KNIGHT

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January 25, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Re: File No. S7-10-04 Regulation NMS
Proposed Rules and Amendments to Joint Industry Plans ("NMS Release")
Release No. 34-50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004)

Dear Mr. Katz:

Knight Trading Group, Inc. ("Knight")[1] welcomes the opportunity to offer our comments to the Securities and Exchange Commission ("Commission") on re-proposed Regulation NMS (the "Reproposal"). Knight supports the Commission's efforts to modernize the regulatory framework for the national market system to address the serious market structure issues that exist today. Our comments expand upon the testimony we have previously provided at the Commission's April 21, 2004 public hearings on the NMS Release, and the comment letter we filed on July 2, 2004 in response to the Commission's initial request for comment on Regulation NMS.[2]

As we noted in our previous submission, the U.S. equity markets have transformed significantly since Congress amended the Securities Exchange Act in 1975 to establish the goals of the national market system. As Congress and the Commission both anticipated, data processing and communications technology have provided opportunities to improve trading efficiencies and enhance competition. Today, in fact, many market

[1] Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., and Knight Equity Markets International, Ltd., all of whom are registered broker-dealers. Knight and its affiliates, make markets in equity securities listed on Nasdaq, the OTC Bulletin Board, the New York Stock Exchange, and American Stock Exchange, both in the United States and Europe. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer, we make markets in nearly all equity securities. On active days, Knight executes in excess of one million trades, with volume exceeding one billion shares. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, Knight employs nearly 700 people.

[2] Knight previously submitted a comment letter to the Commission dated July 2, 2004 in response to Release No. 34-49325 and Release 34-49749. We respectfully request that that response be incorporated herein by reference.

centers offer automated trading facilities and compete with one another to attract order flow on the basis of their ability to execute incoming market and marketable limit orders instantaneously and at a certain trade price, which are qualities that many investors desire. Further, the core national market system goals of best execution, transparency, competition and market linkage are all premised on a single concept – the national best bid and offer (NBBO) or better.

We applaud the Commission for undertaking the complex task of strengthening and improving our national market system, and for the time it has expended meeting with various industry constituents to better understand a cross-section of perspectives. We are grateful for being provided the opportunity to both submit this additional comment letter, as well as to have met with the Commission and Commission Staff to discuss our views on this important initiative.

While we agree with the Commission that our national market system is in need of change and modernization, we disagree with certain key tenets of the approach advanced in the current Reproposal. Rather, we echo the views of many market participants (including, Nasdaq, the NYSE, financial institutions, and industry trade organizations) as it relates to adopting a more measured, poised approach to overhauling the U.S. capital markets.

Trade-Through Rule

One of the most critical components of the new Reproposal is the Trade-Through Rule. This aspect of the Reproposal has received significant attention and comment over the last several months. One thing is clear: the consensus of many market constituents is that an extension of the Trade-Through Rule is not needed at this point in time.

For example, in a Wall Street Journal commentary, Robert Greifeld, the CEO of the Nasdaq Stock Market wrote,

> Without a direct rule mandating that all investor orders need to be protected, we would remain dependent on the defining principle of best execution, self-regulatory organization and SEC oversight, and competition in the market to ensure that limit orders are protected. This multifaceted principle of best execution is a concept ….that has existed across all industries for centuries.[3]

Without a government-specified path for orders, all market centers have competed aggressively to create innovative and cutting-edge technologies, and to insure that their costs are as low as possible. Indeed, we believe that U.S. investors have never in the history of the U.S. capital markets experienced the pricing, speed and technological

[3] Wall Street Journal, (Dec. 8, 2004) p. A12.

efficiencies that they experience today. In short, the typical public investor experience in an equity transaction can be defined fairly today by two characteristics: (1) blinding speed; and, (2) the best published price.

John Thain, CEO of the NYSE, commented,

> Today, the preferences of investors and issuers, rather than regulation, determine which market models are successful. Investors in U.S. markets benefit from spreads that are among the tightest and transaction costs that are among the lowest in the world. They also benefit from the freedom to choose the type of execution that is right for their order. They choose strategies most appropriate for the size of their order and the nature of the stock traded. Whether they are a retail investor purchasing 100 shares or an institution trading one million shares, they have options that enable them to receive the best price from their trading venue.[4]

As evidence of this fact, one need only consider the information available through SEC Rule 11Ac1-5 (Rule 5).[5] Rule 5 was designed to promote visibility and competition in order execution quality, particularly with respect to relative execution price and speed. Rule 5 has succeeded. The Commission should be applauded for its foresight in adopting this rule, as Rule 5 has provided the investor with a level of transparency that is unparalleled in any commercial setting. For the first time in the history of our markets, all market participants must post their execute statistics in accordance with standardized metrics. This has helped to level the playing field among competing market centers, in that they can be uniformly benchmarked against each other. Order routing firms, on behalf of their clients, can now make more informed and intelligent routing decisions to suit their client needs. Rule 5 has also placed enormous pressure on market centers to compete and improve. This is exactly the type of competition, one based on transparency and fairness, which has made our markets the most efficient and effective in the world, and has served to improve significantly the quality of executions provided to investors.

These sentiments have been echoed throughout marketplace by a variety of market constituents. For example, in the comment letter filed by the Security Traders Association (STA), the STA urged the Commission not to overregulate with the proposed Trade-Through Rule, but to adopt a phased approach by mandating connectivity and access between market participants. We agree that such surgical and targeted changes would far better serve investors in that they would promote, “fair and equal access to markets; and more transparency.”[6]

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[4] Wall Street Journal, (Dec.21, 2004) p. A18.

[5] On November 17, 2000, the Commission adopted Rule 5 which requires "market centers" that trade national market system securities to make available standardized, monthly reports containing statistical information about "covered order" executions.

[6] Comment letter filed by the STA, p. 3 (January 19, 2005). *See* www.securitytraders.org

We wholeheartedly agree with this strong consensus, and firmly believe that a refined and targeted approach would clearly be the better course to take, and would obviate the need for further regulation. The current trading of equities is highly regulated and geared to the protection of investors. It stands apart from the regulation of other commercial transactions both in the U.S. and overseas. Further, mandates should be carefully considered to ensure that investors receive significant tangible benefits. In balancing the need for change and modernization of the rules governing the structure of the equity markets with the importance of promoting competitive forces, we urge the Commission to be cautious as it considers additional rules. Competition is the hallmark of capitalism and the spark which ignites innovation and progress. These are the engines which should drive positive change, rather than untested, mandated paths of trading.

As we noted in our July 2nd comment letter, not only is the extension of the Trade-Through rule not needed, but we believe that the preferred alternative would be to completely rescind the trade-through rule for listed stocks as well. The Commission has noted that trade-through protection is a fundamental precept of the national market system, a perspective with which we completely agree. Our difference lies not in the nature of the goal, but how best to get there. We believe that competitive forces will achieve the Commission's goals in a far less intrusive way once efficient and economic access is achieved.

In support of this Reproposal, the Commission has made reference to an analysis that concluded that 7.2% of the volume (or, roughly 2% of trades) executed on Nasdaq are traded through.[7] However, the adoption of a Trade-Through Rule does not necessarily lead to the conclusion that there will be any meaningful decrease in the small percentage of trade-throughs that occur on Nasdaq. As such, strapping the Nasdaq market with additional regulation with no demonstrated need or foreseeable benefit, may cause unintended results which may be difficult, if not impossible, to reverse once imposed. Advancing efficiency, competition and transparency is a much more effective solution to address this issue, rather than the drastic restructuring contemplated by the Reproposal. Nonetheless, if after establishing proper connectivity and access the Commission believes that further change is needed (e.g., some of the items suggested in its Reproposal), it can take the next step at that time.

Mandating more effective connectivity and access between market centers and participants is truly the next phase in the ongoing construction of a true national market system. The reason is straightforward: automated execution is a prerequisite to any type of nationwide price protection for public limit orders. There are ample descriptions of the trading inefficiencies that a non-automated market can cause for automated markets that are forced to deal with its inaccessible quotes. These problems also place brokers

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[7] *Memorandum from the Office of Economic Analysis "Analysis of Trade-throughs in Nasdaq and NYSE Issues"* dated December 15, 2004.

unfairly at risk for best execution liability when they are unable to obtain a better price for a customer because that price was inaccessible.

Importantly as well, the costs associated with either of the Commission's proposals dealing with trade-through will be substantial – particularly in the Nasdaq market where no trade-through rule has ever existed. Firms will be required to significantly augment their trading systems to effectively protect the market – in addition to the protection they are already required to provide to orders residing on their individual books. In short, the technology costs associated with the exponential increase in message traffic due, in part, to chasing quotes in stocks where the pricing changes several times within one second, would be daunting.[8] In addition, firms would be required to develop compliance and surveillance systems to monitor and supervise adherence with these rules, as well as add additional personnel to fulfill these functions. In light of these issues, it is clear that irreparable damage could be inflicted upon the efficiency of our markets with such a restrictive proposal, with only hopes of minimal benefits. Consequently, we submit that the costs associated with these changes far outweigh the nominal benefit of the Reproposal – especially in light of the fact the alternatives suggested in this letter (as well as those of the other market participants) provide a far less invasive, less costly way to achieve similar – if not far better, results.

Access to quotations

In the Reproposal, the Commission advanced two alternatives of the Trade-Through Rule: (a) market BBO alternative (commonly referred to as, "Top-of-Book") and, (b) voluntary display alternative (commonly referred to as, "Depth-of-Book"). We firmly believe that neither alternative is warranted. Specifically, if the Commission were to instead require seamless connectivity and permit immediate access to published quotations, market participants would be in a much better position to continue their pursuit of, and deliver, best execution. Equally as important, the investor will, and should, continue to demand faster and more efficient executions. Competition, if allowed to take its natural path and flourish, will spur – as it has done for the last 100 years, innovation and efficiency which have made our markets the envy of the entire world. Such an approach would also provide the Commission with valuable, reliable data upon which they could consider future action once they have thoroughly studied the results.

We do believe however, that non-SRO market centers such as ECNs must make their quotations available for auto-execution through the facilities of an SRO. In this way, other market participants will only have to maintain access to six or seven markets, not dozens.

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[8] In a world of flickering quotes, and with most trade-throughs today occurring at one penny, one has to question what possible benefit can be derived from such a restrictive proposal. Importantly as well, the Commission has recognized in the past that trade-throughs at these levels in certain liquid securities are not unacceptable when it adopted the de minimis trade-through exemptions for ETFs.

Additionally, we believe that manual quotes should not be part of the NBBO.[9] Only orders immediately accessible should be part of the NBBO. To proceed otherwise would not only hold the industry to an unfair standard of best execution, but would also serve to protect a somewhat antiquated market segment that has been marginalized by competition and innovative technology advancements.

Access Fees

It is necessary to address the market distortions caused by access fees (i.e., the economic incentive of certain market participants to lock and cross). We believe that all access fees should be eliminated. As we have previously stated, rate making should only be imposed as a last resort. However, if not completely eliminated, we support initiatives to control those costs. We also agree that all market participants should be permitted to charge fees, and that these fees should be applied to all orders and not just protected orders.

Sub-Penny Quoting

We have continuously opposed sub-penny quoting. If quoting conventions were to shift to sub-pennies, quote traffic would increase exponentially, forcing the industry into another round of substantial capital investments to accommodate the quote traffic. Most harmful to investors, penny pricing has made it easy for market professionals to step ahead of limit orders by providing economically insignificant price improvement, undermining the basic tenet of time priority that their limit orders should enjoy. Sub-penny trading would exacerbate these problems, and only benefit a small group of market professionals.

Locked and Crossed Markets

For all the reasons noted in our initial comment letter, we recommend that the Commission adopt a rule prohibiting any market participant from locking the quotation of an automated market. Knight has been a strong proponent for the elimination of locked and crossed markets and fully supports any proposed rule that eliminates this practice.

Market Data

We support a market data distribution structure which rewards quotations and trades, and discourages print shredding.

[9] The inclusion of manual, inaccessible quotes in the NBBO also diminishes somewhat the accuracy and precision of Rule 5 statistics.

Conclusion

We reiterate that U.S. equity markets are at an important point in their development. We fully support the considerable progress made toward achieving the goals of the national market system, but caution against acting too hastily on the Trade-Through expansion. Knight urges the Commission to carefully consider these issues, and to adopt a more measured approach toward overhauling the U.S. capital markets. We firmly believe that such an approach would be a more effective method of addressing these issues, as well as provide the Commission with important empirical data to consider in assessing whether further changes are indeed needed.

We join with our constituents, colleagues and competitors throughout the industry in respectfully urging the Commission to refrain from further changes to current trade through rules until the alternatives and analysis noted above can be properly examined.

Thank you again for providing us with the opportunity to comment on this critical initiative. Knight would welcome the opportunity to discuss our comments with the Commission.

Sincerely yours,

Thomas M. Joyce

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
Robert L. D. Colby, Deputy Director, Division of Market Regulation