AMERITRADE
Holding Corporation

January 26, 2005

VIA ELECTRONIC MAIL

Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: *Regulation NMS, File S7-10-04, SEA Rel. No. 50,870 (December 16, 2004), 69 FR 77424 (December 27, 2004)*

Dear Mr. Katz:

Ameritrade, Inc.[1] ("Ameritrade" or "the Firm") appreciates the opportunity to provide comments on the Commission's reproposal of Regulation NMS.[2] Ameritrade commends the Securities and Exchange Commission ("Commission") for undertaking to update our securities markets, and we encourage the Commission to design Regulation NMS for the protection of investors by promoting greater market efficiency through competition. This letter supplements our earlier comments with respect to proposed Regulation NMS.[3]

I. Executive Summary

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1 Ameritrade Holding Corporation ("Ameritrade Holding") has a 29-year history of providing financial services to self-directed investors. Ameritrade Holding's wholly owned subsidiary, Ameritrade, Inc., acts as a self-directed broker serving an investor base comprised of over 3.6 million client accounts. Ameritrade does not solicit orders, make discretionary investments on behalf of our clients, or provide proprietary research or advice regarding securities. Rather, Ameritrade empowers the individual investor by providing them with tools they need to make their own investment decisions. In exchange for a low commission, we accept and deliver the order to buy or sell securities to the appropriate exchange, market maker, electronic communications network or other alternative market for execution. Ameritrade does not trade for its own account or make a market in any security.

2 *See* Regulation NMS, File S7-10-04, SEA Rel. No. 50,870 (December 16, 2004), 69 FR 77424 (December 27, 2004) ("Reproposing Release").

3 *See* Letter from Ellen L. S. Koplow, Executive Vice President and General Counsel, Ameritrade, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004, and Letter from John S. Markle, Associate General Counsel, Ameritrade, to Jonathan G. Katz, Secretary, Commission, dated October 13, 2004.

A. Trade Through Proposal

- Repeal the existing trade through rule; or
- If there is to be a trade through rule, the rule should not be extended to the NASDAQ marketplace; or
- If there is to be an intermarket trade through rule, the rule should protect all limit orders and not just the best priced limit order ("Voluntary Depth Alternative").
- The comment period for the Hybrid Proposal should be extended to a date past the adoption of Regulation NMS.
- Manual quotes should not be included in the BBO.
- The duty of best execution should be clarified if trading centers can bypass manual quotes, but manual quotes remain included in the duty of best execution.
- The adopting release should not contain language discriminating against certain classes of investors.

B. Access and Access Fees

- Trading centers should be required to provide non-discriminatory access to market participants.
- If access fees are to be regulated, then manual and automated quotes should be subject to the caps.

C. Sub-Penny Quoting

- Sub-penny quoting should be prohibited with no exceptions or exemptions.

D. Market Data Reproposal

- A comprehensive solution should be developed to resolve market data issues rather than just an interim solution.
- Market data fees are presently imposed in a manner that discriminates against online retail investors
- Market data revenues should be distributed on the basis of executed trades only and not on the basis of quotes.

II. Trade Through Proposal

A. Repeal the Existing Trade Through Rule

With respect to the trade through aspect of Regulation NMS, Ameritrade supports the modernization and reformation of the antiquated and inefficient systems in the listed securities market. Over time, the existing ITS trade through rule has become anachronistic and preserves existing monopolies that harm retail investors by thwarting competition. For these reasons and for the reasons expressed in our earlier comment letters, Ameritrade believes that a trade through rule is no longer necessary. We believe that market center competition, when combined with a broker's duty of best execution, will result in a national market system that provides the best combination of efficient pricing, low costs and liquidity. We further believe that the markets can operate efficiently without the presence of a trade through rule and that repeal of the existing ITS trade through rule would lead to greater intermarket competition, increased connectivity and improved transparency. As a result, the Commission has a tremendous opportunity to propel the listed market to greater efficiency -- all to the benefit of the investing public. Therefore, Ameritrade's clear preference is for the existing ITS trade through rule to be repealed.

B. Trade Through Rule Should Not Be Extended to the NASDAQ Marketplace

However, if the Commission decides to adopt a new trade through rule as part of Regulation NMS, Ameritrade believes that the new rule, like the existing ITS rule, should apply to listed securities only and that the rule should not be extended to the NASDAQ marketplace. The NASDAQ marketplace does not appear to have a trade through problem or to have quality of execution concerns that justify the imposition of a trade through rule on that marketplace. By the Commission's own analysis and from publicly available execution data:

Trade throughs in the NASDAQ marketplace represent a disproportionately small percentage of total trades with over half of these trade throughs occurring in *de minimis* amounts.

- there are only a small number of trade throughs in the NASDAQ marketplace (about 2.5% of trades);[4]
- more than half of these trade throughs are outside the quote for only one penny per share;[5] and
- the NASDAQ marketplace is already dominated by limit orders (86%).[6]

NASDAQ outperforms NYSE and AMEX in executions at or better than the quote with overwhelmingly superior execution times.

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[4] *See* Analysis of Trade-throughs in Nasdaq and NYSE Issues, Memorandum from the Commission's Office of Economic Analysis to the File (December 15, 2004) ("OEA Analysis of Trade Throughs") .

[5] *Id.*

[6] *See* Comparative analysis of execution quality on NYSE and NASDAQ based on a matched sample of stocks, Memorandum from the Commission's Office of Economic Analysis to the File (December 15, 2004).

- the NASDAQ marketplace has greater execution speed than the NYSE marketplace in all categories except the greater than 5000 share category;[7]
- the NASDAQ marketplace has superior market execution quality in nearly all areas except the 100-499 share category;[8]
- 89.3% of shares in the NASDAQ marketplace are executed at or better than the quoted price with an average execution time of 2.2 seconds;[9]
- 80.4% of shares in the NYSE marketplace are executed at or better than the quoted price with an average execution time of 12 seconds;[10] and
- 83.1% of shares in the AMEX marketplace are executed at or better than the quoted price with an outlandish average execution time of 13.7 seconds.[11]

So, we are not clear where the trade through problem is in the NASDAQ marketplace. As far as the NASDAQ marketplace is concerned, extension of the trade through rule appears to be a solution in search of a problem.[12] For good reasons, according to November 2004 data, Ameritrade clients clearly favor the NASDAQ marketplace with 67% of Ameritrade trades in NASDAQ market securities and only 27% of Ameritrade trades in NYSE listed securities.

The Commission is moving in the right direction by proposing that a quotation must be immediately and automatically accessible in order to be protected by any reformed trade through rule, but the NASDAQ marketplace already has these characteristics. We believe that the NASDAQ marketplace does not need a trade through rule because it is more competitive than the listed market and provides better execution quality to investors. Therefore, we respectfully suggest that the Commission limit the application of any reformed trade through rule to the market for listed securities, which is where it is needed.

C. Adopt the Voluntary Depth Alternative

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[7] *Id.*

[8] *Id.*

[9] According to the Commission's 11Ac1-5 publicly available data representing market orders from 100-1999 shares for November 2004.

[10] *Id.*

[11] *Id.*

[12] The Commission expressed concern that there were traded-through quotations in 2003 representing "approximately $209 million in NASDAQ stocks" but later also pointed out that the trading volume in 2003 in NMS stocks was "more than $17 trillion in 2003." Reproposing Release, *supra* note 2, at 69 FR 77443.

If the Commission decides both to adopt a new trade through rule and to extend the new trade through rule to the NASDAQ marketplace, then Ameritrade strongly encourages the Commission to move toward the Voluntary Depth Alternative and not just adopt the Market BBO Alternative. The Market BBO Alternative would protect only the best priced limit orders, while all other limit orders are unprotected and can be traded through with impunity. Restricting protection to the top-of-the-book fails to encourage limit orders and fails to enhance liquidity. Ameritrade is a strong supporter of limit orders with over 50% of our client orders being represented by limit orders, and we believe that our position is aligned with that of the Commission.[13]

In order for a trade through rule to be effective, it should protect all limit orders and the Voluntary Depth Alternative does so. The Voluntary Depth Alternative encourages limit orders, which will enhance rather than discourage liquidity. In a post-decimalization world, where there often is a lack of size quoted at the top-of-the-book, Ameritrade believes that if there is to be trade through rule, the rule should protect all limit orders.

We understand that the Commission is wary of the peculiar implementation problems posed by the Voluntary Depth Alternative, and we respectfully suggest that a properly structured pilot program in select securities could serve as a bridge between the Market BBO Alternative and the Voluntary Depth Alternative. This approach should allow time for, and provide experience with, the implementation challenges of the Voluntary Depth Alternative.

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[13] Ameritrade agrees with the following language that appears in the Reproposing Release, *supra* note 2, at 69 FR 77434, regarding limit orders:

> *The Commission therefore preliminarily believes that the reproposed Trade-Through Rule is needed to encourage greater use of limit orders. The more limit orders available at better prices and greater size, the more liquidity available to fill incoming marketable orders. Increased liquidity, in turn, could lead market participants to interact more often with displayed orders, which would lead to greater use of limit orders, and thus begin the cycle again.*

We also agree with Chairman Donaldson's statements regarding the importance of limit orders at a hearing held on "Regulation NMS And Developments In Market Structure" by the Committee on Banking, Housing and Urban Affairs of the United States Senate on July 21, 2004:

> *I particularly want to emphasize the importance of price protection and encouraging the display of limit orders. These orders typically define the best displayed prices in a stock. They are a critical source of public price discovery that is essential to the efficient operation of markets. Competition among markets is a vital aspect of efficient markets, but we must also assure vigorous competition among the orders of buyers and sellers in a stock. If investor limit orders are neglected and trades occur at inferior prices without good reason, I believe that it harms both the particular investors involved and perhaps more importantly, the integrity of the markets as a whole. Small investors, justifiably, may not understand why their order is bypassed by trading in other markets. But many of the largest institutional investors have also stressed to the Commission that they believe enhanced protection of investor limited orders is one of the weaknesses in the current national market system that needs to be addressed.*

The adoption of the Market BBO Alternative alone, without approved future steps toward the Voluntary Depth Alternative, would cause the trade through aspect of Regulation NMS to fall short of the objectives set by the Commission for any such new rule.

D. Comment Period for the NYSE Hybrid Proposal Should Be Extended

Because Regulation NMS is inextricably linked to the NYSE's proposal to transform its traditional floor-based model into a hybrid market that also offers automated electronic executions to its quotes ("Hybrid Proposal"),[14] Ameritrade believes that the Commission should assure that the public has the opportunity to fully appreciate the effect of any Commission rulemaking under Regulation NMS. We note that there are significant aspects of the Hybrid Proposal that could be profoundly affected by Commission decisions with respect to the application of proposed Regulation NMS. At a minimum, Ameritrade is of the view that the Commission should allow additional time for comment on the Hybrid Proposal after the adoption of Regulation NMS and should defer any decision on the Hybrid Proposal for the time being.

Ameritrade applauds the NYSE's efforts to provide investors with the ability to control the manner in which their orders are executed. For this reason, we believe that many of the suggested Hybrid Proposal changes to Direct+ will be beneficial to investors. We believe that eliminating order size restrictions, permitting immediate or cancel orders, eliminating the 30-second limitation for consecutive auto-ex orders, and permitting market orders to be automatically executed are significant improvements to the current Direct+ offering.

In our comment letter, however, we also expressed concern that there are a number of aspects of the Hybrid Proposal that raised both policy and practical issues.[15] While the NYSE has done much to address ambiguity in the practical aspects of its Hybrid Proposal, there still are fundamental fairness issues, as well as specific conflict issues, that remain unresolved and may adversely affect retail investors.

One of the critical issues for retail investors is the extent to which the revised Hybrid Proposal may fail to meet the Commission's criteria under any definition of "automated quotes" or "automated trading center," as those terms may be used in Regulation NMS, when adopted. An automated trading center is defined in the Commission's reproposal as one in which the trading center, among other things, has "adopted reasonable standards" for determining when its quotations change from automated to manual.

As the dominant market for listed securities, the efficacy of central elements of the Commission's Regulation NMS initiative will depend upon the extent to which the NYSE adapts

[14] *See* Notice of Filing of Amendments Nos. 2 and 3 to a Proposed Rule Change Relating to Enhancements to the Exchange's Existing Automatic Execution Facility Pilot (NYSE Direct+), SEA Rel. No. 50,667, SR-NYSE-2004-05 (Nov. 15, 2004).

[15] *See* Letter from Ellen L.S. Koplow, Executive Vice President, Ameritrade, to Jonathan G. Katz, Secretary, Commission, dated September 22, 2004.

in light of the proposed initiative. In particular, we question whether certain portions of the current Hybrid Proposal are consistent with the requirements that an automated trading center has "adopted reasonable standards limiting when its quotations change from automated quotations to manual quotations, and vice versa, to specifically defined circumstances that promote fair, efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets."

E. Manual Quotes Should Not Be Included in the BBO

The Commission also should give careful consideration to the effect that the mixed display of manual and automated quotes in the BBO will have on retail investors.[16] Ameritrade clients want transparency, firm quotes and immediate execution. While the Commission's reproposal would require that manual quotes be designated with a special identifier, it is our strong view that this solution will result in investor confusion and discontentment.

Many retail investors do not have a professional understanding of market structure and are unlikely to understand the significance of any identifier and its effect on their ability to obtain access to that quote. It is very likely that investors will perceive that they have been harmed when their individual orders are not executed at the BBO in favor of an automated execution. We think that this issue should be of significant concern because it is very likely to profoundly undermine the confidence of investors both in their broker and in the fairness of the securities markets.

In a similar vein, if manual quotes are included in the NBBO and are not automatically accessible to the investing public, the result may be not only that investors are confused but that the quote itself may be compromised. It is Ameritrade's view that only orders that are immediately accessible should be a part of the NBBO.

In particular, Ameritrade does not believe that trading centers should be permitted to stream quotes that are identified as manual quotes. In our view, streaming quotes are synonymous with automated quotes, and trading centers with manual quotes should not be able to display streaming quotes. Such an activity may constitute a violation of the Commission's Firm Quote Rule, and we respectfully suggest that the Commission address this situation in the adopting release.

F. Clarify Duty of Best Execution

A similar issue arises with respect to the duty of best execution. All brokers and many other market intermediaries have a duty to obtain best execution on behalf of their clients. Ameritrade takes this duty very seriously and fulfills its obligation by attempting to obtain the best possible execution. However, the trade through aspect of reproposed Regulation NMS

[16] An example of this impact can be found in the Commission's OEA Analysis of Trade Throughs, *supra* note 4, which established that the manual AMEX model generates an extremely high rate of trade throughs in NASDAQ listed securities (26.3%).

appropriately permits trading centers to bypass more favorably priced manual quotations in favor of automated quotations. Yet, there is no corresponding relief for brokers who will remain obligated to consider manual quotations when fulfilling their best execution duties.

After adoption, Regulations NMS could produce a mixed environment where manual quotes are displayed with automated quotes, but trading centers can trade through manual quotes, while brokers must consider manual quotes when fulfilling their duty of best execution. This mishmash could result in brokers being subject to significant regulatory and/or litigation risk by ignoring the manual quotations that are ignored by trading systems. If quotes cannot be automatically accessible, our concern is that brokers, such as Ameritrade, under the duty of best execution, may be held to a standard which, by definition, will not be possible to meet.

Ameritrade respectfully suggests that the Commission clarify the obligations of brokers so that an apparent Hobson's choice is not required. More specifically, we believe that the Commission should provide guidance that will clarify the obligations of brokers in meeting their best execution obligations in light of the adoption of a new trade through rule.

G. Consider Revising Language Discriminating against Certain Classes of Investors

Ameritrade is an advocate for all retail investors. We believe that when a client reaches a trading decision and enters an order, neither Ameritrade nor the marketplace will distinguish that client as a long-term investor from a short-term investor at the time of order execution. So, why treat one differently from another in the Reproposing Release? We strive to provide value-added services to all of our clients whether their investment intention is long-term, short-term, or varies from day to day.

We were surprised to notice several references in the trade through aspect of the Reproposing Release distinguishing, in an undefined fashion, between "long-term investors" and short-term traders," with the latter being disparaged.[17] Ironically, in the market data aspect of the

[17] For example, the Commission states in the Reproposing Release, *supra* note 2, at 69 FR 77434, that:

> *The end result should be an NMS that more fully meets the needs of a broad spectrum of investors, particularly the long-term investors, as opposed to short-term traders, that benefit most from improved market depth and liquidity.*

Ameritrade's experience leads us to conclude that long-term and short-term investors benefit equally from improved market depth and liquidity.

For another example, the Commission states in the Reproposing Release, *supra* note 2, at 69 FR 77440, that:

> . . . *This conflict between protecting the best displayed prices and facilitating short-term trading strategies raises a fundamental policy question --- should the overall efficiency of the NMS defer to the needs of professional traders, many of whom rarely intend to hold a position overnight? Or should the NMS serve the needs of longer-term investors, both large and small, that will benefit substantially from intermarket price protection.*

Reproposing Release, there is language extolling the virtues of what we assume are "short-term traders" when their activities appear to advance the Commission's objectives on that particular page.[18]

In Section 11A of the Exchange Act, Congress directed the Commission to use its authority under the Exchange Act to facilitate the establishment of a national market system for securities. There are numerous references in the Exchange Act to "investors" and for the Commission to act "for the protection of investors," seemingly without distinction between classes of investors, save for the definition of "qualified investor." Section 11A even contains a reference to an obligation to impose "equal regulation." It is not clear to us that the Reproposing Release language endorsing the arbitrary regulatory discrimination of different classes of investors is in furtherance of the purposes of the Exchange Act.[19]

We believe that traders and other short term investors provide substantial benefits to long term investors and to the overall efficiency of the markets.[20] Traders not only take away liquidity, but also provide liquidity in the form of limit orders, which appears to be at variance to statements made in the Reproposing Release. In fact, the most significant structural reforms that have taken place over the past ten years in the NASDAQ marketplace, which have benefited all investors, including the development of ECNs, have evolved from business models designed to meet the needs of short-term traders. While the Commission may wish to make decisions on access based on other policy considerations, NMS policies that favor a distinction between long and short-term investors should be discouraged. Therefore, we respectfully suggest that the Commission revisit the relevant language in the Reproposing Release and make appropriate revisions to the same for purposes of the adopting release.

> *. . . To the extent that the interests of professional traders and market intermediaries in a broad opt-out exception conflict with those of investors, the interests of investors are entitled to take precedence. In this way, the NMS will fulfill its Exchange Act objectives to promote fair and efficient equity markets for investors and to serve the public interest.*

18

> *. . . With the advent of highly-sophisticated order-routing algorithms, automated quotations throughout the NMS can be accessed with lightning speed. Some of these algorithms are specifically designed to search the market for displayed liquidity and sweep such liquidity immediately when it is displayed. The market discipline imposed by these order-routing practices should greatly reduce the potential for "low cost" quotations at the NBBO if the reproposed formula were adopted. A market participant would need to think carefully about whether it is truly willing to trade at a price, particularly a price as attractive as the NBBO, before displaying accessible and automated quotations to earn market data revenue.*

Reproposing Release, *supra* note 2, 69 FR 77465.

19 While "dealers" are required to be registered with the Commission, the definition of a dealer generally has excluded traders who do not hold themselves out to the public as being in the business of buying and selling securities. Thus, it is not apparent that the Exchange Act requires that any distinction be made between the activities of investors based on the volume or frequency of trading. *See* Louis Loss & Joel Seligman, SECURITIES REGULATION (3d ed. 1990), at 2983-84.

20 We would further note that in common parlance, all traders must be considered professional as opposed to amateur, since they seek an economic return for their activities.

III. Access and Access Fees

Ameritrade supports the reproposed access rule. If adopted, this rule would promote fair and non-discriminatory access to quotations displayed by trading centers through a "soft" or private linkage approach. While Ameritrade believes that trading centers should be required to provide non-discriminatory access to market participants, Ameritrade does not favor government regulation of access fees. Competition should determine these rates. Through competitive market forces, order flow will naturally gravitate to the automated market centers that provide the best combination of speed, reliability, costs and liquidity. We also believe that there should be careful consideration given to the concept of protected quotes and non-protected quotes within this aspect of the proposal. If a cap is adopted, then Ameritrade respectfully suggests that it should apply uniformly to all quotes, whether automated or manual.[21]

IV. Sub-Penny Quoting

Although we applaud the Commission's reproposal of a rule to prohibit a market from accepting, ranking or displaying orders, quotes or indications of interest in increments finer than a penny, we do not believe that the rule should contain an exception for securities trading under $1.00. The appropriate answer to this issue is for the NYSE, AMEX and NASDAQ markets to uniformly enforce listing standards, which generally require a security to trade above $1.00. Further, we do not believe that the Commission should provide an exemption from the rule for actively-traded ETFs. Ameritrade's experience is that most of the sub-penny quoting occurs in ETFs. Given that we believe that the elimination of sub-penny quoting can help to further restore investor confidence, increase transparency and enhance liquidity, we encourage the Commission to adopt a rule prohibiting sub-penny quoting with no exceptions or exemptions.

V. Market Data Reproposal

As the Commission is aware, data costs and revenues to market centers have increased exponentially in the past decade, without any significant independent review. Ameritrade is interested in first gaining an understanding of the costs associated with providing market data, and then determining the appropriate structure to allow for either a return of excess revenues back to investors or creating a model in which market data revenues equal the cost of providing such information to the investing public. Not only are market participants forced to pay the costs of the data they provide, participants do not know whether the fees are reasonable due to the absence of transparency.

Under the current system, market data fees are presently imposed in an entirely discriminatory fashion. Investors accessing real-time quotes through an account executive by

[21] Reproposed Rule 610 (c) imposes limits on the fees that a "trading center" can charge "*for the execution of orders against its **protected** quotations in an NMS stock . . . .*" Reproposed Rule 600 (b) defines a "trading center" as a "*national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.*"

telephone, from devices in branch offices, and from media distributors do not incur market data fees. If the same investor, however, uses an online brokerage account to access real-time quotes, market data fees are charged based on each instance a real-time quote is accessed. It is our view that the Commission should address this inequitable circumstance rather than merely adopting an interim band-aid.

Further, as we understand the reproposal, market data revenue would be divided among the exchanges through a two-step process. First, stocks would be weighted by the square root of the dollar volume. Second, the revenue for a given stock would be divided among the exchanges in the following proportions: 25% for share of trades, 25% for share of dollar volume, and 50% for share of displayed liquidity (based on time-weighted depth at the best quote). We have concerns with this third proportion. In our view, market data revenue should be distributed on the basis of executed trades only and not quotes. Otherwise, there is a perverse incentive for activities such as streaming quotes, which may generate market data revenue but few executions.

Our general view is that the Commission should act to address substantial problems in the governance and sale of market data in a comprehensive manner. Our clear preference is that the Commission adopt a comprehensive solution to the market data issues that have lingered unresolved for so many years rather than adopting an interim solution that unnecessarily discriminates against retail investors. An interim solution that merely rearranges the revenue pie for those already at the table should not be the chosen path.[22]

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Ameritrade thanks the Commission for considering its comments. Please contact me at 201/761-5570 if you would like to discuss our comments further.

Sincerely,

Phylis M. Esposito

Phylis M. Esposito
Executive Vice President, Chief Strategy Officer

[22] In this regard, we want to reiterate our prior concerns with the NYSE's pricing proposal for OpenBook. While the Commission has made clear that it intends to consider sweeping reforms to the governance and pricing structure of the market data plans in the future, we believe that the Commission owes an obligation to investors to assure that new fees, which are clearly inappropriate and excessive, are not approved during the short term. *See* Notice of filing of a Proposed Rule Change Establishing Fees for Receiving NYSE OpenBook® on a Real-Time Basis, SEA Rel. No. 50,275, SR-NYSE-2004-43 (Aug. 26, 2004) ("OpenBook"). *See also* Letter from Ellen L. S. Koplow, Executive Vice President and General Counsel, Ameritrade, to Jonathan G. Katz, Secretary, Commission, dated September 23, 2004.

CC: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid

Annette L. Nazareth
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