

# HILL, THOMPSON, MAGID & CO., INC.

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May 29, 2007

rule-comments@sec.gov

Nancy M. Morris, Secretary,  
Securities and Exchange Commission,  
100 F Street, NE.  
Washington, DC 20549-1090.

Re: Release No. 34-55717; File No. SR-NASD-2007-029  
National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule  
Change Relating to Access Fee Display Requirements for the OTCBB

Dear Ms. Morris:

Hill, Thompson, Magid & Co., Inc.<sup>1</sup> ("Hill") appreciates the opportunity afforded by the Securities & Exchange Commission (the "Commission") to comment on the National Association of Securities Dealers ("NASD") Proposed Rule Change Relating to Access Fee Display Requirements (the "Proposal") for the OTCBB.<sup>2</sup>

The 6500 series of NASD rules<sup>3</sup>, known as the "OTC Bulletin Board Rules"<sup>4</sup>, address the operation, use and regulation of the of the OTC Bulletin Board Service ("OTCBB"). NASD Rule 6540 directly addresses requirements applicable to market makers. Paragraph (b)<sup>5</sup> thereof provides that a qualifying alternative trading system (ATS) or

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<sup>1</sup> Hill, Thompson, Magid & Co., Inc. is a wholly owned subsidiary of the Royal Bank of Canada ("RBC"). RBC is Canada's largest bank as measured by assets and market capitalization and one of North America's leading diversified financial services companies. RBC employs approximately 70,000 full- and part-time employees who serve more than 14 million personal, business, public sector and institutional clients through offices in North America and 34 countries around the world.

<sup>2</sup> Release No. 34-55717; File No. SR-NASD-2007-029.

<sup>3</sup> NASD Rule 6500.

<sup>4</sup> NASD Rule 6510.

<sup>5</sup> NASD Rule 6540 (b) An alternative trading system (ATS), as defined in Regulation ATS, Rule 300(a), or electronic communications network (ECN) as defined in SEC Rule 600(b)(23), shall be eligible to participate in the Service, provided however, that such ATS or ECN is an NASD member and otherwise meets the

electronic communications network (ECN), shall be eligible to participate in the OTCBB and shall be deemed a market maker when such term is used within the OTCBB rules. Paragraph (c)<sup>6</sup> thereof requires an ATS or ECN to include any non-member<sup>7</sup> or post transaction access fee in its quote.

The NASD expresses concern that requiring an ATS or ECN to include access fees in its posted quote raises technical difficulties in quoting, trade reporting and proprietary trading. The NASD expresses its concern that a conflict exists between the obligations an ATS or ECN has under NASD Rule 6540(c)<sup>8</sup>, the requirement to include any access fee charged to a non-member in its quote, and its obligations under NASD Rule 2320(g)(2)<sup>9</sup>, which requires a market maker posting in two or more quotation mediums to display the same priced quotation in each medium. Posting to the OTCBB with an access fee and posting within its system without an access fee results in posted price divergence to the extent of the access fee. There is a similar concern with the effect of quote inclusive access fees on trade reporting. A trade reported inclusive of a fee, i.e. between the electronic network and a market maker, and a trade reported exclusive of a fee, i.e. between an electronic network and its member, would diverge by the amount of the access fee. NASD also expresses concern that executing trades at prices divergent by the amount of the access may be construed as an ATS or ECN engaging in proprietary trading.

As resolution, the NASD proposes amending NASD Rule 6540(c) to permit a participating ATS or ECN to exclude from its quote access fees at or below a defined threshold: three mils per share for securities trading at or above a dollar a share and three tenths of a percent for securities trading below a dollar a share.<sup>10</sup> Such amendment is not a matter of first impression. In 2005, the NASD proposed amending 6540(c) to resolve conflicts between ATS or ECN access fee posting requirements and its sub-penny initiative.<sup>11</sup> The instant proposal differs to the extent of the imposition by the NASD of

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requirements for participation set forth in the OTC Bulletin Board Rules. Where used in the OTC Bulletin Board Rules, the term "market maker" shall be construed to include a participating ATS or ECN.

<sup>6</sup> NASD Rule 6540 (c) A participating ATS or ECN shall reflect non-subscriber access or post-transaction fees in the ATS's or ECN's posted quote in the OTC Bulletin Board montage.

<sup>7</sup> As used throughout Hill's comment letter the term "non-member" means a non-member of the respective ATS or ECN. The term is not used herein to designate a non-member of the NASD.

<sup>8</sup> See Footnote 6 supra.

<sup>9</sup> NASD Rule 2320(g)(2) Members that display priced quotations on a real-time basis for a non-exchange-listed security in two or more quotation mediums that permit quotation updates on a real-time basis must display the same priced quotations for the security in each medium.

<sup>10</sup> Release No. 34-55717; File No. SR-NASD-2007-029.

<sup>11</sup> Release No. 34-53024; File No. SR-NASD-2005-095 Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 2 Thereto Relating to Sub-Penny Restrictions for Non-Nasdaq Over-the-Counter Equity Securities

access fee caps. However, Hill must respectfully disagree with the NASD that fee caps are sufficient to protect the OTCBB market place from the historically adverse effects of access fees on market transparency, price discovery, best execution, locked/crossed markets, fee gaming and fee disputes. Comments<sup>12</sup> submitted in response to the sub-penny proposal, with the exception of Archipelago, uniformly opposed non quote access fees. The commenters' raised a broad array of material issues that the imposition of fee caps does not adequately address.

In April 2007 there were 222 market makers participating in the OTCBB trading 3,494 issues<sup>13</sup>. Of these presently two market makers participate under Regulation ATS or ECN: Knight ("Direct Edge") and Archipelago ("ArcaEdge").<sup>14</sup> Knight has previously stated its intention not to charge access fees.<sup>15</sup> While additional market makers may appear under Regulation ATS or ECN to participate on the OTCBB, at present the discussion is about one, Archipelago. It is disquieting that the NASD proposes a market structure change to the advantage of the business model of one member that disadvantages all others. There is no showing by the NASD of a need to facilitate a broad market initiative for the benefit of the market place. Nor is there a showing by the

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<sup>12</sup> See Letter from Andrew B. Stevens, Assistant General Counsel, NYSE Group, Inc., and Greg O'Connor, Director of Compliance, Archipelago Trading Services, Inc., to Nancy M. Morris, Secretary, Commission, dated February 14, 2007; Letter from Julian Rainero, on behalf of Pershing LLC, to Nancy M. Morris, Secretary, Commission, dated March 6, 2006; Letter from Patrick E. Brake, Jr., General Counsel, Hill, Thompson, Magid & Co., Inc., to Nancy M. Morris, Secretary, Commission, dated February 21, 2006; Letter from Jerry O'Connell, Chairman, Trading Committee, Securities Industry Association, to Nancy M. Morris, Secretary, Commission, dated February 17, 2006; Letter from William Yancey, Chairman, and John C. Giesea, President and Chief Executive Officer, Security Traders Association, to Nancy M. Morris, Secretary, Commission, dated February 8, 2006; Letter from R. Cromwell Coulson, Chief Executive Officer, Pink Sheets LLC, to Nancy M. Morris, Secretary, Commission, dated January 26, 2006; Letter from Phylis M. Esposito, Executive Vice President, Chief Strategy Officer, Ameritrade, Inc., to Nancy M. Morris, Secretary, Commission, dated January 24, 2006; Letter from Leonard J. Amoruso, Knight Capital Group, Inc., to Nancy M. Morris, Secretary, Commission, dated January 24, 2006; Letter from Michael Santucci, President, Kimberly Unger, Executive Director, and Stephen J. Nelson, Co-Chair, Security Traders Association of New York, Inc., to Nancy M. Morris, Secretary, Commission, dated January 24, 2006; Letter from Phylis M. Esposito, Executive Vice President, Chief Strategy Officer, Ameritrade, Inc., to Nancy M. Morris, Secretary, Commission, dated October 31, 2005; and Letter from Kevin J. P. O'Hara, Chief Administrative Officer & General Counsel, Archipelago Trading Services, Inc., to Nancy M. Morris, Secretary, Commission, dated September 23, 2005. <http://www.sec.gov/rules/sro/nasd/nasd2005095.shtml>

<sup>13</sup> <http://www.otcbb.com/dynamic/tradingdata/monthly/generalstatistics.htm> .

<sup>14</sup> Two electronic based market makers, Automated Trading Desk, LLC and Noble Trading.Com, Inc., participate in the OTCBB. However, neither is to Hill's understanding an ATS or ECN.

<sup>15</sup> See Letter from Leonard J. Amoruso, Knight Capital Group, Inc., to Nancy M. Morris, Secretary, Commission, dated January 24, 2006Knight Letter.

member firm that such market structure change is necessary to permit it to compete fairly in the market place. The NASD sub-penny proposal<sup>16</sup> was a market wide initiative. Hill did not oppose it. The amendment to the sub-penny initiative drafted in response to Archipelago's comment letter was still in furtherance of the NASD's market initiative. We vigorously disagreed with and opposed the amendment. But the amendment's proposal made sense in the context of the NASD's market wide initiative. The current proposal differs. It proposes a market structure change without market wide purpose.

In the proposing release the NASD expresses concern that compliance with Rule 2320(g)(2)<sup>17</sup> will be impaired if access fees are incorporated in an ATS or ECN quote resulting in impairment of price discovery and transparency between OTCBB quotes and quotes within the ATS or ECN. As discussed above, the OTCBB quote and the ATS or ECN internal quote will diverge by the amount of the access fee. Removing the access fee from the ATS or ECN quote results in Rule 2320(g)(2) compliance for the ATS or ECN. It does so, however, at the expense of transparency and price discovery across the whole OTCBB creating a dual tier or possibly multi-tiered market within the OTCBB.<sup>18</sup> Adjusting this technical compliance issue, which exists solely within and between an ATS or ECN and its members distorts best execution between an ATS or ECN and all other OTCBB contra party market makers. The issues of ATS or ECN trade reporting and proprietary trading mirror the quote issue, being quote inclusive access fee generated.

No real functional price or regulatory differential exists between access fee transactions whether quote inclusive ("quoted fee") or quote exclusive ("billed fee")<sup>19</sup>. Three mils or three tenths of a percent are the same money whether included in the quote or billed. An ATS or ECN that charges and collects an access fee has the same monetary differential between its execution with the street side and its execution with its member customers whether charged as a quoted fee or a billed fee. Corresponding quotes of a dollar plus three mils on the OTCBB and a dollar to members, whether as quoted fee or billed fee, equally result in posting divergent quotes in two quotation mediums. This applies equally to an ATS or ECN when trade reporting. And may equally be viewed as an ATS or ECN engaging in proprietary trading - buying at one price-selling at another. The point is access fees, whether quoted or billed result in the same monetary quote,

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<sup>16</sup> Release No. 34-52280; File No. SR-NASD-2005-095. Withdrawn 04/20/2007.

<sup>17</sup> NASD Rule 2320(g)(2).

<sup>18</sup> Actually the market place created is more complex than two tiers. It would be multi-tiered, comprised of non access fee quotes of non ATS or ECN market makers, non access fee quotes of ATS or ECN market makers who choose not to charge, and access fee quotes of ATS or ECN market makers who chose to charge. This is further complicated by the addition of ATS or ECN market makers who for competitive reasons or otherwise choose to charge fees below the cap.

<sup>19</sup> For this discussion Hill uses the term "quoted fee" for quote inclusive fees as required by NASD Rule 6540(c). The term "billed fee" represents access fees that are not quote inclusive or billed post transaction.

trade reporting and execution differentials. Accordingly the issues raised in the Proposal clearly emerge as ones of regulatory form rather than regulatory function.

Nor does the Proposal further the intent that Rule 2320(g)(2) facilitate best execution. The NASD in the rule's proposing release states, "NASD Regulation believes that members' displaying different priced quotations in different quotation mediums for the same security can be confusing and misleading to other market participants and, more importantly, to public investors. Moreover, requiring that members display consistent priced quotations in multiple quotation mediums will enhance the ability of other market participants to ascertain the best inter-dealer market for a security."<sup>20</sup> The Commission in its discussion on approval states, "Currently, an NASD member may display different priced quotations for the same non-Nasdaq security in different quotation mediums. The Commission believes that this practice can be confusing to market participants and, in particular, to public investors. Requiring that members display consistent priced quotations in multiple quotation mediums will enhance the ability of market participants to ascertain the best inter-dealer market for a non-Nasdaq security."<sup>21</sup> However, hidden costs impede best execution. If an ATS or ECN is not required to reflect all costs in their posted quotes, this effectively imposes hidden transaction costs on market participants. "Display of ECN fees in the quote is the only way to allow the broker-dealer to make optimally fast routing decisions without fear of mistakenly hitting an inferior quote".<sup>22</sup>

Quoted fee is the current OTCBB standard<sup>23</sup>. Fortunately, the OTCBB had the experience and knowledge of the history of access fee market disruptions when it first addressed the entry of an ATS or ECN into the OTCBB. Incorporating access fees in the quote was a skillful resolution balancing the rights of the two business models, market maker and ATS or ECN. It is a resolution discussed by the Commission in the Reg ATS Adopting Release.<sup>24</sup> The Commission there states its intent to revisit the issue at such time as the NMS markets move to decimalization. Quoted fees are transparent, without distortion to the quote montage, provide simplicity in best execution surveillance for firms and for the regulators while providing cost efficient billing and collection. With the

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<sup>20</sup> Release No. 34-42958; File No. SR-NASD-00-20

<sup>21</sup> Release No. 34-43319; File No. SR-NASD-00-20

<sup>22</sup> R. Gasser, J.P. Morgan Securities Inc., October 5, 2000

<sup>23</sup> NASD Rule 6540(c).

<sup>24</sup> Release No. 34-40760; File No. S7-12-98. The exchange or association may also require alternative trading system fees to be charged in a manner consistent with the exchange's or association's market, such as requiring the fee to be incorporated in the displayed quote. At such time as quotations in the national market system are reflected in decimals rather than in fractions, the Commission will reconsider the rule's limitation on alternative trading systems charging fees only as permitted by the national securities exchange or national securities association to which they are linked. At that time, the Commission will also consider whether alternative trading systems should be permitted or required to reflect any fee charged in their quotations.

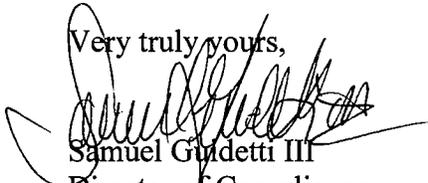
exception of ex-clearing trades, quoted fees settle automatically through the clearing house.

However, as the NASD brings to our attention, quoted fees do present technical compliance issues for the ATS or ECN model. Hill submits it is not necessary to shift the access fee paradigm from quoted fees to billed fees, even if such fees are capped, to provide the regulatory relief responsive to issues raised in the proposal. Hill submits these issues are readily addressed without market structure change through the NASD's existing exemptive authority.<sup>25</sup> The Commission, in the adopting release authorizing ATS or ECN participation in the OTCBB, indicated its expectation that the NASD would address how the transactions of ATS or ECN will be reported, cleared, and confirmed in light of the fact that such quote must include non-subscriber access or post-transaction fees.<sup>26</sup>

For the above stated reasons, Hill recommends the Commission not approve the NASD's proposal to amend access fee display requirements for the OTCBB.

We appreciate your consideration of these views, and would be pleased to discuss them further with you.

Very truly yours,



Samuel Gindetti III  
Director of Compliance

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<sup>25</sup> NASD Rule 2320(g)(5) (5) Pursuant to the Rule 9600 Series, the staff, for good cause shown, after taking into consideration all relevant factors, may exempt any transaction or classes of transactions, either unconditionally or on specified terms, from any or all of the provisions of this paragraph if it determines that such exemption is consistent with the purpose of this Rule, the protection of investors, and the public interest.

<sup>26</sup> Release No. 34-45915; File No. SR-NASD-2001-44 In addition, the Commission expects that the NASD will address how transactions on the OTCBB that result from the posted quote of an ATS or ECN will be reported, cleared, and confirmed in light of the fact that such quote must include non-subscriber access or post-transaction fees, if any. At Footnote 21.