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January 26, 2005

VIA HAND DELIVERY

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

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OFFICE OF THE SECRETARY

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

Dear Mr. Katz:

The Specialist Association ("Association") of the New York Stock Exchange ("NYSE" or "Exchange") welcomes the opportunity to comment on the Securities and Exchange Commission's ("Commission") reproposal of Regulation NMS.[1] It is clear from the text of the Reproposing Release and the reformation of the proposed rules that the Commission and its staff have carefully considered the numerous comment letters previously submitted on Regulation NMS. In fact, we are gratified that the Commission appears to have agreed with many of the comments that we made with respect to prior iterations of the Regulation, including the extension of the trade-through rule to the OTC market.[2] We will not repeat those comments (which related to many aspects of Regulation NMS), but respectfully refer the Commission to our prior comment letter with respect to those elements of the Reproposal that are similar to the Commission's earlier version of the proposed Regulation.

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[1] *See* Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) (the "Reproposing Release"). The Commission's original release proposing Regulation NMS was published almost a year ago in Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) ("Proposing Release"), and the Commission requested additional comments on proposed Regulation NMS in Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release").

[2] Letter from David Humphreville, President, The Specialist Association, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004.

We believe that the alternative version of the Trade-Through Rule pursuant to which immediately accessible bids and offers representing the highest bid and the lowest offer displayed by any trading center would be protected against trade-throughs ("Market BBO Alternative") is the best way to ensure that our markets continue to be the envy of the world by preserving the benefits that investors receive through the operation of the auction market at the NYSE. The auction process at the NYSE, in which the members of the Association and others participate, performs a vital price discovery function that benefits all investors, whether retail or institutional. Should the Commission, however, decide instead to adopt the alternative version of the Trade-Through Rule, contemplating extension of trade-through protection to bids and offers away from the highest bid and lowest offer if those "away" bids and offers are immediately accessible (that is, to depth-of-book bids and offers) ("DOB Alternative"), we believe that the value that the auction market function of the NYSE floor brings to U.S. investors and to the U.S. trading markets will be lost. The Market BBO Alternative better meets the Commission's stated goals for the Trade-Through Rule without the detrimental effects that seem to us certain to result from the DOB Alternative. As a result, the Commission should adopt the Market BBO Alternative.

The Re-proposed Trade-Through Rule.

As now proposed, Rule 611 of Regulation NMS ("Trade-Through Rule") would establish market-wide price protection for automated quotations in any NMS stock that are "immediately accessible." Under this proposal, "trading centers," which include SRO trading facilities, ATSs, exchange specialists, OTC market makers, and block positioners, would have to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of "protected" quotes, and if they wish to rely on an exception to the Rule, those procedures must be reasonably designed to assure compliance with that exception. These protections only extend to "automated" quotations – those that are displayed and immediately accessible through automatic execution (*i.e.,* an incoming order must be able to receive an immediate execution up to full size of the quote without human intervention). A trading center that displays both automated quotes and manual quotes (that is, quotes that are not immediately and automatically accessible and therefore are not protected under the Rule) must meet basic standards of fair and efficient access so that the public can achieve executions against the market's automated quotations. If the market does not meet those standards, none of its quotations could qualify as automated, and therefore constitute "protected" quotations.

We appreciate the Commission's willingness to facilitate hybrid trading systems, such as the hybrid system proposed by the NYSE, that combine both automated and manual quotes and executions. By doing so, the Commission is helping to ensure that investors have a real choice between wholly automatic executions at the displayed automated quote and the potential for price improvement and supplemental liquidity inherent in an auction on an exchange floor. In the Reproposing Release, however, the Commission has proposed two alternatives regarding the scope of the Trade-Through Rule. Under one, the Market BBO Alternative, price protection afforded by the Trade Through Rule would be limited to top-of-book or a trading center's highest displayed bid and lowest displayed offer in the size displayed. Under the other, the DOB Alternative, such protection would be extended to the displayed depth-of-book if that market center voluntarily displayed such depth pursuant to a national market system plan. The DOB Alternative, in our view, contravenes the Commission's stated purpose of facilitating hybrid trading systems and would do vast harm to the U.S. trading markets. Instead, the protections of the Trade-Through Rule should be extended only to the best automated quotes displayed by a trading center, as proposed in the Market BBO Alternative.

The Market BBO Alternative Should be Adopted.

Under the Market BBO Alternative, a "protected" bid or offer for purposes of the Trade-Through Rule would be a quotation in an NMS stock that (i) is displayed by an automated trading center, (ii) is disseminated pursuant to an effective national market system plan, and (iii) is an automated quotation that is the best bid or best offer of a national securities exchange, Nasdaq, or a national securities association other than the best bid or best offer of Nasdaq (*i.e.*, the ADF). By protecting only the best quotes of each automated trading center, this Alternative would encourage aggressive quoting within each trading center (*i.e.*, intra-market competition) and should continue to produce the tighter spreads that now characterize our markets. Inter-market competition also would be encouraged because each automated trading center would be required to take into account the best bid or offer automatically available in other markets. Thus, if another market's quote is better, that better bid or offer would have to be taken prior to transacting at an inferior price or the transaction would have to occur at a price equal to or better than that other market's superior quote.

The Trade-Through Rule is intended to encourage investors to display their limit orders, to reward those who are willing to display the best prices, and to encourage inter-market competition.[3] Limiting trade-through protections to each trading center's top-of-book would accomplish those goals without causing the negative effects on the markets and investors that would result from the DOB Alternative. Of the two proposed Alternatives, we urge the Commission to adopt the Market BBO Alternative.

[3] *See, e.g.*, Reproposing Release, 69 FR at 77426, 77430.

The DOB Alternative Should be Rejected.

Under the DOB Alternative, in addition to all of the quotations under the Market BBO Alternative, any additional bids or offers that are designated as protected bids or protected offers pursuant to an effective national market system plan also would be protected from trade-throughs. We express below fundamental market structure objections to this Alternative. We also believe that efforts to implement this Alternative would force the markets to solve a number of complicated problems, also discussed below.

First, as a practical matter, it should be recognized that, to comply with the DOB Alternative, trading centers would have to develop the means to monitor many more protected quotations displayed by other markets and to route more orders to execute against those quotes than would be necessary under the Market BBO Alternative. If the DOB Alternative were to be adopted, and one market were to choose to designate the entirety of its displayed quotes as "protected" (as surely would be the case), it is more than likely that all other markets would conclude that they must do the same to remain competitive. Under this Alternative, a trading center's automated trading and routing systems thus would have to be programmed to review all displayed quotes (including, of course, protected depth-of-book bids and offers) from all other trading centers for Trade-Through Rule purposes, an exponential increase over the number of quotes that would have to be considered to comply with the Market BBO Alternative. Furthermore, under the Reproposal, a market's DOB quotes (*i.e.*, all of its quotes that it designates to be afforded trade-through protection) could not be "protected" quotes unless market participants were to have access to information as to which quotes are protected, information concerning those quotes is made available on fair and reasonable terms, and market participants have fair and efficient access to the protected quotes at a reasonable cost. Attempting to do this has enormous potential for overburdening the electronic systems on which the markets and investors rely and would require much more in the way of programming for compliance and cost.

The Commission and its staff already have seen what can occur when quoting activity exceeds systems capacity in connection with the quoting of options, which resulted in the rationing of quote message capacity among the different options exchanges and degradation of market information concerning those quotes. The extremely high level of options quote message traffic also led to other problems such as flickering quotes and the inability of certain end-users (*e.g.*, investors without sufficiently high-bandwidth communications services) to access the full range of current market data. The adoption of the DOB Alternative could easily result in similar capacity-related issues relating to NMS stocks and in any event surely would frustrate achievement of the Commission's stated goal of "advance[ing] the principle of limit order protection while ... avoiding practical implementation problems."[4]

The most objectionable consequence of the DOB Alternative, however, would be the effects that this Alternative would have on fundamental market structure. In our view, adoption of this Alternative would create, in effect, a virtual Central Limit Order Book.[5] The establishment of such a monolithic governmental utility has been rejected by the Commission many times over the years since the idea was first introduced, and several Commissioners and the Director of the Commission's Division of Market Regulation again stated their opposition to doing that at the December 16, 2004 Open Commission Meeting to consider Reproposal of Regulation NMS.[6] If the DOB Alternative were to be adopted, however, the Commission would be doing, essentially, precisely what it has vowed it would not do.[7]

Although the DOB Alternative differs from the traditional concept of a CLOB in several respects, those distinctions do not change the fact that this Alternative would establish a universal, government-mandated electronic order execution system. While all markets' displayed orders would still be displayed separately on those respective markets under the DOB Alternative (rather than being consolidated into a single, centralized display), each of those trading centers would have to be linked electronically to each other to enable participants in those trading centers to access all protected quotes in each other's market. This would commoditize the trading markets, turning them into a virtual single electronic facility. In other words, such a "virtual" single electronic market would produce the same result, and suffer from the same defects, as would attend creation, by regulatory fiat, of a CLOB. As discussed later in this letter, this would negatively affect both intra-market and inter-market competition and, most importantly, would result in the demise of the auction market, to the ultimate detriment of the markets as a whole and investors.

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[4] Reproposing Release, 69 FR at 77427.

[5] Under the traditional notion of a CLOB, all quoting interest in all markets would be consolidated into a single, centralized display and orders would be executed by both price and time priority.

[6] The statements of Chairman Donaldson, the other Commissioners and Senior Staff of the Division of Market Regulation can be accessed through the web cast recording of the December 15, 2004 Open Meeting of the Commission, which can be found on the Commission's website at: http://www.sec.gov/news/openmeetings.shtml.

[7] *Id.*

We note that, under the DOB-based Trade-Through Rule, there would only be universal price priority, but not time priority (as would be available in the true CLOB).[8] As a result, the universal "virtual" electronic system that we think would be certain to flow from adoption of the DOB Alternative would create new disadvantages for investors. For example, without time priority, it would be possible for "late-comers" bidding and offering at prices inferior to the best quoted prices to step ahead of other market participants' previously displayed interest at the same prices, thus increasing the incidence of free-riding on other market participants' displayed trading interest and thereby discouraging the expression of such interest in the marketplace.

The DOB Alternative also would likely result in all U.S. markets becoming wholly electronic, and result in the destruction of the auction market trading system, which we and many others think would be contrary to the best interests of the markets and investors. The virtues of the auction market trading system have been underscored by the recent study by the Commission's Office of Economic Analysis, cited in the Reproposing Release, showing that the volatility of stocks traded in the Nasdaq market (an almost wholly electronic market) far exceeds the volatility of stocks traded on the NYSE (an open-outcry, auction market, but with electronic features).[9] The increased volatility in Nasdaq stocks, particularly in times of market stress, results from its mostly electronic nature and from the absence of rules requiring Nasdaq market makers to continue trading against momentary market trends (and, as a result, failing to compel them to contribute to price continuity and market depth when most needed). NYSE specialists, of course, are subject to rules requiring such behavior, operating in an environment where compliance with such principles is a practical possibility, and the relative stability of prices on the NYSE is due, in large part, to those requirements. Those same rules help ensure that trading in stocks on the Exchange opens as close to the opening bell as possible, and that openings and re-openings following trading halts are timely, fair, orderly and appropriately reflect market

[8] Although the Trade-Through Rule with the DOB Alternative, as proposed, does not take time priority into account, once the inter-market systems that scan all orders displayed in other markets to ensure price priority for purposes of the Rule have been established, it would be a small step to then require those systems to take into account the time an order was actually displayed on that other market. In fact, order time information is already captured by SRO surveillance systems, such as to monitor compliance with the Limit Order Display Rule, Exchange Act Rule 11Ac1-4. Thus, establishment of a true CLOB, which we believe would be extremely ill-advised and objectionable, could readily follow.

[9] *See* Memorandum to File from the SEC's Office of Economic Analysis, dated December 15, 2004, Re: Analysis of Volatility for Stocks Switching from Nasdaq to NYSE.

conditions at the time. As we noted in our previous comment letter on Regulation NMS, not only are purely electronic trading systems not subject to the same rules as Exchange members, but they also are incapable of performing the same functions.

Several aspects of the DOB Alternative ultimately would deprive investors of the choice of execution venues and trading methods and consequently the benefits of the auction market.

First, although the DOB Alternative is "voluntary," once a single market obtains trade-through protection for the entirety of its book, all other markets will follow. To attract customer limit orders, every market is going to have to ensure that all of their quotes are "protected" to the greatest extent possible (as no market will want to have to admit that it offers less protection to limit orders than other markets). This will require the markets to become wholly automated, as a practical matter, and investors will lose the benefits of the auction market, particularly with respect to obtaining regular opportunities for price improvement.

Second, if trade-through protections are limited to just top-of-book, as under the Market BBO Alternative, an auction market could continue to readily come to a central price for a customer's order below the top-of-book because the Trade-Through Rule would only require that the best displayed bids or offers in other markets must be taken out before execution of the remainder of the order in the originating market at the negotiated price. Under the DOB Alternative, however, the auction market would have to be put aside to enable participants in such a trade to take out every quote throughout other markets' books, possible only by creating and using an electronic order-routing system programmed to access all better automated quotes on any market at or before consummation of the trade. (Such a system would not even be a so-called "smart router," since it could not base routing decisions on likelihood of execution, historical fill rates or any criteria other than displayed prices.) Once such electronic order routing is required for all transactions in a market, there is little incentive or room to conduct a manual auction.

The DOB Alternative also would severely limit the ability of auction markets to effectively price and execute block-size orders because such pricing would have to take into account all displayed quotes, including those away from the best bid or offer, on each of the other nine currently-established trading centers. (Depending on how many cents away from the top-of-book the auction price is, the number of displayed DOB quotes in other markets to be considered could and often would be extremely large.) At the time a specialist prices the block, based on the displayed prices and sizes in other markets that he or she sees, however, whether those better-priced quotes can be executed against will be uncertain.[10] Before even part of the block trade may be executed in the auction market, inter-market sweep orders would have to be sent to each of those other markets in an attempt to access all better-priced quotes. While some of the sweep orders may result in executions, not all may be executed (because the destination quote was exhausted or cancelled before arrival of the sweep order). While the broker may have agreed conditionally to fill part of the order at the block price based on an assumption that the other portion would be filled through the inter-market sweep, if those away market orders do not result in sufficient executions, the broker may regard conditions to have changed sufficiently to justify renegotiation of the price – and, thus, the customer's order may not be completely filled. In turn, this could require, in response to new quotes in other markets at a price superior to the renegotiated price, generation and transmission of yet another sweep order. This could result in repetition of the same frustration through more failures of anticipated fills of that new sweep order as the auction market chases the cascade of changing quotes in other markets.[11] This also would result in multiple executions in multiple markets (increasing the problems caused by fragmentation) with only a small possibility of the original market executing any residual amount, and at prices that may have now been disturbed by the execution of several sweep orders. There would be little or no room for an auction market under this scenario.

In addition, requiring a market to take out more than just the top-of-book to avoid trade-throughs could be seen as encouraging less than optimal quoting in those markets. Displayed size at the best quote has been steadily diminishing over the years, and adoption of the DOB Alternative seems to us likely to exacerbate that problem. For example, a person who does not want to be out front by displaying the best quote in his market could simply quote at a couple of cents away from the BBO in that market and still be reasonably assured of participating in any

[10] This is so largely because of quoting algorithms used by many market participants that can change and/or cancel quotes within nano-seconds of events (new quotes or executions) occurring in various markets. The Commission does not appear to have adequately taken these systems into account in the reproposal.

[11] If blocks become too difficult to execute on exchange floors, those trades instead will be sent elsewhere, such as to an ATS, or to a block desk of a firm for internal execution, or even to a foreign market. Because those venues often are not accessible by small retail customers, there is a danger of bifurcating the markets into separate execution facilities for retail and institutional customers. The additional liquidity provided by block trades will be lost from the public markets in that case. Also, the migration of block trades from exchanges removes another reason for maintaining the auction function, making it more likely that exchanges would end up as wholly electronic trading facilities.

large block presented for execution in any market while his less-than-best quote is displayed. We believe that this will reduce the likelihood that quotes with size will be displayed at the best price in any market, harming intra-market competition. Such a result obviously would be detrimental to the markets in general and all investors.

Finally, as the Commission notes in the Reproposing Release,[12] the rules of many trading centers provide that reserve (*i.e.*, undisplayed) orders, including additional size associated with a displayed order and its displayed size, at a better price than other displayed bids or offers within that trading center, have priority over displayed interest at worse prices. The DOB Alternative would permit such "reserve" undisplayed orders to receive trade-through protection, displacing the displayed orders at inferior prices that, under the DOB Alternative, caused a depth-of-book sweep order to be sent to that market center in the first place. This, however, is antithetical to the theme that runs throughout all of the Commission's proposing releases relating to Regulation NMS: encouraging market participants to add to liquidity by entering and displaying limit orders. One of the principles behind the Commission's proposed structural overhaul of the U.S. markets is the need to provide better trade-through protection to displayed orders. Because of the way many trading centers work today, however, the DOB Alternative would end up rewarding persons who choose *not* to display their full size through the use of a reserve size functionality - enabling them to achieve execution of their undisplayed limit orders alongside or even in front of the limit orders of those who have chosen to display their interest. The DOB Alternative thus would add to the practice of free-riding the displayed orders and prices of others without adding anything to price and size transparency. In this way, the DBO Alternative would fail to foster the "integrated competition among orders [that] promotes more efficient pricing of individual stocks" that the Commission seeks to create through proposed Regulation NMS.[13] It therefore should be rejected.

Although the Commission has stated that it does not seek to pick winners and losers of the market structure "wars" through Regulation NMS, if it determines to adopt the DOB Alternative, the Commission will have essentially picked a "winner" – the wholly electronic marketplace. As we have previously argued, and as the Commission's own economists have confirmed, this would be harmful to the U.S. markets. The auction market system provides important benefits to our markets, and these benefits must be preserved. Because of the harm the DOB Alternative would cause to the U.S. markets, such a drastic structural change, if it is to

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[12] 69 FR at 77441.

[13] *Id.* at 77426.

occur, must be the result of deliberate and careful consideration by both Congress and the Commission, not merely the by-product of a hastily-considered Reproposal.

While the Commission has emphasized the length of time that Regulation NMS has been under consideration, up until this point the discussion has only related to top of the book trade-throughs. It would be incredible if a new proposal that is basically intended to encourage the display of limit orders could result in such a drastic overhaul of the very nature of the U.S. securities markets and elimination of the auction market. Moreover, the rush to consider the DOB Alternative is inconsistent with the Commission's premise that it has engaged in an extensive deliberative process with respect to Regulation NMS.

The Market BBO Alternative enables the auction market to operate as intended. Auction participants can more readily price and execute block trades to the benefit of investors, and electronic routers would not be required in order to handle such orders because a market only would be required to take into account a single quote at each other market, not multiple quotes at multiple markets. Fragmentation would be minimized, and customers would get better overall executions. In this regard, if a market is required only to consider the best quotes of each other market, as it would under the Market BBO Alternative, the first market arguably would be more likely to match the other markets' best quotes, which would help ensure a fast execution of the customer's order at the best price. Thus, the Market BBO Alternative is clearly the better choice.

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We truly appreciate the opportunity to provide further comments on the various portions of the proposed rules as the Commission considers the final aspects of Regulation NMS, as we have appreciated the Commission's and its staff's willingness to discuss these difficult issues with us and other interested persons over the course of the last year. If you have any questions concerning any part of our letter or would like to discuss with us any aspect of proposed Regulation NMS that we have not addressed, please contact me at (212) 589-0490. We look forward to continuing our dialogue with the Commission and its Staff on these crucial, and timely, market structure issues.

Sincerely yours,

David Humphreville

David Humphreville
President

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