The Security Traders Association of New York, Inc.

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

JAN 25 2005

RE: Release No. 34-50870; File No. S7-10-04
Proposed Rule: Regulation NMS

Dear Mr. Katz:

The Security Traders Association of New York, Inc. ("STANY")[1] respectfully submits these comments in response to the above captioned Release No. 34-50780 34, File No. S7-10-04 ("Reproposal" or "reproposed Reg. NMS"). [2] We recognize the effort expended by the Commissioners and staff of the Securities and Exchange Commission (the "Commission" or "SEC") in evaluating comments made in more than 700 letters and in testimony taken in response to the original Reg. NMS filing of February 26, 2004 and the subsequent Reg. NMS filing of May 20, 2004. STANY commends the Commission for evaluating and attempting to address the complex issues facing the national market system ("NMS") and taking the time and effort to hear from market participants at all levels. We are especially grateful to have the opportunity to comment on the Reproposal.

Since 1937, STANY has represented the largest affiliate of The Security Traders Association ("STA"). The membership of STANY is comprised of individuals involved in all aspects of equity trading. In formulating comments to the Reproposal we have once again asked our members to put aside individual interests and biases and focus instead on the best interests of all market participants, especially the investor. Our members may have different business models[3] but they have a shared interest in fostering efficient and liquid markets and in promoting investor protection. As a group of traders, we are extremely concerned about maintaining the integrity and premier status of the US equity markets. STANY fully supports the principles of price transparency through aggressive quoting, market efficiency, order and market competition, reduction in trading costs, and best execution. However, we take a different view from the Commission staff as to how to best achieve these objectives.

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[1] STANY is a professional trade organization serving individual traders in the New York metropolitan area. STANY works to improve the ethics, business standards, and working environment for its members, who are engaged in the purchase, sale, and trading of securities. STANY represents the shared interests of its approximately 1,700 members from over 300 firms and is the largest affiliate of The Security Traders Association (STA).

[2] STANY previously submitted a letter to the Commission dated June 30, 2004 in response to Release-No. 49325 Release No. 34-49749, File No. S7-10-04 ("Supplemental Request for Comment"). STANY respectfully requests that its prior comments be incorporated herein by reference and that the Commission consider its comments as a whole.

[3] STANY's present membership is diverse. Members are employed by order execution facilities, national securities exchanges, and national securities associations, buy-side and sell side trading firms, etc. While we have attempted to gain a consensus wherever possible, given the diverse nature of the business in which our members are engaged, the views expressed herein may not necessarily be shared by each and every member.

The Commission noted in the Reproposal " The NMS need to be enhanced and modernized, *not because it has failed investors, but because it has been successful in promoting growth, efficiency, innovation and competition that many of the old rules are outdated.*"[4] (Emphasis added) We, at STANY, agree. The United States has the most efficient and robust markets in the world. We believe that it is imperative that **change only be effected if it is necessary and truly in the best interests of the US markets.** Investor protection should be paramount, but capital formation and maintenance of our premier status, is essential if the US is going to continue to provide the best markets for investors and businesses alike. We are especially thankful to see that Commissioners Atkins and Glassman are cautious about the Reproposal. We appreciate that they, not only see no need to rush to implement regulation, but that they acknowledge that hasty changes to a healthy market may result in harm. We urge that caution be exercised when making changes as extensive as those contemplated in the Reproposal. The potential unintended consequences and hidden risk to the US markets should not be ignored or downplayed. The sweeping changes contemplated by the proposed rule dictate the need for careful consideration to avoid the potential for creating greater harm than the hoped-for benefits.

Summary of STANY's Position

The Commission's attempt to enhance the regulatory structure of the US markets and modernize the National Market System is laudable. Although STANY does not support the adoption of the inter-market Trade-Through Rule- Rule 611(also known as the Order protection rule), we believe that other provisions in Reg. NMS would be beneficial to an orderly, and efficient national market system and should be adopted.

We support those sections of Reg. NMS that are designed to achieve more efficient access to quotes and that recognize a distinction between manual and automated quotes. For example, we support the inclusion of the definition of automated quotations and automated trading centers in Reg. NMS and believe that manual quotes should be excluded from best execution statistics with, or without, an inter-market trade-through rule. We likewise believe that, even in the absence of an inter-market Trade-Through Rule, "intermarket sweep orders" would be beneficial to market participants in meeting their Best Execution obligations. As discussed in more detail below, with certain reservations, we support a cap on access fees, however, we believe that that cap should not be limited to "protected quotes" as defined in Reproposed Reg. NMS but should apply to all access fees regardless of whether they are "protected" by a trade-through rule. We also appreciate the Commission's acknowledgment of the importance of fair access and connectivity to the orderly functioning of a national market system. We wholeheartedly support the Sub-penny proposal and are pleased to see progress towards a more equitable distribution of Market Data Fees.

Other aspects of the Reproposal are troubling to us. We have serious concerns about the reproposed Trade-Through Rule Alternatives and questions about the Access Rule. Our concerns are addressed below. Once again, we thank the Commission for giving us the opportunity to express our position and for taking the time to consider our comments.

ACCESS RULE

Competitive forces rather than a mandated inter-market Trade-Through Rule will better achieve the goals of a NMS envisioned by Congress.

STANY believes that the most effective way to promote competition among orders and among market centers, reduce trading costs to investors, and ensure that the markets keep pace with technological changes is to mandate connectivity and access between market centers and participants. If market centers were fully connected, the NMS would emerge from the competitive forces envisioned by Congress. Given connectivity and auto-execution each market center would have to compete for order flow based on its offerings to investors and the efficiency of its model. Liquidity would gravitate to the most

[4] Reproposal at page 10.

efficient provider. Winners and losers would emerge based upon which market participants best meet the demands of their clients. Market centers would be driven to innovate and effect positive changes in order to attract order flow. Those who do, will flourish and those that did not, will fail.

We believe that the US markets function extremely well because for the most part there are multiple markets trading any particular security. Volume is currently dispersed among competing markets and market models based upon choices made by market participants. Vigorous competition and innovation in the US equity markets are the direct result of multiple trading models and multiple trading participants.

Access to quotations

STANY believes that the Commission vastly underestimates the access issues presented in its Reproposal. Since, the primary goal of proposed Reg. NMS is to achieve electronic access to quotes in all domestic markets, we believe the physical realities of compliance undermine the primary salutary objective of the proposed rule.

Electronic access to a quote published by any market requires some sort of electronic connection to that market and the software necessary to communicate with that market. Each connection represents a point of failure – if a market participant is to be assured of relatively constant access, there must be hardware and software redundancy. Moreover, each connection and its software must be maintained, which implies regular hardware and software upgrades for users and vendors. The number of connections that must be installed and maintained therefore multiplies the cost of access.

In a perfect world, each market would use the same system to publish electronic quotes and communicate with other markets. A world of competition is never perfect. Accordingly, each of the various existing markets has developed widely different protocols for entering quotes into, and communicating with, its systems. These markets have developed proprietary systems that are marketed based on their cost, ease of use, various functions and speed, to name just a few differences. In each case, this implies different proprietary software and communications protocols.

A market participant wishing to access any particular market must develop a system, or use a system developed by some third party, such as BRASS, that has developed the hardware and software necessary to communicate with that market. The expense of access increases proportionally by the number of markets that must be accessed. At the present time, most Nasdaq market makers can readily access any quote published in the Nasdaq market by developing an electronic connection with Nasdaq, primarily through the use of BRASS or some other system developed and maintained by a third-party vendor. Larger market makers may have separate electronic connections to one or more ECNs. A few may also have some form of electronic access to the New York Stock Exchange, but electronic access to the New York Stock Exchange is at a primitive stage of development.

The ADF is not a single market. Accordingly, it is possible for hundreds, if not thousands of ECNs or market makers to publish quotes as a separate market center in the ADF. Under the Reproposal, any ECN or market maker that published quotes in the ADF would have to be accessed electronically, if either its top of book or voluntary published depth of quotes were traded through. **We firmly believe that some limits must be imposed on the number of markets that are required to be accessed and the manner of access, or Reproposed Reg NMS will fail as a matter of economic reality.**

The Reproposal states that, "those ATSs and market makers that choose to display quotations in the ADF should bear the responsibility of *providing a level and cost of access to their quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.*"[5] *(Emphasis added)* The Reproposal fails to take into account the fact that each point of access will require a separate connection and the development of appropriate software to achieve this access. Even if the cost of development and maintenance were identical to the cost, for example, of accessing

[5] Reproposal at page 100.

Nasdaq's quotes, the cost of accessing more than one or two additional markets would be prohibitive for most of STANY's members. It should be noted that the cost of connection to Nasdaq is quite expensive.

Most market participants achieve linkage through private vendors, rather than through internally developed proprietary systems. In turn, the network of private linkages is driven by private business decisions and based on customer demand. **Linkage to any other market center or ECN quoting in the ADF is, for the most part, outside of the control of any individual ATS or market maker**. For truly effective linkage, a number of key vendors, e.g., BRASS, *royal*blue, LAVA, REDI, would have to establish linkage if the bulk of market participants are to access the new ATS's or market maker's quotes. This requires time and money and needs to be a business priority of the linkage vendor.

If linkage vendors are focused on other programming priorities, e.g., to prepare for the NYSE Hybrid and new Reg. NMS rules, this programming effort may be subject to excessive delay. Our concern is that it is significantly easier, practically speaking, to get a quote published in the national market system (which has a public utility) than it is to ensure effective linkage via several private vendors.

STANY is also concerned that the Commission has relied unduly on private linkages to achieve the electronic access demanded in the Reproposal. We are especially concerned about the notion that cost differences in the membership of different markets will be equalized by SRO members charging fees for linkages to quotes on their market. This would seem to be another form of access fee that would have the extremely undesirable effect of subsidizing the cost of SRO membership by private fees charged for linkages to that SRO's market. Economic reality dictates that these subsidies would insulate certain markets from competitive pressures.

STANY submits that a member of any SRO should be able to achieve access to any quote that it is required by law or regulation to access through electronic access to that member's SRO. A member should not be required to establish linkages and develop software to communicate with multiple markets as a matter of regulatory compliance. That should be true for any market whether the ADF, NYSE, Nasdaq or any other.

Markets that wish to encourage members to access quotes by private linkages may offer services and cost advantages to encourage direct linkages to those quotes. Each member could then decide on a case-by-case basis whether it makes economic sense to incur the cost and effort to establish and maintain a private link with other markets.

STANY therefore proposes that, as a condition of requiring members of other SROs to access their quotes, each market should be required to provide a connection to the market from which it seeks protection. The market seeking protection should make its quotes accessible to other markets' participants in the same manner and at the same cost as other quotes published in that market.

For this reason, we advise the Commission to consider the following alternatives:

1. Require the Nasdaq and UTP market participants to develop a public inter-market linkage facility for the Nasdaq trading environment or alternatively,

2. Require any SRO to maintain linkages with any and all quoting market participants that are required to access that SRO's market and,

3. Require the development of routing standards for the nine SROs and Nasdaq that enable order routing firms to send inter-market sweep orders that identify trading centers to be excluded from the inter-market sweep exception. In this scenario, receiving market centers would be subject to trade- through obligations under Rule 611 for identified trading centers (i.e., trading centers with which the order router does not have connectivity.)

Access Fees

STANY favors the abolition of access fees, however, if the Commission elects not to eliminate these fees, STANY supports a per share cap.

It has been STANY's long-standing position that access fees charged to non-subscribers by ECNs should be eliminated. We commented on access fees at length in our June 30, 2004 letter in response to the original Reg. NMS proposal and incorporate those comments herein by reference.

Despite the position which we have heretofore taken, STANY is grateful to the Commission for its efforts to correct the distortions in the market created by the footnote in the Order Handling Rules that resulted in a proliferation of access fees. We understand the difficulty, which the Commission has had in coming to terms with the disparate views on this subject and appreciate the effort that has clearly been expended in seeking a workable resolution.

In the absence of a complete elimination of non-subscriber access fees, STANY supports the Commission's compromise of a $0.003 per share cap for securities priced at greater than $1.00 and a cap of not more than 0.3% of the quote price of securities priced at less than $1.00.[6] We are especially supportive of the Commission's extending the right to charge these fees to market makers. Likewise, we are pleased that the Commission proposes capping fees on both displayed and reserve quotes.

STANY encourages the Commission to address the issue of access fess even if a Trade-Through Rule is not implemented and supports the application of a cap on access fees to not only those quotes that are "protected" but to all quotes.

STANY has reservations about the level of fees for quotes that are not "protected." We believe that the limitation on access fees should apply to the entire montage. A tiered approach to access fees- with only "protected" quotes subject to a limitation- will not achieve a uniform quoting convention. The best way to truly level the playing field and establish a uniform trading convention, which would enable market participants to easily understand price, would be to eliminate access fees altogether or in the alternative set a consistent cap.

We strongly believe that a uniform trading convention and a level playing field are in the best interests of the investing public. In discussing its decision to cap access fess the Commission states; " Section 11A(c)(1)(B) of the Exchange Act authorizes the Commission to adopt rules assuring the fairness and usefulness of quotations in information. For quotations to be fair and useful, there must be some limit on the extent to which the true price for those who access quotations, and the true price realized by those who supply liquidity for quotations can vary from the displayed price." [7] We agree with the Commission that harmonizing quotation practices is, not only consistent with the statutory purposes of the NMS, but also in the best interests of investors.

In the absence of elimination of access fees, STANY, supports a fee cap across the board- for "protected" and "unprotected" quotes, whether there is an inter-market trade-through rule or not. Likewise, we believe that all market participants that display quotations through a trading center's facilities should be permitted to charge access fees irrespective of whether their quotes are "protected" by a trade-through rule.

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[6] Some members of STANY are opposed to rate setting by the Commission and therefore oppose the fee caps proposed in Reg. NMS. Other members have suggested that, a cumulative cap of $0.001 per share would be more appropriate than the $0.003 selected by the Commission. However, recognizing the difficulty that the Commission has had in reaching a workable compromise, the majority of our members, in the absence of abolition of access fees, do not oppose the caps suggested by the Commission.

[7] Reproposal at page 107.

TRADE-THROUGH RULE

In a letter dated June 30, 2004 in response to the original Reg. NMS proposal, STANY expressed its belief that an **inter-market Trade-Through Rule was unnecessary**:

> STANY believes that there will be no need for a uniform trade-through rule if issues of connectivity, access, and automatic execution are adequately addressed. If the National Best Bid and Offer ("NBBO") in every market is immediately accessible to away markets then, STANY believes that, broker-dealers' Best Execution obligations would be sufficient to protect the interests of all investors and ensure that superior prices are sought. Additional regulation, in the form of a trade-through rule, is both unnecessary and anticompetitive.

We have carefully listened to the on-going discussions and read the many letters submitted by interested parties in response to the original Reg. NMS release. The dialogue has been healthy and the debate vigorous, but we have heard nothing since June to cause us to change the opinion, which we expressed in our June 30, 2004 letter. **We continue to question the need for an inter-market Trade-Through Rule and urge the Commission to implement only such regulation as can be proved <u>necessary</u> and likely to achieve the goals of a NMS.**

<u>Access, automation and competitive innovation, not Regulation, is the better approach to an efficient, cost effective, and robust NMS.</u>

In the Reproposal, the Commission staff acknowledges that: "...[T]he very existence of intermarket protection against trade-throughs is premised on the ability of trading centers to trade with, rather than trade through, the protected quotations displayed by other trading centers." [8]. **We agree that without efficient inter-market access to quotes an inter-market Trade-Through Rule would be ineffective.** Furthermore, we believe that with efficient inter-market access to quotes a Trade-Through Rule would be unnecessary. **In other words, the Trade-Through Rule will not work without efficient inter-market access, but will not be needed once efficient inter-market access is ensured.** Therefore, STANY believes that there should be no inter-market trade-through rules.

In the interests of the best national market system possible, we believe that the Commission should approve the access rule proposal (with certain exceptions noted below), abolish all existing trade-through rules, and allow the NYSE to implement its proposed enhancements to Direct+[9]. Once these enhancements to the markets are effected, the Commission can reevaluate the need for an inter-market trade-through rule based on this experience. **Only after connectivity and access are achieved can there be a proper determination as to whether there exists a problem that requires market-wide trade-through regulation.**

We believe it is in the best interests of the US markets, investors and all market participants for the Commission to take a measured, step by step approach rather than to create regulation that could, at best be redundant and at worst might "undermine the fundamental principals that make our markets strong,

[8] Reproposal at page 92.

[9] Exchange Act Release No. 34-50667, File No. SR-NYSE-2004-05. The NYSE has spent considerable time and effort to formulate a plan, intended to transform its Direct+ automated trading platform into a viable competitor to other electronic based market centers. STANY believes that the NYSE should be permitted to implement its Hybrid model as quickly as possible in pilot form. Although we may have had numerous questions about the original NYSE proposal, we were pleased to see the NYSE issue a second release addressing many of the concerns raised by STANY and others in their letters of comment. In light of the announcement of the SEC's Reproposal, STANY had not submitted comments to the NYSE's second proposal. While we have several questions and take some issue with portions of the filing, (such as sweep functionality and the broker interest file) we commend the NYSE for its move toward modernizing its marketplace.

including innovation, competition, and ever-increasing efficiency."[10] **We strongly oppose additional regulation without demonstrative evidence that such regulation is necessary and will advance Congress's mandate with respect to the NMS.** We do not believe that the Commission has demonstrated a problem that requires a regulatory "fix."

<u>Data used to support the Commission's finding does not support the need for an inter-market Trade-Through Rule:</u>

The Commission staff has submitted justification for the need for an inter-market Trade-Through Rule based upon a study[11] of four trading days conducted by the Office of Economic Analysis, in which it is concluded that 7.9% of the total volume in the NYSE and 7.2% of the total volume in Nasdaq constitute trade-throughs[12]. When looked at as a percentage of trades that number is approximately 2.5% in both the NYSE (where there is a trade-through rule) and Nasdaq, (which presently does not have a trade-through rule.) While the Commission staff characterizes these percentages as "significant", we agree with Commissioner Atkins that trade-throughs of 2-3% of total trades in Nasdaq and the NYSE do not rise to a level that justifies the massive restructuring of the markets as suggested in the Reproposal.[13]

Using the Commissions numbers- **97.5% of the "regular" trades done in both markets already are executed at the best available price.** The NYSE, which currently has a trade-through rule, fairs much the same in the Commission's study as Nasdaq, which functions without a trade-through rule. In markets where only 2.5% of trades represent trade-throughs we should ask ourselves- how much lower can we realistically go? And should an attempt to achieve this marginal improvement by made without consideration of the costs- both monetary and in terms of potential unintended consequences?

Moreover, we are confident that even this small number of trade-throughs would be substantially lower if fair and efficient access was available when the study was conducted. We note that the study states, "In Nasdaq issues, trade-throughs occurred less frequently on the ArcaEx. The comparatively low ArcaEx trade-through rate likely reflects their electronic trading model..."[14] We believe that the majority of trade-throughs presently occur because market participants either, cannot access better quotes in certain away markets or, choose not to because the fees to access these "better priced" quotes are excessive.

Also, in determining whether trade-throughs are a problem that require significant SEC intervention, consideration should to be given to the fact that at least some portion of trade-throughs observed in the

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[10] Speech by SEC Commissioner Paul S. Atkins: Remarks before the Open Meeting to Consider the Reproposal of Regulation NMS December 15, 2004, at page 1.

[11] STANY does not purport to know whether the Commission's analysis of trading on four dates in 2003- September 18, October 16, November 20 and December 18, 2003- is in fact accurate. As the report acknowledges accurate trade-through analysis is difficult: "While trade-through identification seems straightforward, in practice it is complicated by quickly changing quotes, systems time lags, data limitations, and imperfect access to markets." *Memorandum from the Office of Economic Analysis "Analysis of Trade-throughs in Nasdaq and NYSE Issues"* dated December 15, 2004 at page 1.

[12] The Commission notes that block trades account for 50% of the trade throughs in both markets.

[13] Speech by SEC Commissioner Paul S. Atkins: Remarks before the Open Meeting to Consider the Reproposal of Regulation NMS December 15, 2004 at page 4. "The release indicates that the trade through rule is also needed to address the "significant" number of trade throughs. This significant number amounts to a "whopping" 2-3% of total trades in both the Nasdaq and NYSE. The staff represents that the absence of a stronger trade through rule cost American investors a total of $326 million in 2003. This amount represents roughly .002% or the approximately $17 trillion in total dollar share volume that traded in both markets last year. But, just last month in our SRO Concept Release we said that the $410 million in market data costs to the industry was minimal. I question what the true cost to American investors will be if the proposed reform instead negatively affects the efficiency of the markets, increasing spreads and internalization and thereby, increasing transaction costs for investors."

[14] *Memorandum from the Office of Economic Analysis "Analysis of Trade-throughs in Nasdaq and NYSE Issues"* dated December 15, 2004 at page 3. The SEC notes that 1.6% of trade on ArcaEx were reported as trade-throughs versus 26.3% on the American Stock Exchange. The SEC attributes this discrepancy to the differences in trading models between the electronic ArcaEx and the manual AMEX.

study were inadvertent and/or caused by the inability of traders to "see" the better price. Likewise, we question how many of the 2.5% trade-throughs in the Commission's study were attributable to such systems issues as false positives or clock drift. Trade reporting can also account for some of the apparent trade-throughs. Nasdaq requires that a trade be reported within 90 seconds of execution.[15] The difference between execution time and the time that a trade is reported, especially in block trades, may result in trades being reported out of sequence. What appears to be a "trade-through" is often simply an out-of sequence report. If each of the above factors were considered, we believe that the already low incidences of trade-throughs noted by the Commission would be much lower.

In addition, there has been no demonstrated problem with trading on Nasdaq, which would justify the extension of a trade-through rule. Imposition of a trade-through rule upon the Nasdaq market may in fact create a problem where none exists today. STANY would like to refer the Commission to a study conducted at the University of Pittsburgh in 2003[16], which compared the trading of similar stocks on Nasdaq and the NYSE during periods of "stress". The conclusion, in short, was that bid-ask spreads were shown to be narrower and liquidity shown to be greater in the Nasdaq stocks. We strongly oppose changing the way in which Nasdaq stocks are traded.

We question whether the Commission is correct in assuming that an inter-market Trade-Through Rule will in fact be an incentive for investors to place more limit orders.

At a meeting on Regulation NMS at the American Enterprise Institute on January 11, 2005, Eric Roiter, Senior Vice President and General Counsel of Fidelity Management & Research Company, acknowledged that it is unlikely that any Trade-Through Rule would achieve the Commission's sought for result of expanding the placement of limit orders. He speculated that there might be a marginal increase in retail customer limit orders, but that institutional investors, representing the vast majority of US investors through mutual funds, would be highly unlikely to place additional large-sized limit orders even with inter-market trade-through protection. His estimation confirmed our conviction that the Trade-Through Rule will have little effect on those who place limit orders. Presently, institutional investors are reticent to place large limit orders on the NYSE, even though trading on the NYSE is subject to a trade-through rule. When Nasdaq implemented SuperMontage it was assumed that with increased automation there would be increased incentive for market participants to place limit orders. Reality proved otherwise- market participants were no more interested in "showing their hands" than before.

Institutions and other investors hesitate to place limit orders, not because of the 2% risk that their displayed orders might be traded-through, but rather because limit orders act as free options to the market and carry with them market impact costs. Disclosure of trading interests, especially interests of institutions which frequently trade stock in large blocks, raise trading costs for those institutions to the detriment of their customers. The Trade-Through Rule will not only fail to return the result of increased limit order placement, but it may ultimately be counter intuitive to the SEC's stated objective[17] of lowering trading costs for the long-term investor. [18]

[15] NASD Rule 6420- Trade Reporting.

[16] *Information Shocks and Stock Market Liquidity" A Comparison of the New York Stock Exchange and Nasdaq*, Kenneth Lehn, Sukesh Patro and Kuldeep Shastri, Joseph M. Katz Graduate School of Business University of Pittsburgh, presented at a conference organized by the American Enterprise Institute, June 10, 2004.

[17] Reproposal at page 63. " The Commission believes that two of the most important public policy functions of the secondary markets are to minimize trading costs for the long-term investor and to reduce the cost of capital for listed companies."

[18] STANY is concerned that the Commission is unduly favoring long-term investment strategies over short-term trading. It should be considered that both long-term investors and short-term traders assume risk and importantly, both commit capital and provide liquidity.

<u>STANY is not in favor of either the Market BBO or the Voluntary Depth Alternative proposal.</u>

The Reproposal requests that interested parties choose between two alternatives to the Trade-Through Rule – a Market BBO Alternative (also known as "Top of Book") and a Voluntary Display Alternative ("DOB"). **Neither choice is justified by present market conditions.**

The DOB Alternative would undermine the competitive strength of the US equity markets and substitute regulation for customer choice.

In the Reproposal the Commission states that Reg. NMS is "designed to strengthen and enhance the efficiency of linkages among the various competing markets, but without mandating any particular type of trading model" and that "[i]nvestor choice and competition will determine the relative success or failure of the various competing markets."[19] STANY supports the principals articulated by the Commission, but believes that contrary to these stated objectives, the DOB Alternative will eliminate investor choice and stifle competition among market centers.

The DOB Alternative could delay the NYSE's Hybrid and/or render it moot.

If inter-market depth protection were to become a policy mandate, this would appear to require a significant change to the NYSE's Hybrid Proposal.[20] The 'sweep order,' Liquidity Replenishment Points (LRPs) and other fundamental features of the Hybrid were specifically designed to take out top-of-book quotes and then to sweep through the NYSE's depth of book. These features would need to be redesigned and could delay the rollout of the Hybrid market. As Commissioner Atkins noted, the DOB Alternative would "render the hybrid model dead on arrival." The NYSE has already made significant developments in this process of market structure evolution. Its Hybrid model provides the access and functionality necessary to access its book electronically. From this, brokerage firms will be able to access the NYSE and other markets simultaneously to give customers best price. We, like Commissioner Atkins, are interested in seeing the NYSE implement its plans for enhanced electronic trading and urge the Commission to reject a proposal that would moot the efforts made by the NYSE.

Costs of implementation of a DOB Alternative would far outweigh any possible benefit.

Any perceived or contemplated benefits of extending the Trade-Through Rule to cover the DOB would be outweighed by costs and difficulties of implementation. We do not believe that DOB protection can be implemented in a practical and cost effective manner. Areas of potential concern include general costs of implementation, increase in market data fees, capacity issues with quote dissemination and exponential exacerbation of issues relating to surveillance, compliance and exception reporting.

For example, the capacity problems of dissemination of DOB quotes can be illustrated by looking at just one security. Currently Microsoft (MSFT) has approximately 90 market makers and ECNs in its quote montage. Given that there are 100 possible price points per dollar (assuming quoting will be limited to penny increments) there could potentially be 9000 separate quotes per dollar. Multiplied by the current price of MSFT- $27 theoretically there could be quotes at 243,000 price points for that one stock alone. While it may not be common to have quotes on a broker-dealer's books that are so far away from the NBBO, it is possible. Certainly there are quotes that are more than one dollar way from the inside. Just considering the Nasdaq 100, for each dollar theoretically you could have 1 million quotes (100 price points X 100 market makers per stock X 100 stocks) If you consider quotes more than $1 away from the inside or stocks outside the Nasdaq 100, the number jumps significantly. Quote traffic chokes the data pipeline now (an unintended consequence of decimalization) but the possible exponential growth in

[19] Reproposal at page 11.

[20] Amendment No. 2 to File No. SR-NYSE-2004-05 Relating to Amendments to NYSE Direct Plus+, filed November 8, 2004 (referred to as "Hybrid 2"), which amends Amendment No. 1 to File No. SR-NYSE-2004-05, filed July 30, 2004 (referred to as "Hybrid 1").

quote traffic from DOB protection would be enormously problematic, even if taken to levels significantly below those used in this example.

<u>The Market BBO Alternative is logically flawed and should be rejected.</u>

STANY notes that several market participants have submitted comments in support of the Market BBO Alternative as a compromise between trade-through protection and competition. We do not believe that a "compromise" alternative is appropriate, especially given the lack of evidence suggesting that a trade-through rule is necessary.

Not only is the Market BBO Alternative a poor compromise, it is also logically flawed. **The Market BBO Alternative offers protection to quotes in one market that may be inferior to quotes in another market.** For example, assume that the NYSE shows bids in XYZ security as follows: 20.00 for 1000 shares and 19.99 for 20,000 shares. At the same time the best bid in XYZ on ArcaEx is 19.90 for 1,000 shares. Under the Market BBO Alternative 19.90 bid on ArcaEx would be protected but the superior 19.99 bid on the NYSE would not be. In a NMS that is truly connected, and where the NYSE Hybrid market is given an opportunity to develop, there would be no need for this type of "protection". In such a market, all three bids would be executed and given "protection" in the proper sequence.

Under the Market BBO Alternative market participants will have an incentive to enter quotes in a particular market based upon the likelihood that their quotes will be protected in that market. We expect that many, perhaps hundreds or thousands, of market centers will become ADF participants seeking to gain "protection" for quotes, that while top of the ADF, may be inferior to quotes in other markets. The cost of linkages to all of these ADF market centers would be prohibitive and wasteful. Currently market centers compete for order flow based upon their offering to investors and the efficiencies of their market model. With the Market BBO Alternative, market participants can be expected to spread liquidity over the nine SROs, and Nasdaq based on the likelihood of their orders being the Market BBO. We believe that increased fragmentation will be an undesirable and likely consequence to the Market BBO Alternative proposed by the Commission.

<u>If the Commission imposes an inter-market Trade-Through Rule for all NMS securities, only the NBBO should be protected.</u>

Given our belief that an inter-market trade-through rule constitutes unnecessary, excessive and unjustified regulation, if the Commissioners vote to impose such a rule, we suggest that the it is incumbent upon them to fashion a rule that is both supportable and that will minimize the likelihood of unintended negative consequences.

If it is truly the Commission's goal to protect the **best price** for all equity securities as an incentive to investors to place limit orders, then that is what should be done- **protect the "best" price which is the NBBO.** To the extent that the Commission believes that price protection is necessary as an inducement to market participants and investors to place limit orders, then protection of the NBBO should induce the placement of the best priced quotes. An NBBO price protection rule is logical and consistent with the stated objectives of a trade-through rule and would minimize the potential for unintended harm to the markets.

<u>STANY is concerned about specific aspects of the Trade-Though Rule as drafted in the Reproposal.</u>

<u>STANY opposes the inclusion of manual quotes in the NBBO for purposes of measuring Best Execution.</u>

We applaud the Commission for its distinction between automated quotes and manual quotes. The definition of an automated quote in the Reproposal is reasoned and considered and shows the care with which the Commission staff listened to comments made in connection with the original Reg. NMS proposal and the supplemental release. However, we would strongly argue for the exclusion of manual quotes from the NBBO and from statistical reports on order execution quality under proposed rule 605 and current Rule 11Ac1-5. **Only quotes that are automated and accessible should be part of the NBBO.**

In the Reproposal, it appears as if the Commission is defining Best Execution as best price. STANY is concerned with this departure from the Commission's past position of recognizing that factors other than price legitimately impact execution decisions.

STANY's members firmly believe that factors other than just price determine customer's routing decisions. A key factor is certainty of execution. To the extent that manual quotes do not provide the same level of certainty as automatically executable quotes, it might be in a customer's best interest to avoid them when making trading decisions. To include these quotes in statistical calculations upon which a broker-dealer's execution duties are judged is unfair. Seen in the light of best execution, if quotes cannot be automatically accessed, the industry will likely be held to a standard, which will be impossible to meet. The idea that trade through is governed by the principle of Best Execution needs to be extended to the NBBO.

'Stopped' orders should be excepted from Rule 611.

In deciding not to include a "stopped' order exception to the reproposed Trade-Through Rule the Commission states, "The Commission preliminary does not believe that 'stopped' orders should be excepted from Reproposed Rule 611 because their execution is based, at least indirectly, on the quoted price of a stock at the time of execution and their material terms are known when the commitment to execute the order was made." In our view, this logic is flawed. In the liquidity provision process involving the commitment of capital, the final price of the execution often bears little or no relationship to the quoted market at the time of the execution. While it is true that the quoted price of a stock helps to inform the 'stop price,' the same is not true regarding the quoted price of a stock at the time the order is printed.

STANY believes that a 'stopped' order exception to the Reproposed Trade-Through Rule is essential and appropriate for the following reasons:

1. The frequency with which 'stopped' orders are, in fact, printed without any direct relationship to the quoted price of a stock at the time of execution;

2. The importance of 'stopping' stock plays in a broker-dealer's role as a liquidity provider; and

3. Subjecting 'stopped' orders to Rule 611 will impede a broker dealer's ability to commit capital to block facilitation while providing little added benefit to marketplace.

STANY is also concerned about how the Commission will interpret or define a 'stop' order. If a Trade-Through Rule is implemented without an exception for 'stopped' orders, we request that the Commission provide clarity on how a 'stop' order should be executed to avoid transgression of the rule.

We respectfully request that the Commission except 'stopped orders' from Rule 611. As with VWAP orders, any transaction effected by the broker-dealer during the period in which the 'stop' order is being filled would remain subject to Rule 611.

The Commission should provide additional clarification on the "material delay exception" to the Trade-Through Rule, specifically related to the "objective parameters" for use of this exception.

The Material Delay Exception allows a firm to trade-through the quotes of any market center that is experiencing systems (or other) problems that are slowing down order routing/execution processes. "A trading center would act reasonably in the current trading environment if it bypassed the quotations of another trading center that had repeatedly failed to respond to orders within a ***one-second*** time frame (after adjusting for any potential delays in transmission not attributable to the other trading center)."[21] While a market center would be required to "establish specific and objective parameters for its use of the exception in its policies and procedures," some lingering questions and concerns exist regarding the practical application of this exception.

For example:

- If a market center is having a problem with a limited number of stocks (e.g., two), could a firm trade-through all of the quotes of that market?
- Will a market be required to notify all market participants if it is experiencing material delays or will this determination be made on a case-by-case basis by each individual order routing firm?
- How long does the trade-through exception continue in this situation? e.g., for the rest of the trading day, or up until the market notifies the public that the material delay is over?
- There is material variance among member firms and order routing vendors regarding the sophistication and precision of tools utilized for measurement and source location of system latencies. The ability to identify and measure latency sources becomes more difficult at the sub-second level. How does the SEC intend to ensure consistency across market participants in the measurement and application of this exception?

Our members have concerns about the implementation issues surrounding the ability of a participant to detect when a protected quotation is issued by a trading center that is experiencing a failure or material delay (a.k.a. "self help"). While we believe this is an area that will require on-going dialogue within the industry, we suggest that, at the outset, the Commission require exchanges and other market centers to promptly notify the public when they are experiencing "systems problems" and, in these circumstances, require all quotes to be marked as non-automated quotes. Similarly, exchanges and other market centers should be prepared to promptly notify the public when their "systems problems" are resolved.

We believe that it may also be difficult for the affected trading center to inform all market participants when its quotes are problematic. Therefore, we believe that in addition to requiring that an automated trading center "identify its quotations as manual whenever it has reason to believe that it is not capable of providing immediate responses to orders", the SIP should have override functionality to ensure the "manual flag" is set when instructed to do so by the affected trading center or SRO. However, in the Nasdaq marketplace this should not happen until an independent SIP is in place.

Conclusion

STANY firmly believes that the best way to affect positive changes in the national market system is through enhanced access among markets. Because of the importance of access to the efficiency of the NMS, STANY has suggested several possible ways in which mandated access can realistically be achieved. Automated execution of orders and auto-refresh when orders are filled, combined with mandated connectivity of markets, will bring about the constructive changes that the Commission and market participants hope to achieve- namely efficient markets, enhanced liquidity and transparency, and increased investor confidence. Over-regulation, on the other hand, is likely to result in stifled competition, increased costs to market participants and investors, and a host of other unintended negative consequences.

While we oppose the concept of "trading-through", we view the adoption of an inter-market Trade-Through Rule as unnecessary regulation that is unlikely to achieve meaningful positive changes in the NMS. Given connectivity, auto-execution, and the best execution and agency obligations of market participants, we do not believe that there exists a need for a trade-through rule. More importantly, we do

[21] Reproposal at page 45.

not believe that an inter-market Trade-Through Rule is likely to achieve the goals articulated by the Commission such as increased placement of limit orders. The, at best marginal, gains that may inure from the rule do not justify the costs and difficulties of implementation.

STANY recognizes that regulation is necessary to the securities markets; however, we also believe that it should be enacted judiciously. We urge the Commission to enact only such regulation that is truly necessary to the welfare of the US markets and caution against the imposition of costly regulation that is unlikely to achieve the goals for which it is purportedly recommended. The Commission should allow competition, which has thus far served US investors well, to determine the optimal set of market structure rules.

We appreciate the opportunity to comment on the important changes contemplated in the Reproposal and would be happy to discuss these comments or provide any assistance to the Commission as it may require.

Respectfully submitted,

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