB requirement, we recommend that the Commission consider establishing a "pilot program" under which a small number of highly liquid NMS stocks are subject to DOB protection, so that the effects of this alternative can be studied. In a manner similar to the pilot program currently being developed for Regulation SHO, a DOB pilot program would allow the SEC to obtain empirical data that will help assess whether this approach is, in fact, beneficial and, if so, should be applied to all NMS securities.

Overall, our concern with the Voluntary Depth Alternative, and our view that its implementation should be carefully considered and controlled, is rooted in our view that there really is no proper place for the Trade-Through Rule in the current market structure. As detailed above, we believe that for many orders, price is only one of several factors that figure into the calculus of when and how to execute an order. Execution of any such order can be affected negatively if an obligation remains to access one or several markets for the sole purpose of satisfying a price-only rule in a marketplace where less than all quotations are visible and accessible. We would want to be sure (and would think that the Commission would want to be sure) that the systems in place at each automated trading center for internally sweeping their books, and the mechanism for sweeping the depth of the combined books of all such market centers, is efficient and fast, so that this requirement does not again lead to lost opportunities to execute particular orders at the appropriate venue or venues.

C. The SEC Should Define the Standards for Hybrid Markets

The re-proposed Trade-Through Rule protects only quotations that are immediately and automatically accessible. However, the NYSE and the American Stock Exchange have expressed an intention to establish "hybrid" facilities that offer automatic execution while maintaining a traditional floor-based auction market. The SEC therefore included in the Re-proposal an approach intended to permit a hybrid market to display both automated and manual quotations, provided the market meets basic standards that promote fair and efficient public access to the market's automated quotations, without requiring routing of orders to a hybrid market with inaccessible quotations. Under Rule 600(b)(4), for a trading center to qualify as an "automated trading center" it will be required to (I) have systems and rules enabling it to display quotations that meet the automated quotation requirements, (ii) identify all quotations other than automated quotations as manual, (iii) immediately identify quotations as manual if there is reason to believe the trading center cannot display automated quotations, and (iv) adopt reasonable standards limiting when quotations change from automated to manual (and vice versa) to specifically defined situations that promote fair and efficient access to automated quotations and are consistent with maintaining fair and orderly markets.

We have serious misgivings regarding how the determination is to be made regarding when quotations of a "hybrid" market will be protected by the Rule. The Rule leaves it up to the trading center to adopt reasonable standards limiting when its quotations change from automated to manual (or vice versa). While we agree that it is necessary to require that automated quotations be switched on and off only in narrow, specifically defined circumstances, we are concerned that leaving it to the trading center's discretion to control when that occurs potentially could disadvantage various classes of market participants. We therefore suggest that, rather than leaving it to each trading center to define such standards (which could be used to favor one class of market participant over another), such standards should be established and defined by the Commission as part of the Rule. This will prevent the emergence of multiple standards for different trading centers.

To permit hybrid markets to create their own standards would expose the marketplace to the risk that a trading center using the hybrid model will be able to avoid application of the Rule whenever it benefits that trading center or particular market participants. Indeed, a market could develop and apply such standards in an anti-competitive manner that maximizes the market share of that exchange, or certain participants thereof, at the expense of the best possible execution for customer orders. We note that the NYSE's hybrid market proposal -- NYSE Direct+ -- includes a plan to create a "Broker Agency Interest File" that would permit NYSE floor brokers to electronically represent customer interest at varying price levels at or outside the quote. This function is designed to "give customers choice and floor brokers flexibility in representing orders over time at the point of sale, thereby maximizing their ability to obtain the best execution possible." This interest would not be displayed unless it is at or becomes the NYSE best bid or offer. Generally, an automatic execution order would trade against displayed interest and any undisplayed reserve at the bid or offer price before it would sweep the book. A similar "Specialist Interest File" would enable specialists to "systemically supplement the quote, determine price points outside the quote to which he or she wants to provide liquidity by bidding or offering on behalf of its dealer account . . . facilitate a single-price execution at the bid or offer price, and systemically match outgoing ITS commitments."

These features are similar to the reserve size function found on many ECNs, and while we understand and agree that it would be beneficial to the marketplace for specialists and floor brokers to express interest at different price levels, so that automatic execution orders access all interest available at particular price levels, we do not understand why this function is not extended to all NYSE member firms directly. The same considerations that have led the Commission to propose Regulation NMS and to consider the need for the Trade-Through Rule, require nothing less than direct, open access for orders for *all* market participants to any order-book mechanism designed to provide depth and liquidity, and we call upon the Commission to impose such a requirement on the NYSE if Direct+ is approved.

III. Conclusion

For all of the foregoing reasons, we believe that a Trade-Through Rule is inappropriate, unnecessary and, indeed, could be detrimental to the continual growth and development of the marketplace, which only can come when competition is allowed to drive market structure. However, if a Trade-Through Rule is to be implemented, we believe that the Commission should do so carefully and incrementally, beginning with the Market BBO Alternative while investigating the viability of a DOB approach through a limited pilot program that will enable the Commission to evaluate the effects of such a rule on all markets, market participants, and orders. In this way, any final decision will run far less risk of triggering unforeseen negative consequences that may be difficult to reverse.

Once again, we appreciate the opportunity to provide our views on this important matter. If there are any questions regarding the views stated in this letter, or if you would like to discuss the matter further with us, please contact the undersigned at (212) 862-6651, Richard Chase (212) 858-7111, David Serena (212) 858-6061 or Anthony LaRosa (212) 428-6647 at RBC Capital Markets Corporation.

Sincerely,

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RBC Capital Markets Corporation