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February 7, 2005

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

Re: Regulation NMS (File No. S7-10-04)

Dear Mr. Katz:

The Securities and Exchange Commission and staff of the Division of Market Regulation have undertaken a most formidable task over the past several years, and especially in the last year. There have been few, if any, more polarizing issues in recent times than the future and direction of the national market system for equity securities. How this issue is ultimately addressed by the Commission will undoubtedly have substantial, permanent impacts (including possibly some unintended ones) on a wide variety of market participants, ranging from floor-based and electronic trading venues, retail and institutional broker-dealers and various end-user constituents, including retail investors, traditional buy-side institutions, hedge funds and quantitative and program traders.

As a consequence, the SEC and staff have received hundreds of comment letters on either or both of the initial Regulation NMS proposals, listened to hours of public testimony during its Regulation NMS hearings and attended scores of meetings with market participants. The goal of these efforts is to devise a set of rules designed to achieve a handful of fundamental objectives in furtherance of a modern national market system. The challenge of considering and weighing divergent views, interpretations and prognostications has clearly been daunting, and, even while we do not agree with much of the Commission's reproposal of Regulation NMS (the "Reproposal")[1], Morgan Stanley & Co. Incorporated appreciates the opportunities provided by the individual Commission members and Market Regulation staff to explain our views and their thoughtful consideration of them.

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[1] Securities Exchange Release Act No. 50870 (December 16, 2004).

I. Introduction

As stated in our comment letter on Regulation NMS as originally proposed and subsequently supplemented,[2] we supported the SEC's proposal of a limited trade-through prohibition, as it would serve the important purposes of (i) enhancing standards of best execution, particularly of market orders, (ii) encouraging and protecting the most aggressive resting limit orders that established the best bid and offer in a particular trading center, and (iii) so long as such protection would be limited solely to automated quotations, encouraging trading centers to leverage existing technology by making their quotations readily accessible, all with a view toward enhancing competition among orders and markets. Our support of Regulation NMS, however, was predicated on the enhancement of competition, not the imposition of a regulatory framework that would raise the specter of mandated mediocrity. More to the point, our support was explicitly conditioned on the ability of market participants to opt out of trade-through protection under circumstances which they in their reasonable discretion believed to be warranted and in the best interests of their clients. Specifically, we said that Regulation NMS, as originally proposed:

> [R]epresent[ed] a carefully considered balance between protecting resting orders on away markets and allowing investors and broker-dealers the freedom to 'vote with their feet' if they are dissatisfied with the service they are getting from a particular market center. . . . The mere existence of the opt-out . . . [would] compel markets to compete and eliminate the complacency that results inevitably from regulatory routing mandates.

Consequently, we believe the Commission's Reproposal, notwithstanding certain enhancements the Commission has added to ease implementation and compliance, represents a significant step backward from the original proposal, primarily because of the elimination of the opt-out exception.

The balance of this letter describes our broad concerns with the Reproposal, as well as additional enhancements that we believe should be implemented if the Commission determines ultimately to approve Regulation NMS substantially as reproposed. In summary:

(1) Without a workable opt-out exception, we <u>cannot</u> support a compulsory trade-through prohibition.

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[2] Letter from Thomas N. McManus, Managing Director and Counsel, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated August 19, 2004. Among other things, we stated that: (i) trade-through protection should only be afforded to "automated" quotations; (ii) trade-through protection should only be afforded to the best bid and best offer in any particular market center, including Nasdaq and the ADF; (iii) broad, enforceable standards of accessibility should be dictated, although no minimum speed standard should be imposed; (iv) access fees must be nominal and in any event evenly applied to redress the longstanding inequality that favored ECNs; and (v) most importantly, informed market participants should be able to opt out of trade-through protection.

(2) If the SEC ultimately decides to impose a trade-through prohibition without an opt-out exception, *we would advocate, at a minimum*:

(i) Flexible, reasonable standards that take into account the practical realities of the market place in the context of attempting to avoid trade-throughs, locking/crossing of automated quotations, the challenges presented by "flickering quotations," markets whose time clocks are not synchronized and the like;

(ii) A private linkage approach as opposed to a "hard," unitary linkage;

(iii) No trade-through protection for and removal from the national best bid and offer of manual quotations;

(iv) Reasonable exceptions to the Order Protection Rule for intermarket sweep orders, benchmark orders and "flickering quotes" (though, as noted below these exceptions on their own would not go far enough);

(v) Requiring SROs to employ reasonable, objective standards for switching automated quotes to manual, and vice versa; and

(vi) Imposing specific standards for qualifying as an automated trading center, including IOC functionality for automated quotations and the capacity to identify all quotations other than automated quotations as manual.

(3) If the SEC ultimately decides to impose a trade-through prohibition without an opt-out exception, *we believe the following problems would need to be addressed*:

(i) The "material delay" exception is far too narrowly drawn – we believe it should give broker-dealers with best execution obligations the flexibility to avoid a trading center for reasons that go beyond that trading center's response times (similar to the flexibility that is available today);

(ii) Trade-through protection should not be extended beyond the best automated bid and offer disseminated by any particular SRO (*i.e.*, we believe the depth of book proposal is inferior to top of book);

(iii) Manual quotes should be excluded from the NBBO, and at a minimum they should be excluded from the reference NBBO for purposes of SEC Rule 11Ac1-5 disclosure of execution quality; and

(iv) The absence of a general opt-out exception will make large block facilitation trades difficult to execute, to the detriment of clients. Additional exceptions should be provided for stop orders as well as some relief to enable dealers to commit to execute block trades (as principal or on an agency cross basis) without contemporaneously having to print them to the tape pending return of intermarket sweep order executions that would adjust the customer's price.

(4) The $0.003 "cap" on access fees is not immaterial and would effectively create a static industry standard with little incentive to continue to lower them.

(5) Given the extensive technology changes and market data bandwidth that will be needed to implement the revised NMS framework, perhaps sub-penny quoting should be reexamined so that access fees can be reflected in quotations.

II. Philosophical Objections to Reproposal

As noted above, we initially supported Regulation NMS because it represented a balanced approach to achieving a number of fundamental objectives. Conceptually we understood the benefits to all investors that trade-through protection could potentially provide from a best execution perspective, though we were (and remain) skeptical of the economic analyses presented by the Commission in the Reproposal to support certain policy rationales. In particular, we cannot agree with the SEC's view that the single most important objective of the SEC's trade-through rule alternatives is the protection of limit orders, as the only effective way to accomplish that objective would be to impose market-wide price/time priority (in effect, a consolidated limit order book ("CLOB")). However, neither the top of book nor depth of book alternatives proposed would even purport to protect all limit orders. Thus, we feel the SEC has emphasized too strongly, to the detriment of other important considerations (and without compelling, objective evidence that there is a need for such protection beyond competitive market forces), the need to protect limit orders, because its proposed solution lands far short of its target.

There are other policy objectives and practical issues that must be considered – such as providing best execution for held market orders, enabling broker-dealers to avoid markets they perceive to be qualitatively inferior (even if technically compliant with whatever rules and standards the SEC has dictated) and facilitating the ability of dealers to commit capital quickly and efficiently to large-sized orders without unduly affecting the trading market for that stock. The framework of Regulation NMS *as originally proposed*, subject to a few incremental changes, was a model of activist yet restrained regulation. It imposed certain strict rules, but would be subject to broad, flexible standards that allowed trading centers and order routers the ability to distinguish themselves competitively on the basis of their smart order routing, execution response times, ability to attract liquidity and so forth.

Unfortunately, with the Reproposal it appears the Commission has shifted its focus predominantly if not exclusively to the protection of limit orders, stripping the rule of the flexibility initially provided to the end-users of the markets and indirectly setting extremely low bars for compliance with access rules by SROs that we believe will do more harm to the markets than good. We find it ironic that, notwithstanding such emphasis on protecting limit orders, the Commission has proposed two alternatives, both of which would continue to allow market participants to match the prices established by limit order placers (a practice the SEC refers to as "free-riding") and to permit executions at prices inferior to resting limit orders on markets' order books following the exhaustion of other limit orders by hidden reserves.[3]

Therefore, as described in more detail below, we do not support either of the alternative Order Protection Rules if it is not accompanied by some meaningful ability on the part of market participants, be they broker-dealers with best execution obligations or other end-users, to avoid trading centers they find are in technical compliance with Regulation NMS standards but nonetheless provide inferior service, are difficult to access for reasons unrelated to service (*e.g.*, linkage bandwidth), or, far worse, devise ways in which to "game" the regulatory protection conferred on their orders or even brazenly disregard the rules and take their chances with enforcement. As a broker-dealer with best-execution obligations emanating from regulatory, common law and franchise perspectives, we believe it is simply unfair to expect us to serve our clients with our hands tied behind our backs. As stated in our original letter, we hope that there would be limited circumstances under which an opt-out would be exercised; however, the existence of the right to opt-out would discourage the kinds of behavior we are concerned will likely emerge if market participants are denied the ability to "vote with their feet."

III. Specific Comments on Reproposal

If the Commission ultimately decides to approve Regulation NMS with a market-wide trade-through prohibition that is not constrained by an opt-out exception as originally proposed, we submit the following comments and concerns:

A. Elimination of Opt-Out Exception

The Commission states in the Reproposal that its removal of the opt-out exception from the Order Protection Rule was due largely to its having (i) eliminated any protection

[3] This is not to suggest that we necessarily support market-wide price/time priority; the point we are making is that there are other considerations equally as important as the protection of limit orders. This distinction explains why we were largely supportive of the original Regulation NMS proposal and have major concerns with the Reproposal.

of manual quotes, (ii) imposed standards for qualifying as "automated trading centers," (iii) imposed minimum standards for access and (iv) imposed a hard limitation on access fees. While we agree that these changes generally would strengthen any Order Protection Rule, we strongly disagree that they justify eliminating an opt-out exception.

We believe the SEC has effectively established an access time standard of one second, which is hardly an aggressive standard given current technology. An opt-out exception would enable market participants to punish a comparatively slow, or otherwise deficient, trading center by routing away. We also referred earlier to other concerns we have in terms of gaming and the like, which should also form the basis for allowing a market participant to opt out of routing to a certain venue. As amply demonstrated in the ITS, ECN and UTP experiences of the recent past, relatively small volume market centers can have a significant, negative impact on the overall efficiency of the national market system when they seek to take advantage of the regulatory framework to increase their market shares and maximize their own profitability.

As stated in our previous comment letter, it was our hope that an opt-out exception would seldom need to be used, other than in connection with temporary technological problems besetting a trading center or a linkage to a trading center. Notwithstanding its potentially infrequent use, its mere existence as an option would likely spur higher levels of competition among market participants and enhance overall execution quality. We are concerned that the newly proposed Order Protection Rule may not provide a sufficient amount of flexibility to market participants that encounter a minimally competitive or outright non-compliant trading center.

B. Market BBO Alternative vs. Voluntary Depth Alternative

The Commission has proposed two alternative approaches to protecting limit orders. The first is the Market BBO Alternative, whereby only an automated quotation that is the best bid or offer of an exchange SRO, Nasdaq or the ADF would be considered a protected quotation. The second is the Voluntary Depth Alternative, whereby, in addition to the best bids/offers of each marketplace, such other additional bids or offers that are designated as protected bids/offers by trading centers, on a purely voluntary basis, would be considered protected quotations. In our previous comment letter, we supported a market-wide trade-through prohibition subject, among other things, to the SEC's revising the proposal so that only the best bids and offers displayed by participants in Nasdaq and the ADF would be considered protected quotations. In addition to being concerned about the competitive advantage that allowing protection of potentially every quotation on their markets might convey to Nasdaq and the ADF, we were concerned about other, more practical issues (described below) associated with the protection of quotations below the best bid/offer disseminated by a particular SRO. While, as noted above, we do not support either proposal absent an opt-out exception, our strong preference between the two alternatives (if forced to choose) would continue to be the Market BBO Alternative. We believe that the SEC has improved upon the original proposal in its application to Nasdaq and the ADF by allowing protection of only the best bid/offer displayed by participants in those facilities as opposed to those of their individual quote providers.

We oppose the Voluntary Depth Alternative on a number of levels. First, and perhaps most fundamentally, we strongly disagree with those who may believe that a depth of book alternative is more intellectually pure than a top of book approach. Some have even taken to call it a short step away from a CLOB. That we find hard to understand, as the depth of book alternative does not even begin to approach a CLOB. A depth of book alternative would purport to protect more limit orders, and consequently raise expectations among investors to that end. However, given that reserve sizes at superior prices can exhaust the liquidity of incoming orders, the fact that an SRO's protection of additional limit orders is voluntary and the fact that there is no intermarket time priority among limit orders, apparent trade-throughs would still occur routinely under a depth of book regime. Indeed it is clear to us that the instances of apparent trade-throughs under a depth of book approach would far exceed those under a top of book approach, potentially leading to more investor complaints and regulatory scrutiny, even while orders were being satisfied at the best available prices. In addition, given the fact that there may be hundreds of price points that dealers would be required to sweep prior to printing a block trade with an institutional client, the depth of book alternative would likely have a chilling effect on dealers' willingness to commit capital.

C. Additional Exceptions

Notwithstanding the foregoing, we understand that we may have to operate in an environment in which trade-throughs are prohibited and only a few exceptions are available. As noted above, Morgan Stanley supported the originally proposed opt-out exception, so we view the inclusion of transaction-based exceptions to the trade-through prohibition as mere consolation. Nonetheless, in the absence of an opt-out, these exceptions are necessary and we believe the Commission was correct in recognizing that they would not dilute the effectiveness of the trade-through prohibition; on the contrary, they are critical to preserving the ability of dealers to facilitate executions of large orders from institutional investors, including principal capital commitments and agency cross transactions. We do believe, however, that in some respects these exceptions are under-inclusive and too narrowly drawn.

Following are some of the issues and gaps that we believe need to be addressed as part of any final Regulation NMS approval.

1. Impact on Large Order Executions

a. Block Trades

One of the exceptions to the trade-through prohibition that the SEC has proposed is for "benchmark orders," the execution of which would be at prices that were not based, directly or indirectly, on the quoted price of the stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made. Common examples cited were volume weighted average price guarantees and closing price guarantees. While we certainly do not dispute that the execution of these orders should not require compliance with the trade-through prohibition, we believe short shrift has been given to the practical aspects of routine block facilitations by dealers in connection with large-sized orders. Block facilitations can be effected either as capital commitment executions or on an agency cross basis.[4] Consider the following example:[5]

> Client places order with Dealer to buy 500,000 shares of XYZ and requests a capital commitment on a portion of the order (say, 150,000 shares) to start, with the balance of the order to be executed gradually over the course of the trading day by Dealer as agent, benchmarked on a best efforts basis by Dealer to VWAP. At the time the order is placed, the NBBO for XYZ is $50.00 - $50.01, 1000 shares per side. Dealer considers a number of factors in determining the price at which it believes a block of 150,000 shares would "clear" in the market, and offers to sell Client the first 150,000 shares at $50.05. Assuming Client agrees to that price, Dealer could execute 150,000 shares at $50.05 in the over-the-counter market and report the trade to ACT. Under either of the proposed Order Protection Rule alternatives, however, Dealer would be required to satisfy certain other better-priced quotations/orders in the national market system up the amount of displayed size associated with those quotations/orders. Thus, under the Market BBO Alternative, Dealer would, simultaneously with executing the block with Client, send intermarket sweep orders to, say, four different trading centers to execute against offers of $50.01, $50.02, $50.03 and $50.04 (this assumes the NBBO has not changed). The tricky part is when Dealer receives executions back. If Dealer receives back 15,000 shares as a result of the intermarket sweep orders, those shares must be passed along to Client (as they would improve Client's overall price).

The trouble is that Dealer already executed and printed the Client side of the transaction. Does Dealer cancel and correct the execution, so that Client's price is adjusted to take into account those better-priced executions? This could lead to some awkward and sloppy ticketing problems. Also, would Dealer then have to absorb the extra 15,000 shares at the block print price? If so the risk premium to Client will be significantly greater. Instead, would Dealer cancel 15,000 of the 150,000 shares from the tape, and then put up another 15,000 share print at the improved prices? Does Dealer

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[4] We are not concerned about "clean" agency cross situations, where the price to both sides of a transaction is inside the prevailing NBBO at the time of execution. Rather, we are concerned about situations where one counterparty to a transaction is motivated to buy or sell a large amount of a security, whereby a buyer would be willing to "pay up" or a seller would be willing to "sell down" to get out of a position quickly. The same issue is raised regardless whether we as a dealer or another client takes the other side of that trade.

[5] This example involves a hypothetical capital commitment trade, but could just as easily involve another client taking the other side of the client order, as described in footnote 4, *supra*.

wait until executions are received back as a result of the intermarket sweep orders before executing the block with Client? As we interpret the rule as proposed, Dealer would have to continue satisfying better priced orders in that case.

These concerns are very real and very predictable, and could, at a minimum, lead to some very confusing audit trails. We would propose that an additional exception be included in Regulation NMS, therefore, that would allow a dealer to guarantee a price to a client (accompanied by a requirement to document the precise time when that guarantee is entered), but not to have to print simultaneously with the sending of intermarket sweep orders, allowing the dealer to adjust the guarantee based solely on the prices of executions received back.

An alternative would be to allow a dealer to take a snapshot of the market contemporaneously with agreeing to the block price with a client and reduce the size of the block to be executed and printed (at the block price) at that time by the number of shares in the aggregate the dealer needs to execute against via intermarket sweep orders to comply with the trade-through prohibition. Executions received back from intermarket sweep orders would be booked to the client on an agency or riskless principal basis. To the extent that the dealer does not get executed on the full amount of its intermarket sweep orders, the dealer would then need to execute the balance of the block as principal at the block price (without having to sweep the market again).

In either case these would not be characterized as exceptions to the trade-through prohibition, because the dealer would be required to satisfy the better-priced orders according to whichever alternative the SEC approves. These alternatives would merely be an accommodation to enable dealers to commit capital or cross customer orders efficiently while avoiding cancellations of portions of executions on the tape, executions of excess shares, cancels and corrects on client order tickets and the like.

b. Stops

In the Reproposal, the SEC specifically excluded stopped orders from eligibility for the benchmark order exception to the trade-through prohibition.[6] We are concerned that the absence of such an exception would effectively and unnecessarily preclude an extremely common form of capital commitment that dealers provide to institutional investors. It is our hope and belief that the Commission did so inadvertently and without full appreciation of the impact that not including an exception for stops would have on dealer-investor interactions. Following is an example of how a typical stop order would work:

[6] Specifically, the Reproposal states: "The Commission preliminarily 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." Reproposal at 87, n.149.

> Client (large institutional investor) places order with Dealer at 10am to purchase 500,000 shares of XYZ. The NBBO for XYZ at the time the order is placed is \$50.00 – \$50.01, 1000 shares per side. Dealer stops Client at \$50.10, meaning Dealer guarantees Client will pay no more than \$50.10 per share for the full 500,000 shares on a volume weighted basis, and may pay less depending on Dealer's ability to execute orders at prices less than the stop price. If by 3pm the price rises to \$50.13, and Client's volume weighted average price for 400,000 shares is at that time \$50.10 per share, Dealer, which would now be at risk on the balance, 100,000 shares, can decide to sell the balance to Client at the stop price of \$50.10. Currently, Dealer would sell the balance to Client at the stop price and print the transaction to ACT. Under the proposed Order Protection Rule, however, Dealer would be required to send intermarket sweep orders to take out better bids from \$50.11 to \$50.13. Unlike the situation where Dealer merely commits to a price upon receipt of an order at a price below the bid (for a customer sale) or above the offer (for a customer purchase), where executions received from intermarket sweep orders would inure to the benefit of the client, in this case such executions would be worse for Client and would therefore have to be absorbed by Dealer. Because of that risk, it is unlikely that dealers would be willing to guarantee their clients the stop price absent an exception to the trade-through prohibition (or, alternatively, clients would almost certainly be required to pay dealers a greater risk premium for risking their capital in this manner). Ultimately we believe that without an exception for stops, they will effectively be rendered a relic of the past, an unfortunate victim of unintended consequences.

Accordingly, we recommend that the SEC include in Regulation NMS an exception to the Order Protection Rule for stop elections (i) where the price to a client purchaser is less than the current inside bid for the stock when the stop is elected, and (ii) where the price to a client seller is greater than the current inside offer for the stock when the stop is elected.

c. Facilitations Priced with Reference to Derivatives

We believe the Commission should consider another type of transaction within the scope of a benchmark exception. Specifically, we believe Regulation NMS should be focused exclusively on transactions involving equity securities *for cash*, as opposed to transactions in which equity securities are bought from or sold to a client by a dealer concurrently with a related transaction in an equity derivative, such as a convertible bond or equity option. In effect, these transactions involve swapping a stock position, in whole or in part, against a position in the derivatives, where the prices for the stock and the derivative are linked to each other. In the event that the value of the equities determined with reference to the derivatives happened to be above/below the inside bid/offer (if the client were the buyer/seller), requiring the dealer to satisfy better priced bids/offers would distort the economics of the trade from both counterparties' standpoint and introduce risks that would not otherwise have existed.

2. Expansion of Material Delay Exception

In our previous comment letter we lauded the SEC's restraint in declining to impose a time standard for protected quotation accessibility, though our view was inextricably linked with our support of an opt-out exception (where opt-out could be exercised, among other potentially legitimate reasons, if a trading center was perceived to be materially slow yet technically compliant). We believe that the ability of market participants to avoid a trading center that is nominally compliant but competitively inferior imposes the right kind of discipline on that trading center to respond to the demands of market participants at the risk of losing market share.

While the SEC did not explicitly impose a time standard for accessibility in the Reproposal, opting instead to require trading centers to respond "immediately" and "without any programmed delay" to incoming orders to execute against protected quotations, we are concerned (indeed convinced) that it created a *de facto* standard in connection with its "material delay" exception. Specifically, the material delay exception would enable market participants to avoid routing orders to trading centers experiencing a failure, material delay or malfunction of its systems or equipment. Consistent or persistent failure to respond to incoming orders *within one second* would enable market participants to utilize this exception.

We are troubled by the framework of this exception for a number of reasons. First, by limiting availability of the exception to delays of more than one second, the SEC has recreated the lowest common denominator problem of the Intermarket Trading System that market structure reform presumably was intended to address. Technology exists today to receive, fill and respond to incoming orders in minute fractions of a second. So why settle on a standard that, on a relative basis, is a veritable eternity? Indeed, why settle on a defined number at all? Our concern is centered primarily on exchanges that are currently floor-based and will have to significantly automate their processes to qualify as automated trading centers – what incentive will these exchanges have to invest in the technology required to respond to incoming orders more quickly than one second? Beyond the floor-based markets, we question whether other trading centers, even those that are currently electronic, find some commercial benefit in installing technology that responds more slowly than it does currently? We foresee significant disparities in execution response times, whereby technically compliant but relatively slow trading centers will cause significant queuing of orders and slow down the entire order execution process on a market-wide basis.

Another issue we have with this exception is why it is limited merely to response delays? The Commission has obviously recognized the practical necessity for market participants to be able to ignore a particular market center when that market center routinely is failing to respond in a "timely" manner. But why should material delays form the only justifiable basis to ignore a trading center's quotations? Any number of reasons, including the gaming and non-compliance issues raised earlier, implicate identical concerns and should also justify a market participant's effectively "opting out" of a venue.

Accordingly, we recommend that the Commission expand this exception to provide the flexibility market participants need to avoid market centers that are not only consistently slow to respond to incoming orders on a relative basis (eliminating the one-second "standard") but also for any other objective, reasonable basis, much as they are permitted to today and in fact often must do to satisfy existing fiduciary and best execution obligations. Similar to the flexibility Regulation NMS would provide to SROs to switch a quotation from automated to manual (*i.e.*, requiring only that they have objective standards for switching to manual and back), the SEC should impose a reasonableness standard and require market participants to document decisions to disregard the automated quotations of an automated trading center that is not competitive with other markets on a relative basis.

D. Removal of Manual Quotes from NBBO

In our previous comment letter, we proposed that manual quotes should not be given any level of protection under the trade-through prohibition. Thus, we were pleased that under the Reproposal, manual quotes would not be protected, market participants would be permitted to lock/cross manual quotes and SROs displaying manual quotes would not be eligible to receive any market data revenue in respect of manual quotes. Nonetheless, we believe the SEC should have gone further in discouraging the display of potentially inaccessible quotes by removing manual quotes from the consolidated national best bid/offer. As we noted in our previous letter, a number of broker-dealer activities (including automatic executions of marketable orders), as well as execution performance, are based on or measured off of the consolidated NBBO, not the least of which are SEC Rule 11Ac1-5 execution quality statistics. If the SEC remains uncomfortable at the present time with excluding manual quotations from the NBBO, we believe a reasonable alternative would be to allow market centers to disregard manual quotations for purposes of determining the reference NBBO for the purpose of reporting execution quality pursuant to Rule 11Ac1-5. We would also ask the Commission to explicitly recognize market participants' legitimate interest in weighing non-price factors when determining their best execution obligations by not routing to non-automated quotations.

E. Access Fees and Sub-Penny Quotations

The Reproposal includes a rule that would "cap" the access fee that a trading center could charge for executing an incoming order against any protected quotation to $0.003 ("3 mils") per share. We are deeply troubled by this proposal. Contrary to any characterization that 3 mils would represent a "cap" on access fees, we believe that 3 mils would effectively be a floor, especially with the proposed elimination of the opt-out exception. Access fees started out at a maximum of 1½ cents in 1997 and have gradually decreased over time through competitive forces and regulatory action to what the

Commission views as current business practice (*i.e.*, an average charge across the industry of about 3 mils). However, without the ability to avoid a trading center that charges 3 mils compared to another that charges 1 mil or ½ mil, what commercial incentives will remain for trading centers to continue to compete with each other on the basis of their access fees? A 3-mil access fee is likely to become ossified unless and until the Commission were to intervene again and demand a decrease, a rate-setting role the Commission has historically and understandably eschewed.

The Commission contends that competitive forces can continue to put pressure on access fees – for example, a trading center that charges 3 mils might be placed further down in a broker-dealer's routing tables than a trading center that charges less than 3 mils. We do not agree that such action alone would result in any material competitive disadvantage to a trading center charging 3 mils. If we are correct about that, then one would expect all trading centers to remain at 3 mils, effectively putting an abrupt end to the gradual yet substantial cutting of access fees over the past couple of years. If we are wrong and the amount a trading center charges for access affects routing tables, then perhaps 3 mils (versus 2 mils or 1 mil) is not an immaterial amount, and we should reconsider our opposition to reflecting access fees in sub-penny quotations.

On this latter point, we note that one of the key reasons that has been articulated by regulators and market participants alike to prohibit sub-penny quotations is the limitation in bandwidth of market data vendors. That is an issue that continues to be the root cause of the 5- and 10-cent minimum price variations in the standardized options market. Nonetheless, given the dramatic increase in quotations that would be disseminated by the central processor if the Commission were to approve either the Voluntary Depth Alternative or, to a lesser degree, the Market BBO Alternative, it would appear that the limited bandwidth Rubicon has been crossed. If that is in fact the case, and technical limitations no longer serve as an argument for opponents of sub-penny quotations, and access fees remain a material component of broker-dealers' routing protocols, then we believe the Commission needs to reconsider its proposal to prohibit all sub-penny quotations. For example, a reasonable compromise might be to permit sub-penny quoting when the sole purpose is to reflect an access fee, but, to address other concerns the Commission has articulated (with which we continue to agree), prohibit sub-penny quotations under all other circumstances.

F. Reiteration of Certain Practical Comments

We wish to reiterate certain comments made in our previous comment letter concerning some very practical considerations that need to be addressed as part of any final Regulation NMS approval. These issues were not addressed in the Reproposal. Below are those comments exactly as articulated in our previous letter.

1. Clearly Erroneous Quotes, Orders and Trades

Currently, the markets do not have equivalent standards for determining when a quote or order is clearly erroneous. In connection with its uniform trade-through rule, the Commission should standardize the elements of a clearly erroneous quote that can be ignored for trade-through purposes. A trade-through rule based on automated quotes and fair access to those quotes can be corrupted by the submission of a clearly erroneous quote or order to an automated market. To help prevent such erroneous quotes and orders from negatively impacting the markets and participants' related order handling obligations, the SEC may wish to require markets to adopt a "speed bump" similar to the current Nasdaq procedure. Under this type of procedure, a market participant submitting a quote that is 10% or more away from the previous last sale price of the security would receive a query from the market displaying the quote as to the legitimacy of that quote. The market participant would have to respond affirmatively, and immediately, to the query for the quote to be disseminated. In addition, the Commission should address the disparate policies across markets (including the ECNs) for canceling clearly erroneous trades after the fact. Absent uniform guidelines, these policies will have a similar negative impact on the smooth operation of the trade-through rule.

2. Trading Halts

Another situation that the SEC also will need to address relates to trading halts and the application of the trade-through rule. An automated market should clearly identify when it is halted for a particular security or when it is no longer providing automated quotes for that security. Otherwise, a stale quote could create a logjam as other automated markets would be prevented from trading through that quote.

3. Clock Synchronization

In order to monitor and enforce a trade-through rule, it is essential that the Commission promulgate standards for an intermarket clock. The existing clock synchronization standards, which differ by market, combined with penny trading increments, would render it virtually impossible to effectively monitor compliance with the proposed trade-through rule.

IV. Implementation Issues

There are two additional points we wish to make regarding implementation of Regulation NMS, one relevant to enforcement, the other to the practical considerations of effecting the coding changes and other modifications necessary to begin operating under a new regime.

As to the first point, we note that both trade-through rule alternatives recognize the practical realities of the market place. For example, by requiring each trading center to establish, maintain and enforce written policies and procedures that are *reasonably* *designed* to prevent trade-throughs of protected quotations (and, if relying on an exception, that are *reasonably designed* to assurance compliance with the terms of the exception), the SEC recognizes that trade-throughs cannot be prevented with 100% certainty. The regulatory flexibility inherent in this standard is helpful for market participants as they consider the massive technology upgrade that awaits them upon Regulation NMS's ultimate approval, particularly given data latencies, bandwidth limitations and the associated technical challenges.

Regulation NMS also would require exchanges, Nasdaq and the NASD to establish and enforce rules that require their members to *reasonably avoid* displaying quotations that lock or cross any protected quotation and *reasonably designed* to assure reconciliation of locked/crossed quotations, and prohibit members from engaging in a *pattern or practice* of displaying locking/crossing quotations. Again, this reflects the SEC's recognition that locked/crossed markets can occur accidentally, especially given the differing speeds with which trading centers update their quotations. The SEC clearly understands that locked/crossed markets cannot be completely eliminated, rather only minimized with procedures reasonably directed toward that result.

The examples above indicate the Commission's and Market Regulation staff's awareness of practical market realities. It is essential that in implementation, the flexibility provided for in the rules as promulgated will be similarly recognized and observed in the context of the SEC's and SROs' various surveillance, examination and enforcement programs. In this regard, we request that such efforts take into account the fact that while technology brings obvious efficiencies, honest coding errors can lead to numerous faults. An environment in which inadvertent mistakes are dealt with more prudentially and clearly distinguished (from a punitive standpoint in particular) from nefarious behavior would be enormously beneficial to an industry currently overwhelmed with technology mandates. Clear language on these issues in the final release would go a long way toward addressing these concerns.

Our second point is that the intra-firm and market-wide technology effort that will be required to implement a Regulation NMS that includes either of the alternative trade-through prohibitions will require dramatic and far-reaching changes. While we recognize that the Commission will certainly want to ensure that all market constituencies are putting forth the effort toward a timely implementation of Regulation NMS, we ask it to establish reasonable deadlines and work closely with the industry to achieve a series of milestones in implementation. It is essential that all market constituents work collaboratively and cooperatively with each other and with the SEC throughout the implementation period. It is absolutely critical that the SEC provide, and compel the SROs to provide, timely and broadly disseminated guidance to the interpretive questions that will inevitably surface during the implementation period.

V. Conclusion

In closing, we believe that when it comes to market structure, the right result is worth waiting for. It is imperative that we not proceed in the wrong direction for the sake of getting something done quickly. We continue to believe that fostering competition and providing market participants with meaningful choice should be the overriding goals of market structure reform.

Morgan Stanley wishes to extend its gratitude to the Commission and SEC staff once again for their consideration of its views. We have enjoyed sharing our ideas on market structure reform over the past several years, and look forward to further discourse on this critical subject. We would be pleased to discuss this letter with the Commission and staff at their convenience. I can be reached at 212.762.8193, or, alternatively, please feel free to contact my colleague Ivan Freeman, Managing Director and Chief Operating Officer of Morgan Stanley's Institutional Equity Division.

Very truly yours,

Thomas N. McManus
Managing Director and Counsel

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