Merrill Lynch

Global Markets & Investment Banking

February 4, 2005

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

Re: Proposed Regulation NMS; Release No. 34-50870; File No. S7-10-04

Dear Mr. Katz:

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") reproposed Regulation NMS under the Securities Exchange Act of 1934.[1] The reproposed rules address trade-throughs, market access, sub-penny quoting, and market data, with the most significant changes involving the trade-through rule.

Merrill Lynch is one of the world's leading financial management and advisory companies, with offices in 35 countries and private client assets of approximately $1.4 trillion at the end of 2004. Merrill Lynch, along with its affiliated companies, is an important and active participant in the U.S. and global equity markets. We have 70 stock exchange memberships in over 30 countries. Through our Global Private Client Group, our Global Markets and Investment Banking Group, and our Investment Management Group, we offer a range of equity execution services to individual, institutional, and corporate clients.

Given the diverse interests of our clients, on a global basis, our perspective is broad. In general, we believe that, in order to maintain the global preeminence of the U.S. equity capital markets, our market structure must be characterized by fair and efficient markets—transparent prices, firm and accessible quotations, efficient linkages, price protection, and vigorous competition among trading centers offering different products and services.

I. Introduction and Summary of Merrill Lynch Position

We applaud the Commission and the staff's efforts to modernize and improve the operation of our capital markets. We agree that regulation has not kept pace with advances in technology and changing trading strategies, and Commission action is necessary to ensure the

[1] Securities Exchange Act Release No. 34-50870 (December 16, 2004), 69 FR 77424 ("Reproposing Release").

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continued smooth functioning of the National Market System ("NMS") mandated by Congress in 1975. We enthusiastically support those aspects of the reproposal where the Commission sets baseline standards designed to ensure regulatory uniformity across trading centers. On the other hand, we highly value competition and generally favor market-based solutions to market structure issues whenever possible. Whether brought about by regulation or competition, though, our overriding interest is in ensuring that our individual, institutional, and corporate clients obtain the most efficient possible executions at the best possible prices.

The Reproposing Release, like the original Proposing Release and the Supplemental Release,[2] has generated a lively debate about the need for, and extent of, changes to the NMS. The reproposal, among other things, reflects the Commission's view that a price protection *rule* is necessary to protect, and create incentives for the placement of, limit orders. The only remaining question is the scope of that protection. It is no exaggeration to state that the changes the Commission proposes will have profound implications for the U.S. capital markets for years to come. Perhaps the only point of agreement in the current debate is that the effects of these market structure changes cannot be predicted with certainty at this time. Therefore, an incremental approach, we believe, will minimize the implementation challenges and risk of unintended consequences, and will allow for reevaluation of the need for additional regulation as the impact of change is absorbed by the markets.

Merrill Lynch has participated actively in the preparation of the comment letter submitted by the Securities Industry Association ("SIA") and we generally support the views expressed in that letter.[3] Although we too support price protection for limit orders, we do not necessarily believe that can be achieved only through regulation. Our views, which are, for the most part, consistent with those of the SIA, are discussed below.

We support intermarket price protection for firm and immediately accessible quotations, contingent upon adoption of the broad access standards proposed by the Commission and a sufficient amount of time to allow for the development of private intermarket linkages. We applaud the New York Stock Exchange's ("NYSE") recent initiative to enhance automation in that market. In fact, if all trading centers are linked efficiently and offer the capability for immediate and automatic executions, we believe that principles of best execution, self-regulatory organization ("SRO") and SEC oversight, and competition in the market will go a long way toward ensuring that limit orders are protected. If the Commission adopts the fair access requirements and approves NYSE's enhancements to the Direct+ System in the near term, the scope of the price protection rule may well become irrelevant as market forces serve to eliminate trade-throughs.[4]

As discussed in more detail below, if the Commission is convinced that competitive pressures and best execution obligations are insufficient to bring about the desired changes and it

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[2] Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 ("Proposing Release") and Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 ("Supplemental Release").

[3] *See* Letter from Marc Lackritz, President, SIA, to Jonathan G. Katz, Secretary, SEC, dated February 1, 2005.

[4] Of course, due to asynchronous systems and continuous quote updates in very liquid, actively-traded securities, there may continue to be "false positive" trade-throughs.

is therefore necessary to mandate price protection, any price protection rule should have all of the following features. Specifically, the Commission should adopt a price protection rule limiting protection to the national best bid and offer ("NBBO") of the exchanges, The Nasdaq Stock Market ("Nasdaq"), and the NASD's Alternative Display Facility ("ADF"), with all of the following appropriate exceptions, subject to certain refining comments noted below: an exception for certain actively-traded, highly liquid securities; an exception for "flickering quotes" immediately prior to any trade through; an exception to accommodate certain trading strategies and order types, *i.e.*, benchmark trades, including stopped orders; an exception for system malfunctions at a market center; an intermarket sweep exception; and an exception related to openings and reopenings. Like the alternatives the Commission has proposed, such a rule would provide incentives for investors to place limit orders because it would protect those limit orders that are most valuable to the market, *i.e.*, those that better the current price. Protection of the NBBO also would promote competition among trading centers, to the benefit of the markets and all investors.

Rules providing protection for top of the book ("TOB"), on the other hand, actually would operate to deprive investors of best execution in many cases, as discussed below. Protection for depth of book ("DOB") quotations presents significant technological issues and should be pursued only if the Commission determines it necessary after assessing the impact of incremental changes including fair access, improved connectivity to automated markets, and price protection at the NBBO, after a reasonable period of time. In fact, competitive forces may quickly serve to protect limit orders beyond the NBBO and TOB as order routing systems sweep displayed quotes at various price points across multiple trading centers, which is what happens in the Nasdaq market today.

With respect to access fees, Merrill Lynch favors a complete ban. Access fees are an impediment to an efficient market and serve to distort the public quote. Notably, the proposed limitation on access fees is necessary only because a price protection rule would create a monopoly at the best bid or offer. If a market participant must deal with whoever offers the best price at a given moment, the government has created a monopoly. If the government creates a monopoly, then the government also would have to set a ceiling on the rate for accessing that bid or offer. [5]

Sub-penny quoting has a number of adverse effects on the market and Merrill Lynch supports the Commission's proposal to restrict quoting in increments less than one cent for quotes priced greater than $1.00. Because there appears to be a consensus on this provision, we believe the Commission should act promptly to adopt this change. With respect to market data, our views are consistent with those of SIA and other commenters on the original Proposing Release. We believe the level of market data fees should be reviewed and that greater transparency concerning the costs of market data and the fee-setting process is needed.

[5] *See* Bob Greifeld, Millions of Momentary Monopolies, Wall St. J., December 6, 2004, at A13.

II. Price Protection for Limit Orders

A. Open and Fair Access to Automated Trading Centers May Obviate the Need for a Price Protection Rule

Under the reproposal, trading centers must establish policies and procedures reasonably designed to prevent trade-throughs of quotes that are immediately and automatically accessible, or, if relying on one of the rule's exceptions, that are reasonably designed to assure compliance with the exception. In the initial round of comments, most commenters supported a trade-through rule in some form,[6] although in many cases that support was contingent on a broad opt-out provision that was also proposed. Many of the commenters also suggested that fair access is a prerequisite to a price protection rule.

Much has changed since the original Proposing Release. The Supplemental Release shifted the focus from automated markets to automated quotes and the NYSE has taken steps to enhance automation in its market, creating in effect a hybrid market where an auction market will operate side-by-side with an electronic trading platform. If market participants have fair and non-discriminatory access to trading centers, as the Commission has proposed,[7] we believe trading will gravitate to the market that best suits the needs of investors given the characteristics of a particular security, whether that is the NYSE (or another exchange), the Nasdaq market, an Electronic Communications Network ("ECN"), or a liquidity provider for the institutional community. Trading centers will adopt different trading models—floor-based, electronic, or hybrid—and competition, not government regulation, will determine the relative success or failure of various market models. More likely, competition will not produce a clear winner, but will demonstrate the value of existing structures for different issues of securities with different levels of liquidity and market capitalization.

Opponents of reproposed Reg NMS have asserted that price protection, at least with respect to DOB, will lead to consolidation of orders into a single utility for executions. We believe regulation that would "homogenize" the markets would be detrimental to investors. We oppose any efforts to dilute the essence of the existing market structures. Dealer, agency, and auction markets—whether floor-based, electronic, or hybrid—serve various purposes and should be preserved. While electronic markets operate well where there is natural liquidity and depth of trading interest, where there is insufficient depth and liquidity, an auction market (where intermediaries have affirmative obligations to commit capital to take the other side of the market in times of order imbalances) may better serve to dampen volatility and to maintain a fair and orderly market. As long as investors are free to choose one structure or another, trading centers will innovate and improve these models to attract order flow.

Without a rule that artificially directs order flow, trading centers would compete in all areas relevant to order routing determinations, *e.g.*, price, speed, depth, cost, etc. Trading centers

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[6] The proposed rule would differ from the existing Intermarket Trading System ("ITS") trade-through rule in that it would apply to the Nasdaq market in addition to the listed market, and would be an enforceable prohibition versus the post-trade complaint process that exists in ITS today.

[7] *See supra* Section III. A.

would compete not only on their levels of automation, but on other services as well, such as transaction fees and fees for viewing limit orders away from the best bids and offers. Competition also would promote innovation and ensure greater responsiveness to the needs of market participants. Trading centers that don't attract sufficient order flow to provide executions to best priced limit orders would be "disciplined" as broker-dealers, guided by their best execution obligations, avoid those trading centers in favor of trading centers that consistently provide executions and efficient, immediate access to the best bids and offers, and to bids and offers below the TOB. Trading centers could be bypassed for other legitimate reasons as well, *e.g.*, leakage of information regarding the identity of a large investor seeking to trade in large quantities of a stock on a given day, or unfair informational advantages given to members.

In the Nasdaq market, where there is no rule that artificially directs order flow, *i.e.*, a trade-through rule, competition from ECNs has resulted in improved services and reduced costs for investors. Despite the absence of mandated linkages, a web of proprietary linkages between pools of liquidity has been created and limit orders represent a substantial portion of the orders for Nasdaq stocks. Broker-dealers trading in the Nasdaq market employ sophisticated routing technology that automatically seeks out liquidity across trading centers. In fact, the original vision of Congress for a securities market of competing venues and direct access by investors has been at least partially achieved in the Nasdaq market.[8]

Notably, the NYSE is in the process of automating its marketplace and offering customers a choice in the way their orders are executed. Enhancements to Direct+, known as the hybrid market proposal, will expand the automated execution capability of the NYSE, providing greater opportunities for intermarket competition.[9] When investors have the ability to execute against immediately accessible automated quotes, NYSE will be subject to the same competitive forces that have contributed to the current state of the Nasdaq market. We believe competition will drive automated markets continually to improve their functionality. As technology improves, trading centers will develop increasingly faster trade execution systems and increasingly lower fee structures to attract investors. Government standards, on the other hand, inevitably become the lowest common denominator. We urge the Commission to consider whether competition, connectivity, and automation are not sufficient to prevent trade-throughs in the markets before adopting changes that will undoubtedly entail implementation and compliance burdens at significant cost for all market participants.

B. Any Price Protection Rule Should Be Limited to the NBBO

In connection with the reproposed price protection rule, the Commission seeks comment on two alternatives, asking which is more likely to advance principles of limit order protection while preserving intermarket competition and avoiding potential implementation problems. The first alternative would protect only the best bids and offers ("BBOs") of the eight national securities exchanges and the NASD (*i.e.*, Nasdaq and the ADF) provided that the quotation is

[8] Section 11A of the Exchange Act envisions a market structure characterized by full transparency where competing markets are linked together to provide the ability to effectively and efficiently execute customers' orders in the best available market. *See* Proposing Release at 11130.

[9] *See* Securities Exchange Act Release No. 50667 (November 15, 2004), 69 FR 67980.

immediately accessible for automatic execution. The second alternative also would protect the BBOs of the various SROs and Nasdaq, but would establish a mechanism for a market to secure protection for its DOB quotations at prices below its best bid or above its best offer voluntarily disseminated in the consolidated quotation stream.

As indicated above, Merrill Lynch believes a price protection rule could be superfluous in markets offering efficient access and immediate, automatic executions. Nevertheless, if the Commission determines that a price protection rule is necessary, we believe it should be limited, at least initially, to the NBBO. Like the TOB alternative proposed by the Commission, protecting limit orders at the NBBO also would encourage investors to post limit orders and quote aggressively, which is important to price discovery, and would promote competition among trading centers by protecting those limit orders that are most valuable to the market. Moreover, trade-throughs at the NBBO would be an enforceable prohibition applicable to all markets versus the complaint-driven process that exists today under the Intermarket Trading System ("ITS") trade-through rule, which applies only in listed markets. Protection of limit orders, which will occur both as a result of the rule *and* improved access to automated quotes, should encourage greater use of limit orders, adding to the natural liquidity in the market to the benefit of all investors, large and small, as well as those who commit capital to facilitate customer transactions.

The TOB alternative, on the other hand, presents some anomalies that are inconsistent with the protection of limit orders and principles of best execution. Specifically, the TOB alternative will not prevent trade-throughs in all instances, which will impact trading strategies. For example, a market participant trading at the TOB in multiple trading centers would bypass superior prices displayed in one of the trading centers if those prices are below the TOB at another trading center. It is unclear how this will affect trading behavior although we are certain that strategies will be devised to address such anomalies. In the meantime, it would present an untenable situation for broker-dealers who would be required to access the best displayed prices to meet their best execution obligations.

1. Clarification of Issues in Connection with Exceptions

If the Commission determines to adopt a price protection rule, we strongly believe that exceptions are necessary to accommodate certain trading strategies and order types. Specifically, we urge the Commission to consider an exemption, as proposed by the SIA, for certain actively-traded securities. We are generally supportive of the Commission's proposed self-help exception, and we believe intermarket sweep orders, although characterized as an exception, are entirely consistent with a price protection rule. Certain liquidity-providing transactions, including benchmark trades, are beneficial to the market and we do not believe that the Commission intends to curtail firms from putting their capital at risk to facilitate customer transactions. We therefore urge the Commission to provide additional clarification with respect to the exception for benchmark trades to confirm our ability to continue to commit capital in these situations.

a. Liquidity Exception

We note that the SIA has urged the Commission to consider an exception to the price protection rule for certain heavily-traded securities (the "liquidity exception"). We agree that these securities, which typically also feature heavy quote traffic, would account for a disproportionate share of the surveillance and technology resources related to compliance with a price protection rule. Unlike the flickering quote exception, the SIA proposed exception would relieve market participants of the compliance burdens associated with applying the price protection rule to heavily traded securities. We believe such an exception, if implemented on a pilot basis as the SIA proposes, could provide the SEC with the ability to study the operation of the markets without a price protection rule and to determine whether a price protection rule continues to be necessary for any securities.

b. Flickering Quotes

Recognizing that there could be a high incidence of false positive trade-throughs, the SEC proposes to address those that are attributable to rapidly moving quotations by excepting a transaction if the trading center displaying the protected quotation that was traded through had displayed within one second prior to execution of the trade-through, a best bid or offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction. We believe the securities most likely to experience frequent quote updates, and consequently flickering quotes, are those heavily traded securities that are least likely to benefit from a price protection rule. Therefore, we fully support this exception, although we question whether it is necessary or desirable to prescribe a timeframe in the rule. We do not believe the SEC should dictate technology speeds. Rather than the proposed one-second window, we believe the price protection rule should provide an exception for flickering quotes *immediately* before the trade that was traded through. The SEC could determine what is "immediate" through interpretation, which would provide the flexibility to change the timeframe as technology evolves.

c. Benchmark Trades

The benchmark trade exception would facilitate the execution of an order that is not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order is made. Our understanding is that we could rely on the benchmark trade exception to execute an order, without limitation on the time interval and without regard to better-priced protected quotations at other trading centers, as long as the price to our customer is based not on current market conditions, but rather on a pre-existing formula, such as a volume weighted average price transaction ("VWAP").

Additionally, the Commission appears to suggest that the benchmark exception would not encompass stopped orders because their execution is based, at least indirectly, on the quoted price of a stock at the time of execution and their material terms are known when the commitment to execute the order is made. If a firm guarantees the customer an execution at no worse than the stop price, but indicates that the customer may do better, we see no reason to treat such orders any differently than VWAP orders, where neither party walks away knowing any firm price.[10] Clarification of such an exception will encourage continued commitment of capital without eroding the benefits of price protection.

2. Regulatory Obligations Should Not be Measured Against Inaccessible Quotes

The Commission, recognizing that quotes of manual markets may not be accessible to all market participants, would exclude such quotes from the price protection rule. However, the Commission states in the reproposing release that adoption of the price protection rule would in no way lessen a broker-dealer's duty of best execution. Certainly, in reviewing their order routing practices, firms should be able to take into consideration the responsiveness of certain markets in determining whether to route to that market for best execution purposes. We urge the Commission to clarify that broker-dealers, in such cases, will not be held to manual quotes when seeking to obtain best execution.

Likewise, when calculating trading statistics under Rule 11Ac1-5 under the Exchange Act, manual quotes will merely skew the statistics. Indeed, the Commission itself has recognized the relative unimportance of manual quotes by disregarding them in the revised market data allocation formula. We therefore urge the Commission to eliminate manual quotes from the calculation of Rule 11Ac1-5 statistics.

III. Market Access Proposal

A. Standards Will Ensure Non-Discriminatory Access to All Trading Centers

The reproposal would prohibit a national securities exchange or national securities association from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member to the quotations in an NMS stock displayed through its SRO trading facility. We agree that the Commission should set broad standards for trading centers to provide open and fair access to their quotes and we support the Commission's proposal, which contemplates competitive, proprietary intermarket linkages rather than a mandatory public linkage. Clearly, the Nasdaq market demonstrates that private linkages are practicable.[11]

The Commission notes in its Supplemental Release that access could remain a problem at relatively inactive Alternative Trading Systems ("ATSs") or market makers with little trading volume whose quotations are displayed only in the NASD's ADF. Market participants can obtain access to such quotes only through direct connections with the particular ATS or market maker. If the SEC obligates market participants to trade with any such trading center displaying

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[10] Examples demonstrating these points are set out in the SIA comment letter. The SIA letter also offers suggestions on ways to improve upon the exceptions and we support those recommendations. *Supra* note 3.

[11] Trading centers that are not themselves broker-dealers now have (or are in the process of acquiring) affiliated broker-dealers in order to access liquidity in other trading centers.

the BBO by promulgating a price protection rule, firms could be required to create many private linkages to relatively small, insignificant ATSs.[12] The reproposal, in which the SEC proposes to require that all trading centers provide a level and cost of access that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities, may be a workable alternative, although it does not relieve market participants of the need to develop linkages with any number of insignificant trading centers.

The Commission also proposes to lower the "fair access" threshold in Regulation ATS from twenty percent of the trading volume of a particular stock to five percent in order to ensure that the quotes of all significant market participants are accessible throughout the NMS. Merrill Lynch supports lowering the fair access threshold as the Commission proposes.

B. Fees

Merrill Lynch has long believed that the non-transparent access fees that only ECNs are permitted to charge should be eliminated because the fees are an impediment to an efficient market and distort the public quote. We continue to support a complete ban on access fees.

The proposal attempts to level the playing field by allowing any trading center, not just ECNs, to charge a fee for accessing its protected quotations. By standardizing a fee cap at $.003 per share, the proposal would address, to some extent, the transparency concerns associated with access fees that are not apparent in an advertised quote. However, broker-dealers could still be forced to pay excessive fees on non-protected quotations. If the Commission is determined to go forward with the fee cap, we believe it should be applied to all accessed quotes, not only protected quotes.

C. SRO Rules Regarding Locked and Crossed Markets

Merrill Lynch supports the SEC proposal that would require SROs to promulgate rules designed to discourage market participants from locking and crossing markets. We also agree that it is appropriate to permit automated quotations to lock or cross manual quotations and we support the Commission's proposal in this area.

IV. Sub Penny Quotations

The reproposal would prohibit SROs, ECNs, vendors, brokers or dealers from ranking, displaying or accepting from any person a bid or offer, an order, or an indication of interest equal to or greater than $1.00 in an increment of less than one cent. Bids, offers, and indications of interest priced less than $1.00 could not be quoted in increments smaller than $.0001. Sub-penny quoting has several adverse effects that may erode investor confidence and we believe the

[12] Many commenters endorsed the concept discussed in the Supplemental Release that relatively small markets, *e.g.*, trading centers with less than 5% volume, be required by rule to participate in SRO execution systems for their top-of-book. Others recommended that the SEC mandate that all trading centers make their top-of-book available to other market participants via a public intermarket linkage facility.

Commission's proposal would address these concerns. The reproposal differs from the original proposal in that the prohibition derives from the price of the order, rather than the price of the stock, thereby eliminating the need to re-classify stocks as "sub-penny eligible" based on fluctuations in their valuation, stock splits, or other price movements. Merrill Lynch believes this is a more workable alternative and we support the Commission's proposal. Indeed, we believe there is broad industry support for the prohibition on sub-penny quoting and we urge the Commission to act promptly to adopt this provision.

V. Conclusion

Merrill Lynch appreciates the opportunity to comment on these far-reaching proposals designed to modernize the NMS. We firmly believe that we can achieve the best prices and services for our customers in a market structure characterized by fair and efficient access to competing venues offering various execution options. Nevertheless, we appreciate the Commission's desire to set standards to ensure regulatory uniformity across trading centers. If the Commission determines that competitive pressures and fiduciary duties are insufficient to achieve its public policy goals, we favor a "first step" approach with price protection initially limited to the NBBO, which would provide benefits to the market while minimizing the implementation and operating costs of the proposed alternatives that ultimately will be passed on to investors. Based on its experience with price protection at the NBBO, the Commission could later determine whether implementing the TOB or DOB alternatives would be appropriate or necessary.

We thank you again for the opportunity to comment. If you have any questions or would like to discuss our comments further, please contact the undersigned at 212.449.6059.

Sincerely,

Michael J. Lynch
Managing Director

cc: Chairman William H. Donaldson
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