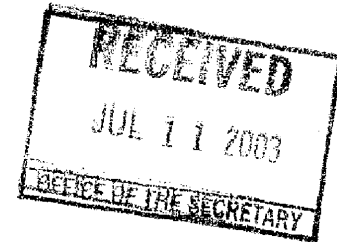


VIA: FEDERAL EXPRESS

July 8, 2003

Mr. Jonathan Katz, Secretary
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549



Re: SEC File No File No. S7-11-03 – Nasdaq Petition for Rule Making

Citigroup Global Capital Markets, Inc. (“CGMI” or the “Firm”) is pleased to submit this comment letter on the **Nasdaq Petition for Rule Making** (the “Petition”). As described more fully below, we support many of the underlying objectives set forth in **Nasdaq’s** petition, and we urge the Commission to address **expeditiously the** issue that **Nasdaq** raises. We believe that the time is **ripe** for the Commission to address the issues of regulatory arbitrage, and to exercise **its** rule-making authority under the Securities Exchange Act of 1934 (the “**Exchange Act**”) to ensure that investors receive the same **basic** protections no matter where an order is executed in the United States.

CGMI, which is formerly known as Salomon Smith Barney Inc., is an indirect wholly-owned subsidiary of Citigroup, Inc. CGMI is a registered **Nasdaq** market maker in approximately 800 Nasdaq-listed securities. CGMI is a member in **good** standing with **the NASD**, the **New** York Stock Exchange, and a number of other self-regulatory organizations/national **securities exchanges**. In addition, CGMI and **its affiliate** firms transact **securities** business in **more than 34** countries. Given our global **presence** and involvement in many jurisdictions each having different regulatory schemes, we believe we are in a **unique** position to address **many of the issues** that **Nasdaq** raises in the Petition.

Background

On **April 14, 2004**, **Nasdaq** filed with the Commission the Petition, in which Nasdaq requests that the Commission address “unequal and inadequate regulation” by the other **markets** that trade Nasdaq-listed securities. **Nasdaq** argues that exchanges are using regulation for competitive **purposes**, which **Nasdaq** asserts is inappropriate. Nasdaq argues that it has become increasingly difficult for the **NASD** to oversee trading in



Nasdaq securities **as more** regional exchanges and market centers begin trading Nasdaq **issues** on an unlisted trading **privileges** (“UTP”) basis. This fragmentation makes it much more difficult for any one regulator to detect **and** deter complex fraud and manipulative schemes that **may be effected** across multiple markets. Nasdaq suggests that the obligations of the NASD’s Order Audit Trail **System** (“OATS”), or other similar mandatory audit-trail requirements, should **apply** no matter **where** an order is routed for execution.

Nasdaq **asserts** that there **is** a gap in the **rule** structure **as well as** regulatory **resources** among the **exchanges** that **trade Nasdaq** issues. **Nasdaq** urges **the** exchanges to alter their **rule structures** to **ensure** that customers receive certain basic protections, and **to** dedicate appropriate resources to adequately surveil **for** activity on the particular exchange.

To address the issues related to fragmentation and regulatory arbitrage, Nasdaq **requests** that the Commission **use** its authority under the Exchange **Act** and Rules, and intercede in the following three ways:

- 1) **Nasdaq** requests **that the** Commission amend **the** rules of the UTP Exchanges to establish uniform trading rules and to ensure equal surveillance and **enforcement** of those **rules**.
- 2) Nasdaq requests that the Commission immediately order that the exchanges’ **costs** of regulation -- including audit trail collection, **surveillance**, and enforcement -- be aggregated and deducted from the market data revenue collected **pursuant** to the UTP Plan.
- 3) **Nasdaq** asks the Commission to identify markets that trade Nasdaq-listed **securities** without **approved rules, order** audit trail, surveillance, and examination programs that **are** sufficient to protect investors that buy and **sell** Nasdaq-listed securities on **those** markets. For those that do not, Nasdaq requests that the Commission exercise **its** authority under the **Exchange Act** to prohibit **the launch** or continuation of Nasdaq trading by any market that fails to **protect investors** as required under the **Act**.

The Commission requests that commenter address a **series** of questions related to the Petition, which CGMI **has** attempted to do in an **integrated** manner below.

Comments

We commend the Commission for focusing on the important market-structure issues that **the** Petition **raises**. **We** believe that the Commission is at a crossroads **given** the **recent** changes in the Nasdaq market. In particular, we believe that the rather sudden burst of UTP trading in Nasdaq-listed issues by competing market centers, in combination with **the** unique issues raised by electronic communications networks aligning themselves with **existing exchanges**, raises difficult and complex issues of first impression. In **resolving** these issues, **the** Commission should **be** guided foremost by the interest of protecting investors and **restoring confidence** in the national markets. **As** such, **we urge** the **Commission** to take action to ensure that no **matter** where **an** order is routed for **execution**, it receives **the same level** of protection and oversight. Strong regulation across all trading **venues** will ensure that **the** U.S. capital markets maintain their preeminence.

As explained in detail below, **issues** with **access fees**, sub-penny trading, and uniform regulatory obligations **each have a** significant impact on incentives for being a market maker. Significant **differences** in regulatory obligations between **Nasdaq** and other **markets** ultimately **create a** disincentive for firms to **provide** liquidity through market making. This will lead to less liquid markets, which ultimately will harm the investing public, issuers, **and** the national **market system**.

Access Fees and Locked-Crossed Markets. In our experience, the proliferation of UTP trading of Nasdaq securities **has caused** significant fragmentation in Nasdaq. **As** the Commission is **well aware**, a substantial portion of Nasdaq order **flow** has migrated to new "low cost" market centers. The fact that at least two of **these** new markets **are** electronic communications networks/alternative trading **systems** ("ECNs") that **are** grafted onto **existing** regional **exchanges** **poses** difficult **challenges** for market participants and the Commission. **Market** participants confront difficult issues with **access fees**, jurisdictional reach of certain **rules**, conflicts in marketplace obligations, and general concerns with **best execution**. The **resulting** fragmentation has created **legal** and regulatory uncertainty, which can hardly benefit **investors or** the market. The Commission must act to resolve outstanding conflicts, cure the **resulting** inefficiencies, and restore certainty and confidence to the markets.

A major concern for virtually all **market participants is the** arbitrage opportunities created by quote-access fees and **the lack** of an inter-market lock/cross **rule**. While the **NASD** and **Nasdaq** **have** adopted **rules** regarding locked/crossed markets, there is no inter-market rule governing the entry of quotations that lock or cross another market

center.¹ Additionally, unlike participants in the Intermarket Trading System (“ITS”) for the listed **markets**, ECNs are permitted to **charge a fee** to the public when their **quote is accessed**. The combination of these two structural **issues creates opportunities for fee arbitrage** among **markets** and market **participants**. This in turn **harms** public investors, and **disrupts** fair and **orderly** markets, as illustrated below.

For example, a market participant (“MP”) has a proprietary limit order to buy 1000 shares at \$20, and the inside market is \$19.99 to \$20.00. MP’s limit order is **marketable** against the \$20 **offer**. The \$20 offer represents a retail sell limit order that is being displayed in “Exchange A.” In this case, MP has two **options** on how to handle its proprietary order: 1) send the order to **Exchange A** and pay an access fee (typically, .003 cents per/share); or 2) route **the order** to another market **center** (e.g., Exchange C), lock Exchange A’s quote, and wait for the market participant representing the limit order on Exchange A to **access** MP’s locking quote. **MP A has a great incentive to lock the market** by posting on Exchange C because Exchange C will pay MP a **rebate** (.002 cents per/share) to **execute** its order there.

As this example illustrates, the opportunity for fee arbitrage harms the customer limit order that is being displayed in Exchange A. While **the order has price and time priority**, it goes unexecuted at least for a **brief moment** in time. Second, trading costs **are** increased for **the market** participant that is displaying the customer sell limit **order**, since best execution **concerns** will require **her** or him to access the market that initiated the lock.² Similarly, fee arbitrage harms the quality of the market because of the increase in frequency of locked/crossed markets.³ While locks/crosses often are short in duration, they distort price discovery for that **period**. **In the aggregate, we understand that some active Nasdaq stocks are locked for 25 percent of the trading day, which in CGMI’s view is unacceptable and indicative of a structural problem.**

To address this **issue, we urge the Commission to adopt a locked/crossed market rule that applies to all market participants no matter where they decide to post their liquidity. As a first approach, we would favor eliminating quote-access fees that only ECNs are permitted to charge. We do not think that it is appropriate for a special class of market participants -- ECNs -- to be able to charge the public an access fee when**

¹ A locked market occurs **when a quote is entered on the bid (offer) side of the market that is priced the same as the national best offer (best bid)**. A crossed market occurs when **a quote is entered on the bid (offer) side of the market that is priced greater than the national best offer (best bid)**.

² **Many market participants stop providing automatic execution guarantees in locked markets, and most (if not all) stop executing retail orders in crossed markets, due to best execution concerns and lack of price discovery.**

³ **We understand that some market participants employ a trading strategy that is specifically aimed at arbitraging access fees. Also, some popular trading systems and service bureaus have developed functionality to assist with these arbitrage strategies by posting locking limits in unlinked markets.**

representing an agency order, while other market participants who engage in virtually **identical** activity **are** prohibited from doing so. The Commission should allow **all** market participants to charge a quote access fee, or allow **no** market participant to charge **such** fee to public investors.⁴

While the preferable approach is to prohibit outright quote-access **fees**, CGMI understands that a narrowly-tailored solution may be more practical, at least for the near term. In this connection, **we** believe the Commission should adopt a rule that requires **market** participants to first attempt to access electronic markets before posting **an** order in the public **quote** stream that **locks/crosses** the national **best bid/best offer** (“NBBO”).⁵ Under this approach, if a market participant does not first **attempt** to access a quote **and** instead locks/crosses the NBBO, the **market** participant initiating the lock/cross would be prohibited from **charging** the public an **access** fee. This approach is similar to that which existed under NASD Rule 4613(e) **prior** to proliferation of UTP trading in Nasdaq, and therefore is practical from the Firm’s perspective (if tailored to apply to electronically accessible **markets**)!

Sub-Penny Trading. The time is **ripe** to address **the** issue of **sub-penny** trading. While **the exchanges** and self-regulatory organizations (“SROs”) transmit to data vendors quotations at the minimum **price** variation (“MPV”) of a penny, market participant **are** permitted to submit **orders** and quotes to ECNs and SRO trading **systems** that are priced in increments **finer** than the MPV. The market receiving the **sub-penny** order or **quote** rounds it **to the nearest** penny for display, and data vendors transmit **the** quote data **at** the penny level, consistent with their obligations under Exchange **Act Rule** 11Ac1-2 (“Vendor Display Rule”). **However**, some SRO trading systems and ECNs that accept orders in **sub-penny prices** disseminate **sub-penny prices** to their subscriber **via** their proprietary **order** book information. Many broker/dealers, exchanges, and service bureaus **incorporate** ECN **sub-penny book** quote/order information into their display and routing/execution engines.

Sub-penny pricing potentially distorts the public quote stream, creates hidden **markets**, and harms **the** average retail individual investor. While certain professional

⁴ Of course, broker/dealers (e.g., market makers and ECNs) should be permitted to continue to charge their **own** customers commissions and related fees.

⁵ This requirement should apply to markets whose quotes are electronically accessible, in that market participants should not be held to quotes of market centers that do not provide automated executions (i.e., executions within a few seconds).

⁶ This issue demonstrates the complex regulatory issues created by fragmentation. There has been general uncertainty whether the obligations under NASD Rule 4613(e) and 4613A(e) apply across markets. Arguably, it is logically inconsistent that a market participant may do indirectly (i.e., lock/cross the best bid/best offer through an away market) what the market participant is prohibited from doing directly in Nasdaq or the Alternative Display Facility (“ADF”). We understand, however, that it is the NASD’s view that the aforementioned rules are market based.

traders often have access to ECNs' proprietary book information and the sub-penny **prices reflected therein**, most retail investors do not. The main **source** that most investors **use** to **price** their orders and make investment decisions – Nasdaq Level II data and the NYSE's Consolidated Quote Data – is devoid of this important **sub-penny** order/quote information. Additionally, many professional traders use order-routing systems that direct orders based on this sub-penny pricing information. In contrast, many retail firms do not accept orders **in** sub-penny increments. Thus, not only do most retail investors not see the sub-penny **prices**, they cannot adequately compete **for** executions.

All investors should have access to the **same** level of **pricing** information. The most prudent action **is** for the Commission to mandate that the public quote and last sales (executions) be priced **at** the MPV. **We** understand that there would **be** significant technology implications if the Commission were to mandate the display of quote and order information at **the** sub-penny level. The burden of displaying orders at the sub-penny level far **exceeds** the benefit, in our **view**, particularly since U.S. currency is marked **to** the penny and virtually all other business transactions are **priced** to the penny. The investor protection and regulatory concerns associated with penny pricing, pennying, and front running, would be exacerbated if the Commission **were** to adopt sub-penny **pricing** across markets.⁷ The Commission **was** prompted to adopt Exchange Act Rule 11Ac1-4 and amendments to 11Ac1-1 (collectively, **the** "Order Handling Rules"), in **part**, because of concerns with hidden markets (retail versus wholesale/profession markets) and **lack** of transparency in the public quote. We believe it is wholly appropriate for the Commission to **take** remedial action to address **sub-penny pricing**, since this **issue presents many** of the same concerns **that prompted** the SEC to adopt the Order Handling Rules.⁸

Uniform Audit Trail and Real-Time Surveillance Requirements. **We** concur with Nasdaq that there should be a uniform audit trail system that is capable of detecting fraud, manipulation **and** other **rule** violations **across markets**. Instead of requiring each **SRO** to **adopt** distinct audit trail **requirements and** systems, we think it would **be** preferable for **there** to be one uniform audit trail system that **is** administered by a single SRO. This approach would reduce the potential for conflicting rules and obligations, and duplicative systems and technology requirements.

⁷ **Sub-penny pricing has an impact** on short sale regulation and limit order protection standards. **We** believe if the Commission is concerned **with** "pennying" on **the exchanges**, the Commission should be **equally if not more** concerned **with sup-penny pricing**.

⁸ **It is also concerning that the display of ECN book information by certain broker/dealers and exchanges is not subject to the uniform display requirements set forth in the Vendor Display Rule.** **We** believe **that this issue is of the same relevance as the Commission's guidance on the display of consolidated data at the MPV level.** See Letter dated July 23, 2002, from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Securities and Exchange Commission, to Edward Knight, Executive Vice President and General Counsel, Nasdaq Stock Market, Inc.

A similar concern exists for monitoring last sale prices. While Nasdaq's Market Watch Department actively monitors and validates Nasdaq-reported last sales, it appears that this **does** not occur at many of **the** other active market centers.⁹ As a result, aberrant prints that **are reported** by **the** other markets can distort the consolidated last sale.¹⁰ This **makes** index rebalance and "witching" days particularly difficult for dealers that accept market-on-close orders, as well **as** for mutual funds and index services that **price** off of the last sale. **The** Commission should require **each** SRO to put in place a comprehensive real-time, last sale surveillance function that meets minimum standards, or the Commission should centralize the "last-sale surveillance" function with one self-regulatory organization.¹¹

Uniformity of Marketplace Rules. We believe that it is in the best interest of the securities **industry** for the markets to **be** well regulated. Well-regulated markets **inspire confidence** and attract investors and issuers. The **U.S.** markets have been the envy of the world, in **part**, because the Commission has ensured through **its** oversight that issuers **and** investors **are** adequately protected and treated fairly. A loss of confidence will only drive investors away, not attract them to our markets. In our view, Nasdaq **serves** a critical role in the U.S. capital markets, in that it provide a vehicle for capital formation for companies that would not **otherwise quality** for listing on **the** New York Stock Exchange, **the** London Stock Exchange, and other similar markets. Many of these companies are leaders in their industry, and have fueled **the** economy by providing jobs, innovative technology and **new** consumer products.

Competition among **markets** is **one** of **the** **cornerstones** of the national **market** system. Clearly, competition in **Nasdaq** and certain regulatory changes have led to a reduction in trading costs, as **evidenced** by narrowed spreads and lower transaction fees. This, in turn, **has** benefited public investors. **The** interest in fostering competition among markets must carefully be balanced against the **need** for strong regulation. In the end, we **believe** that protecting investors is **paramount**. **As such, we are puzzled** that **some** **markets are using** the lack of regulation to attract order flow. **Whether a customer is defrauded or protected** should not **be based** on **where** the order **is** executed. Markets should not be **using** **gaps** in **rules** to attract orders at the **expense** of providing adequate oversight **and** regulation **of** that market.

⁹ For example, Nasdaq MarketWatch often will contact **market** participants on a **real-time** basis to verify that a trade is valid, and not **erroneous**.

¹⁰ We note that **away** markets **are** still relevant to the **Nasdaq** Official Closing Price ("NOCP") because Nasdaq retains the authority to adjust **the** NOCP **based** on **trades** that **are** reported away from Nasdaq. This introduces **risk** for market participants that use the NOCP to price market-on-close orders, indexes, and other financial products. See Head Trader Alerts 2003- **89** and **93** on Nasdaqtrader.com

¹¹ The SRO that performs this function should be compensated, of **course, for** its costs.

To this end, **we are concerned with the lack of uniformity in short sale and trade reporting obligations.**¹² **Some markets have declined to adopt a short sale rule for Nasdaq securities, while other markets have implemented such a rule.”** Those markets without a rule **use** this regulatory hole to attract order flow to that exchange.¹⁴ **We believe** that short **sale** regulation either provides needed protections for investors, issuers, and the market, or it **does not**. If the Commission deems this type of regulation **as important and** meaningful, then the Commission should require each market to adopt consistent short-sale rules. Markets should not **be** permitted to **use** the presence or lack of short **sale obligations** as a basis for attracting order flow or company **listings.**¹⁵ **If the Commission concludes short sale regulation is valuable, we would favor each market adopting a “bid test” ruled that is modeled on NASD Rule 3350.**¹⁶

Similarly, the Commission should harmonize trade-reporting **rules across markets, since** regulatory obligations are **often tied** to reported volume. Differences in trade-reporting practices, such as with riskless principal trading, have a direct impact on reported volume.¹⁷ This, in turn, **effects** regulatory obligations such as fair access requirements under Regulation **ATS, CQS** market maker quotation obligation, and the

¹² **As** stated above, we are concerned with the lack of uniformity of locked/crossed market obligations.

¹³ For example, the Chicago Stock Exchange, the Cincinnati Stock Exchange, and the Archipelago Exchange have no short sale rule for Nasdaq issues. In contrast, the Boston Stock Exchange, Nasdaq, and the Alternative Display Facility (“ADF”) each have adopted bid-test based short sale rules.

¹⁴ **This** raises similar concerns as fee arbitrage. For example, a market participant in Nasdaq that otherwise is prohibited from executing a short sale limit order (i.e., an order that is priced at or below the inside bid, during a down bid), can circumvent short **sale** regulations by routing **the** order to a market without a **short sale rule**. **These** markets will display the short sale order, and lock or **cross** the market, since the non-exempt short sale order is priced at or below the national best bid. One goal of short sale regulation is to prevent price manipulation that is often caused by successive short sales at or below the national best bid. The underlying aim of **the rule** is frustrated if the proscribed conduct is not prohibited across **all** markets trading the same securities.

¹⁵ If a listing market does not have a short sale rule, a competitor listing market will use this fact to attract company listings. Conversely, if a listing market has enacted a short sale rule, its competitor trading markets (i.e., market that competes for order flow, but not listings) will use **the lack** of a short sale rule to attract order flow. Again, this is another example of how regulation is being used for commercial gain.

¹⁶ The lack of a **uniform** short sale **rule** has posed **some** difficult jurisdictional issues for firms. Specifically, some have taken **the view that Rule 3350** is a conduct-based rule, and that it prohibits a member from **affecting** an illegal **short sale** (i.e., a **short** sale at or below the current bid, during a down bid situation) on markets that do **not** have a **short** sale rule. **See NASD Notice to Members, 94-68, Question 32.** Others **have** taken the view that Rule 3350 is market-based rule (even though it is in the “Conduct Rule” section of **the** NASD manual) and thus applies only to the Nasdaq market and ADF. A similar jurisdictional issue exists under **the** NASD’s Manning Rule (IM-2110-2).

¹⁷ We understand that in some instances an **exchange** member will **execute a** trade through a Nasdaq systems, the exchange will also report the trade to the tape even though Nasdaq systems have automatically reported the execution. It appears that these exchanges do not **have** rules specifically addressing this type of conduct.

NASD's trading **activity** fee. Reported **volume** has a direct impact on the **allocation** of **market data** under the Nasdaq UTP Plan, as **well as** certain **exchange** profit sharing plans. Standardizing the obligations across markets **would** assist firms in meeting their regulatory obligations and would remove markets economic incentives to inflate volume.

We wish to **emphasize** that we are not advocating that markets adopt identical rule **sets**. Marketplace rules should **be** tailored to comport with a market's structure. In undertaking review of **the various** SROs' rules, the Commission must **be** guided by the **need to** ensure consistent obligations and the **need** avoid duplicative and/or conflicting **rule** requirements. Resolving conflicts **and** ambiguities among similar SRO **rules** will lead to **more** efficient markets, and relieve firms of the burdens that are created by conflicting regulatory obligations.

Best Execution. **Lastly**, the Commission should **use** this opportunity to **address** best execution and trade-through obligations. **We are** concerned that certain manual markets are able to set the national best bid/best offer but their quotes are otherwise inaccessible, when **these** quotes are virtually inaccessible. Specifically, **we** are concerned that the quotes from these manual markets are used as a basis for measuring firms' best execution obligations. **Inaccessible** markets are particularly troubling in the highly automated Nasdaq environment where customers **often** value and demand **speed** and certainty. **We** believe that either, similarly-situated markets should be measured against **other** similar markets (electronic to electronic/manual to manual) or the Commission should **impose** minimum response times of a few seconds on all markets."

Summary

Access fees, sub-penny trading, **and** unequal regulation **each have** a significant **impact** on incentives to being a **market maker**. Except **for** exemptions from the short sale rule and **affirmative** determination **obligations** and the **ability to post** liquidity on an **attributed basis**, there **are few** benefits to **being a Nasdaq market maker**. **Each of the** aforementioned issues creates **a hurdle to liquidity provision**.

Substantial differences in regulatory obligations among markets **will encourage** traditional **market makers (and** other broker/dealers) to **quote** and/or trade in less-regulated markets, since they **can engage** in **virtually** the same activity outside of Nasdaq with **fewer** obligations and **costs**. The **special** fee-charging **status** of ECNs also **creates** disincentives for **market makers** to **post** liquidity through their Nasdaq **quotes**, given that

¹⁸ **As to the listed** market, given that **approximately 80 percent** of the volume is reported to the **New York Stock Exchange**, we do not believe that **the regulatory issues** presented in the Nasdaq petition rise to the same level of concern in **the listed** environment. The Commission should **first address** the Nasdaq **market** since **SEC resources are limited**.



market makers are **unable** to charge **an** access **fee** but receive rebates when they represent orders through ECNs. Further, uneven short-sale regulation encourages liquidity to migrate from highly-regulated environments such as Nasdaq and the **NASD**, to **some** of the less-regulated markets. Customers will demand that brokers route their orders those **markets** without a short sale so that they **can** skirt **the NASD** and Nasdaq rule requirements. This will exacerbate the **fee** arbitrage and locked/crossed markets issues described above, and increase fragmentation.

Without Commission action, fragmentation will only serve to hamper the NASD's ability to effectively detect and deter fraud and manipulation and to protect investors. Fragmentation and regulatory arbitrage will discourage firms from providing liquidity through market marking activities. Ultimately, this could **lead** to **even** more consolidation in the industry, **less competition** for order flow, greater fragmentation, and less-liquid markets. **To be** sure, the public will not benefit from a diminution in liquidity or less regulation. The Commission should act expeditiously to curtail any further harm to the public, issuers and the markets alike.

* * * *

We thank the Commission for this opportunity to comment on these important issues. Please feel **free** to contact John Malitzis at 212-723-5875, Amy Reich at 212-723-5781, or me if you have any questions.

Very truly yours

A handwritten signature in cursive script, appearing to read "Richard G. Ketchum".

Richard G. Ketchum