11 eWall Street Mt. Pleasant, South Carolina 29464 T 843.789.2000 F 843.789.2010 W www.atdesk.com

Automated Trading Desk, LLC

January 26, 2005

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

Re: File No. **S7-10-04**

Dear Mr. Katz:

Automated Trading Desk, LLC ("ATD") appreciates this opportunity to comment on Regulation NMS ("Reg NMS"). ATD is a technology firm that develops software and systems for the use of its brokerage subsidiaries to trade Nasdaq and listed equities on an automated basis. Since 1994, ATD has traded on its own behalf and for institutional clients through Automated Trading Desk Brokerage Services, LLC ("ATDB"). Since 2003, ATD has provided execution services for a broad spectrum of retail order sending firms through Automated Trading Desk Financial Services, LLC ("AUTO"). In 2004, ATD accounted for approximately 5% of all Nasdaq daily trades and 2% of all NYSE daily trades through ATDB and AUTO. The vast majority of these orders were passive limit orders entered via nearly every ATS and exchange possible.

Reg NMS is a significant proposal attempting to solve many of the issues associated with decades of change in the marketplace. The Commission clearly believes these proposals will be beneficial for market structure. However, many of the proposed changes appear to be based on the Commission's particular philosophical view of how the markets should operate as opposed to how they actually function. The Commission, throughout the proposal, flatly asserts the rules will increase the displayed depth and liquidity in the NMS. In several particulars, we believe the Commission is mistaken.

Trade-Through Rule

The Commission has decided that the Trade-Through Rule (aka "Order Protection Rule") will eliminate the majority of trade-throughs in today's marketplace. The Commission correctly identifies block-trades and trading-through 100-share quotes as significant sources of trade-throughs. However, the Commission fails to identify why other trade-throughs occur in today's market. Although proposed Reg NMS will stop some trade-throughs, we believe it will specifically allow most to continue. To begin to understand the effect of the proposed Trade-Through Rule, one must first understand why trade-throughs occur today. Then, and only then, can one examine what the likely effect of the proposed rule will be.

"WHY?"

Why do trade-throughs occur today?

In the listed market, the Commission highlighted exceptions in the current ITS Trade-Through Rule which allow block positioners to trade-through the market and which permit trade-throughs of 100-share quotations. What the Commission failed to specifically identify is that the NYSE and the AMEX regularly trade-through the limits of other market centers largely for anti-competitive reasons.[1] In an era of automation, the specialists understand it is highly unlikely that firms placing orders onto an Alternative Trading System ("ATS") will go through the hassle of calling the ATS, that the ATS will then call the specialist, and that the specialist will then deliver the fill owed. Conversely, ATSs are deathly afraid of being forced to give up a listed transaction to the specialists if they allow trade-throughs to occur.[2] For these reasons, all ATSs have built-in automated protections that prevent executions from occurring which could be potential violations of the current Intermarket Trade-Through Rule. These facts thwart competition in the listed marketplace and keep spreads artificially wide, both of which inevitably harm the public investor.

In the Nasdaq market, trade-throughs also occur for a variety of reasons. Block positioners account for a large percentage of trade-throughs, especially from a shares traded perspective. However, there are other important reasons for trade-throughs in Nasdaq that the Commission does not mention in the proposed release. A primary reason for Nasdaq trade-throughs is the use of reserve (or undisplayed) size. While reserve size orders have been in use for a very long time, these orders proliferated after the implementation of decimalization. As pennies became the minimum price variation, firms were then able to "penny-jump" large limit orders by economically insignificant amounts. Limit order traders quickly learned to protect their true interest by displaying only a small portion of their orders in Nasdaq and other ATSs. As a result of this behavioral shift, firms sweeping liquidity from the market inadvertently trade-through these reserve size orders. Obviously the sweeping firm would prefer not to incur higher execution costs; however, in an effort to quickly accumulate a position, they trade-through to their detriment. The trade off is between (1) speed and certainty of acquisition vs. (2) slowing down the trading process in an effort to find reserve size at the risk of missing liquidity at price points away from the market.

---

[1] According to the Commission's own study, the NYSE is twice as likely to trade-through the Nasdaq's quote than through their own quote. Analysis of Trade-throughs in Nasdaq and NYSE issues, Office of Economic Analysis, December 15, 2004 ("SEC Trade-through analysis") at Table 12.

[2] Some of the ATSs aggressively utilize the various exemptions in the ITS trade-through rules, partially explaining the high percentage of trade-throughs cited by the Commission in their study. SEC Trade-through analysis at Table 12. Of course, the worst percentage offender of trade-throughs in any category is the American Stock Exchange. SEC Trade-through analysis at 3 ("26.3% of [AMEX] trades were trade-throughs [in Nasdaq stocks]"), Table 5.

“WHAT?”

What will be the likely impact of the Trade-Through Rule in this version of Reg NMS?

The rule as proposed will reduce the number of trade-throughs of automated 100-share quotations in the listed marketplace. This is beneficial to the market so long as the protected quotations are truly automated per the rules defined within the proposal. With the anticipated introduction of reserve size orders in the listed marketplace, the benefit of this change will be substantially dampened.

The proposed rules specifically allow for trade-throughs via the “intermarket sweep” functionality. Trade-throughs of reserve orders will continue in the Nasdaq market just as is it does today. A similar trade-through will also begin to appear in the listed market as those market centers begin to implement reserve size functionality. The NYSE’s Hybrid Proposal includes a reserve size order that will cause the same trade-through phenomenon in the listed market as occurs in the Nasdaq market today. If the goal of the Commission is to prevent trade-throughs, **this rule does not meet that objective**.

The proposal will also fundamentally change the way Nasdaq block positioners handle orders for their customers. Instead of making a guarantee to execute at a specific price, thereby adding liquidity to the marketplace and assuming the market risk on the position, these firms will guarantee to “stop” an order at a specific price away from the market. Such practitioners will then immediately sweep liquidity in order to push the market to the price point of their guarantee. These firms will largely profit from “mean reversion” which, while risky, is a well-understood and practiced technique. Such practitioners will want to move the market aggressively with as little volume as possible in order to internalize a larger piece of the original order. This will increase volatility in the Nasdaq marketplace.

One of the Commission’s stated goals is to increase the number of displayed limit orders and the “quality”[3] of such orders. ATD is a significant user of limit orders of size and quality in both marketplaces. ATD’s orders would be run over by the activity of these Nasdaq block positioners. We clearly do not believe such adverse selection will motivate us to place larger limit orders for longer periods of time into the market.

In describing the potential benefits of the proposed rule, the Commission “believes that [the] $321 million estimated annual benefit [in bypassed limit orders], particularly when combined with the benefits of enhanced investor confidence in the fairness and orderliness of the equity markets, would justify the one-time cost of implementation and ongoing annual cost of the reproposed Trade-Through Rule.”[4] We believe the logic of this statement is fundamentally flawed. The proposed rule will create added market volatility due to behavioral changes by block positioners, the Nasdaq market will be

---

[3] The Commission appears to define quality as a combination of size of displayed order and the time the order remains displayed. Reproposed Regulation NMS at 35.

[4] Reproposed Regulation NMS at 74.

largely unaffected with regards to trade-throughs due to reserve size, and the listed market will begin to mimic the Nasdaq market's reserve size trade-throughs.

Depth Of Book ("DOB") vs. Best Bid Offer ("BBO")

In the proposed Trade-Through Rule, the Commission asks several questions regarding the use of Depth of Book vs. Best Bid Offer. Of the two alternatives, DOB would philosophically do the most to protect limit orders. While philosophy may drive some decisions, practicality must also be considered. Implementation of DOB has many consequences. First and foremost, DOB will be more difficult for all organizations to place into production. Fundamentally firms would be forced to access much more data including full books from all participants. At first blush, this would appear to be a minor change. Actually it is a large structural issue that will take some organizations a significant amount of time to implement. The problem is the least capable organization will drive how quickly this alternative can be implemented. All participants' systems must be up and running before it is practical to start. This pattern has repeated time-and-time again (decimalization, Order-Handling, OATS, etc…) In our estimation, choosing to adopt DOB rather than BBO will add at least twelve months to a scheduled phase-in and greatly increase the financial burden on the marketplace.

An alarming consequence of the DOB alternative would be a vast increase in the dissemination of market data. Over the course of the past several months, the number of quote updates has increased significantly. In particular, the number of orders being disseminated that are priced away from the market has increased, thus requiring more bandwidth to monitor the full market. Approval of the DOB alternative would yet again significantly increase the number of orders displayed to the market. We believe most firms are not prepared for the increase in market data that would accompany this change. This enormous flood of data is certain to challenge the ability of the Securities Information Processor ("SIP") to process and display the information in a timely manner (even with the SIP's recent bandwidth upgrade.) Any delay of data will subvert the intention of the Commission to protect posted limit orders. The "self-help" system delay exception to the Trade-Through Rule would be invoked on a daily basis thereby eviscerating the rule itself. From a practical perspective, it may be necessary to adopt the BBO alternative because the technical infrastructure of the market simply cannot support the onslaught of data the DOB alternative would create.

Sub-penny Proposal

ATD strongly supports the Commission's efforts to ban sub-penny pricing in stocks trading above $1, as sub-penny quoting leads to abusive market behavior and confuses the investing public. We encourage the Commission to immediately adopt this proposal. In contrast to other elements of the proposal, we do not believe there are significant technological or structural impediments to immediate implementation.

Access Rule

ATD generally supports the Commission in its proposal to allow fair access to quotations and to limit the amount of access fees. Regarding access fees, we would point out the Commission has a singular opportunity to do more than maintain the status quo in the market. In today's world of 0.003 fees and 0.002 rebates (slightly more or less depending upon the ATS), no ATS is capable of lowering their fees and rebates significantly because the limit orders upon which they depend will flee to other ATSs which offer higher rebates. The Commission could decide to cap fees at 0.002 or 0.001. This would force the ATSs to rebate less. Rebate driven strategies would be significantly impaired, and the remaining limit orders would largely be those seeking to find value in the market as opposed to merely earning a rebate.

ATD strongly supports the Commission's provision preventing locked and crossed markets. This goes hand-in-hand with access fees. Current economics encourage placement of orders which lock other market centers in order to both garner rebates and eliminate access fees. Much of the incentive to lock would be eliminated if access fees were capped at lower levels.

As with the sub-penny proposal, ATD would encourage the Commission to immediately adopt the access fee proposal (including the prevention of locked and crossed markets) as quickly as possible. While there are some technological issues to overcome, those problems are orders of magnitude less than those raised by the Trade-Through Rule. There is no reason to delay implementation of this part of the proposal.

Market Data

ATD is concerned about allocating credit for quoting as a component of the tape revenue calculations. The Commission believes the market will penalize participants who attempt to game the formula by placing orders to gain market data revenue.[5] We respectfully disagree. Frankly, this mentality has created the current environment which spawned trade shredding and rebate driven strategies. Under this aspect of the proposal, sophisticated firms will have a tremendous incentive to place orders which have little to no chance of executing while generating market data revenue.

If such a pattern of increased quoting occurs, it will require an increase in bandwidth necessary to deliver quotes to the marketplace. Everyone who reads such data will be penalized because of the added networking expense. This is an unfortunate result of any plan that encourages irrelevant quoting behavior.

[5] Reproposed Regulation NMS at 158-159.

Manual Markets

One of our fears is that Reg NMS may provide a raison d'être for manual markets. In particular, the participation of the AMEX in Nasdaq stocks is of grave concern.

The American Heritage® Dictionary defines *insignificant* as "having little or no meaning." In December 2004, the AMEX accounted for only 0.09% of all trades and 0.46% of all volume in EBAY. In striking contrast, the AMEX was at the inside of EBAY 58.7% of the time during the same period. In our view, such behavior by the AMEX does not add value to the national market system.[6] They distort the automated market with slow quotes which frequently cross the rest of the market. Only a manual trading system such as the AMEX could get away with such a perversion of the electronic marketplace.

The Commission has recognized the lack of value in manual quotes. Manual quotes have little or no economic value and are therefore excluded from participation in data revenue. Manual quotes are not provided trade-through protection. Manual quotes may be locked or crossed, although they may not lock or cross an automated quotation. Nevertheless, the Commission is proposing to retain NBBO status for these manual quotes. This is logically inconsistent, and provides incentives for unreasonable quoting behavior by manual markets.

In such a scenario, the AMEX may be willing to maintain a quote in Nasdaq stocks which establishes the NBBO even where there is no immediate intention to trade. Any firm wishing to provide liquidity to incoming orders has two choices: (1) match the price quoted by the AMEX, which is often unrelated to the actual trading interest in the stock at the time; or (2) route an order to the AMEX. If the order is routed to the AMEX, the specialist is basically provided with a free option on the order. If the market moves in their favor, the order will likely be executed. Otherwise, the order will remain unexecuted (but only after the opportunity to facilitate the customer's order at prices actually available have long since passed.)

In discussing the market data revenue proposal, the Commission stated, "Given the severe deficiencies of these formulas, however, it does not believe that the interests of any particular business model should preclude updating the formulas to reflect current market conditions."[7] Much the same could be said of manual markets such as the AMEX. In other words, given the severe deficiencies of manual markets, the Commission should not be precluded from updating the determination of the NBBO to reflect current market conditions.

---

[6] In reproposed Reg NMS at 89, the Commission states a concern that "eliminating manual quotations from the NBBO potentially would widen spreads in many stocks, even though the quotations often may in fact represent the best indication of the current market price of the stock." While the AMEX's quotes in EBAY may be narrowing the spread, they are obviously not providing a true indication of where the AMEX specialist intends to trade.

[7] In reproposed Reg NMS at 157.

ATD recognizes the Commission is faced with difficult choices regarding manual markets. Where a manual market is the primary market of a security, it may make some sense to allow that market's quotes to be included in the determination of the NBBO. However, in automated markets, this is clearly adverse to the purposes of Reg NMS. ATD suggests that, at a minimum, manual quotes be removed from the NBBO where the manual market is not the primary market.

Conclusion

ATD commends the Commission for tackling the thorny market structure issues in Reg NMS. If adopted, the access fee and sub-penny pricing proposals should be very beneficial to the national market system and should be implemented quickly. These rules are related to obvious, well-understood problems in the markets today. Further, the solutions to these problems are narrowly tailored to address the issues involved.

In contrast to these proposals, the trade-through proposal, under either alternative, appears to be a solution in search of a problem. This proposal is a sweeping change that we believe may have a tremendous number of potential unintended consequences.

If the Commission is determined to approve a trade-through proposal regardless of the potential negative consequences, we respectfully suggest a phased-in approach utilizing a pilot program. With a pilot program, empirical data could be collected and analyzed to determine the actual effects prior to wholesale implementation.

ATD appreciates the opportunity to submit its views on these matters and would be happy to discuss these issues further.

Sincerely,

Steve Swanson

Steve Swanson
CEO & President
Automated Trading Desk, LLC