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BOSTON
STOCK EXCHANGE

January 26, 2005

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

RE: File No. S7-10-04 – Regulation NMS

Dear Mr. Katz,

The Boston Stock Exchange ("BSE") appreciates the opportunity to respond to the request for comment on the Security and Exchange Commission's re-proposal of Regulation NMS. We believe this process reinforces the value of public comment and the importance of the vetting of proposals.

The BSE agrees with the Commission that many of the current rules affecting our national market are in need of change in order to keep pace with new technology and its affect on trading practices. The rule proposals support a common thread of competition through greater efficiency where the best execution is focused primarily on best price. We continue to believe that the best price is the most important element of best execution responsibility for all securities.

PREFACE

We have addressed each of the four key rules[1] discussed in the reproposed Regulation NMS and where concerns have surfaced we have presented comment for further consideration.

Overall, we generally agree with the changes presented in the reproposal with the exception of the Voluntary Depth of Book alternative, presented as another choice for the protection of customer limit orders. We have devoted most of our comments to properly amplify the consequences that a Depth of Book alternative could have on investors, the market structure overall, and the BSE.

[1] The four substantive rule proposals are referred to as: (a) A Uniform Trade-through Rule for all Market Centers; (b) a Market Access Rule to modernize the terms of access to quotations and execution of orders in the NMS; (c) Sub-penny Quoting Proposal with certain restrictions on quoting and order routing; and (d) a Market Data Proposal including amendments to rules and joint industry plans for dissemination of market information.

We hope the Commission will consider the areas where we have provided constructive comments and concerns.

EXECUTIVE SUMMARY

Reproposed Trade-Through Rule

The Exchange believes that the reproposed uniform Trade-through Rule is critical to the protection of the customer limit orders through "protected quotes" for all securities. Regulation NMS defines NMS securities to include both NASDAQ and Exchange listed stocks. Minimum investor protection principles should not be bifurcated on the basis of whether a security trades in either a listed or NASDAQ environment.

The two proposed alternatives to the trade-through provision each provide elements of price protection of customer orders. **We agree with the first alternative, "Market BBO Alternative"** (also referred to as the "Top of Book") **as the best and most practical means of protecting the best bid and offer in each market.** We do not support the second alternative, the "Voluntary Depth Alternative" (referred to as "Depth of Book" or "DOB") that is intended to offer protection of quotes at multiple price levels.

Market Access

The Exchange supports the establishment of a uniform market access rule to enable limit order book protection either directly or indirectly through a member in a non-discriminatory basis.

The Exchange had previously opposed the proposed $.002 fee cap per share in favor of competitive rates for transactions and other services. **The Exchange continues to believe that competition remains as the principal driving force in setting fees to retain and/or attract business.** We do not believe the SEC should be setting fee caps to resolve a problem created by certain past ECN locked market practices.

Sub-Penny Quotes

The Exchange supports the reproposed restriction on sub-penny quoting in NMS issues of $1 or above and for NMS issues less than $1 a restriction based on the price of the quotation or order in increments smaller than $0.01 rather than the price of the NMS stock itself. **We also support retention of trade reporting in sub-penny increments** in order to recognize mid-point or VWAP algorithms and for the purpose of providing price improvement.

Market Data Rules

The Exchange opposed the original proposal because of the complexity of the formula and the exclusion of trades under $5000. We recognize the need to address certain distortions that have surfaced under the current Plan formulas. **The reproposed formula addresses our primary concerns expressed in our earlier response**. The new proposal should be re-evaluated periodically, in part, because we are not able to project at this time, the true impact of the quoting share of the formula at the NBBO. **A pilot approval process is needed to address potential unintended consequences.**

DISCUSSION

The Commission states that its objectives of the reproposed rules are intended to strengthen the NMS in three primary ways.

1. "... update antiquated rules."
2. "... level the competitive playing field by promoting equal regulation of different types of stocks and markets."
3. "... promote greater order interaction and displayed depth."[2]

We agree with the first objective, that many of the rules among the markets are antiquated and in need of change. These changes are necessary in order to recognize the new and sophisticated technology that has changed how the markets and investors utilize this new information and how and where they trade.

We agree with the second objective of leveling the competitive playing field. The Commission's application of the trade-through rule to both NASDAQ stocks and Exchange listed stocks is a major step toward equal regulation.

The Exchange has concerns with the Commission's third objective for greater order interaction and displayed depth if the DOB alternative is approved. We believe the Top of the Book alternative will promote greater competition by each market in order to attract orders to their best quotes. Each market center would be enabled to provide price protection within their own market first and to design their market model to promote order competition as well. The balance needed between competition among the markets and competition among individual orders under the Top of the Book alternative would be maintained or improved.[3]

The BSE has provided comments on each of the four principal rule proposals below, with particular attention, to the two proposed trade-through alternatives.

Reproposed Trade-through Rule

NMS Securities

The Exchange continues to support the mandate for equal standards in providing protection to customer limit orders for all NMS securities. The proposal for a uniform

[2] *See* Regulation NMS proposal. "B. Objectives for suture NMS" at 10.

[3] *See* Regulation NMS proposal. "B. Objectives for future NMS" at 10. The Commission states, in its reproposal, that "NMS is premised on promoting fair competition among markets, ...linked together,... in a unified system that promotes interaction among orders of buyers and sellers in a particular NMS stock."

Trade-through rule for both listed and NASDAQ securities, as NMS securities, is a move towards leveling the competitive playing field through equal regulatory responsibilities.

The Commission staffs' own studies of effective spreads and execution quality for both the market for NASDAQ stocks and NYSE stocks concluded that each market has significant strengths. But, both markets also have weaknesses that could be reduced by strengthened protection against trade-throughs.

The Commission staffs' analysis of short-term volatility for trading in NASDAQ and NYSE stocks is characterized as "transitory volatility." This study found that transitory volatility (short term fluctuation from the fundamental or "true" value of a stock) was significantly higher for NASDAQ stocks than for NYSE stocks.

The reproposed Trade-through Rule, by promoting greater depth and liquidity, through increased transparency of automated quotes, would help reduce excessive transitory volatility in NASDAQ stocks. The disparity in rules among the competing markets has often resulted in inconsistent applications of best execution responsibilities. Investors with an investment portfolio comprised of both listed and NASDAQ securities must receive equal protection of his orders regardless of whether a security trades in either a listed or NASDAQ environment.

Trade-through Reform

The reproposed Trade-through rule mandates the adoption and enforcement of written policies and procedures that are reasonably designed to prevent trade throughs of protected quotations with certain exceptions. This rule requires the automation of quotations for display by an automated trading center as "protected quotations" under two proposed alternatives.

The first, "Top of Book Alternative" would provide protection to an automated quotation that is the BBO of an exchange SRO, NASDAQ and the NASD (its Automated Display Facility). The DOB alternative would protect, in addition to the top of the book from each market, the depth-of-book quotations that a market voluntarily displays pursuant to an effective national market system plan. Both alternatives would permit trade-throughs of a manual quote that must be identified as such.

Top of the Book Alternative

The Exchange supports the Top of the Book alternative that requires the protection of quotations at the best bid and offer, that are immediately accessible through an automatic execution trading center[4]. We believe this alternative will lead to a more competitive quoting environment with better prices for the public investor. The

[4] Defined as a national securities exchange or national securities association that operates an SRO trading facility (currently nine SROs), an alternative trading system, an exchange market maker, an OTC market maker, or any other broker/dealer that executes orders internally by trading as principal or crossing orders as agent.

emphasis on the best price protection element of best execution, as opposed to speed under the earlier "opt out" provision is the guiding principle here.

We agree that the identification of manual (non-protected) quotes is the most appropriate means of facilitation of order routing technology. This requirement to identify, on a quote-by-quote basis, indications from a specialist, that a particular quote was not available for immediate automatic execution at that time, will enable the markets to identify quotes that are available for immediate execution. The distinction between automated (protected) and manual (unprotected) quotes would still accommodate those situations in a particular stock, where a manual quote would be appropriate to protect orders in unusual situations. These situations could include high volatility, highly priced and/or thinly traded stocks, highly unusual market activity that may warrant special attention to an excessive order imbalance, gapped quotes, or floor broker flexibility in representing larger orders to meet best execution responsibilities.

The Top of the Book alternative will recognize competitive pricing initiatives with highly automated interaction among the competing markets. This means a displayed automated limit order at the BBO will be executed. This alternative will increase investor confidence and provide added incentive to investors to place limit orders with their broker to increase the chances for a better-priced execution.

We have reviewed the proposed trade-through exemptions,[5] similar to some of the existing ITS Plan provisions and we believe these too are valid provisions that will reinforce a higher level of automated efficiency. Most exemptions recognize unusual problems that would cause delays on automated executions, especially in high volume stocks, with the exception of the intermarket sweep function. This function provides opportunities for more efficient pricing of larger sized orders and resolution of pricing anomalies. The intermarket sweep function will help respond to certain pricing and quoting inefficiencies, comparable to the current ITS Plan "contemporaneous" commitment interpretation to avoid trade throughs, but with much greater certainty and speed.

Voluntary DOB Alternative

The BSE supports the overriding goal of providing limit order protection for the best displayed prices of protected quotes, present in both alternatives, but we cannot support the DOB alternative

Competition among the markets has principally been premised on the ability to utilize price discovery initiatives, reduce costs, provide reasonable fees for services and

[5] The exceptions to the trade-through rule include: 1) A trading center displaying protected quotes experiencing a failure, material delay or equipment problem which provides a "self help" remedy to another market to trade-through that particular quote at that time, 2) non-regular way transactions, 3) Opening, re-opening or closing trades, 4) Trades during a crossed market 5) Sweep order trade execution, 6) Sweep order routing with concurrent trade execution, 7) benchmark orders and/or VWAP orders, 8) flickering quotes (generally within one second) and elimination of exceptions for block transactions and 100 share (ITS Plan reference) quotes. There is, notably, no "opt out" provision.

order routing through intermediary links, including ITS, floor brokers, member sponsored DOT interfaces and (ATS) automated markets. The desire for the Commission to further automate the markets through mandates is appropriate in some aspects where National Plan unanimity has posed obstacles or where certain trading practices have surfaced that are not addressed through current rules and surveillance procedures. There is however, a need to balance these mandates and retain incentives for the markets to compete for order flow through innovation and efficiency.

The Commission states that it "has sought to avoid extremes of (1) isolated markets that trade an NMS stock without regard to trading in other markets and thereby fragment the competition among buyers and sellers in that stock, and (2) a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets."[6]

If the DOB alternative, voluntary or through political pressure, emerges as the new NMS model, the structure of the markets would transform into a virtual Consolidated Limit Order Book ("CLOB"). A CLOB environment would blend the markets into a centralized price priority order book. An environment that would shift the competitive pendulum away from innovation among individual competing markets to intermarket order competition. An alternative that creates a competitive imbalance contrary to one of the expressed goals of the Commission.

The DOB alternative would force the markets into a government sponsored, centralized NMS. The requirement to display all limit orders on a book and disseminate this information through a National Market System Plan would undermine the efforts and the benefits of an individual market to attract orders to its markets. Orders on the book below the BBO could be swept away by a competing market order under the DOB alternative. Typically, orders placed on the book, away from the market are not initiated for price discovery but rather as defensive tools to take advantage of price fluctuations or to establish risk parameters. We believe the markets must retain their ability to compete individually for order flow and enhance their own independent business models to provide best executions based on their member and customer profiles.

The interaction of institutional orders with retail orders would be reduced under this alternative. This would impact liquidity and the price discovery process. A virtual CLOB would require display of all limits in order to seek protection. Institutions and floor brokers with fiduciary responsibilities typically do not want their entire buying or selling interest displayed because it could affect their execution price performance and costs. The likely response by some of these participants would be to migrate to crossing platforms or perhaps foreign markets thereby removing liquidity from the national displayed markets.

Generally speaking, floor brokers are challenged every day to deliver the best price to larger orders they receive that, for good reason, are not fully displayed because of that adverse pricing impact they could have on the market. Under the DOB alternative,

[6] Release reproposing Regulation NMS, Objectives for Future NMS, at 10.

brokers must undertake a laborious review of multiple price levels on displayed limit order books across all markets before deciding upon the best execution opportunity.

Lastly, but most significant in terms of the undertaking needed to build a DOB alternative, is time and the cost involved. The extent of technological work required is so complex, and would impact most, if not all, individual markets' existing trading platforms and surveillance programs, that the cost/benefit considerations make this alternative untenable.

In sum, we believe that the reproposed Regulation NMS's focus on trade-throughs and market access present significant changes in terms of linkage and order handling. The DOB alternative however, is impractical and does not meet the cost/benefit test. On the other hand, the Top of Book alternative presents a workable solution that preserves the balance of market competition with order competition and recognizes the important concept of best price.

Market Access

The Exchange stated in its earlier response to Regulation NMS that it would continue to support market access to its Limit order books to include non-member access indirectly through a member on a non-discriminatory basic.

The Exchange believes that access fees are not the same as exchange transaction fees. The exchanges' transaction fees, as well as any other fees assessed on its' members are filed with and approved by the SEC. The fees we apply to different services[7] are designed to respond to competitive factors geared to support our business model. These fees must be fair and reasonable in order to be competitive, especially in an environment of significant cost pressure from our members' own business models. Exchange fees are published and known by all parties to a transaction.

We believe the Commission should revisit its approach to the problems created by unreasonable ECN access fees. The problems of locked markets by certain ECNs to attract orders posted (with fees and rebates) to meet the requirements of best execution responsibilities by other markets should be addressed directly by the SEC under Regulation ATS.

Related to locked or crossed markets, the reproposal recognizes the need for enforcement of patterns or practices of this activity and that incidental locks or crosses can occur. We plan to survail and enforce this activity consistent with Regulation NMS requirements.

[7] Among these services that are linked either directly or indirectly are: regulatory and compliance; surveillance; systems support; operations; administration and finance; etc.

Sub-Penny Quotes

We support with the restrictions on sub-penny quoting in NMS issues of $1 (one dollar) or above and the ranking, displaying, or accepting of an order or indication of interest. That the proposed sub-penny restriction based on the price of the quotation or order rather than the price of the stock when less than $1, is the best means of establishing this restriction.

The retention of sub-penny increments for trade reporting of mid-point or VWAP algorithms to price its execution reports based on prices unrelated to the current quote is justified. These finer increments would enable markets to provide price improvement without affecting quotes.

Market Data Rules

The exchange had previously objected to the original market data proposal because of the elements comprising a very complex formula and the exclusion of trades for less than $5000 contract value. We believe the 50/50 allocation between trades and quotes in the new formula is easier to understand though we do not now, nor can we predict what impact the quote portion of the formula would have on our market.

We had recommended in our earlier response, to change the formula to measure share market share versus trade market share. This would respond to some of the concerns related to gaming and tape shredding. We continue to believe this would recognize more accurately, the value contributed by each market to the NMS infrastructure.

The reproposal does not address specifically who would administer the calculation and distribution of revenues under a revised formula for all NMS securities. We do not currently have statistical data available to project what impact a new formula would have on our current business model. Regardless of who and how this responsibility is structured, it will involve additional costs.

The impact of a new formula could be particularly significant to the BSE and other individual markets. We recommend that this portion of the Regulation NMS market proposal be implemented as a pilot, in order to consider any unexpected or unintended consequences of the revisions to the formula, and enable the participants to provide input as warranted.

Regarding plan governance, we support a non-voting advisory Committee, although we have concerns regarding the potential size of the committee. The Exchange would recommend a small Advisory Committee that could meet periodically but not necessarily at the same time as the Operating Committee and still provide valued input.

Periodic attendance at regular meetings could be agenda driven in order to minimize the frequency and need for combined meetings.

CONCLUSION

We wish to thank the Commission and staff who have spent so much time and effort on this entire Regulation NMS Proposal including the many meetings, hearings and evaluations of comments. This has been an educational process for many participants gathering information and evaluating the numerous responses to these proposals.

We hope the Commission and staff will continue to seek our input on these matters that are so complex yet profound in terms of the importance to our future Market reformation.

Respectfully submitted,

George W. Mann, Jr.
General Counsel