NSX National Stock℠ Exchange

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VIA FEDERAL EXPRESS

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

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

Dear Mr. Katz:

The National Stock Exchange ("NSX" or the "Exchange") respectfully submits the following comments to the Securities and Exchange Commission ("SEC" or the "Commission") on proposed Regulation NMS ("Reg NMS"). The Exchange appreciates the SEC's efforts to enhance and modernize the regulatory framework for the National Market System.

NSX would like to offers comments in each of the four market structure areas covered by Reg NMS: (1) trade-through reform; (2) market data revenue allocation; (3) access fees; and (4) sub-penny pricing.

Trade-Through Reform

It is useful to recall that the trade-through rule came into being over two decades ago, during the reforms that led to the creation of the National Market System, the Consolidated Tape and Quote Associations, and the Intermarket Trading System. At that time, regional exchanges could not access primary market quotes, allowing the primary markets to ignore regional quotes. A trade-through rule initially benefited the regional exchanges because it provided them with a more level playing field to compete against the primary markets that, not surprisingly, were originally opposed to the idea of a trade-through rule. Ironically, twenty years later, trade-through protection has become crucial to preserving the primary markets' franchises against nimble, technology-centric competitors.

Since the establishment of the trade-through rule, virtually all of the innovation has come from non-primary exchanges and electronic trading platforms. Automation of the trading process and fierce competition have not only reduced trading costs and vastly improved efficiency, but they have also created opportunities for new types of participants in the capital markets that otherwise would have never had the ability to make a business of trading on such thin margins.

The Nasdaq market has had great success as a completely automated market, and it has proven to be an excellent laboratory for an alternative structure. Yet it was not until after much-needed reform and the addition of order handling rules in the mid-1990s that the Nasdaq marketplace took off. Most significantly, the Nasdaq market structure has not impeded competition. Electronic Communications Networks ("ECNs") and other trading platforms have been successful by leveraging technology and promoting their respective business models, and the result is a more efficient and cost-effective market structure.

At the end of every trade execution, all investors strive to receive the best price, and whichever means can achieve that end will be pursued. To suggest that rational traders are routinely willing to pay up a few cents when "trading through" another market is absurd. In practice, this occurs because they are not actually trading through a price; instead, they are choosing to trade through a quote that has historically not been accessible in a timely manner due to the fact that it emanates from either a manual non-automated market or is not based on real-time market information. Smart order routing technology allows simultaneous access to multiple markets at the push of a button, but in listed markets the trade-through rule brings every market to the lowest common denominator. It is akin to an entire class capable and willing to do calculus being forced to endlessly study multiplication tables because of a lone student who refuses to advance.

Incredibly, the lowest common denominator allows a specialist on the New York Stock Exchange (the "NYSE") thirty seconds to decide whether the price he or she is displaying is really the price at which he or she is willing to trade. Yet any limit order that resides on an ECN or Nasdaq is actionable, which in turn encourages limit order submission. The trade-through issue is not about whether speed or price is more important in a trade execution. It is not even about creating a structure that balances the goals of best price and certainty of execution. It is about leveraging technology that has long been available so that each market center can access each other's quotes instantaneously and irrevocably.

There is no trade-through rule in Nasdaq-listed securities, and yet competition is fierce between NSX, the Archipelago Exchange ("ArcaEx") and Nasdaq when it comes to the execution of Nasdaq stocks. ECNs have thrived due to their ability to provide a cost-effective platform for Nasdaq trading. The NYSE would have one believe that the reason that 80% of listed volume still takes place on its floor is due to the unparalleled liquidity that exists and the price discovery that takes place there. The entire NYSE argument hinges on the claim that the best price is paramount – even if it takes a few seconds to get it – and that the Big Board routinely will deliver best price. The irony of the trade-through protection in NYSE-listed stocks is that the biggest beneficiary of the rule – the NYSE - is the market with the least advanced technology, the most inhibitive trading rules, the lowest execution quality, and the most trade-through rule violations. The trade-through rule protects the NYSE's monopoly and is therefore a major barrier to competition. It is shameful that all investors do not benefit from the fruits of technology and innovation in all capital markets transactions. ECNs have demonstrated the true cost of executing a trade, and it is very close to zero.

It is important to discuss the trade-through rule in the context of the specialist system in place on the NYSE and the American Stock Exchange ("AMEX"), a system in which a single firm is awarded the franchise to simultaneously oversee trading in and opportunistically trade for profit in a particular stock.

The cost to make markets in Microsoft stock on the Nasdaq market is zero, and any registered market maker can start making competitive markets in the stock tomorrow. Yet, if Microsoft were a NYSE-listed stock, a broker-dealer would willingly pay millions of dollars to become the sole specialist because: (1) he or she would be in a unique and privileged position to see order flow and information that is immensely valuable to someone who is in the business of taking long or short positions in the stock as a market maker; and (2) nearly 80% of the share volume is captive to the NYSE due to the regulatory impediments - like the trade-through rule - that stand in the way of competitors.

LaBranche & Company, Inc. ("LaBranche"), the largest NYSE specialist, values its specialist stock list (consisting of 576 stocks) at $369 million as of March 31, 2004, according to SEC filings. A recent Merrill Lynch research report stated that LaBranche's top 25 stocks accounted for 38% of principal trading revenue. It follows then, that an average large cap, liquid stock is worth almost $6 million to an NYSE specialist (and the biggest stocks, obviously, are worth significantly more).

ECNs have encouraged liquidity providers to place limit orders by compensating them with rebates. The transaction fees that liquidity takers pay for access to the liquidity fund these rebates. NYSE encourages its own liquidity providers (specialists) by compensating them through various efforts to preserve a structure that grants them a monopoly on a given stock, option value for public limit orders, and a trade-through rule that serves little purpose other than to lock out legitimate competitive alternatives for listed orders.

If the Nasdaq market is one laboratory for an alternative market structure, then the three-cent "de minimis" exemption from the trade-through rule for the three most active exchange-traded funds ("ETFs") is certainly another. More importantly, ETFs are securities that are listed on a primary exchange with a specialist model and inferior technology for order handling and matching. The results of the "de minimis" exemption should discourage anyone who believes the trade-through rule is fundamental to preserving investor's interests: according to a University of California at Berkeley study, effective and realized spreads were lower after the trade-through exemption went into effect in 2002. Furthermore, in the first quarter of 2004, 9 billion shares of the three most active ETFs, QQQ, SPY and DIA, were traded market-wide. During the same period two years prior to the exemption, volume in these issues totaled only 6.2 billion shares. This 45% increase in volume (versus 15% in overall NYSE volume) is further evidence that the existing trade-through rule is simply unnecessary.

As we see in the Nasdaq world, the trade-through rule itself becomes irrelevant so long as we uphold the broker's fiduciary duty of best execution. Furthermore, removing a trade-through rule that masquerades as investor protection will attract new suppliers of liquidity in listed stocks, just as the industry experienced in Nasdaq listings and ETFs. Opportunistic firms will have the ability to compete for profits of fractions of a penny per share since they will be free of the onerous floor-based cost structure. The result will surely be even bigger liquidity pools, more trading volume, and a reduction in average transaction costs for the investing public as a whole.

Given all of the above, the Exchange supports the Commission's call for an "opt-out" of the trade-through rule for manual markets. If the national best bid or offer has been disseminated by a manual market, then that bid or offer may not actually be the best price because it might not be available. Legally, a manual market has sixty seconds to update its quote, and therefore it is often the case – as demonstrated by the high percentage of price disimprovement on the NYSE – that the best advertised quote does not necessarily represent a quote that can actually be traded against. As the Commission notes in its proposal, a "benefit of providing investors with the flexibility to choose whether their orders should trade through a better quote is that it might create market forces that would discipline markets that provided slow executions or inadequate access to their markets. If investors were not satisfied with the level of automation or service provided by a market center, they could choose to have their orders executed without regard to that market's quote, thus putting pressure on the market to improve its services."

The public investor must be given the freedom to trade on the marketplace of his or her choosing by having the opportunity to "opt-out" of receiving the best advertised price. An opt-out provision must be efficient and user-friendly, and it must allow investors to take advantage of this choice without onerous requirements.

Should the Commission decide to preserve the trade-through rule, NSX suggests that the SEC consider extending the ETF "de minimis" pilot to the top one hundred NYSE-listed issues. The ETF pilot has been successful in reducing costs, expanding technological efficiencies, and enhancing liquidity for the three top ETF products, and the Exchange believes that an extension would give the Commission, in a controlled incremental fashion, the opportunity to prove whether or not a "de minimis" exception could provide similar benefits to other actively traded securities.

Although SEC Rule 11Ac1-5 data clearly supports the argument that the trade-through rule should not be extended to Nasdaq, if the SEC does decide to extend the trade-through rule to the Nasdaq marketplace when it trades Nasdaq-listed securities, then it is important that the SEC make clear that this new Nasdaq trade-through rule covers intramarket as well as intermarket trade-throughs in order to prevent Nasdaq from having a significant regulatory advantage over the exchanges that trade Nasdaq-listed stocks. It would be illogical for a Nasdaq member to be prohibited from trading through another market center but not prohibited from trading through another Nasdaq member, and it would also be illogical to permit the entire Nasdaq market to continue to opt-out of intramarket trade-throughs without also allowing exchanges to do the same when exchanges are trading Nasdaq-listed securities.

Equally important, if the Commission decides not to extend the trade through rule to the Nasdaq marketplace when it trades Nasdaq-listed securities, then it is important to grant exchanges the ability to trade Nasdaq-listed issues without intramarket or intermarket trade-through requirements. To do otherwise would be to allow Nasdaq to retain a significant regulatory advantage over its competitors. NSX has had for many years a rule change proposal in front of the SEC – called its "voluntary book" proposal – that would eliminate this regulatory advantage. Now is the time to either approve NSX's voluntary book filing or to eliminate the ability of broker-dealers to trade-through better-priced orders in Nasdaq's marketplace. Only in this manner can the mandate of the Securities Exchange Act of 1934 that self-regulatory organizations be subject to equal regulation be adequately fulfilled.

Finally, the trade-through rule is intimately connected to the ITS locked and crossed market rules, and therefore any meaningful market structure must consider all these rules together. NSX believes that, at a minimum, in order to be consistent and to ensure that any change to the trade-through rule has the intended effect, the Commission should either allow broker-dealers to lock and cross quotations that emanate from manual markets or exclude manual market quotes from the national best bid and offer ("NBBO") calculation.

Market Data Revenue Allocation

NSX challenges the assumption that the current system for market data revenue allocation needs to be changed, and NSX would like to caution the Commission against making a change that could prove to be far worse than any problem that exists today.

It is important to place the issue before the Commission in historical context. The current market data revenue distribution method has been in place for over twenty-five years. For most of that time, the current method has been perceived by the securities industry to be fair, easy to administer, and effective. The method was first questioned two years ago by Nasdaq for competitive reasons. At that time, Nasdaq lost a significant amount of order flow to NSX as a result of an innovative NSX cost initiative: in order to respond to the brokerage community's long-stated need for lower market data costs, NSX made a strategic decision to combine the operating leverage of its efficient all-electronic market with a utility cost model. This strategic combination enabled NSX to lower market data costs for broker-dealers by generating and then sharing net revenue with its members, just like a true mutual company.

Because other market centers that trade Nasdaq-listed securities were forced by NSX's competitive initiative to copy NSX and share 50% of their market data revenue, NSX's success in breaking Nasdaq's monopoly is now saving investors $65 million a year, or half the amount of the market data pool for Nasdaq-listed securities. In a similar fashion, NSX led the way in reducing the cost of Amex-listed market data, helping broker-dealers and the public investor community to save another $50 million annually. Without such initiatives, the public investor would not have the opportunity he or she has today to choose from multiple broker-dealers who are offering automated, price-improved executions for less than ten dollars.

Even Nasdaq is now publicly acknowledging that it had been earning much more in market data fees than was needed to cover its regulatory and operational expenses. This acknowledgment is evidence that, if allowed to, competition works. All of the savings described above were accomplished through competitive forces rather than legislative or regulatory mandate. If, as Reg NMS suggests, the SEC is not going to address the explicit cost of market data by lowering the overall size of the market data revenue pool, then it is important that the Commission preserve a competitive environment among self-regulatory organizations ("SROs") in order to continue to indirectly bring down the cost of market data for the brokerage community and the public investor.

The premise that a trade-based formula creates economic distortions, regulatory distortions, or inappropriate incentives to engage in fraudulent behavior does not warrant the proposed change to market data revenue allocation. Even if one believes that fraudulent activities are encouraged by the current distribution system, such actions represent rule violations that are already being regulated by effective SRO enforcement programs. The potential for such malfeasance no more justifies the adoption of the proposed costly solution than the potential for speeding justifies closing down the highway system. To the extent that the Commission would like to reduce any perceived incentive for brokers to break up trades, the current Nasdaq approach for sharing market data, which averages trade and share market share, may provide a simple means for reducing this incentive for NYSE and Amex-listed securities.

The proposed formula amendment is unnecessarily complex, misguided in its price discovery value judgment, and expensive to administer. Because of its inordinate complexity, the formula has become a poster child in the industry for the inherent limitations of regulation. Elimination of the price improvement portion of the proposed formula is certainly a step in the right direction in terms of eliminating unnecessary complexity. However, if the SEC determines to adopt the remaining quote portion of the formula, NSX believes that it is important to prevent manual quotes from receiving any revenue distribution because such quotes do not accurately reflect the current state of the market and are not accessible.

On the issue of price discovery value, the formula proposes to include only trades that have a dollar value of $5000 or greater as eligible for market data revenue. By the SEC's own admission, this methodology would exclude 50% of all trades that are reported to the tape. The belief that trades with less than $5000 in dollar value have no price discovery value defies logic. For example, the new formula includes a 100-share trade of a $55 stock like Johnson & Johnson but excludes a 1200-share trade a $4 stock like Sun Microsystems, even if the Sun trade creates a new high or low of the day. The fact is that, in the current electronic trading environment, all trades have price discovery value.

With respect to the administrative expense of the proposed formula, the National Market System is now generating over 18 million NBBO quotes daily across eight market centers. Imagine the ongoing cost of determining how many thousands of quote credits each particular quote is due for each of the 23,400 seconds in each trading day. The calculation becomes particularly ludicrous if you consider that, in one example provided in the release, a single quote that equaled the NBBO for three seconds would be entitled to 12,000 credits. While

NSX appreciates the desire of the Commission to encourage quote competition, the benefits of doing so through the proposed formula amendment simply do not come close to outweighing the new formula's administrative costs.

Vigorous quote competition already exists today. The fact is that price discovery is centralized electronically today on a public investor's personal computer. The combination of the SEC order handling rules, easily accessible market data, and electronic order routing and execution now provides a highly efficient price discovery process. Compared to a monopolistic, physically centralized marketplace, the price discovery in this electronic environment has the additional advantage of encouraging competition between exchanges, which results in technological innovation, cost reduction, and disaster recovery protection that would never occur if all order flow were physically concentrated on one exchange.

Whatever action the SEC ultimately takes in the area of market data revenue, NSX would like to suggest three additional initiatives. First, it is vital to combine such action with changes that require quote and trade market data to become real-time. To do otherwise would be to ignore the premise on which the quote competition and the value of market data are based: that the Consolidated Quote and Consolidated Tape reflect accurately the current state of the market. More specifically, the Consolidated Quote Plan's ("CQ Plan") sixty-second quote update provision and the Consolidated Tape Plan's ("CT Plan") ninety-second trade reporting provision must be significantly reduced. Given the electronic nature of the trading world today, real-time market information – which is the stated purpose of the CQ and CT Plans – means automatic quote updating and automatic trade reporting.

Second, the SEC should ask the General Accounting Office to conduct a financial audit of the Tape A, B, and C Securities Information Processors ("SIPs"). Such an action will ensure that inappropriate exchange or association expenses are not finding their way onto the SIP financial statements and that the SIP charges are reasonably related to the cost of collecting, validating, and disseminating market data.

Third, the SEC should become actively engaged in the establishment of an independent SIP administrator for the trading of Nasdaq-listed securities. This effort has floundered for a long time and will simply not be accomplished without active SEC involvement.

Access Fees

NSX supports the Commission's objective to expand the public investor's low-cost access to the best available price. NSX is puzzled, however, by the

Commission's willingness to become so deeply involved in transaction fee rates – an area of intense market competition – when the Commission, in the same release, specifically eschews rate setting in another area – market data – where the Commission has granted the exchanges and Nasdaq monopoly pricing powers. It seems inconsistent, on the one hand, for the Commission to say that it will not touch a $425 million pool of market data revenue but then, on the other hand, for the SEC to attempt to legislate a cap of $0.002 on exchange and ECN access fees. To the extent that the Commission is focused on correcting an inequity – the ability of ECNs but not market makers to charge access fees – it appears that a more sensible solution might be to let market makers charge access fees and then let competition dictate the rest. If best execution includes the lowest transaction charges as well as the best price and the best technology, then market discipline will impose transaction fee limitations in a more sensible, less artificial way.

NSX sees no harm in rewarding broker-dealers for providing liquidity. In fact, liquidity provider fees contribute to a fair and orderly market: they help dampen intra-day volatility because they encourage broker-dealers to provide liquidity.

With respect to the issue of "attributed" quotes, the SEC proposal gives the primary markets an immediate advantage because, in the case of the NYSE, it has a sole specialist model, and, in the case of Nasdaq, it currently has the capability to attach a market maker identifier on each of its quotes. NSX and other exchanges that utilize a multiple specialist market structure have been trying unsuccessfully for years to get the NYSE and Nasdaq, as Securities Information Processors for Tape A, B, and C, to develop the capability for NSX and others to attach a market maker identifier to their disseminated quotes. Obviously then, before the access fee quote section of Reg. NMS could be implemented, the SEC needs to first ensure that the SIPs have developed a multiple market maker participant identifier capability for all their participants so that these participants can comply with the "attributed" quote requirement.

<u>Sub-penny Pricing</u>

NSX supports the Commission's proposal to establish $0.01 as a minimum increment for quoting securities. NSX understands the benefits that sub-penny pricing can bring to market efficiency and price improvement. However, the Exchange believes these benefits are outweighed at this time by the certainty and order that the establishment of a minimum price variation will provide. NSX does believe that, once the entire trading community has become more comfortable with electronic trading, future conditions will probably warrant a reassessment of the $0.01 minimum price variation standard.

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We appreciate the opportunity to express our views on this important proposal. If the Commission or its staff has any additional questions, please call me at 312.786.8894.

Sincerely,

David Colker
Chief Executive Officer and President

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

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Ms. Lori A. Richards, Director, Office of Compliance Inspections and Examinations
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