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July 2, 2004

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

Re: File No. S7-10-04 – Regulation NMS

Dear Mr. Katz:

The New York Stock Exchange appreciates the opportunity to comment on proposed Regulation NMS. We applaud the Commission's leadership in advancing a comprehensive proposal that addresses a number of important structural issues in the U.S. securities market. We also recognize that modernizing the national market system ("NMS") rules is imperative in today's world of rapidly advancing technologies and evolving market models.

At the same time, we strongly believe that the principles that lie at the heart of providing the fairest possible market and of protecting all investors, large and small, remain as valid today as they were when Congress first legislated NMS. Indeed, it is thanks to these core principles that the United States enjoys the broadest, deepest, most liquid and competitive markets in the world. This is why, in our view, the paramount mission of public policy must be to protect the interests of public investors. Therefore, as we seek to make our stock markets ever more efficient and competitive, let us be mindful of these core principles that are designed to protect the investing public:

- **The Customer Comes First.** Our national market structure should require intermediaries to place their customers' interests ahead of their own;

- **Best Price.** Every order, regardless of the market to which it is sent, should have the opportunity to receive the best price available;

- **Protection of Limit Orders.** Limit orders provide liquidity to the market and accessible limit orders must be assured an execution before a trade occurs at an inferior price;

- **Choice.** Investors are best served when markets are free to compete and offer an array of execution options, including the opportunity for price improvement;

- **Reduced Volatility.** Greater intraday volatility raises the cost of capital for listed companies;

- **Speed.** Speed should be an option for those customers who want it, but most investors prefer best price over faster executions;

- **Transparency.** Investors should have widespread access to the market data of their choosing on an uninterrupted basis. Transparency requires that quotes do not have hidden fees, and that last sale prices be attributed to the market on which they take place, not to a market that buys trade reports to increase its share of market data revenues; and

- **Competition.** Commission ratemaking should always be a last resort. Competition typically does a better job than government ratemaking in providing fairly priced services to investors.

Since 1975, our changing market landscape has given rise to practices that are inconsistent with these principles. Proposed Regulation NMS seeks to end many of the most distorting practices and to realign the system with its core principles. However, several of the proposal's recommendations fall short of what we would consider our common objectives. The following comments reflect how we believe the proposal can be improved.

1. <u>Trade-Through Rule</u>

The trade-through or "best-price" rule has been an essential component of nationwide price protection since 1981. The rule was adopted to ensure price protection for investors who post limit orders in any U.S. market. We believe that objective remains every bit as worthy today as it was 23 years ago. In fact, if we are truly committed to placing the interests of investors first, we cannot ignore the central importance of the best-price rule. The best-price rule:

- Protects investors by assuring that they get the best price regardless of the market where they initially send their order;

- Promotes liquidity by protecting customer limit orders;

- Ensures that small investors can compete with large investors;

- Promotes fair and orderly markets; and

- Decreases market volatility and increases transparency.

Clearly, these protections were considered of utmost importance when the Congress, the Commission and the industry all embraced price protection as one of the organizing principles of the national market system. Bypassing, or trading through, a market's quotation creates four victims:

- The investor who buys or sells shares at a price inferior to the best price;
- The investor whose better-priced limit order is ignored;
- Market transparency and price discovery, since a stock is priced at something other than its true value; and
- Market liquidity and capital formation, since investors will lose confidence in the fairness of the market and will be less willing to submit limit orders knowing that they may be bypassed.

Some of our customers have told us they can better serve investors by taking a price that is available immediately by automated execution instead of exposing an order to the floor auction for a brief period for potential price improvement. While our data shows that orders executed on our floor in the auction often receive better prices than orders that simply hit our quote, we understand why customers want automatic execution as an option. That is why we are moving quickly to leverage technology to offer choices to investors and all constituents of the Exchange.

The principle of best price is also key for listed companies. NYSE-listed companies currently benefit from the advantages of head-to-head competition where all buyers and sellers bid against one another in a real-time auction. In recent interviews, 364 NYSE listed company officials told us market quality was by far the most important element for them in selecting an exchange, and they cited reduced volatility as the most critical component of market quality. Companies listed on our market find that their share prices are less volatile and more reflective of fundamentals. The 48 companies that moved their listings from Nasdaq to NYSE during 2002 and 2003 found price volatility and effective spreads, on average, reduced by half. Reduced volatility tends to make shares more attractive to long-term investors, and reduces the overall cost of capital to our listed companies.

a) Opt-Out Exception

Proposed Regulation NMS acknowledges that nationwide price protection is a core aspect of the NMS. As a result, the Commission is recommending extension of the application of the trade-through rule to Nasdaq stocks. Given this fact, we are concerned to see that the Commission has included a provision that would allow customers to opt out of the trade-through rule. Permission to opt out would have potentially grave consequences for our market and undermine the stated goals of Regulation NMS.

Proponents of the opt-out exception claim that customers have the right to define best execution for themselves, and that some customers would rather sacrifice the opportunity for the best price and price improvement for greater certainty and speed. These proponents call for the opt-out exception to be as simple and widely applicable as possible. These claims ignore the policy rationale of the trade-through rule, which is to protect the public limit order from being traded through – not to indulge the motivations of individuals seeking to bypass that order.

The opt-out exception would be detrimental to the integrity of the marketplace and contrary to good public policy. It would facilitate and encourage injurious practices such as internalization. A fundamental precept of our national market system is that orders should, whenever possible, be exposed to the market and be given the opportunity to compete and interact with other orders without the intervention of a dealer. Orders that are internalized do not have this opportunity. An opt-out exception will encourage internalization by creating a low standard against which brokers may justify executions at the NBBO as the best price that can be achieved.

Opt-out could also lead market intermediaries to select markets based on payment schemes rather than market quality. This would exacerbate conflicts of interest between brokers and their customers, and could fuel market fragmentation to the detriment of investors.

As discussed previously, there are real victims when the best price rule is violated, including individual investors whose orders are unfairly bypassed, and our entire marketplace, whose integrity, efficiency and liquidity would be compromised. In a situation where markets are providing quotes with similar accessibility, anonymity, and speed, there is simply no rationale for permitting selective market participants to ignore displayed quotations in other markets. All markets and market participants have a stake in ensuring that the interests of individual investors and the integrity of the pricing structure are maintained.

We agree that investors should not be forced to pursue the best price across the national market system at the risk of missing the second best price. Fortunately, the Commission has addressed this concern by proposing to revise the best-price rule to protect only quotations that can be executed through an auto-execution facility. With this modification, there is no principled public policy justification for adopting an opt-out provision.

b) Automatic Quote Access

In proposed Regulation NMS, the Commission builds a strong incentive for markets to make their quotations immediately and automatically accessible. This January, the New York Stock Exchange Board of Directors approved the transformation of our market into a hybrid of a floor based agency auction market and automatic execution facility. We will make the speed and execution certainty of our existing automatic execution platform, known as NYSE Direct+®, available to a wider range of investor orders. Direct+ offers immediate, automated execution for those customers who want it, foregoing the price improvement that often occurs in the agency auction process. Trades that are executed using Direct+ will be guaranteed the best-displayed price available in our system. If there is a better executable quote immediately available in another market, our systems will automatically either match the price of the quote or route the order there.

In its supplemental request for comment, the Commission asks whether automatic and manual execution criteria should be distinguished on a quotation-by-quotation rather than market-by-market basis. We strongly support the concept of a quotation-by-quotation approach, which considers whether a quotation is automatically executable at any moment in time. For instance, if a market that normally offers execution automatically moves into manual execution mode in a particular stock for a period of time, quotations in that stock from that market during that period of time should lose their trade- through protection up to the *de minimis* exception amounts. However, once the quote returns to automatic execution mode, its quotations should be protected.

The Commission has asked whether there should be an exception to the trade-through rule for certain types of transactions. Given the current SEC-approved interpretation that the best-displayed price in each market center can be satisfied contemporaneously with a trade at an inferior price, we believe that better prices should still be protected. This protection should not, however, extend beyond the best-displayed price at each SRO, to the best at each ECN or market maker.

Some insist the trade-through rule is out-of-date because it does not take into consideration the need for speed. To the extent that speed affects one's ability to access the best price, it is a significant factor. However, we believe that best price is the end. Technology may enable trades to be executed in milliseconds, but technology should not drive market structure decisions – principles should. As stated previously, price protection and integrity of our markets have been key components of the national market system since its inception. They are not antiquated or outdated rules, but important principles that should be maintained for the benefit of investors, issuers, and market participants.

In its supplemental request, the Commission notes that the access standards proposed are intended to assure that all parties have effective indirect access through members and subscribers to quotations displayed by SRO order execution facilities and quality market participants, thereby preventing the necessity for direct, intermarket linkages between market centers such as the Intermarket Trading System ("ITS"). The Exchange fully supports this proposal and agrees that these access standards provide a meaningful alternative to ITS.

2. <u>Access Fees</u>

We understand the Commission's desire to address the question of hidden ECN access fees charged when an ECN's quote is accessed through SuperMontage. These fees distort the quotations available within that market to the extent they are not included as a part of the quoted price and have not been agreed to in advance by those being charged. We believe, however, that the Commission's proposal to regulate by Commission rule the transaction charges imposed by every market in the U.S. is not the most efficient or fairest way of dealing with what we consider an isolated problem.

Each exchange and ECN, as well as Nasdaq and the NASD, has developed a schedule of charges for its members or subscribers that is designed both to raise necessary revenue for operating its market and to allocate those charges appropriately. In the case of exchanges, Nasdaq, and the NASD, the Commission approves these charges under the standards of the Exchange Act, which require a market to equitably allocate those fees among various constituencies. This type of oversight has cultivated robust inter-market competition, and has historically kept transaction fees low for all SRO participants. The Commission's proposal would deprive markets of the flexibility envisioned by the Exchange Act, in effect forcing them to charge a standard fee to all users.

We believe a more sensible solution would be to amend Regulation ATS and the Commission's quote rule so that no market could publish a quotation that would include an additional fee not expressly agreed to by its members or subscribers. Thus, exchange and association member fees, and ECN subscriber fees – all fees agreed to in advance – would be permitted, but fees that are charged to the contra party to the trade without consent would be prohibited. In that way, quotations at a stated price would all have the same meaning and members of exchanges and associations, and subscribers to ECNs, can factor in those charges when making routing decisions. Once routed to any market, the member or subscriber can be sure that the stated price is in fact what it will pay or receive.

3. Market Data

For the third time in five years, the Commission in proposed Regulation NMS has attempted to address distortions in the dissemination of market information. In 1999, the Commission published a concept release on market information fees and revenues. In the summer of 2000, the Commission established an Advisory Committee on Market Information ("Advisory Committee"), which included a representative of the NYSE.

As we noted in our response to the concept release and during Advisory Committee meetings, real-time information related to trading in our listed stocks is widely available to professional and individual investors alike. The cost of this information to customers, in real terms, has declined dramatically over the past 30 years; many investors receive our data free of charge. Investors can receive our data over their computers, telephones and pagers, and from many other sources.

In both the concept release and the Advisory Committee proceedings, the Commission asked the industry to consider the advisability of tying market data fees to the costs of producing market data. The Committee recognized the practical difficulties of such an approach since any cost accounting methodology is dependent upon sometimes arcane, often subjective assumptions, which would vary from market to market. In addition, our economic experts and most of the 40 or so comments on the Advisory Committee's concept release characterized the tying of fees to costs as a flawed approach:

> Advisory Committee members believe the Commission's proposed flexible cost-based approach essentially is a "ratemaking" approach, and that this is unwise and, ultimately, would prove unworkable. The "public utility" cost-based ratemaking approach is generally disfavored today. It is resource-intensive, involves arbitrary judgments on appropriate costs, and creates distorting economic incentives. Accordingly, the Advisory Committee recommends that the Commission not adopt a cost-based approach for determining whether market information fees are consistent with the Exchange Act. *

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* Report of the Advisory Committee on Market Information: A Blue Print for Responsible Change (September 14, 2001, at pg. 93)

In the Regulation NMS proposal, the Commission has correctly identified the use of exchanges as print facilities and other problematic practices as the critical problems relating to market data. However, these problems arise from a single root cause: the existence of the market data consortia. Permitting markets to withdraw from the consortia would address these distortions, and would reestablish the link between the value of a market's data (in other words, its contribution to price discovery) and the fair allocation of its costs among, and as determined by, its constituent users. This would end the inter-market subsidies and market-distorting incentives created by the current system.

Conclusion

We appreciate this chance to share our views on these vital issues. We thank the members and staff of the Commission for the invaluable work that they have done. The opportunity presented by proposed Regulation NMS is to create a superior national market system. The goal is within reach, if we remember that the promise of technology must go hand-in-hand with the principles of a fair and competitive national market system based on best price and that puts the interests of investors first. It is these principles that have made the U.S. securities markets the largest, most liquid, and most vibrant in the world, and they can and should be preserved.

Sincerely,

Darla C. Stuckey

Attachment:
Detailed Comments

DETAILED COMMENTS

PART I: THE TRADE-THROUGH RULE AND PROPOSED EXCEPTIONS

1. The Trade-Through Rule.

Since the earliest notions of a national market system in the early 1970s, price protection of public limit orders has been a fundamental precept. After the adoption of the Securities Acts Amendments of 1975, in which the Commission was directed to facilitate the establishment of a national market system, the Commission issued two status reports on the national market system, each of which reiterated this goal.[1]

> The Commission believes that nationwide price protection – whereby any appropriately displayed public limit order for a qualified security is assured of receiving an execution prior to any execution by a broker or dealer at an inferior price – should be a basic characteristic of a national market system.[2]

Since this statement in 1979, the Commission has never wavered from this goal. It was in response to this statement that the ITS Plan participants adopted the trade-through rule two years later. The Commission's adoption of the Order Handling Rules in 1999, which require the display of public limit orders made a trade- through rule all the more important.

Due to the resistance of the OTC market-making community, however, there has never been a similar rule for Nasdaq stocks. Although there have been many arguments over the years why a trade-through rule was impossible to construct in the over-the-counter market or why it is not necessary, no one has addressed the simple fact that the lack of trade-through protection for Nasdaq stocks hurts investors.

As we discuss in our summary letter, there are many victims when a trade-through occurs. First and most obvious is the person whose order is executed at an inferior price. Second, and perhaps more importantly, trade-through rules protect investors whose better-priced limit orders would otherwise be ignored. One of the constant themes at the Commission's market structure hearings was that market participants are placing fewer limit orders.

Lack of a trade-through rule, or adopting a trade-through rule with an opt-out provision, will exacerbate this trend.

The trade-through rule also benefits those who do not participate in a trade. Because the national best bid and offer reflect supply and demand, application of the trade-through

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[1] Securities Exchange Act Release No. 14416 (January 26, 1978), 43 FR 4354; Securities Exchange Act Release No. 15671 (March 22, 1979), 44 FR 20360.
[2] Id. at 20362.

rule makes best price paramount and allows investors to accurately compare the merits of one issuer's stock relative to another and to make better-informed investment decisions. It also benefits issuers because it dampens price volatility and helps in the price discovery process. Reduced volatility helps attract investors. It makes the holdings of issuers' shareholders more liquid.

2. Exceptions to the Trade-Through Rule.

a) Automatic Quote Execution Exception

Some have argued that the trade-through rule is out-of-date because it does not take into consideration the need for speed. To the extent that speed affects one's ability to access the best price, it is an important factor. However, we do believe that speed is not an end in itself. Even though technology has advanced to the point where trades can be executed at lightning speed, technology should not drive market structure decisions – principles should. The fundamental principle that the national market system has been based on since its inception is assuring that customers – not intermediaries – always come first. This means assuring that customers get the best price available. Surveys have shown that retail investors attach less importance to receiving the fastest execution.[3] Rather, retail investors care first and foremost about receiving the best price – regardless of whether they invest directly through an individual brokerage account, or indirectly via mutual funds, 401K plans or other investment vehicles.

We are committed to making our market a true hybrid that will combine the best features of an automatic execution market with the best features of the traditional auction market. In order to offer choice to a wide range of investors, we will increase our emphasis on speed by expanding the scope of Direct+®, NYSE's automatic order execution facility. Currently, Direct+ accounts for only ten percent of NYSE's trading activity; however, it still executes more trades in listed stocks than all ECNs in the U.S. combined.

Our expanded Direct+ functionality will allow NYSE members to automatically access our published quotation, which includes the disclosed interest at that price represented by floor brokers and specialists. Since the trade-through rule is designed to provide quote competition by protecting best prices, the issue of whether a market center provides multiple price sweeps should not be a trade-through rule consideration but rather a policy decision on the part of each market center.

Expanding the scope of Direct+ will give NYSE members the optimal selection of order-execution choices, from completely automatic to manually handled brokered orders. If an investor wants speed and is willing to give up the opportunity for price improvement, Direct+'s automatic execution will provide investors with the best price available in the NYSE system. Alternatively, investors may still elect to afford their orders the advantages of the NYSE's floor-based auction with the aim of finding a better price than any market displays. In either case,

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[3] An ORC International Consumer Survey conducted in October, 2003 found that 88 percent of those surveyed would be willing to wait longer, up to 20 seconds, to obtain best price (in fact, 67 percent would be willing to wait longer than 30 seconds.).

investors will always be afforded the opportunity to receive the best price available in the national market system.

In its Proposing Release[4] and Supplemental Request for Comment,[5] the Commission has requested comment on various aspects of the "fast market" provisions of the proposal. In this regard, we note the following:

- The Commission should define an "automated order execution facility" as a market that electronically receives and executes orders against its best bid/offer. The definition should not establish a time parameter based upon an arbitrary "millisecond" standard.

- The Commission has asked whether the proper way of determining whether a market qualifies as an "automated" market should be on a quotation-by-quotation basis. We strongly agree. With this approach the Commission will avoid having to regulate what percentage of the time a market must be in automatic execution mode.

- We also support a requirement that quotations should be auto-refreshed. Without this capability, there could be significant periods of time when a market will have no displayed quotation. In the Proposing Release, the Commission identified "false positive" situations where quotes are changing so rapidly that trades might appear to be trade-throughs but actually are not. We would recommend, in order to avoid "false positives", that the Commission consider a "no cancellation" standard that defines a minimum time standard a quote must be displayed unless there is an execution against the quote, or an improved quote.

- The Commission also asks whether the definition of "automated quote" a) should include a requirement for an "automated response," i.e., immediately reporting back an execution or a cancellation, and b) make explicit a requirement for automatic execution functionality for the whole order or provide an automatic cancellation for the remaining portion of an order that is not executed. We believe that the Commission should not determine a unitary process for reporting cancellations, as there are alternatives available to investors in cases when the sought-after-quotation is no longer available. If an investor wants an immediate and automatic report of cancellation for the portion of an order that is not executed, the investor can place an "immediate or cancel" ("IOC") order which incorporates that functionality. However, NYSE customers using SuperDot frequently program their own parameters for an order with a cancellation, i.e., they do not want an order automatically cancelled except on their own instruction. Still others do not want a cancellation but, rather, want continued representation of an order in the market or its placement on the limit order book. A rule setting forth a unitary process would deprive investors the range of investment options and strategies currently

[4] Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) ("Proposing Release").

[5] Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release").

available to them, and would not be necessary as long as a market gives investors the option to enter IOC orders.

- We agree with the Commission that there should be specific limits on the number of cents by which an automated market can trade through a non-automated market. Permitting an automated market to trade through a non-automated market by an unlimited amount is unfair to investors who have placed their orders at the non-automated market.

- The Commission has asked whether there needs to be an exception to the trade-through rule for program or basket trades that get executed at a single price. Given the current SEC-approved interpretation that the best displayed price in each market center can be satisfied contemporaneously with a trade at an inferior price, we believe that better prices should still be protected. This protection should not, however, extend beyond the best-displayed price at each SRO to the best at each ECN or market maker.

- Finally, we agree that an exception should be provided for market participants who may wish to use an "intermarket sweep order" designed to take out the top of the book in several markets at once. In those circumstances, if the bid or offer of the market receiving such an order is not the best, it might attempt to send that order to the market displaying the best quote – a quote that the sender has already accessed. The Exchange agrees that it would be unnecessary to reroute such an order to the better quote, or to characterize the execution of the order as a trade-through. We would note, however, that an "intermarket sweep order" would have to be so designated to provide notice to the recipient markets and to provide the necessary audit trail data for surveillance, as well as broker/dealer compliance purposes

Although Regulation NMS Release does not deal with the issue, it is our assumption that the Commission's temporary ETF exemption would cease to exist if and when Regulation NMS is implemented. We note that, if the automated market exemption were approved, there would no longer be any reason for the ETF exemption to exist.

b) Opt-Out Exception

i. Opt-Outs Serve Intermediaries, Not Investors.

Certain intermediaries in the trading process have aggressively promoted the proposed opt-out exception. The terms of the Commission's proposed trade-through rule – which would permit auto-execution quotes to bypass manual quotes for those who prefer speed and certainty over the opportunity for price improvement – addresses the claim that an opt-out is justified on policy grounds. We see no reason to permit intermediaries to provide their customers with anything less than the best price available. The opt-out exception is bad public policy, the negative consequences of which would be many:

- **Undermines Regulation NMS.** Price protection has always been a core feature of the national market system. Regulation NMS seeks to strengthen this objective. The proposed extension of the trade-through rule to Nasdaq stocks, the proposal to require that all markets provide non-discriminatory access, the proposal to reduce locked and crossed markets, the proposed market data revenue allocation formula and the proposed changes to Regulation ATS are all examples. Allowing investors to waive the trade-through rule is inconsistent with this objective.

- **Discourages Limit Orders.** Regulatory policy should encourage investors to place and display limit orders. Limit orders narrow bid-ask spreads; reduce price volatility; increase depth and liquidity; enhance inter-market quote competition; and improve the price discovery process. However, if the opt-out exception were adopted, those investors would see their limit orders bypassed. This would hurt public confidence in the integrity of the market, would discourage customers from continuing to enter limit orders, and would thereby reduce liquidity and depth.

- **Discourages Order Interaction.** One of the core principles of the national market system holds that orders should have the possibility of being exposed to the market, so that they may compete and interact with other orders without the intervention of a dealer. Orders that are internalized do not have this opportunity. An opt-out exception will encourage internalization by creating a low standard against which brokers may justify executions at the NBBO as the best price that can be achieved. An opt-out exception would also exacerbate conflicts of interest between brokers and their customers.

- **Harms Retail Investors.** The trade-through rule plays a critical role in the market by assuring retail investors that their limit orders will be protected. This encourages their continued participation in the market.

- **Damages Market Quality.** Limit orders lower market volatility, a factor that is attractive to both investors and issuers. For instance, the 48 companies that moved their listing from Nasdaq – a market without a trade-through rule – to NYSE during 2002 and 2003 found price volatility, on average, reduced by half.[6] An opt-out exemption would degrade the ameliorative effects of the trade-through rule in order to accommodate the business interests of some intermediaries.

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[6] For empirical evidence, see the following studies:

A. "Market Structure, Fragmentation and Market Quality: Evidence from Recent Listing Switches," Paul Bennett and Li Wei (2003), which can be found at: http://www.nyse.com/pdfs/marketqualitystudy03.pdf,

B. "Execution Costs on Nasdaq and the NYSE," NYSE Research Department (May 14, 2003), which can be found at: http://www.nyse.com/pdfs/executioncosts.pdf,

C. "A Comparison of Intraday Volatility on the NYSE and Nasdaq," Daniel G. Weaver (2002), which can be found at: http://www.nyse.com/pdfs/2002-03a.pdf.

Proponents of the proposed opt-out exception claim that customers have the right to define best execution for themselves.[7] These claims ignore the policy underpinnings of the trade-through rule — to protect public limit orders from being traded though, and not to indulge the wishes of the person bypassing those orders.

ii. Monitoring Informed Consent and Disclosing the NBBO.

As proposed, the opt-out exception would require informed consent by the customer on an order-by-order basis and would require that the broker handling the order inform its customer within 30 days of the NBBO at the time of execution. Both of these provisions are problematic. With respect to informed consent, we believe that informed consent on an order-by-order basis is essential, but anticipate that firms executing orders for day traders and computerized trading platforms would provide systemic ways of always opting out. The proposal would also permit a market to declare that it will only accept opt-out orders and then presumably make order entry the equivalent of informed consent. The process of interpreting what constitutes informed consent, documenting it and surveilling for violations would require an immense effort, and the net effect on our public markets would be negative. Additionally, we can see no reason why a firm should be allowed to wait 30 days to tell a customer how much money it lost by opting out. If speed is so important, there is no reason why the customer cannot be informed of its opt-out loss on its confirmation.

3. Treatment of OTC Market Makers.

Under the terms of the ITS Plan, all quotations from CAES market makers are consolidated into a single BBO quotation which is disseminated to all ITS Participants. In order to avoid a trade-through, a market must either satisfy the quotation or match its price, but in either event there is only a single quotation that must be accounted for. Proposed Regulation NMS would change this by requiring a market to satisfy better priced quotations of all OTC Market Makers, including ECNs and market makers who quote through the ADF. This will substantially increase the burden of compliance and will give the quotations of OTC Market Makers greater protection than the quotations of other broker-dealers communicated on exchanges. As such it would constitute unequal regulation.

PART II: MARKET ACCESS

The Commission has proposed a series of related rules to accomplish more universal access to markets. As a general matter we support these initiatives. However, we have some suggestions for how they can be improved.

1. Intermarket Linkages.

We support the Commission's proposal to require all market centers to permit access to their quotes on terms that are not "unfairly discriminatory." In the market for listed stocks, we

[7] We should note that automated execution does not necessarily translate into certainty. The NSX, which provides automated execution of ITS commitments, fails to execute inbound commitments 49% of the time.

believe that proposed Regulation NMS will provide the framework for alternatives to ITS for intermarket access, a change that we have advocated for some time and that we continue to support.

2. Regulation ATS.

The Commission should require ECNs to publish their quotations in national market system securities through an SRO regardless of their trading volume. As proposed, this requirement would still only apply if an ECN had more than 5% of the volume in that security. Given the state of technology, there is no reason why even a small ECN should not publish its quotations through an SRO. Publication of all ECN quotations would increase liquidity and enhance price discovery.

3. Access Fees.

Regulation NMS's proposed cap on access fees amounts to government ratemaking – a solution that rarely works and usually results in unintended, negative consequences. Lumping SRO transaction fees with access fees and applying the cap to both would have an even more detrimental effect. SRO transaction fees have played no part in the access fee problem and are not analogous to access fees. By lumping transaction fees with access fees for rate regulation purposes, Regulation NMS threatens to subject problem-free transaction fees to the lowest common regulatory denominator, adding new costs to investors.

a) Government Ratemaking Is Rarely a Good Answer.

As a general matter, we believe that Commission ratemaking creates economic distortions and unintended consequences. It runs counter to the trend in other industries where government ratemaking has given way to competition as the best way of assuring the lowest price to customers. This is particularly true in the securities industry where there is fierce competition among the various markets trading national market system securities.

As an example of the problems that can arise from ratemaking, we point out the following anomalies in the proposal:

- An ECN can disseminate its quotations through Nasdaq, the ADF or an exchange. The access fee proposal would treat each of these scenarios differently.

- If an ECN quotes through Nasdaq, it will be treated like a Nasdaq market maker and, if it is accessed through SuperMontage, may charge 1 mil for access. It may also negotiate with Nasdaq to receive a portion of any fee Nasdaq charges.

- If the ECN quotes through an exchange, the exchange can charge 1 mil but the ECN cannot charge an additional access fee, unless the exchange displays the quote with an ECN identifier that the SEC deems to qualify as an attributable quote. Thus, the ECN quoting through an exchange may not be able to receive any access fee.

- If the ECN quotes through the ADF, it is a Quoting Market Participant and can charge no more than 1 mil. Since the ADF cannot charge an access fee, the ECN would be limited to an access fee of 1 mil. However, if an ECN does not quote through the ADF, it can also provide direct access to subscribers (i.e., not through a Quoting Market Center) and charge any fee up to 2 mils.

The Commission does not justify why it proposes to treat each of these situations differently. The fact that they produce different results underscores the difficulties and unforeseen consequences that can arise from ratemaking.

b) The Commission Should Limit the Process Regulation to ECN Access Fees

i. Transaction Fees Are Not the Same as Access Fees.

In its recent Concept Release on Competitive Developments in the Options Markets, the Commission noted that "the [Exchange] Act provides a self-regulatory organization ('SRO') wide latitude in imposing fees on its members." As well it should. There is a big difference between fees that SROs or ECNs impose on their members or subscribers and the fees that ECNs impose on non-subscribers that unintentionally access their quotations through SuperMontage.

SRO transaction fees are fees that an SRO's members agree to pay the SRO for the privilege of executing trades among themselves through the SRO's facilities. Unlike access fees, they are completely known by both sides of a trade *before* it takes place and do not vary based upon the identity of the counter-party. They are analogous to the fees charged by ECNs to their subscribers for the privilege of executing trades through the ECN's facilities.

Access fees are fundamentally different. ECN access fees are not mutually agreed upon. Instead, when a broker-dealer trades with the ECN's displayed quote through an SRO's facilities, the ECN unilaterally imposes an access fee that is not reflected in the quote or agreed to in advance. For example, if an NASD member submits an undesignated market order into SuperMontage, the order will be executed against quotes reflected in SuperMontage on the basis of price/time priority. However, the quotes in SuperMontage are not all created equally. Some quotes (those of market makers) reflect the actual price at which the trade will be executed and others (those of ECNs) do not. These hidden fees are inherently unfair to the unsuspecting contra-party and should simply be banned.

We believe a sensible solution would be to amend Regulation ATS and the Commission's quote rule so that no market could publish a quotation that would include an additional fee not expressly agreed to by the member or subscriber. Thus, exchange and association member fees, as well as ECN subscriber fees – all fees agreed to in advance – would be permitted, but fees that are charged to the contra party to the trade without consent would be prohibited. In that way, quotations at a stated price will all have the same meaning and members of exchanges and subscribers to ECNs can factor in those charges when making routing decisions. Once routed to any market, the member or subscriber can be sure that the stated price is in fact what it will pay or receive.

No doubt in proposing to regulate transaction fees as well as access fees, the Commission was concerned about the interaction between the proposed trade-through rule and the ability of markets to impose exorbitant fees that others would have to pay to avoid liability under the trade-through rule. However, there are more precise and targeted ways of addressing this problem.

SRO fees are already subject to Commission regulation under Section 19 of the Exchange Act. Nothing more is needed. ECN fees are not regulated in that way because the Commission determined not to regulate ECNs as exchanges. However, there is no reason why

ECN fees could not be regulated in the same way exchange fees are: by submission of those fees to the Commission for approval. ECN subscribers that access the ECN directly should pay whatever fee they negotiate with the ECN. Brokers that access the ECN through an SRO facility should pay the SRO transaction fee and not some additional add-on access fee.

There are alternative solutions that would limit proposed regulation to ECN access fees. For example, the Commission could require Nasdaq and other markets to place quotes of ECNs that charge access fees at the end of the execution queue. SuperMontage previously included an algorithm that worked this way but it was eliminated several years ago. Or, the Commission could require ECNs that charge access fees to round their displayed quotations up/down to the next penny.

ii. Unintended Negative Consequences.

Currently, NYSE has a multi-tiered pricing model that seeks to equitably allocate the costs of operating and regulating our market across all our market participants. In addition, the NYSE and other markets adjust their transaction-based pricing schedules to attract various types of orders. Imposing a cap on all transaction fees will take away take away the flexibility of markets to craft their fees in a way that suits their business models, equitably allocates their costs and provides choices to their constituents.

4. <u>Attribution and Specialists.</u>

In NYSE's unitary specialist system, the specialist is always the "responsible broker or dealer" for the purposes of the Commission's Firm Quote Rule. Specific attribution of a quote to the NYSE specialist is unnecessary. We appreciate the Commission's recognition that the term "attributable quote" would include the quote of an assigned specialist, even if it is not identified in CQS.

5. <u>Locked and Crossed Markets.</u>

We believe that locked/crossed markets represent market inefficiency. Today, we see market centers abusing the trading process by allowing their users to intentionally lock or cross markets. Insofar as brokers lock or cross markets on a recurrent basis or are found to do so intentionally, they should be disciplined. We concur with the proposal to require SROs to establish rules to reduce the incidence of inter-market locked and crossed quotations. We further propose that Regulation NMS should penalize those who lock markets by allowing market participants to trade through a quote that locks a market. The ITS Plan currently imposes this penalty. With the possible exception of "slow markets," we see no reason why a market should be permitted to lock or cross the quotation of another market.

PART III: SUB-PENNY QUOTING

We support Regulation NMS's proposal to prohibit sub-penny quoting for shares trading at $1 or higher. Market centers that allow members to submit quotes for orders in increments of smaller than one penny have contributed to "flickering" and inaccessible quotes as well as the undesirable practice by which a broker-dealer "improves" the existing quote by an insignificant amount in order to have its interest "step ahead" of earlier orders in the limit order queue. Furthermore, we see no policy reason to treat the markets for exchange-traded funds any differently. The ban should apply to trading in those instruments as well.

PART IV: MARKET DATA

In general we support the de-regulatory theme associated with several of the proposed changes to the way market data is regulated, in particular the inclusion of a number of the recommendations of the Commission's 2001 Federal Advisory Committee on Market Information ("the Advisory Committee"). These changes should facilitate our ability to make data widely available at reasonable cost.

1. Abolish the Market Data Consortia.

Although proposed Regulation NMS incorporates several of the collateral recommendations of the Advisory Committee, it does not follow the committee's core recommendation to end the market data consortia. Instead, the Commission is enmeshing itself further into ratemaking by modifying the consortia's revenue-sharing formulas. If history is any guide, this formula will elicit new business models that seek to "game" the revised formulas and result in other unintended consequences.

We urge the Commission to deal with the distortions and dysfunctions currently existing by following the recommendations of its Advisory Committee, to avoid ratemaking, and to take the steps necessary to let market forces rather than intrusive regulation determine proper pricing structures.

In the course of the Advisory Committee's deliberations, we, along with others, also identified many collateral benefits to limiting the consortia, including:

- Exploiting advances in computer and communications technology;
- Eliminating the dysfunction of the consortia that has given rise to a host of inter-market disputes and other contentious issues;
- Eliminating the antitrust risk arising when competitive markets engage in collective pricing, and other collective actions;
- Fostering inter-market quote competition and innovation in data technology, products and services;
- Reducing data latency resulting from the use of an exclusive processor; and
- Eliminating the costs of the exclusive processor.

The release has articulated as a reason for eschewing the advice of its Advisory Committee a concern that market data from every market continue to be available to investors. Unless regional exchange data is bundled with primary market data, some argue that either their data will not be disclosed or, if the Commission requires disclosure, they will use this requirement to extort unreasonably high fees from subscribers. We believe these concerns are unfounded. The trade-through rule will incent markets to appropriately price data so that their quotes would be published and thus not ignored. In addition, the Commission would continue to review all fees to approve them as being fair and reasonable.

2. <u>Ban Abusive Practices.</u>

Regulation NMS cites the proliferation of wash sales and tape shredding and the use of exchanges as print facilities as the reasons to amend the consortia's revenue-allocation formula. All three practices, as well as the practice of using market data revenue to pay for order flow, are harmful to the industry. So are business models and fee structures that markets have adopted in order to discourage the posting of public limit orders, thereby making it easier to use these markets as de facto print facilities. We believe that the abandonment of the market data consortia will cut off the funding for these distortions. Proposed Regulation NMS should clearly and unequivocally ban them.

3. <u>Revenue-Allocation Formula.</u>

Eliminating the market data consortia would obviate the need for a revenue-allocation formula. However, if Regulation NMS does not abandon joint market pricing of market data by otherwise competing markets, we see merit in rewarding markets that post quality quotes and in taking the dollar value of trades into account in the revenue-allocation formula. The proposed modifications to the revenue-allocation formulas would not, however, do as good a job at achieving the Commission's goal of removing the economic and regulatory distortions that undermine the market data plans as would banning the practices that give rise to the distortions. We have the following more specific comments regarding the proposed formula.

a) NBBO Improvement Share.

We support the concept of making quote improvement an important part of the formula. However, calculating the proposed NBBO Improvement Share is complicated and requires processing time and resources. Instead, NYSE proposes an alternative formula for the NBBO Improvement Share. For every second that a market provides a quote that is either the national best bid or the national best offer, it would receive a credit. The NBBO Improvement Share would be determined based on each market's proportionate share of the total number of credits awarded. As today, a quote would be deemed to constitute the best bid or offer on the basis of price/size/time priority. At any time, only one market's quote could be the best bid or the best offer. The credit would be determined strictly by the amount of time that a quote represents the NBBO and would not be value-weighted. This proposal provides a simple, auditable method for rewarding markets for improving the NBBO.

b) Gaming.

Since trades would continue to comprise 50 percent of the formula, the proposed formula would not eradicate the gaming of trades that takes place today. It would also provide fresh incentives for the gaming of quotes. For example, the proposed formula might lead to payments for quotes, to flickering quotes designed to eliminate other markets' NBBO Improvement share credits, to a market maker's alternating quotes that rise and fall by a penny in order to maximize NBBO Improvement share credits during periods of inactive trading in a security.

c) Quote Competition.

We support the proposed use of quotes in the formula. In our view, a significant quote factor would provide larger incentives for aggressive quote competition. We note, however, that the adoption of the opt-out exemption in the proposed trade-through rule would act to frustrate and reduce quote competition, undermining the formula's incentives for increasing it.

d) Block Trades.

We support the formula's use of square roots and dollar values (i.e., price x size). Both elements give more weight to quoting and trading in thinly traded stocks, higher-priced stocks and larger transactions. However, we believe that the Trade Share and Quote Share calculations (but not the Security Income Allocation calculation) should cap the dollar value that any single trade can contribute to the formula because those calculations are disproportionately weighted in favor of large block trades. The fact that brokers typically complete block trades outside of the price-discovery process justifies such a cap.

4. <u>Dissemination of Transaction Reports.</u>

Regulation NMS proposes to remove the current regulation that prohibits SROs and their members from disseminating their trade reports independently. We strongly support this concept, and welcome the ability to disseminate its transaction reports as a separate, independent supplement to the dissemination of a consolidated stream of last sale prices. We also support the proposal to continue to allow a national securities exchange to "separately or jointly" impose reasonable, uniform charges for distribution of transaction reports.

5. <u>Vendor Display Rule.</u>

We believe that the vendor display rule has outlived its usefulness. Market forces, rather than regulation, should determine the form and nature of market data services. Eliminating the vendor display rule in its entirety would promote the development of new and innovative market data services, would give investors greater choice in their consumption of market data, would create market data rate structures that are devoid of intermarket subsidies and other economic distortions, and would require markets to compete on the basis of the quality of their data.

a) Non-Compliance with Vendor Display Rule.

Eliminate the vendor display requirement would remove an existing problem of non-compliance. In making trading decisions or assessing whether they receive the best possible execution of their orders, retail investors typically receive market data by means of on-line connections with their brokers or, to a lesser extent, by means of vendor services. Our experience suggests that many of those third-party services do not comply with the consolidated display requirements.

b) Trading or Order-Routing Decisions.

If the Commission retains the consolidated display requirement, it should provide further guidance as to which "trading and order-routing" contexts are affected. For instance, the rule would seem to require the use of consolidated displays for terminals on broker-dealer trading desks and for on-line services that have order entry capabilities. It is less clear if the requirement would apply to displays that registered representatives or money managers use to monitor market activity. We also note that few, if any, market data service providers provide retail investors with order-routing capabilities