January 31, 2005

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

Re: File Number S7-10-04, Regulation NMS Re-Proposal

Dear Mr. Katz:

The Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") welcomes the opportunity to offer our comments on the Securities and Exchange Commission's ("Commission") Regulation NMS proposal.[1] Regulation NMS will have a profound impact on the structure of the market, the quality of executions and the systems utilized to accomplish such actions, all of which, are critical components for ensuring the integrity of the US securities market and the safety of public customers. Phlx maintains no doubt that the Commission's sole purpose in re-proposing Regulation NMS is to promote even greater market transparency for all market participants. Phlx commends the Commission and its staff for their efforts to resolve these complex and market critical questions.

I. The Trade Through Rule

Phlx believes intermarket price protection of firm and accessible quotes is not only necessary, but should foster a more efficient marketplace, which is consistent with protecting investors and the public interest. Although the Exchange is in general agreement with proposed Rule 611, which is also known as the Trade-Through Rule[2], we remain concerned that it will result in implementation, financial and compliance difficulties.

(a) Scope of Protected Quotation

Market BBO. Phlx is generally supportive of the Market BBO Alternative. However, upon reviewing the Re-Proposing Release's sections on Consideration of Costs and Benefits, Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation, Consideration of Impact on the Economy and Regulatory Flexibility Act regarding the two alternatives, Phlx noted discussion about the

[1] Securities Exchange Act Release Nos. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) ("Proposing Release"); 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release"); 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004) ("Re-Proposing Release").
[2] Proposed 17 CFR 242.611 ("Rule 611").

cost of these proposed changes, but no discussion on the amount of time needed to implement them.[3] To that end, Phlx urges the Commission to set an implementation date of at least one year following adoption of a final rule, if the Commission adopts the Market BBO Alternative. Phlx believes this amount of time will be needed for both the Exchange and its members and customers to assess the final rule language, and plan and complete the technology and operational work needed to accommodate the Market BBO Alternative. Of course, Phlx also expects that it will need to assess, draft, process through internal governance, file and receive approval from the Commission for proposed rule changes to accommodate the proposals contained in Regulation NMS. We believe one year is needed to properly analyze and implement this proposal.

Voluntary Depth. Phlx strongly opposes the Voluntary Depth Alternative proposed in Regulation NMS.[4] The Voluntary Depth Alternative would extend trade-through protection to all of the quotations displayed by a market pursuant to an effective national market system plan. The Voluntary Depth Alternative may have a negative impact on the institutional trading community. With a market's depth of book receiving protection at other marketplaces, not just the top of the book, brokers may find that they have no realistic choice but to represent all of their orders on the displayed book in order to gain the protection that it offers. As a result, customers who traditionally employed brokers to hold orders off the displayed book in order to gauge the market and minimize market impact would be severely impacted. Furthermore, the Exchange believes that the Voluntary Depth Alternative may actually have the opposite effect intended by the Commission, in that institutions (in fear of their order flow being picked off by day traders and other momentum traders) will revert to forcing them to hide their order flow through the use of alternative systems, such as POSIT, Harborside and LiquidNet.

Additionally, this Alternative would require enormous resources to be expended by each market to support the compilation and dissemination of outbound depth of book quotations as well as the receipt and processing of inbound depth of book quotations from other markets. Additionally, the capacity of data communications in the intermarket quotation apparatus (exchanges and vendors) would need to be significantly expanded. The expense to smaller exchanges, such as Phlx, to make these processing and capacity increases would be spread over a smaller revenue base, when compared to larger exchanges.

However, if the Commission adopts the Voluntary Depth Alternative, the Exchange strongly urges that the Commission appoint an industry-wide committee to determine the time period needed to implement such technology and oversee the effort. Because of the immense work needed to facilitate a Voluntary Depth Alternative, the Exchange is unclear in how much time such an endeavor would require, but certainly it would require more time than the system changes to accommodate the Market BBO plan.

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[3] See Re-Proposing Release, 69 FR at 77479-77480.
[4] Proposed 17 CFR 242.600(b)(57), Alternative B.

(b) Flickering Quotes

Phlx opposes the exception to the Trade-Through Rule contained in proposed Rule 611(b)(8), which creates an exception for so-called flickering quotations. Rule 611(b)(8) excepts a transaction from the Trade-Through Rule if "[t]he trading center displaying the protected quotation that was traded through had displayed, within one second prior to execution of the transaction that constituted the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction."[5]

This exemption will create arbitrage opportunities for computerized market participants. Rule 611(b)(8) would allow a market to ignore an away market's quote, for purposes of the Trade-Through Rule, for up to one second, during which time sophisticated computerized arbitrage systems could take advantage of this regulatory gap in trade-through protection to their gain. For example, this exception will allow a computerized market participant to execute on Exchange A at an inferior price to the new, superior quote just displayed by Exchange B and still allow that computerized system to seek and receive an execution at the superior quote on Exchange B, thereby using its speedy system to gain the price difference between the two quotes. This result could be avoided if this exception were eliminated and therefore markets were required to protect quotations immediately instead of waiting one second.

(c) Intermarket Sweep Orders

Phlx would like to clarify the treatment of orders a market center receives immediately following the receipt of an order that resulted in the routing of intermarket sweep orders. Rule 611(b)(6) excepts a transaction from the Trade-Through Rule if "[t]he transaction that constituted the trade-through was effected by a trading center that *simultaneously* routed an intermarket sweep order to execute against the full displayed size of any protected quotation in the NMS stock that was traded through."[6] Phlx anticipates that it will receive an order to trade at a price that is inferior to the protected quotation displayed on another market to which it has just immediately routed an intermarket sweep order (as the result of an earlier order) which will, when executed, completely exhaust the protected quotation displayed on that exchange. Phlx would want to execute this order at the apparently inferior price, with the knowledge that it had already satisfied the other market by the routing of the yet unexecuted intermarket sweep order. However, the current language in Rule 611(b)(6) suggests that Phlx would need to route *another* intermarket sweep order to meet the simultaneous routing requirement under the rule. This subsequent routing would likely be futile since the earlier intermarket sweep order will have traded with the protected quotation. In addition, it will require both Phlx and the away market to create, route, receive, cancel and return an order that Phlx knows is likely to serve no purpose other than comply with this reading of the rule. Phlx believes that a better outcome would be for the Commission to either interpret or modify the rule to allow a market to trade-through a protected quotation so

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[5] Proposed 17 CFR 242.611(b)(8).
[6] Proposed 17 CFR 242.611(b)(6) (emphasis added).

long as an intermarket sweep order it has routed to the market displaying the protected quotation remains unexecuted or uncancelled.

II. The Access Rule

The Exchange would like to comment on a number of aspects of proposed Rule 610, which is also know as the Access Rule.[7] Understanding the controversy and complex issues surrounding access fees, Phlx supports the Commission's efforts to develop a market wide solution. However, the Exchange is concerned about the scope of the proposed solutions, as described below.

(a) Access Fees

Phlx opposes the fee cap of $0.003 per share for executions against its protected quotations. Rule 610(c) states "[a] trading center shall not impose, nor permit to be imposed, any fee or fees for the execution of orders against its protected quotations in an NMS stock that exceed or accumulate to more than . . . $0.003 per share . . . ."[8] Phlx's current fee schedule was created and is regularly reexamined in light of competitive forces that exist in a market free from government ratemaking. While Phlx does not currently charge more than this amount for most executions that would be protected quotations, we are concerned, from a policy standpoint, that the proposed cap on access fees constitutes government ratemaking inconsistent with the Exchange Act. Government ratemaking, by its very nature, is anti-competitive. Moreover, Section 23(a)(2) of the Securities Exchange Act of 1934[9], added with the 1975 Amendments, directs the Commission to consider the impact that its rulemaking would have on competition, and prohibits the Commission from adopting a rule that "would impose a burden on competition not necessary or appropriate in furtherance of the purposes" of the Act.

The Commission stated that that adoption of this rule, creating a cap on fees that exchanges and others may charge, would "encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among marketplaces thereby increasing efficiency and competition."[10] On the contrary, Phlx believes that the proposal, if enacted, would denigrate the efficiency of the marketplaces that Phlx and other exchanges have created with competitive, statutorily consistent fees and distort the current, robust landscape in which marketplaces compete with each other in the amounts and types of fees charged to our customers. Phlx can find no compelling justification for the Commission to take such intrusive action, nor does Phlx believe the Commission can justify the proposal under the standards of Section 23(a)(2).

In addition, the proposed fee cap arguably limits Phlx's ability to most effectively meet its responsibilities to its shareholders. This government ratemaking would have the

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[7] Proposed 17 CFR 242.610 ("Rule 610").
[8] Proposed 17 CFR 242.610(c).
[9] 15 U.S.C. § 78w(a)(2).
[10] See Proposing Release, 69 FR at 11162.

effect of restricting amounts and types of fees a for-profit exchange can impose, which could severely limit its ability to effectively operate in the competitive exchange landscape.

(b) Access to Broker-Dealers

Phlx would like to clarify its obligations pursuant to Rule 610(a). Rule 610(a) states that "[a] national securities exchange . . . shall not impose unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the national securities exchange . . . to the quotations in an NMS stock displayed through its SRO trading facility."[11] Currently Phlx restricts access through its equity trading system to customer orders but permits broker-dealers orders under defined circumstances.[12] When access is restricted, Phlx makes no distinction between member and non-member broker-dealers. The Exchange seeks clarity on whether Rule 610(a) would allow Phlx to continue to restrict access to its quotations from orders for the account of broker-dealers and their associated persons.

III. Market Data Rules and Plan Amendments

The Exchange would like to comment on a number of aspects of Regulation NMS regarding proposed amendments to the Market Data Rules and Plans. The Exchange is concerned that following changes to the Vendor Display Rule and certain aspects of the proposed market revenue formula may not fully achieve the goal of preserving the vital benefits that investors current enjoy from these Rules and Plans.

(a) Required Display of Information

Phlx opposes the removal of the quote montage requirement from the Vendor Display Rule.[13] Currently, the Vendor Display Rule requires market data vendors and broker-dealers, when providing their customers with trade data from any one market center, to provide them with the consolidated last sale and quotation data from all reporting market centers. This consolidated market data is a critical component of the national market system, without which effective inter-market competition could not exist. The Commission is proposing to limit the consolidated quotation information that vendors and broker-dealers must provide to the prices and sizes of the NBBO quotes along with market identification. Vendors and broker-dealers would no longer have to make available the consolidated montage of all best-priced quotations provided by the reporting market centers.

Phlx opposes this change because it would deprive investors of a ready means to compare the depth and liquidity that competing markets, including Phlx, offer in a security. In today's national market system and decimal environment, where NBBO quotes often lack any meaningful size, it is just as important for investors and their

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[11] Proposed 17 CFR 242.610(a).
[12] See Phlx Rule 229, Supplemental Material .02.
[13] Currently 17 CFR 240.11Ac1-2, proposed to be re-designated as 17 CFR 242.603.

brokers to know which markets are quoting near the NBBO and at what size as it is for them to know which markets are quoting at the NBBO. The Commission should be seeking to promote market transparency, not impair it.

Additionally, under Regulation NMS, the existence of protected quotations away from the NBBO would necessitate the routing of intermarket sweep orders before trading could take place at the prices of those protected quotations. The absence of this quote montage, as required today, could complicate the efforts of those attempting to comply with the Trade-Through Rule and their use of intermarket sweep orders.

(b) Formula Favors Low Dollar Volume Stocks

Phlx opposes the use of the square root function in the Security Income Allocation formula.[14] The use of the square root function in this formula has the effect of increasing the allocation of total market data revenues in securities that have a lower dollar volume at the expense of those with a higher dollar volume. This effect grows more pronounced if extremely low dollar volume stocks are compared with extremely high dollar volume stocks. The Commission states that, in its judgment, "on average and not necessarily in every particular case, a $50,000 trade in a stock with an average daily trading volume of $500,000 is marginally more useful to investors than a $50,000 trade in a stock with an average daily trading volume of $500 million."[15] The Commission offers no support for this proposition. In contrast, the opposite proposition (trades in the latter stock are more important than trades in the former stock) could be made since investors have decided to trade 1,000 times more dollar value of the latter stock than the former stock. The outcome of this potential overvaluing of low dollar volume stocks is a disproportionate windfall for markets that trade these low dollar securities, while disadvantaging broader trading in higher dollar stocks.

(c) Exclusion of Sub-Second Quotes

Phlx would like to clarify whether quotes that exist for less than one second will receive credit in the market data formula. The proposed Formula Amendment to the Market Data Revenue Plans suggests that a quote must exist for at least one second in order for it to qualify for a Quote Credit.[16] Phlx believes that even protected quotations, which by definition must be available automatically and immediately, that exist for less than one second provide the price discovery value that lead the Commission to propose the inclusion of the Quoting Share in the market data formula. In fact, it is likely that the reason for its short life is that it resulted in an execution. Therefore, Phlx believes that protected quotations, regardless of their duration, should qualify for Quote Credits in the proposed market data formula and would urge the Commission to clarify this position in any adopting release for Regulation NMS.

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[14] Proposed Formula Amendment to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan, Section (b).
[15] See Re-Proposing Release, 69 FR at 77466.
[16] Proposed Formula Amendment to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan, Section (d) ("A Participant shall earn one Quote Credit for each second of time multiplied by dollar value of size that a firm automated bid (offer) transmitted by the Participant to the Processor . . . .").

(d) Overvaluing of Quotes

Phlx opposes the proposed $2 cap in the Trading Share portion of the market data formula. The market data formula limits the Trading Share portion of a security's revenue to be no greater than $2 per trade and would shift that overage to the Quote Share.[17] The Commission provides no justification for the potential increase in the value of quotations in these situations. Further, the cap could encourage tape shredding in order to increase transactions and lower the per trade number below $2, thereby capturing more of the revenue in the Trading Share than would otherwise be available if it was shifted to the Quote Share. Additionally, removal of this feature would further simplify the proposed market data formula.

The Exchange appreciates the opportunity to address the many issues raised by the Re-Proposing Release. Phlx looks forward to working with the members of the Commission and its staff to enhance market transparency and efficiency. If you have any questions concerning these comments, or would like to discuss comments further, please feel free to contact me at (215) 496-5193.

Sincerely,

Meyer S. Frucher
Chairman and Chief Executive Officer
Philadelphia Stock Exchange, Inc.

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[17] Proposed Formula Amendment to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan, Section (c)(i)(B) ("The Trading Share of a Participant in an Eligible Security shall be determined by multiplying (i) an amount equal to the lesser of (A) fifty percent of the Security Income Allocation for the Eligible Security or (B) an amount equal to $2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the Participant's Trade Rating . . . .")