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VIA MESSENGER

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

Re: ***Proposed Regulation NMS File No. S7-10-04***

Dear Mr. Katz:

The Specialist Association ("Association") of the New York Stock Exchange ("NYSE" or "Exchange") welcomes the opportunity to respond to the request of the Securities and Exchange Commission ("Commission") for comments on proposed Regulation NMS.[1] Regulation NMS incorporates four substantive proposals – relating to the regulation of "trade-throughs," access to markets, subpenny quoting, and market data – designed to enhance and modernize the regulatory structure of the U.S. equity markets.

We are pleased to have the opportunity to provide our comments on various aspects of Regulation NMS, particularly those that would affect trading in NYSE-listed stocks and the operations of NYSE specialists. As specialists, the members of the Association have an obligation to maintain fair and orderly markets in the NYSE-listed stocks in which they specialize. They also perform a vital price discovery function on the NYSE that benefits all investors, whether retail or institutional. Indeed, our members provide the national best bid or offer for NYSE listed stocks approximately 90% of the time.

According to the Release, the proposals are designed to address the following three categories of problems: (1) the need for uniform rules that promote equal regulation of, and free competition among, all types of market centers; (2) the need to update antiquated rules that no longer reflect current market conditions; and (3) the need to promote greater order interaction and displayed depth, particularly for the very large orders of institutional investors. Certain of the proposed changes are intended to curb abusive behaviors and practices, and we fully support such action. Although we commend the Commission's attempt to address these problems in an

[1] Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) ("Release"). The Commission subsequently published a supplemental request for comment on proposed Regulation NMS. *See* Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release").

integrated way and support many of the ideas expressed in the Release, we believe that, in other respects, some of the Commission's proposals should be rejected. In addition, some of the Commission's proposed solutions to certain of the problems it has identified in the Release go much farther than is necessary to address those problems and, in this regard, could be improved.

While we address each of the four primary topics covered by the Release in our letter, the Association is particularly concerned with the proposed trade-through and access rules. With respect to these two proposals, we believe the Commission should do the following:

- Apply a uniform trade-through rule across all markets and covering all NMS Stocks, with minimal new exceptions;
    - Permit trade-throughs of "slow" quotes by "fast" quotes by *de minimis* amounts, as opposed to applying an automated/non-automated market distinction.
    - Reject the proposed opt-out exception.
    - Maintain most current exceptions, but eliminate the current 100-share *de minimis* exception.
- Require all quoting market centers and quoting market participants to permit all market participants access to their best quotes on a basis that is not unfairly discriminatory.
- Refuse to engage in rate-setting in relation to access fees, and recognize that ECN access fees and exchange transaction fees are not the same thing.
- Preclude quoting market centers and quoting market participants from charging transactions fees to non-members or non-subscribers.

Each of these points, and others, are discussed more fully below.

I. **TRADE-THROUGH PROPOSAL**

Proposed Rule 611 of Regulation NMS would require each exchange, the NASD, and any order execution facility ("OEF"), which includes ATSs, exchange specialists and market makers, to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market, with specified exceptions. The required policies and procedures of each OEF are to be designed to provide for the monitoring of quotations in other markets and prevent a trade from being effected in its market at a price inferior to a bid or offer that was apparent to an OEF in another market.[2] OEFs are also expected to have a "reasonable process" in place to deal with "false negative" and "false positive" trade-throughs (*i.e.*, those caused by flickering quotes). The proposed trade-through prohibitions would apply to any orders for the account of a broker-dealer or a customer, as well as any orders that an OEF executes internally within its market, whether or not that market posts its best bid and offer in the consolidated quote system. The trade-through restrictions would not apply, however, to bids or offers that are not disseminated pursuant to an effective NMS Plan (*i.e.*, it would not provide protection for the depth of book, but would apply to the top of book only).

Intermarket price priority, whether price protection for customer limit orders or for proprietary broker-dealer quotes, is a cornerstone of the U.S. securities markets. For this reason, we support the Commission's decision to extend trade-through protections across all markets to cover transactions in both listed and Nasdaq securities. We are not aware of any differences between listed and Nasdaq stocks that would justify continued disparate treatment. To the contrary, the extension of trade-through protections to the market for Nasdaq securities is in keeping with the Commission's stated goal of implementing uniform rules that promote equal regulation of, and free competition among, all types of market centers. In this same vein, we agree with the Commission's decision to subject broker-dealers that execute orders internally by trading as principal or crossing agency orders internally, but which do not post quotes or orders in the public quote, to trade-through restrictions.

We note, however, that proposed Regulation NMS would require a market to satisfy better priced quotes of each OTC market maker considered separately. This would be unfair to exchange market participants whose bids and offers are queued by price and consolidated into a single best bid and best offer displayed as the exchange's publicly-disseminated BBO for trade-through purposes. If the anti-trade-through principle is to apply to top-of-book only, as we believe it should, OTC market makers' bids and offers similarly should be queued by price and consolidated into a single publicly-disseminated BBO for trade-through purposes, as is the case today.

Although Regulation NMS would expand the trade-through rule to transactions in Nasdaq securities, the Commission explicitly has requested comment in the Release on the competitive effect of removing the trade-through rule from markets trading exchange-listed securities. As the Commission posited, we believe that, if price protection is not required, and better priced limit orders could be ignored, limit orders would be displayed far less often and those who perform market making functions would be discouraged from displaying better prices

[2] The proposed access rules, discussed below, would help ensure that the trade-through restrictions would not restrict an OEF from trading through the best bid or offer displayed in another market if there is insufficient access to that other market.

and sizes. Wider spreads lead to greater volatility. Together, these effects would demoralize investors and erode confidence in our markets. Thus, not only should trade-through principles continue to apply to listed securities, but the Commission also rightly has determined to extend the principle of intermarket price protection to Nasdaq securities.[3]

Further, trade-through principles should apply equally to all NMS stocks, including ETFs. As discussed more fully below in connection with its proposals relating to access to quotes, the Commission has requested comment on whether it should require all quoting markets to provide automatic execution of electronic orders at their quote. Furthermore, the Commission has proposed an automated quote exception to its trade-through prohibition (also discussed below) which would allow a market offering so-called "fast" quotes to trade through "slow" quotes up to a *de minimis* amount. Under either of these scenarios, there would be no need to continue the existing ETF exception. If the proposed access standard is adopted, there would no longer be delays in execution due to unavailable and/or inaccessible quotes, and if the automated quote exception is adopted, ETFs would be treated the same as any other NMS security so that "slow" quotes for ETFs could be traded-through for a *de minimis* amount. ETFs should be treated no differently than any other security for trade-through purposes.[4] Therefore, we believe that the Commission should allow the temporary *de minimis* trade-through exception for certain ETFs to expire by its terms on December 4, 2004.

Regulation NMS would require each of the exchanges, the NASD and all other OEFs to adopt policies and procedures to prevent the execution of a trade-through (other than one that exempted under the rule) in their respective markets in accordance with the provisions of proposed Rule 611. The Commission instead should consider adopting its own uniform trade-through rule that would extend across all markets and securities, taking into account differences between particular types of OEFs to the extent appropriate. This would ensure that the same

[3] In fact, however, as discussed below, the Commission's proposed opt-out provision would undermine this determination.

[4] We respectfully disagree with the Commission's conclusion in its March 3, 2004 Order extending the temporary *de minimis* trade-through exemption for ETFs that price improvement of three cents on an order for QQQs, DIAs, and SPYs "would not be significant." *See* Release No. 34-49357, 69 FR at 11057. While three cents may not be significant to certain professional traders and market participants that have figured out a way to profit on securities transactions on a basis other than price (*e.g.*, they make profits through access fee rebates) so that price does not matter to them, price improvement of three cents per share would certainly be significant to the average retail investor. In addition, the practice of some ECNs to rebate market data fees, which rebates can exceed the "loss" from repeated trades at prices other than the NBBO, may operate to artificially inflate the trading volume in ETFs. Allowing the current trade-through exemption for ETFs to expire likely will stop such artificial trading activity.

trade-through restrictions would apply throughout the NMS and would foster uniform application of the underlying principles.

Despite the fact that we strongly support price protection for better displayed bids and offers through application of a uniform trade-through rule, we also recognize that there may be some circumstances in which such protection would not be appropriate. For example, a better-priced quote on a market that is inaccessible or stale benefits no one. Under current trade-through rules and procedures, a broker-dealer, market maker or specialist handling an order faced with such a better bid or offer must either (1) attempt to access that quote, wait several seconds until the order is rejected or expires, and then either send the order elsewhere for execution or execute the order itself (after experiencing an unreasonable delay and, if the NBBO has changed in the interim, possibly securing a worse price for the customer), or (2) match that better price even if it does not reflect the true state of the market for the security being bought or sold. In this circumstance, the present system does not always work to the benefit of investors. The new system that would be established under proposed Regulation NMS would help remedy this problem.

The Commission asserts that slow markets, combined with current trade-through rules and procedures, impede the ability of market participants to obtain fast and sure executions of their orders. To address this perceived problem, the Commission has proposed an exception that would permit automated quotes to trade through quotes that are not immediately accessible through an auto-ex facility by a *de minimis* amount.[5] However, the Commission also proposes an "opt-out" provision that would permit market participants (whether customers or broker-dealers trading proprietarily) affirmatively to forego a better price posted in any market, without regard to a *de minimis* amount or whether that market's quotes are automated or non-automated, on an order-by-order basis as long as appropriate disclosures are given. While we understand why an automated quote exception to the trade-through rule is thought to be appropriate, the opt-out exception is not. Rather, the opt-out exception is wholly inconsistent with the concept of intermarket price protection and is unnecessary in the trading environment contemplated by proposed Regulation NMS.

Thus, for the reasons below, while we generally support an automated quote exception, we strongly oppose the opt-out exception.

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[5] In the Proposing Release, this exception originally would have applied to automated and non-automated markets -- automated markets would have been able to trade through quotes displayed by non-automated markets by *de minimis* amounts. As evident from the Supplemental Release as well as the Commission's hearing on Regulation NMS, the Commission is now focusing on, and we support, an automated quote exception.

A. <u>Automated Quote Exception</u>

As noted above, one proposed exception to the trade-through rule would permit a market displaying an automated quote to trade-through a market displaying a manual, or non-automated, quote by a "trade-though limit amount" ranging from one cent to five cents. A market displaying an automated quote would not be permitted, however, to trade through automated quotes displayed in other markets. Markets displaying non-automated quotes would not be able to trade through the quotes of any market, whether those quotes were automated or not.

The Commission would define an "automated quote" as one providing for an "immediate automated response." It asks, in the Supplemental Release, whether providing an immediate automated response should "include immediately sending a report back to the market center that submitted the order, either reporting an execution or cancellation." The explicit details of what would be considered "an immediate automated response" for this purpose, however, are not set out in either of the Releases. Instead, the Commission seeks comment on whether it should set a standard for minimum response times in defining the term "immediate" (*e.g.*, 98% of orders be executed in one second and all orders within 3 seconds), and other possible aspects of a generally applicable "immediate automated response" standard.

While 'the devil is in the details,' and the Association will certainly have views to share with the Commission on all of these issues once more details as to what will constitute "an immediate automated response" and an "automated quote" for purposes of this exception, we offer the following comments at this time.

As the NYSE has stated in testimony on this proposal, the NYSE is committed to providing both enhanced automatic execution functionality through extension of its Direct+® automated trading platform to a wider range of investor orders, and continuation of its agency/auction processes (modified to ensure that trade-throughs of other markets no longer occur). We strongly believe that a market that provides both automated and non-automated execution opportunities should not be precluded from having those of its quotes that are subject to automatic execution be considered "automated." Requiring markets to quote solely on an automated basis would place a value on speed and execution "certainty" greater than the value of price, an inappropriate trade-off. It also would go against the historical mandate of the Commission to refrain from designing markets and "picking winners."

Traditional, floor-based auction markets provide valuable price improvement opportunities that purely electronic markets offering instant executions do not. Specialists on the floor of the NYSE are charged with responsibility for maintaining fair and orderly markets in their assigned securities, and with providing a two-sided quote at all times. At times when there are not sufficient natural buyers and sellers for a stock, or when there are order imbalances, a specialist is required to act as principal to provide liquidity and reduce volatility.[6] Specialists also ensure that stocks open as close to the opening bell as possible, and that openings and reopenings following trading halts are timely, fair, orderly and appropriately reflect market conditions at the time.[7] Indeed, one of the key functions a specialist performs is to dampen volatility in times of market stress. Purely electronic trading systems are not capable of doing this. In fact, the average reduction in price volatility in the stocks of the 48 companies that moved their listing from Nasdaq – a market without a trade-through rule – to the NYSE during 2002 and 2003 was approximately 50%.[8] To completely automate the NYSE trading process, forcing exchanges to become totally electronic markets, would result in exchanges becoming mere ECNs. An incremental gain in speed of execution would come only by sacrificing trading mechanisms that enable market participants to engage in price discovery and that regularly offer opportunities for price improvement.

The NYSE promises to provide the best of both worlds to investors by affording automatic execution to those seeking certainly and speed over the potential for price improvement and a floor-based auction market for those who wish to seek price improvement by participating in a trading crowd. Although the NYSE will provide at least two differing execution facilities to meet differing demands from market participants, the NYSE will have an integrated book for both its automated and more traditional execution facilities.[9] In our view, even in an automated environment, market participants deserve the opportunity to continue to obtain price improvement opportunities through the NYSE's traditional price discovery process. While our Association's members will participate in the NYSE's auto-ex systems by entering quotes into those systems (which often will be the best intermarket quotes), they will also stand ready to conduct auctions when called upon to do so by market participants seeking better prices. The Commission should not force all markets to function only on an automated basis as the price of admission to participation in the national market system. Such a pre-condition to obtaining

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[6] Overall, specialists trade as principal for only about 11% of the total buy and sell volume on the NYSE. When they do so, however, it is generally to ensure continuity and to add depth and liquidity.

[7] Specialists also have a "negative obligation" to refrain from interfering with the opportunity for public orders to be executed against each other. That obligation does not exist in a dealer market or an ECN.

[8] *See, e.g.,* "Market Structure, Fragmentation and Market Quality: Evidence from Recent Listing Switches," Paul Bennett and Li Wei (2003), which is available through the NYSE's website at: http://www.nyse.com/pdfs/marketqualitystudy03.pdf; and "A Comparison of Intraday Volatility on the NYSE and Nasdaq," Daniel G. Weaver (2002), which also is available through the NYSE's website at: http://www.nyse.com/pdfs/2002-03a.pdf.

[9] Although the mechanical details of how this dual system will ultimately be structured have not been determined, the NYSE will ensure that those persons participating in the manual auction process do not trade through better automated quotes available in other markets.

the opportunity to compete would narrow, rather than enhance, investor choice and forfeit the benefits made possible by traditional floor-based auction markets. If the Commission intends to permit trade-throughs of non-automated quotes by automated quote markets, therefore, an automated quote (as opposed to market) exception would preserve both execution models, while still meeting the Commission's objectives.[10]

Second, whatever time parameter the Commission ultimately sets for "immediacy" for purposes of this exception (if it decides that such action is needed), we agree that the current 30-second response time to respond to trades transmitted through the ITS plan is too long.[11] We do not believe that it is necessary, however, for the Commission to attach a particular time period for a response to its concept of an automated quote. Rather, whether a market or quote is automated should be based on whether incoming electronic orders automatically interact with that market's best bid or offer without human intervention (*i.e.*, computer-to-computer) on a price/time priority basis. The key requirement should be that the quoting market is able to act on an order and respond back to the sender without the unnecessary delays inherent in manual intervention.[12]

B. <u>The Opt-Out Exception</u>

Under the Commission's proposal, customers and broker-dealers engaging in proprietary trading could "opt-out" of the trade-through rule by providing informed consent, on an order-by-order basis, to the execution of their orders in one market without regard to the possibility of obtaining a better price in another market, thereby allowing for an immediate execution outside the NBBO. The requirement to obtain informed consent would apply to any broker-dealer that receives order flow from a customer or another broker-dealer even if that broker-dealer would not be considered an order execution facility under the proposed rule. A broker-dealer would not

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[10] In the Supplemental Release, the Commission asks whether a market center should be able to decide, on a security-by-security basis, whether its quotes will be automated or manual and notes that a manual quote exception like the one described in the Supplemental Release would necessarily provide that flexibility. We agree that the specialist assigned to a particular security traded on an exchange should be able to decide whether his quotes at any particular time will be automated or manual.

[11] It has become clear that, in today's markets, ITS has lost its usefulness, and therefore should be dismantled. The function that ITS currently fills can be replicated in a more effective way, such as through smart order routers.

[12] If the Commission does decide to set a specific time parameter, however, it should be careful not to choose such a small period of time that those professional traders with the largest and most powerful computerized trading systems will be able to take advantage of the rule, enjoying a benefit over all other market participants – a result which would be antithetical to achievement of a competitive and fair marketplace.

be required to permit its customers to opt-out of the rule's protections, but if it does so, it would be required to disclose on the trade confirmation or the monthly account statement (as soon as possible but no later than one month after execution) to its customers the NBBO at the time of execution for each opted-out order.

The proposed opt-out exception would swallow the trade-through rule and destroy the whole concept of intermarket price priority, just when it seems possible technologically to ensure it. While the Commission intends the requirement for order-by-order informed consent to protect less sophisticated customers, in reality, such a requirement could have the opposite effect. Front-end electronic order entry systems can easily be designed with a 'check the box' format for opt-outs. As a result, those investors using front-end systems, a large majority of which are likely to be institutional investors and professional traders, are likely to be the persons opting-opt from the trade-through rule. Retail customers are less likely to have access to such electronic order-entry systems.[13] With respect to retail customers (particularly those without electronic access), if the procedures for obtaining informed consent are burdensome, brokers are not likely to offer the choice of opting out to those customers every time those customers submit a limit order (particularly relatively small limit orders) for execution. The large majority of persons likely to utilize the opt-out procedure, therefore, would be professional traders, broker-dealers trading proprietarily, and institutional investors with direct sponsored electronic access to trading venues. It is the smaller customers' limit orders that will likely be traded through by larger, more sophisticated investors on a regular basis. The persons whose orders or better quotes are traded through – persons the trade-through rule is intended to protect – are not the persons being given the choice to forego the rule's protections through the opt-out. This would further tend to split the markets into two tiers, something the Commission is trying to avoid through Regulation NMS and in addition create a new disincentive to the entry of limit orders by investors.[14]

Likewise, because the proposed trade-through rule would extend trade-through protections to Nasdaq securities for the first time, and market participants operating solely in those markets have no experience with the rule's application, it is likely that broker-dealers and other market participants trading in those securities would choose to opt out of the rule rather

[13] Even if small investors did acquire access to such systems, it is unlikely that the Commission would have intended opting out to become routine under a 'check-the-box' format.

[14] Furthermore, as proposed, the opt-out exception, unlike the automated market exception, does not have a *de minimis* allowable trade-through amount, making the opt-out exception even more objectionable. The suggestion by some that there should be no limit on permissible trade-through amount for purposes of the automated market/quote exception should be rejected. The Commission's proposal to permit a trade-through of a manual market or quote by an automated one is based on the theory that the small difference in price and the difference in the timing of the executions between the contrasting markets are roughly equivalent. There is no similar justification for sanctioning trade-throughs in unlimited amounts.

than learn how to comply with it. We question the rationale behind broadly extending the Rule to cover Nasdaq securities so as to equalize the treatment of securities trades across all markets while at the same time permitting all market participants to choose to ignore the Rule and forego its protections in all markets.

Finally, if market maker quotes may be traded through with impunity, they will be less likely to post quotes with size. The opt-out provision is therefore likely to negatively impact market liquidity and depth.

C. Other Exceptions to the Trade-Through Rule

The Commission has proposed several other exceptions to the proposed Trade-Through Rule that mirror current exceptions to trade-through protections. We agree that those current exceptions to trade-through protections, which have been incorporated into proposed Rule 611(b)(1) – (7), should be retained in any new trade-through rule. Furthermore, the Commission should retain the current exception for trading through orders that lock markets as a penalty for posting a quote that locks the market.[15] To better protect retail investors' limit orders, we also agree with the Commission's proposal to eliminate the current 100-share *de minimis* exception to the trade-through rule.

Finally, the Commission has requested additional comment on whether "intermarket sweep orders" should be excepted from the Trade-Through Rule. Provided that the broker-dealer submitting such an order identifies it as such, so that the receiving market will know that it is not required to re-route the order to another market for execution at the NBBO but instead may fill the order at its own BBO, we would not object to such an exception.

II. ACCESS PROPOSAL

A. Market-wide Access

As part of Regulation NMS, the Commission is proposing standards governing access to quotations and the execution of orders for equity securities throughout the national market system. Proposed Rule 610(a) of Regulation NMS would prohibit quoting market centers and quoting market participants from imposing unfairly discriminatory terms that inhibit non-members, non-subscribers, or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers, or customers. We support the

[15] We note that in the Supplemental Release the Commission has asked whether market participants submitting quotations that are automatically executable should be allowed to lock or cross quotations that are identified as *not* being automatically executable. In this regard, "fast" quotes should be able to lock or cross "slow" quotes without violating applicable rules, including the trade-through rule.

Commission's proposal to require all market centers to permit access to their quotes on terms that are not unfairly discriminatory.

The Commission has asked whether, if it requires automatic execution as part of its access rule, it should promulgate performance standards "to ensure that the quotes of all market participants are available for execution" and "assure that market participant orders are executed in substantially equivalent timeframes across all markets." Since most, if not all, markets are likely to meet whatever standard the Commission adopts to meet the "automated market" standard for trade-through rule purposes, it should apply that same standard – the provision of an "immediate" automated response to an incoming order at its quote, whatever that means – in connection with any access rules it ultimately adopts.[16] Indeed, the concepts of access to quotes and price protection across all markets are necessarily linked: if a market participant does not have fair access to a posted quote, compliance with trade-through prohibitions would be difficult, if not impossible.[17] If it does adopt access standards across all markets that require automatic execution, however, the Commission should be careful not to choose a standard that would preclude the price discovery and price improvement possibilities available today through an auction process.

Under the proposal, a quoting market participant also would be required to make its quotations accessible (*i.e.*, available for execution) to all quoting market centers and all other quoting market participants on terms as favorable as those it grants to its most preferred member, customer, or subscriber. We also support the proposed prohibition against quoting market centers and quoting market participants unfairly discriminating against non-members, non-customers, or non-subscribers accessing quotes through that center's or participant's members, customers or subscribers. In this regard, the Commission's proposal to reduce the fair access standard under Regulation ATS from 20% to 5% is appropriate and consistent with the Commission's stated goal of making all quoting market participants' and quoting market centers' quotes accessible to all market participants on a not unfairly discriminatory basis. If an entity's quotes are included in the NMS, such as when an ATS reaches the 5% ADTV level in a security, or even if it voluntarily provides quotes to an SRO for inclusion in the public quote stream, it should necessarily be required to provide fair access to those quotes. An even better alternative,

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[16] The Commission has asked whether it should adopt a performance standard with respect to its proposed access rule. If it does adopt a performance standard regarding access, that standard should provide sufficient time for updating quotes, even automatically, to preclude market participants from taking out the entire book and to enable specialists to appropriately maintain the markets in their assigned stocks.

[17] Furthermore, just as with the trade-through rule, which is based on the best displayed prices throughout the national market system, any requirement to provide universal access to quotes should be limited to the particular quoting market center's or quoting market participant's BBO, rather than its whole book.

however, would be to require all ECNs, even if they have not reached a 5% volume threshold, to publish their quotes in NMS securities through SROs. This requirement would increase liquidity and enhance price discovery.

B. Access Fees

The Commission is rightly concerned that ECN access fees have created distortions in the trading markets. However, the Commission's proposed solution – limiting the fees that any market participants may impose for executions against their quotes to a *de minimis* amount ($0.001 per share per individual market participant, with a total cap of $0.002 per share in any transaction) – extends further than necessary to remedy the perceived problems caused by excessive ECN access fees.

As a preliminary matter, we question the wisdom of the Commission's proposed foray into rate-setting. Congress and the Commission historically have been reticent about getting in the rate-setting business in the securities industry – and with good reason. Congress abolished fixed commission rates for broker-dealers in connection with the 1975 amendments to the Exchange Act. Exchange transaction fees, which vary widely, are currently set through competition. An exchange merely has to submit a rule filing pursuant to Exchange Act Section 19(b)(3)(A) to change its fees, and those fee adjustments are effective upon filing. The Commission rarely disturbs an SRO fee adjustment. Approving a proposed fee based on statutorily-imposed standards, and actually setting the appropriate fee rate, however, are vastly different. ECN access fees have varied significantly over time,[18] and the Release does not set forth any methodology by which it determined that of $0.001 as an appropriate maximum fee for each quoting market participant and quoting market center.

An easier solution to the problem of discriminatory ECN access fees than the Commission's proposed *de minimis* access fee restriction would entail banning unfairly discriminatory access fees altogether. If a quoting market participant displays a quote in the NMS, it should not be able to charge a fee to any person accessing that quote that does not

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[18] For instance, as noted in the Release, the Commission's Staff previously conditioned no-action relief to ECNs on their limiting access fees to $0.009 per share. More recently, Nasdaq has established a maximum permissible quote/order access fee of $0.003 for ECNs that elect to participate in and execute transactions in SuperMontage. *See* Release No. 34-49220 (Feb. 11, 2004)(File No. SR-NASD-2003-128). The Commission further asserts in the Release that several of the largest ECNs pay $0.002 per share to order providers upon the execution of their orders, and simultaneously charge $0.003 to "liquidity takers" whose orders execute against resting limit orders in the ECN. Nowhere in the Release, however, does the Commission explain how it arrived at the proposed $0.001/$0.002 standard as an appropriate access fee limitation.

otherwise have a relationship with that quoting market or market participant.[19] (For example, an ECN should not be permitted to charge a separate access fee to a contra-side broker that has accessed that ECN's quotes through one of the ECN's subscribers in addition to the subscription fee the subscriber is already paying to the ECN for the privilege of participating in the ECN's system.) Competition among market centers will naturally set appropriate fee levels, as market participants decide whether being a subscriber or member of a particular market is economically worthwhile in light of those transaction fees. Competition among broker-dealer members and subscribers for the business of customers seeking access to a particular execution venue also will operate to keep customer transaction fees at appropriate levels.

One portion of the access fee proposal is of particular concern, however. For purposes of its access fee proposals, the Commission would treat exchange transaction fees and ECN access fees as the same thing. That is not the case. Exchange transaction fees are charged only to members of the exchange for transactions executed on that exchange. These fees are known by the parties before any trades are executed, and do not vary depending upon the identity of the counterparty to a particular transaction. Furthermore, these fees contribute to the funding of an exchange's regulatory compliance efforts. We understand that ECNs, on the other hand, which are private entities without similar regulatory responsibilities as SROs, often seek to charge non-subscribers access fees (for example, when that counterparty accesses the ECN's quote through SuperMontage). ECNs also apparently charge different access fee amounts to subscribers and non-subscribers.[20] Instead of charging access fees to non-members or non-subscribers that access their quotes, quoting market centers and quoting market participants should be permitted to charge transaction fees only to their members and subscribers for executed trades. Quoting market centers and quoting market participants could charge whatever fee they believe they could appropriately command, and if a member or subscriber chose to pass that fee along to its customer, it would have to take that into account in connection with its best execution obligations. This proposed solution would keep the Commission out of the unfamiliar business of rate-setting.

III. <u>THE SUB-PENNY QUOTING PROPOSAL</u>

Under current quoting conventions, two-tiered markets have developed. While the exchanges and Nasdaq have adopted rules establishing $0.01 as the minimum quoting increment

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[19] If the Commission does ultimately adopt a cap on access fees for attributable quotes, we appreciate the Commission's clarification in the Supplemental Release that, as long as an exchange publicly identifies the broker-dealer responsible for a quote (*e.g.*, if the SRO publicly identifies the specialist assigned to a security), that broker-dealer should be eligible to receive an access fee with respect to that quote.

[20] We note that we have no objection to ECNs charging subscription fees to their subscribers; it is the practice of charging <u>non-subscribers</u> access fees that is objectionable.

on their respective markets, some ECNs and other market participants have been displaying quotations on their systems in sub-pennies. Because these sub-penny quotes are not currently included in the quotation data that is publicly disseminated, "hidden markets," often not available to the average investor, have been created. In addition, as the Commission recognized, these sub-penny quotes create the opportunity for some market participants to "step ahead" of competing limit orders by an "infinitesimally small amount," which can render important customer protection rules, including exchange priority rules, meaningless.

To address these and other concerns enumerated in the Release, the Commission has proposed to ban sub-penny pricing in most cases. Regulation NMS would prohibit every national securities exchange, national securities association, ATS (including ECNs), vendor, broker or dealer from ranking, displaying or accepting from any person a bid or offer, an order or an indication of interest in any NMS stock, other than those with a share price below $1.00, in an increment of less than $0.01. Under proposed Rule 612, market makers and specialists could not display sub-penny proprietary quotes through any medium, nor could they accept customer limit orders in sub-penny increments. Among other things, the proposed rule is intended to ensure that market participants can only receive execution priority over existing limit orders and quotes by improving the best displayed price by at least a penny. The rule also is intended to mitigate the disincentive to use limit orders by stopping market participants from stepping ahead by bettering the limit price by merely an economically insignificant amount.

We fully support this portion of proposed Regulation NMS. Without a prohibition against sub-penny quoting, the exchanges and Nasdaq could be forced to adopt the practice in order to stay competitive. This further expansion of the practice could increase the problems associated with quote flickering and decreased market depth at the inside quote, as the Commission has posited.

The Commission also has sought comment on whether bids and offers for ETFs should be permitted in sub-pennies. As we stated above in connection with the trade-through rule, we do not believe that ETFs should be treated differently than any other securities. Allowing ETFs, but not other securities, to be quoted in sub-pennies would reinforce the two-tiered market the Commission is attempting to remedy. If ETFs were quoted in sub-pennies, SROs would be required to make expensive systems changes in order to compete with ATSs that currently quote ETFs in sub-pennies. In that event, sub-penny quoting would be even more widespread and the likelihood of flickering quotes in these securities (as well as inadvertent violations of the trade-through rule, once the *de minimis* exception for ETFs expires) would increase. If some markets quoted ETFs in sub-pennies and some did not, the lack of uniformity in pricing would cause investor confusion, and sophisticated investors with access to the technology required to submit sub-penny orders and analyze arbitrage opportunities at the sub-penny level would continue to have an advantage over the average investor. Consequently, there should be no exception made to the prohibition against sub-penny quoting for ETFs.

Finally, we note that while the Commission's proposed rule prohibits sub-penny quotes, it does not preclude sub-penny executions. As proposed, an exchange or association would continue to be able to report or print a trade in a sub-penny increment, and a broker-dealer could provide sub-penny price improvement to a customer order as long as it did not accept sub-penny orders. In addition, the rule would not prohibit an exchange or association from printing a trade that was the result of a mid-point or volume-weighted pricing algorithm, as long as the exchange or association or its members did not otherwise violate the proposed rule with respect to the trading interest that resulted in the execution. While we do not generally object to the printing of sub-penny executions that are the result of VWAP trades or mid-point pricing algorithms employed by certain ATSs, any exceptions for sub-penny reporting or printing should be very narrowly drawn. Permitting broker-dealers to provide internalized sub-penny price improvement would enable those entities to 'step ahead' of posted quotes at the NBBO by an economically insignificant amount, which is one of the problems the Commission seeks to fix by banning sub-penny quoting. Broker-dealers with a larger volume of customer order flow would have an unfair advantage over other market participants by virtue of internalized sub-penny price improvement. Furthermore, the internalized systems would essentially be providing a non-publicly accessible sub-penny quote that would be in violation of the sub-penny quote restriction.

IV. THE MARKET DATA PROPOSALS

A. Market Data Income Allocation

The current formulas in the joint industry plans ("Plans") governing the dissemination of transaction information for allocating revenues derived from market data fees to the SROs are based solely on the number of trades or share volume reported by an SRO. Currently, Network A and Network B (listed stocks) allocate net income based solely on the number of trades reported by an SRO, while Network C (Nasdaq stocks) allocates net income based on an average of a participant's number of trades and its share volume. The Commission believes that this method of allocation, and the rebate practices of some SROs of a portion of those market data revenues, has led to economic and regulatory distortions, creating incentives for "print" facilities, "wash" trades, and "shredded" trades. In addition, the Commission believes those markets that generate the highest quality quotes (*i.e.*, the best prices and the largest sizes) are not necessarily rewarded. The Commission's proposed new, and more complex, formula attempts to divide market data revenues equally between trading and quoting activity in NMS stocks, in order to reward markets that publish the best accessible quotes.

If the Commission is going to retain the current Plan structure and devise a new data fee distribution formula, we generally would support a reallocation of market data revenue that would reward contributions to market quality, including both quoting activity and executions. Although much attention is given to the most actively traded securities, we appreciate the

Commission's recognition of the important service our members provide with respect to the hundreds of other less-actively traded listed securities.[21] Specialists maintain markets and provide continuous quotes for numerous securities in which ECNs and ATSs have little interest, but which are of interest to investors. The SROs providing quotes and executions in those securities should be appropriately rewarded under any allocation formula.

B. Plan Governance

The Commission's proposal also would broaden participation in Plan governance by creating large, unwieldy advisory committees composed of non-SRO representatives. Such committees would be intended to help assure that interested parties have an opportunity to be heard on Plan business, prior to any decision by the Plan operating committees. We question the efficacy of such non-member advisory committees, since they would have no voting or other actual authority to effect any decision-making by a Plan. If the Plans are no longer effective, as the Commission suggests, perhaps the Commission should consider disbanding them.

C. Distribution and Display of Market Data

Under existing rules and joint industry Plans, the trades and best quotes in exchange-listed and Nasdaq-listed stocks are made available on a real-time and consolidated basis. However, under current rules, vendors and broker-dealers that provide any display of market information for an NMS stock must also provide a consolidated display of information from all markets that trade that stock, even if the displayed prices from those markets are far away from the current NBBO. Under the Commission's new proposal, only "core" information – the price, size and market center identification of the NBBO – would be required to be provided by a consolidator for distribution. Individual market centers would be authorized to independently distribute additional data (*e.g.*, limit order books, transaction reports) as they saw fit.

Permitting markets to independently sell their data will enable those markets whose information is more valuable than others' – such as a market with a higher volume of order interaction and greater depth of book – to offer a more useful product to those market participants that actually want access to that information. Permitting market centers to distribute their information independently also will encourage them to provide better markets so that the demand for their market information will increase. Likewise, revenues from that additional market data will reward markets and market participants that provide more transparency and

[21] Under the Commission's allocation formula, for example, the distribution of net income among all Network securities would be in proportion to the square root of the total dollar volume in the security, which, in the Commission's words helps reflect "the importance of price discovery for the vast majority of Network securities," not just the top 5%.

provide the best executions, as long as markets are free to charge for the value associated with their proprietary data.

As with the Commission's access proposal, we do not believe that the Commission should engage in rate-setting with respect to market data. Market data fees received by the Exchange are an important, democratic (that is, these fees are charged equally to every person using the data, not just exchange members) funding source of the NYSE's annual revenues. Instead of capping market data fees, if the Commission's intent is to stop the "wash trading," "print buying" and "tape shredding" made economically advantageous through market data fee rebates, the Commission should prohibit those practices directly. In addition, eliminating the consortia that set collective prices for market data will go a long way toward eliminating many of the perceived problems arising from the current market data fee structures. If non-price-related economic incentives to send a trade to a particular market center for execution are removed, the incidences of tape shredding, wash trades, and print-buying that are of concern to the Commission will assuredly decrease.

* * *

If you have any questions concerning any part of our letter or would like to discuss with us any aspect of proposed Regulation NMS that we have not addressed, please contact me at (212) 589-0490. We look forward to continuing our dialogue with the Commission and its Staff on these crucial, and timely, market structure issues.

Sincerely yours,

David Humphreville/LSP

David Humphreville
President

cc: William H. Donaldson, Chairman
Paul S. Atkins, Commissioner
Roel C. Campos, Commissioner
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