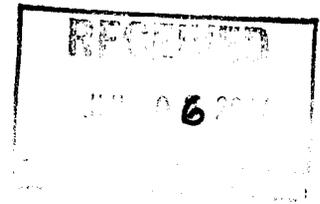




John H. Blucher  
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July 2, 2004

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. 34-49325 (Feb. 26, 2004), 69 FR 11126 (March 9, 2004)  
Extension of Comment Period and Supplemental Request for Comment  
("Supplemental Release"); Release No. 34-49749 (May 20, 2004), 69 FR 30141  
(May 20, 2004)

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Dear Mr. Katz:

Knight Trading Group, Inc. ("Knight")<sup>1</sup> welcomes the opportunity to offer our comments to the Securities and Exchange Commission ("Commission") on proposed Regulation NMS. 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 elaborate upon the testimony of Knight's CEO and President, Thomas M. Joyce, at the Commission's April 21, 2004 public hearings on the NMS Release ("April 21 Hearings").

The U.S. equity markets have undergone a significant transformation 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 centers offer automated trading facilities and compete with one another to attract order flow on the basis of their ability to

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<sup>1</sup> Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., Knight Execution Partners, LLC, Knight Financial Products, LLC, 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, American Stock Exchange, and in options on individual equities, and equity indices, 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 and approximately seventy percent of all option classes. 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, the eight year old publicly traded company employs nearly 1,000 people.

execute incoming market and marketable limit orders instantaneously and at a certain trade price, which are qualities that many investors desire.

### **The Need to Restore the Integrity of the NBBO**

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). By the early 1980s, the NBBO had become widely disseminated and universally perceived as the cornerstone of the national market system. Ironically, certain developments in recent years have diluted the reliability of the NBBO. Of greatest concern are hidden non-subscriber access fees and inadequate access to the public quotations of some market centers, especially manual markets. Decimal pricing has also contributed to less depth at the inside quote and a high incidence of flickering quotes (indeed, quotes can change several times in a single second). These features erode the value of the NBBO and with it the value of consolidated quotation information as an essential mechanism for integrating and promoting competition among market centers. Thus, market centers increasingly refuse or are unable to trade with one another. Locked and crossed markets in Nasdaq stocks occur with an alarming frequency. Trade throughs in listed stocks stubbornly persist.

We support the Commission's efforts to help restore value and integrity to the NBBO. The problems described at length in the NMS Release are very real and cannot be ignored. Doing nothing is not a viable alternative.

Knight commends the Commission for recognizing the need to take action. We are concerned, though, that in certain respects proposed Regulation NMS does not address core market structure problems. First, the Commission should address non-subscriber access fees in two respects: (i) prohibit ECNs from charging access fees when their quotes are accessed through the trading facility of a self-regulatory organization ("SRO"); and (ii) cap or otherwise regulate the non-subscriber access fees that ECNs and market makers may impose directly. Second, the Commission should mandate automated access (and execution) to all publicly displayed quotations. We are convinced that once non-subscriber access fees are addressed and all quotations are available on an automated basis, there will be no need for a trade through rule. It is simply not in the interest of market participants to bypass better prices if they have automated, economically efficient access to them.

If, however, the Commission does not take these actions, it has only one alternative: permit broker-dealers to bypass those venues that continue to charge non-subscriber fees and quotes that are accessible only via manual execution, without liability to their customers. As we describe below, we believe this can be done consistent with a broker-dealer's obligations to its customers, through a best execution safe harbor where the customer is fully informed of its broker-dealer's execution protocols and is provided with the NBBO on its confirmation.

## **Comments on the Specific Features of Proposed Regulation NMS**

### **1. The Commission Should Address Non-Subscriber Access Fees**

Proposed Rule 610 is intended to promote uniform access to quotations. One part of the rule would regulate the access fees that exchanges, Nasdaq and broker-dealers, including ECNs and market makers, may impose.<sup>2</sup> Knight agrees that it is necessary to address the market distortions caused by access fees. We are concerned, though, with the breadth and expansiveness of the Commission's proposal. This type of rate making should only be imposed as a last resort. In reality, the problems, although significant, are confined generally to non-subscriber access fees.

There are two discrete issues. The first is that ECNs are permitted to charge access fees when their quotes are accessed through an SRO trading facility and a user of those facilities is forced to pay those fees without any advance knowledge. The second is that the best execution obligations of brokers and many market makers force them to interact with ECN or market maker quotations that are not available through an SRO trading facility even if the ECN or market maker were to charge an exorbitant access fee.

This issue is exacerbated by the fact that ECNs use non-subscriber access fees captured in this manner to pay liquidity provider rebates to firms for posting orders on their systems. As the Commission is well aware, these rebates encourage harmful, quote gaming practices. For example, the NMS Release describes how some ECN participants intentionally post quotes that lock the market to induce someone to trade against the quote to unlock the market, for the purpose of collecting the liquidity provider rebate. It is bad enough that such practices occur; it is even worse to force others to pay fees to an ECN to subsidize the financial inducements used to encourage such conduct.

The second problem, of equal concern to us, relates to the non-subscriber fees that an ECN or market maker can charge for direct access to published quotes that it has not made available for trading through an SRO facility. Because these quotes are displayed in the NBBO, many broker-dealers are forced, as an extension of their best execution responsibilities, to access the ECN or market maker directly and pay whatever access fee

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<sup>2</sup> Rule 610(b). In addition, Rule 610(a) would also require quoting market centers and quoting market participants to provide non-discriminatory access to their quotes and Rule 610(c) would require SROs to establish rules requiring their members to take reasonable measures to avoid locking or crossing the published quotes of other markets. We believe that Rule 610 is intended to apply to equities and not listed options, *i.e.*, to NMS stocks, but we wish to confirm our understanding because the language of Rule 610 is unclear on this point. The provisions on locked and crossed markets apply to SROs and refer generically to "securities." The provisions on fair access and access fees do not refer to securities. Their scope is defined by reference to the activities of "quoting market participants" and "quoting market centers," which are defined in terms of providing quotes for securities covered by the Quote Rule. That rule, in turn, expressly covers NMS securities, *i.e.*, equities and listed options subject to consolidated trade reporting. The related discussion in the NMS Release focuses on the equity markets, and the rule makes more sense if it is limited in application to NMS stocks.

it is charging. Unlike exchange transaction charges, these fees are not regulated and can be used to extort exorbitant charges from brokers.

To address the market distortions these problems cause, the Commission is proposing to regulate all access and transaction fees. The proposal would cap the amount that any SRO could charge to .001¢ per share and cap the amount an ECN or market maker may charge when accessed through an SRO facility at .001¢ per share. This approach would mitigate the economic impact of access fees by limiting them to very small amounts, and thus would be a positive step towards an equal level playing field. However, Knight recommends a more focused and direct solution. To address the first problem (add-on charges imposed when an ECN is accessed through an SRO facility), ban ECNs from charging access fees when their quotes are lifted indirectly through SuperMontage or another SRO trading facility. To address the second problem (fees charged for direct access), the Commission should (i) cap the direct access fees that ECNs and market makers may charge; (ii) regulate such access fees in the same way it regulates SRO fees; or (iii) allow firms to bypass quotations that are subject to such fees and not accessible through an SRO trading facility.

In addition, the Commission should correct what we believe is an inadvertent gap in the “most favored customer” provision in proposed Rule 610(a)(2)(i). As drafted, that provision would require an ECN or market maker when not quoting through an SRO trading facility to make its quotations directly available for trading to other broker-dealers on the same terms – including fee rates – that it offers its most favored customers, but only when the broker-dealer seeking such access is itself not quoting through an SRO trading facility. We believe, however, that the Commission should extend the most favored customer terms to any broker-dealer seeking to effect trades against ECN or market maker quotes that are not otherwise accessible through an SRO.

ECNs have vigorously lobbied against any prohibition on their ability to charge access fees within SRO trading facilities, claiming that such a move would destroy their economic model. If this is truly the case, and their economic model is based exclusively on the receipt of compulsory fee collections from competitors, then we submit that such a model is flawed and should be changed. In short, ECNs should not be allowed to compromise market integrity through non-subscriber access fees.

The current proposal also contains anomalies that warrant further explanation. For example, the Commission makes no attempt to explain why only attributed quotes should be permitted to have embedded access fees. Unattributed quotes provide the same liquidity as do attributed quotes. Moreover, this distinction would appear to unfairly disadvantage markets such as PCX and NSX that do not have unitary specialists and are not permitted to identify the source of their quotations through the consolidated data stream. Although the Commission indicates in the Supplemental Release that an SRO could display attributed quotes through a proprietary market data stream that it makes publicly available, we question the feasibility of that approach. Moreover, many investors will in all likelihood limit the market data they routinely watch to the

consolidated display and the proprietary data made available by the primary SRO markets. From their perspective, they will not know the sources of quotes on regional exchanges even if the quotes are displayed with attribution in some other way.

Second, the Commission's fee proposal contains an anomaly with respect to quoting through the NASD's alternative display facility ("ADF"). If an ECN's quote is accessed directly through SuperMontage or an exchange, the subscriber can be charged up to .002¢. However, if an ECN's quote is accessed directly through the ADF, the subscriber is only permitted to be charged .001¢. We believe the purpose for this disparity needs to be further explained.

## **2. The Commission Should Mandate Automated Access and Execution**

In its NMS Release, the Commission asks whether it should "mandate automatic execution – that quotes be fully and immediately accessible at their full size – as part of its proposed access standards." [69 FR 11160] The answer is yes. The reason is straightforward: automated execution is a prerequisite to any type of nationwide price protection for public limit orders.

The NMS Release provides 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 are why the Commission is proposing a trade through exception that would allow an automated order execution facility to trade through the published best bid or best offer of any non-automated order execution facility. These problems also place brokers unfairly at risk for best execution liability when they are unable to obtain a better price for a customer because that price was inaccessible.

Thus, Knight recommends that the Commission require the exchanges and Nasdaq ("quoting market centers" under the NMS proposals), and ECNs and market makers that choose not to quote through an SRO order execution facility ("quoting market participants" under the NMS proposal) to provide automated and immediate access to their displayed quotes. The Commission mandated a similar standard in its approval of the ADF, and we agree that such requirements are imperative for an effective national market system. If an ECN or market maker does not wish to provide this access directly, it should be required to make its quotes available through the auto-execution facility of an SRO.

For purposes of this type of rule, Knight generally agrees with the Commission's proposed definition of an automated order execution facility. Under this definition, an order execution facility is deemed automated if it "provides for an immediate automated response to all incoming subject orders for up to the full size" of its publicly displayed best bid or offer. [Proposed Rule 600(b)(50)] We agree with recommendations at the April 21 Hearings that the Commission should define "automated" to mean that an order execution facility provides a response to incoming orders without manual or human intervention.

### 3. The Commission Should Not Adopt a Uniform Trade Through Rule

As trading of Nasdaq stocks equals and exceeds the volume of listed stocks, it is not surprising that the Commission proposes to harmonize certain basic national market system concepts as they apply to the markets for Nasdaq and listed stocks. Perhaps one of the areas that is attracting the most concern is the existence of a trade through rule for listed stocks while Nasdaq markets have never had such a rule. The Commission now proposes to end this difference by adopting a trade through rule for all NMS stocks. We believe that this is the wrong direction to go and that the preferred alternative would be to rescind the trade through rule for listed stocks.

The Commission points out that trade through protection is a fundamental precept of the national market system, a perspective with which we wholeheartedly 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. More specifically, these market forces will help restore the integrity and validity of the NBBO.

If all market centers provide immediate automated trade execution against their published quotes and hidden access fees are eliminated, price competition will become the most meaningful measure of execution quality. When that occurs, free competition among brokers and existing best execution standards will ensure that customers receive intermarket price protection, without need of any formal intermarket trade through restrictions. Markets will have to guarantee trades at the NBBO *as a minimum standard* or they will lose business. Broker-dealers that internalize order flow will have to follow the same market discipline to stay competitive and meet their best execution obligations. Although ECNs are not subject to the same best execution obligations, we believe that customers will not route their orders to ECNs that do not provide a mechanism for receiving an execution at the NBBO.

As proof of our concept, we need only look at data provided by the Commission in the NMS Release. In footnote 50, it points out that trade throughs in the QQQs did not increase after the Commission adopted the so-called *de minimis* trade through exception. By the same token, there is no indication based on Rule 11Ac1-5 data that trade throughs are more common in the market for Nasdaq stocks than for listed stocks. Fundamentally, market participants will do what is best for them if it is quick and cost effective. Trade through protection (or more succinctly, seeking out the best price) is in the best interest of market participants. As such, it need not be mandated by Commission rule.

If the Commission nonetheless adopts a trade through rule, it should adopt the proposed exemption which would allow an automated market to bypass quotes only available via manual execution. It is also imperative that the Commission adopt a corresponding best execution safe harbor to protect brokers from liability under SRO and state best execution standards, which hold brokers to obtaining the NBBO. (We discuss this more fully below.) The trade through exemption would be meaningless so long as trading through a

slow market constitutes a likely violation of a broker's duty of best execution under state and SRO standards.

Knight also supports a reasonable customer opt-out exception. However, we believe that it is administratively unworkable to require a broker-dealer to obtain the customer's consent to a trade price away from the NBBO each time the customer places an order. The Commission should allow a broker-dealer to obtain a customer's standing consent, following appropriate disclosure to ensure that the customer's consent is informed. The restrictions we propose should provide adequate investor protection against abuse of the opt-out exception.

Finally, we recommend that the Commission adopt a rule prohibiting any market from locking the quotation of an automated market, whether or not it adopts a trade through rule. Certain ECNs refuse to send orders to other markets displaying the best price, allowing their participants to deliberately lock those quotes. By permitting this activity, the Commission is shifting responsibility to correct the problem away from those causing it and, in fact, will reward them for locking the market by forcing others to trade against their quotes to unlock the market.

#### **4. The Commission Should Ban Sub-Penny Quoting in NMS Stocks**

The Commission is proposing to ban sub-penny quoting in NMS stocks. Proposed Rule 612 would prohibit the exchanges, NASD/Nasdaq, ECNs, vendors and broker-dealers from displaying, ranking or accepting quotes, orders or indications of interest priced in increments of less than a penny in NMS stocks except those priced below \$1.00 per share. Knight supports this proposal. 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. It would also complicate implementation of any inter-market trade through rule, should the Commission ultimately decide to adopt one.

When the U.S. equity markets moved from quoting in eighths to sixteenths, investors benefited greatly through reduced spreads and increased competition. It is open to question whether the same can be said of the move to penny pricing. The NBBO has far less depth than before, making it a much less reliable gauge of a stock's real price. Investors must now view volume at several price levels away from the NBBO to assess the market for a stock. Penny quoting has led to widespread problems of flickering quotes that are inaccessible and generate excessive quote "tape noise" that undermines the value of consolidated quotation reporting. 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 only benefit a small group of market professionals, and would exacerbate the foregoing problems.

We disagree with those who have suggested that the Commission should allow ETF securities to trade in sub-pennies. This change will not benefit investors, only some market professionals seeking more granular arbitrage opportunities. Sub-penny pricing would be counterproductive for *all* NMS stocks, including ETF securities, by contributing to the problems described above.

### **Alternative to Regulation NMS: Best Execution Safe Harbor Rule**

Best execution factors prominently in the Commission's justifications for its substantive rulemaking proposals. Although the Commission has repeatedly stated that broker-dealers may consider a number of factors when seeking best execution, in reality they are judged under SRO and state standards almost solely on the basis of a trade price's proximity to the NBBO. For the reasons explained above the NBBO has become an unreliable benchmark. It is unfair to expose a broker to liability when it is unable to execute a customer trade at the NBBO because that quote is inaccessible (due to inefficient or non-existent linkages) or non-representative of the market due to hidden fees.

If ECN access fees are not banned within SRO trading facilities (coupled with the other changes we recommend) and universal automated access to quotations is not mandated, the Commission should adopt a best execution safe harbor that makes sense for a national market system in which such problems continue to persist. Specifically, we recommend a safe harbor rule that would allow a broker to execute a customer order in accordance with execution criteria agreed to between the broker and its customer, subject to the added condition that the broker must provide the NBBO on its confirmations. We believe this approach is consistent with the flexibility afforded under the Commission's articulation of best execution standards. It also relies upon the long established federal policy of investor protection through disclosure.

We believe the best execution safe harbor rule would also further the regulatory objectives of the Commission's Regulation NMS proposal. Such an approach would clearly validate the NBBO, and restore it as a meaningful benchmark for best execution. In fact, we submit that such an application of the rule would allow markets to compete fully on the basis of commonly used industry metrics to assess execution quality: speed, price, service, enhanced liquidity, etc., thereby opening the door to meaningful competition in those areas. If slow markets can be bypassed by investors valuing speed and certainty of trade price, self-interest will quickly move the slower markets towards greater automation. If markets are forced to compete in part on the basis of the fees they charge, competition will keep those fees in check and should force ECNs to rethink the wisdom of imposing hidden add-on fees when their quotes are accessed through an SRO trading facility. (It may also force SROs to rethink the wisdom of permitting ECNs to charge such access fees.) This would be particularly the case if the Commission were to require access fees to be reflected in Rule 11Ac1-5 data, as it would undoubtedly impact effective spread and other statistical measurements. Brokers, too, will have their conduct

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influenced by competitive pressures; customers will seek out those brokers who share their standards of execution quality.

Indeed, the case could be made that the safe harbor rule is more closely aligned with the regulatory philosophy reflected in the Exchange Act. When Congress adopted the 1975 Amendments, it made clear that the Commission should seek to achieve the goals of the national market system through an oversight framework that relies upon competitive means to the extent feasible, with the authority to impose regulatory mandates to be held in reserve as a fallback.

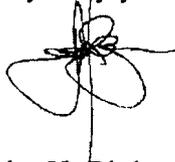
### **Conclusion**

The U.S. equity markets are at an important point in their development. There has been considerable progress towards achieving the goals of the national market system since 1975, but certain market developments are jeopardizing that progress and pose serious obstacles to meaningful intermarket competition and integration of competing market centers. Knight urges the Commission to pursue the regulatory changes we recommend to address the core problems of hidden access fees and inadequate access to published quotations of certain markets or alternatively, to adopt the best execution safe harbor rule we have proposed to allow competitive forces to address those problems.

Since the issues associated with Regulation NMS are so important, it may be appropriate for the Commission to conduct further public hearings to ensure that the regulatory measures the Commission ultimately adopts and their implications for the markets and industry are more fully vetted.

Knight would be happy to discuss our comments with the Commission.

Very truly yours,



John H. Blucher

cc: Chairman William H. Donaldson  
Commissioner Paul S. Atkins  
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