

VIA FEDERAL EXPRESS AND ELECTRONIC MAIL

July 20, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Regulation NMS (File No. S7-10-04)

Dear Mr. Katz:

Citigroup Global Markets, Inc (“Citigroup” or the “Firm”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) proposed Regulation NMS, which contains several interrelated proposals designed to modernize the regulatory structure of the U.S. equities markets.¹ The proposals, involving trade-throughs, intermarket access, sub-penny pricing, and market data, have broad implications for the U.S. capital markets.

Citigroup is a global financial services firm that provides investment banking, securities and commodities trading, asset management, and advisory, research and brokerage services to customers. The Firm is a registered market maker in approximately 2500 Nasdaq-listed and over-the-counter securities, is a member of the National Association of Securities Dealers, Inc. (“NASD”), the New York Stock Exchange, Inc. (“NYSE”), and a number of other national securities exchanges. Additionally, the firm has a substantial floor operation on the NYSE, is a registered market maker in the Consolidated Quotation System (“CQS”), and is one of the largest block positioners in listed securities. Citigroup is also a member of the major financial markets in the UK, Europe, Asia, and Latin America, and conducts business in approximately 34 countries around the world. In addition, Citigroup, through Citigroup Asset Management, provides asset management services to institutional and individual investors, and in doing so acts as a buy-side firm accessing all market centers and participants. As such, we believe we are well positioned to comment on these significant and far-reaching market structure proposals.

¹ Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (“Regulation NMS” or the “NMS Release”). Subsequently, the SEC issued a supplemental request for comment and extended the comment period. Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (“Supplemental Release”).

Citigroup commends the Commission for addressing developments in our markets that affect the operation of the National Market System (“NMS”) mandated by Congress in 1975. Over the last decade, advances in technology, increased trading across multiple venues, the proliferation of alternative trading systems, concerns with regulatory arbitrage, decimal pricing, and sub-penny trading all have given rise to practices that pose challenges to the smooth functioning of the national market system. In response, both Congress and the Commission have held numerous hearings and roundtables over the last several years to debate market structure issues, culminating in the Commission’s issuance of proposed Regulation NMS. We agree with the Commission that the time for resolving these issues is now. We believe, however, that a deliberative, measured approach is necessary in order to minimize the risk of unintended consequences that the proposed rules may present.

As stated in the Release, the Commission’s goal is to advance the objectives of the NMS -- price transparency through aggressive quoting and the display of limit orders, efficiency, competition, and best execution. However, although we believe that a trade-through rule would be superfluous if all markets were linked efficiently and subject to automatic execution, this clearly is not the state of the national market system today. To be certain, Citigroup fully supports the goals associated with a trade-through rule. Undoubtedly, there will be challenges and opportunities for all market participants regardless of the form of the Commission’s final action. In formulating our response, Citigroup has spent a great deal of time analyzing the proposals, thinking through the issues, and anticipating possible unintended consequences. We have attempted to put aside our institutional interests and to consider the structure that would be best for the market overall. We firmly believe that the benefits of fair and efficient markets, characterized by transparent prices, firm and accessible quotations, efficient linkages, and quick executions, accrue to all market participants, but most importantly to our customers whose interests are paramount.

I. Summary

- Intermarket Price Protection. Citigroup supports intermarket price protection. We believe that an intermarket price protection rule should apply to those best bids and best offers that are firm and accessible across all market centers for all Nasdaq and exchange-listed stocks.
 - Citigroup applauds the Commission for distinguishing between fast markets and slow markets, but we believe a more appropriate distinction would be firm quotes and indicative quotes.
 - The Commission should define a firm quote and an indicative quote, and only self-regulatory organizations (“SROs”) should be allowed to post an indicative quote under very limited circumstances pursuant to rules reviewed, approved, and audited by the Commission. Individual brokers

(market makers, specialists, or electronic communications networks) should not have the latitude to determine whether their quote is firm or indicative.

- Because indicative quotes are not firm and not accessible, the right to trade through an indicative quote should be absolute. An indicative quote also should not be allowed to set the National Best Bid and Offer (“NBBO”).
- We also believe that specific and narrowly defined exceptions to a price protection rule would be appropriate for liquidity-providing transactions. Such exceptions would include intermarket sweep orders, large block trades, benchmark trades, closing cross transactions, and certain derivative transactions.
- Intermarket Access. Citigroup believes efficient intermarket access to quotes with which market participants are obligated by regulation to interact, should be a precondition to an intermarket price protection rule and may even render such rule obsolete. The Commission should ensure that linkages are in place and operating effectively before requiring intermarket price protection.
 - Linkages/Connectivity. Citigroup is in favor of the Commission’s proposed market access standards for private linkages. We believe that Alternative Trading Systems (“ATSS”) that represent less than 5% of the volume of a market center should be required to participate in an SRO-sponsored quotation and execution system to ensure fair and reasonable access to the ATS’s quotes.
 - Value to Membership. Citigroup believes that markets should not be able to discriminate unfairly in terms of access, but should be able to charge different fees to non-members who access their market through the existing public linkage in order to avoid a race to the bottom in terms of regulation, and to encourage innovation.
 - Access Fees. Citigroup favors a complete ban on quote access fees. Access fees distort the public quote, and billing and collecting the fees across markets will present a huge administrative burden. In the absence of a complete ban, the proposal represents a reasonable compromise.
 - Locked and Crossed Markets. Citigroup supports the SEC’s proposed rule to prohibit locked and crossed markets.
- Sub-Penny Quoting. Citigroup supports the Commission’s proposal to ban sub-penny quoting, subject to certain clarifications.

- Market Data. Citigroup believes the cost of market data required for regulatory purposes, *i.e.*, last sale and NBBO data, which is used to drive best execution, short sale, and other regulatory obligations, should be limited to the cost of collecting, aggregating, and disseminating the data. Such a cost-based structure should be supported by transparent governance and fee-setting processes.

II. Citigroup Supports A Modified Price Protection Rule for Firm And Accessible Quotes

Citigroup strongly supports an intermarket price protection rule that is applicable across all the securities markets when quotes are firm and accessible. We believe that all markets generally should not trade through firm and accessible quotes. While we have no conclusive empirical or anecdotal evidence that a trade through rule is necessary in Nasdaq, in the interest of regulatory uniformity and compromise, we support a pan-market trade-through rule. Nevertheless, we urge the Commission to consider carefully the costs associated with such a rule and to adopt the trade-through rule only if the benefits clearly outweigh the costs.

Citigroup believes that quotes that are not immediately accessible should be considered “indicative,” and should not drive a broker/dealer’s regulatory obligations (*e.g.*, best execution and short sales). An intermarket price protection rule should apply to any purchase or sale effected through an order execution facility² and to any security (other than an option) that is listed on a national securities exchange or association.

A. Fast Markets Produce Firm Quotes and Slow Markets Produce Indicative Quotes

In the Release, the Commission proposes a fast versus slow market approach under which a fast or automated market would be able to trade through a slow, manual market. Under one of several proposed exceptions, a fast market could trade through a slow market up to certain allowable amounts (based on the price of the stock) that are designed to reflect the cost, including time value, of attempting to access the other market. A fast market could not trade through another fast market in any case. In the Supplemental Release, the Commission proposes a similar distinction at the quotation level. At its core, the fast versus slow market distinction recognizes that in some instances a price protection rule may work to the detriment of customers and may impede best execution where quotes are inaccessible or executions are subject to delay.³ As

² “Order execution facility” is broadly defined to include national securities exchanges and associations that operate a facility that executes orders, Alternative Trading Systems (“ATs”), exchange specialists and market makers, OTC market makers, block positioners, and any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent. *See* Proposed Rule 600(b)(50).

³ The SEC defines a fast market as an “order execution facility that provides for an immediate automated response to all incoming orders for up to the full size of its best bid and offer disseminated pursuant to an effective national market system plan without any restrictions on executions.”

discussed in greater detail below, we generally agree with the fast versus slow market distinction and exception. The fast versus slow market distinction in the proposal already has spurred competition and has prompted some markets to take steps to become more automated and efficient.⁴

In assessing the need for this exception to the trade-through rule, we believe the experience in the Nasdaq market should be instructive. In our experience, we observe very few trade-throughs in the Nasdaq market today, which operates without a trade-through rule, because the duty of best execution requires broker/dealers to obtain the best price for their customers, and because private linkages allow market participants to reach and access all electronic quotes.⁵ Additionally, a majority of the market centers that trade Nasdaq securities are automated. On the other hand, in the listed markets, the interests of providing speed and certainty of execution often conflict with the notion of providing universal price protection. These interests are reconciled more easily where markets are accessible and provide automatic executions.

While Citigroup supports intermarket price protection, we propose several modifications to the rule. These modifications reflect the realities of today's markets. Specifically, instead of the fast market versus slow market approach, we propose a distinction based on firm and accessible quotes versus non-firm and indicative quotes. This is similar to the fast versus slow quote proposal contained in the Supplemental Release, but with some distinctions. Citigroup believes that a price protection rule that is at the quote level would allow markets to make the decision to be firm or indicative on a security by security basis, instead of requiring the market to pick one business model for all securities, for all time. In this connection, Citigroup recognizes that there is value in different market models and types (*e.g.*, electronic, auction, hybrid), and that differing market structures excel in different areas. One model may be better able to provide value-added services to investors and/or to issuers with certain levels of liquidity and market capitalization, while another model may serve the needs of a different constituency. A quote-based approach would not require a market to adopt a single structure for the entire market. Instead, investor choice and competition would drive market structure for a given security -- not rigid rules.

⁴ Indeed, in public hearings that the Commission conducted on Regulation NMS, the NYSE testified that it is moving to a hybrid system that will combine an active trading floor with an automated execution facility. The NYSE has proposed to offer automatic executions for displayed liquidity through enhancements to Direct+, which will operate side-by-side with the auction market. *See* NYSE Testimony, SEC Hearings on Regulation NMS (April 21, 2004) ("Market Structure Hearings"). The American Stock Exchange ("Amex") noted that they may offer automatic execution for certain product lines. *See* Amex Testimony, Market Structure Hearings.

⁵ Although broker/dealers can reach all markets through Nasdaq, markets generally cannot reach one another, and will not reach one another in the absence of an effective linkage and a rule requiring access.

While we believe markets should have the choice to be firm or indicative, we strongly believe that markets should be required to file standards that clearly articulate when a market is firm versus when it is indicative. The ability to “turn off” a firm quote and go slow or indicative should be limited to those situations where there is reasonable justification supported by Commission policy and precedence, such as where there is an order imbalance or where a block is about to be assembled.⁶ The market must keep adequate records demonstrating when it was firm and when it was indicative, as well as detailed records of order-receipt time. This is necessary to address concerns of “backing away” where a market claims its quote is indicative, when in fact the public data stream and the market’s own internal records show that the market was holding itself out as firm when it received a specific order. Also, the decision to be firm or indicative should be made at the SRO level -- individual market participants within an organized market should not be able to control whether their quote is firm or indicative.

Indicative quotes should not drive a market’s or broker/dealer’s regulatory obligations, such as price protection rules, best execution requirements (including calculation of statistics under Exchange Act Rules 11Ac1-5 and 11Ac1-6), and short sale obligations. Additionally, indicative quotes should not be included in the calculation of the NBBO. This is because indicative quotes are not accessible to all market participants and therefore do not add to the price discovery process. This is of particular concern in an environment where a price protection rule can result in disciplinary action, as opposed to a complaint-driven approach, which is the case with the current trade-through rule. Furthermore, an indicative quote could halt the smooth functioning of the market and cause investor orders to go unexecuted if Regulation NMS were to require firms to honor indicative quotes. For example, a market participant could place an order in an inaccessible, indicative quote a few cents away from the inside market to halt trading beyond a certain price level.⁷

To promote self-policing, market participants should be required to publicly disclose the percentage of time, or each actual instance, that they did not provide a response in compliance with the standards required by the rule. This will give market participants the ability to evaluate market performance in order to meet best execution obligations.

As to the specific parameters, we recommend defining a “firm and accessible quote” as follows:

⁶ As set forth in our discussion of block exceptions, we would define a block as 25,000 shares and \$500,000 in value.

⁷ For this reason, we also oppose the price parameters/price bands that are contained in the proposed release, as it would be difficult to administer and, more importantly, could be subject to abuse. Regardless of the application of such a price protection rule, broker/dealers will continue to have a duty to seek to obtain best execution of their customers’ orders.

(1) The quote is subject to automatic and immediate execution or cancellation on a computer-to-computer basis with no human intervention. To manage risk effectively, market participants need certainty as to whether their order has been executed in full or in part, has been declined, or has been successfully canceled;

(2) The quote is subject to execution up to its total displayed size (depending on the size of the order) when an order is routed to that quote to fulfill intermarket price protection obligations (“intermarket sweep order”);

(3) In addition to the instantaneous, computer-to-computer requirement set forth in (1) above, markets should be subject to a maximum turn-around time of no more than one second to provide an execution against displayed size, a partial execution, or a cancellation. If a market exceeds this time, quotes coming from that market should automatically be designated as indicative;

(4) The quote is updated automatically; and

(5) The quote is accessible to all market participants, directly or indirectly, not just market participants in the market from which the quote is emanating.

Any quote that does not meet the requirements described above would be deemed an indicative quote. This requirement is necessary to ensure all markets have access to the best price, not just those members of a particular exchange or market.

Firm markets must be able to trade through indicative markets without regard to price. The price parameters for slow markets that were proposed in the NMS Release would be difficult to administer from a technology perspective, as trading systems would have to continuously read market data and determine the appropriate trade-through level. The proposed price parameters also would be unworkable in a less liquid stock where the spread is greater than the maximum price band. For example, the market could be frozen if the bid/ask spread in an inactive stock were six cents and a market with an indicative (non-actionable) quote were setting the inside bid/offer. In this situation, a market participant could not trade through the indicative quote even though that quote was inaccessible. Citigroup believes that an absolute ability to trade through indicative quotes is essential to a workable price protection rule. We believe that this approach will actually encourage markets to display real and accessible size, while discouraging the display of ephemeral quotes that distort price discovery.

As to specific obligations, we believe that market participants should be required to protect the best bid/best offer of each national securities exchange, and to protect the individual quotes of market makers and ATSs that publish quotes in (and are accessible through) an inter-dealer quotation and execution system of a national securities association. A price protection rule must protect the best bid/best offer in a competing dealer system in order to incent quoting market participants to display limit orders below the market’s best bid/best offer price. This is particularly true in a market like Nasdaq

where market makers and ATSS display attributable quotes at multiple price levels and these quotes are firm and accessible. The obligation to protect exchanges' best bid/best offers and OTC market maker quotes should apply to exchange-listed issues, where quotes are firm and accessible. We also believe that a market participant should be required to interact with displayed size only, and not reserve. Protecting displayed interest only should encourage display of greater size and quote competition, and also should bring certainty in determining a market participant's obligations under a price protection rule.⁸

Lastly, Citigroup believes that the SEC, not the individual market centers, should determine whether a type of quote on any particular market qualifies as "firm" or is "indicative." Otherwise, there invariably will be disputes among markets as to whether their quotes are firm, and market participants will be caught in the middle and unable to comply with regulatory obligations. Having the SEC decide removes any competitive concerns.

B. Exceptions

As noted above, the operation of the trade-through rule as proposed and the related exceptions raise difficult issues. The exceptions are extremely complex, would be difficult and costly to administer, and would impede certain trading strategies. Citigroup urges the Commission to consider alternative exceptions to the proposed trade-through rule as discussed below.

1. Narrowly-Tailored Exceptions Would Be Preferable to the Proposed Universal Opt Out Exception

Under the opt out exception provided in the proposed rule, an order execution facility could trade through a better priced bid/offer displayed on another market if the person for whose account the order is entered makes an informed decision to affirmatively opt out of the trade-through rule. The opt out would be required to be made on an order-by-order basis (*i.e.*, there would be no blanket opt out) and for each opt out order executed, the broker/dealer would have to provide the customer, within thirty days, the NBBO that existed at the time the customer's order was executed.

Citigroup opposes the opt out exception. As the Commission rightly points out, an investor "opt out" exception could create such a gap in the operation of the intermarket trade-through rule that the rule itself could become meaningless. Additionally, while we understand the rationale and the need for disclosure, we believe the conditions required to elect to opt out are so complex that the exception is unworkable. There will be sizeable system changes to implement the confirmation disclosure requirements as well as the order-by-order consent requirement. In short, we

⁸ As a practical matter, the various markets and/or the service bureaus will need to create an order type that takes out displayed size only down to the trade-through price and that bypasses reserve size.

believe significant costs outweigh any benefit from a universal opt out, particularly given our concern that this exception could swallow the rule.⁹ Lastly, we see no reason why a retail order should ever opt out of the best price or receive a fill at anything but the best possible price in the market.

While we disagree with the proposed opt out exception, we nevertheless believe that certain narrowly tailored exceptions to the rule are necessary to facilitate specific liquidity-providing transactions and benchmark trades. We believe that narrowly defined exceptions to the rule will still foster price protection because market participants may only trade through the best price in limited circumstances that are defined by rule. Since the exceptions would be narrowly defined and applicable only to specific transactions for sophisticated investors, there would be no need for the level of confirmation disclosure that the Commission proposes in the NMS Release.

a. Block Trade Exception

We recommend that the intermarket price protection rule contain a limited block exception that would apply for orders of 25,000 shares or more and at least \$500,000 in value. Such an exception would provide institutions the ability to execute a block immediately at a price outside the quote. This would allow traders to avoid parceling the block out over time in a series of transactions, which causes increased transaction costs and potentially inferior execution prices because of market impact.

In addition, a block trade exception is necessary to allow firms to continue to commit capital by taking the other side of a customer order at price levels away from the NBBO. Facilitating block transactions from customers that demand liquidity reduces market impact, which can decrease the cost to institutions and the ultimate investors. The SEC previously has recognized the value that block positioners provide to the market by facilitating capital without having a market moving impact.¹⁰ Additionally, there are rare occasions where multiple customers on opposite sides of the trade agree to a block price that is within the prevailing market but because markets move so quickly, the trade may occur outside the best bid/best offer at the time the trade is facilitated. Citigroup notes that we would define a block more narrowly than SEC and SRO rules. As such, it would be used in far more limited circumstances and, therefore, would not erode the benefits of price protection.

⁹ For commercial, legal and practical reasons, market participants may simply elect to avoid the use of a broad “opt out” exception.

¹⁰ See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 at III.A.3.c. Compare NYSE Rule 72 (b) (clean cross rule using 25,000 share minimum).

b. Specific Transactional Exceptions

The SEC should include in a price-protection rule certain specific exceptions as discussed below, in addition to those miscellaneous exceptions enumerated in the NMS Release for system malfunctions, non-regular way contracts, unusual markets, openings and re-openings, and crossed markets.

Intermarket Sweep. An intermarket sweep order could arise where an order execution facility “wants to be able to route an order(s) to execute against any better-priced bid(s) or offer(s) on other market center(s) at the same time as or prior to executing the remaining balance in its own market at an inferior price, or a market participant could wish to execute [some or all] of an order it holds by sending orders to interact with the best bids and offers displayed on other market centers.”¹¹ A market center that receives one part of an intermarket sweep order would not know that other sweep order(s) have been sent to other market centers. As a result, the receiving market may route the order to another market displaying a better price, even though the order router has already attempted to take out these better prices. We recommend that such an order should carry a flag that can be identified by routing technologies and that indicates that the order execution facility has sent order(s) to take out other relevant quotes. Therefore, a receiving market center could execute such a flagged order without regard to whether a better price was displayed on another market center.

Benchmark Trades. We also recommend that the SEC include a specific exception for trades that occur at a price that is unrelated to the prevailing market price. Specifically, we propose to except volume weighted average pricing trades (“VWAP”), stops,¹² derivative-related trades (*e.g.*, adjusting a hedged position to become delta neutral), complex orders (combined stock and option transactions), guaranteed closing prices, and other similar benchmark trades.¹³ These trades should be exempt from the rule because they are not priced based on current market conditions, but rather based on a pre-existing formula. Trades that are part of the primary market’s single price closing auction must be exempt from the price protection rule in order for the auction mechanism to function correctly.¹⁴

¹¹ Supplemental Release at 30145, n. 32.

¹² An agreement to “stop” securities at a specified price is a guarantee of the purchase or sale of the securities at that price. *See, e.g.*, NYSE Rule 116.

¹³ This exception should be defined broadly enough to accommodate miscellaneous items, such as the use of monetary adjustment accounts.

¹⁴ As a practical matter, a market can only consider the liquidity that is resident on its floor or accessible through its facilities in order for the market to accurately calculate imbalance information and to execute all interest at the closing/clearing price.

We suggest that SROs adopt tape modifiers for each of the exempt transactions. This would bring greater transparency to the tape information. For example, the SROs could use a “.DRV” for a derivatives transaction and a “.ST” for stop stock situations.¹⁵ Finally, we believe that the SEC should retain the ability to exempt specific transactions or a series of transactions from the rule on an as needed basis.

C. Enforcement

We are concerned with false positive trade-throughs resulting from flickering quotes, clocks that are not synchronized, delays in quotation information, and other practicalities of the markets. In fact, SRO audit trail rules require market participants to synchronize their system clocks to the National Institute of Standards and Technology (“NIST”) standard but allow for clock drift of up to three seconds (in either direction) from the NIST clock. In total, Firm A’s clock could be behind three seconds while Firm B’s clock could be ahead three seconds, yielding a six second time difference between clocks. We do not support a de minimis exception from the trade-through rule because of the possibility for gaming. Rather, we recommend that the SEC and SROs consider this time drift in surveilling for compliance with, and enforcement of, the trade-through rule.

III. Effective Operation of the Trade-Through Rule Is Conditioned on Fair Access to Quotes

Fair and efficient access to quotes is critical to the operation of a price protection rule. As discussed below, Citigroup generally supports the Commission’s private linkage proposal that is contained in the Release. Because a price protection rule can only work if market participants can access the quoted prices to which they are held, the Commission must ensure that the fair access rules are in place and are operating as intended before the Commission imposes strict price-protection obligations. The Commission must act vigilantly to ensure that commercial interests do not impede the formation of fair and effective private linkages.

A. Citigroup Supports the Commission’s Proposed Market Access Standards for Private Linkages

The Commission is proposing uniform minimum access standards to ensure that markets that display quotes in the public quote stream are accessible. Under the proposed access rule, an exchange, broker/dealer, or ATS/Electronic Communication Network (“ECN”) that posts its quote in the public quote stream would be prohibited from imposing unfairly discriminatory terms that inhibit non-members, non-subscribers, or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers, or customers. These fair access standards would apply to orders sent directly or indirectly to the quoting market center or quoting market

¹⁵ We note that the NASD recently adopted rule changes to ACT for stop stock situations, and that market participants currently can use the “.W” modifier for VWAP trades. We encourage other SROs to follow suit.

participant. As such, there purportedly would be no need to have direct relationships with every quoting market center or participant.

We support the Commission proposal to require efficient access to the various trading centers. In the existing trading environment where many different trading venues compete for order flow, efficient access is essential to the smooth operation of the NMS. There are only minimal standards governing the manner of access among the competing market centers today and, as a result, a broker/dealer's ability to achieve best execution for its customers may be hampered. The need for efficient linkages, however, is imperative when an intermarket price protection rule requires that market participants reach certain quotes. We agree with the goal of the SEC's proposed market access standards, *i.e.*, encouraging fair and efficient intermarket access through private initiatives. Private linkages will incent market participants to invest in state-of-the-art technology and will ensure that such technology continues to evolve.

B. Membership Needs to be Valued

Although we support private linkages, we note that currently these linkages are not as fully developed as they are in the Nasdaq market. We are concerned that exchanges may use the public linkage, *i.e.*, the Intermarket Trading System ("ITS"), as a short-term or medium-term means for complying with the trade-through rule. We can envision a world where a lesser market uses the free hub to access the primary market. Under the access and quote standardization proposal, the primary market would be limited to charging the accessing market a maximum of \$.002, which is virtually the same rate it could charge its members. The lesser market would get many of the benefits (*i.e.*, access to liquidity) but none of the costs and obligations that members of the primary market incur.

Until adequate private linkages develop, the Commission should not allow competitors unfettered access to an exchange's execution facilities, infrastructure, and regulatory services, without requiring those competitors to absorb at least a portion of the costs that members bear. Citigroup believes a reasonable approach would involve imposing a usage or capacity fee, under which non-members would pay a higher fee as the number of trades routed by the non-member to the exchange increased. Alternatively, to avoid free access to another market's quotes, the Commission could require one market to become a member of a competitor market once the rate of liquidity taking by the first exceeds a certain threshold percent. For example, if a regional exchange accesses the primary market more than 5% of the time, then the regional exchange should be required to become a member of the primary market and pay all fees and costs associated with membership.¹⁶

¹⁶ If a competing market does not pay the cost of using and accessing the primary market's facilities, the primary market's members are in effect subsidizing the competitor market. Arguably, this would be inconsistent with Sections 6(b)(4) and 15A(b)(4) of the Exchange Act, which generally require rules of SROs to provide for the equitable allocation of fees among its members and "other persons using its facilities."

C. Access to Insignificant Market Centers

We note also that reliance on the SEC's proposed market access rules fails to address access issues related to smaller markets. As the SEC noted in the Supplemental Release, under its proposal, access could remain a problem at relatively inactive ATSS or market makers with little trading volume whose quotations are displayed only in the NASD's Alternative Display Facility ("ADF").¹⁷ Market participants could obtain access to such quotations only through direct connections with the particular ATS or market maker. If the SEC obligates market participants to trade with any such market displaying the NBBO by promulgating a trade-through rule--presumably because they will qualify as firm or fast markets -- we are concerned about the costs of creating private linkages to many small ATSS that may charge exorbitant fees for the necessary access. One approach discussed in the Supplemental Release would be to require by rule that relatively small markets (*e.g.*, market maker or ATSS that have less than 5% volume) participate in an SRO execution systems for their top-of-book.¹⁸ For many of the reasons cited above, we strongly support this approach and believe that it is fair and appropriate.¹⁹

D. Access Fees Should Be Eliminated

Under the proposed rule, all quoting market centers, quoting market participants, and broker/dealers displaying attributable quotes through SROs would be permitted to impose a fee for the execution of orders. An SRO order execution facility would be permitted to charge a maximum fee of \$0.001 per share for access to its market. Market makers, specialists, ATSS, and other broker/dealers displaying attributable quotes through SROs would also be permitted to charge a \$0.001 maximum fee for access to their quotes. A customer may get charged more than once in a single transaction, but total access fees would be subject to a \$0.002 cap.

Citigroup has long believed that the non-transparent access fees that only ECNs are permitted to charge should be eliminated because the fees distort the public quote and decrease price transparency. ECNs, like broker/dealers, should only be able to charge customers with whom they have a contractual relationship. We reiterate again our position that quote access fees must be eliminated.

¹⁷ See Supplemental Release at 30146.

¹⁸ We are particularly concerned with quotes that are displayed in the ADF. The Commission should either retire that system or require the NASD to build a central execution facility to execute against quotes that are displayed in that system.

¹⁹ The Commission took a similar approach when adopting the Order Handling Rule. Specifically, the Commission mandated that the ECNs link in to Nasdaq's SelectNet system as a means for access. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 at IV.A.2.c.iii.

In the absence of a complete ban on quote access fees, Citigroup believes the Commission's proposal may be a reasonable compromise, or at least a good interim measure. It addresses a number of our continuing concerns about access fees. The proposal would level the playing field by allowing various categories of market participants, not just ECNs, to charge access fees. It also would help to prevent behavior that distorts the market, like locking markets to receive rebates. Finally, by standardizing the fees, the proposal would address, to some extent, the transparency concerns associated with access fees that are not apparent in an advertised quote.

We urge the Commission to carefully consider the administrative challenges and burdens related to charging and collecting fees in an environment where a single order can be routed to multiple markets. We are very concerned that it will be impossible to accurately track and bill for quote access fees, given that the number of market participants that can charge access fees will increase exponentially and that members of different markets and SROs will be accessing and charging one another. We also are concerned that there is no mechanism for resolving intermarket billing disputes. The Commission must address these practical issues before implementing the fee proposal.

E. Locked and Crossed Markets

Citigroup believes locked and crossed markets are indicative of an inefficient market and are confusing to investors. We have previously urged the Commission to adopt a locked/crossed market rule that applies to all market participants regardless of where they post their liquidity. Citigroup supports a locked/crossed markets rule that would require market participants to first attempt to access electronic markets before posting an order in the public quote stream that would lock/cross the NBBO. We support the Commission's proposal in this area.

IV. Sub-Penny Quoting Proposal

Citigroup is concerned about the adverse effects of sub-penny pricing, including the encouragement of stepping ahead, loss of depth and decreased price clarity, and we believe the Commission's proposal would address these concerns. Sub-penny pricing has a negative impact on certain priority rules that govern which orders are filled first in our securities markets. Traders should be required to make an economically significant contribution to the price of a security to gain priority over other traders. Sub-penny pricing, however, allows traders to step ahead of competing limit orders for an economically insignificant amount to gain execution priority. As a result, stepping ahead may erode investor confidence, particularly when orders remain unexecuted due to executions occurring within sub-pennies of the limit price.

Citigroup supports the SEC's proposal to prohibit SROs, ECNs, vendors, brokers or dealers from ranking, displaying or accepting from any person a bid or offer, an order, or an indication of interest in any NMS stock in an increment of less than one cent. We

believe the rule would protect investors and prevent certain abusive practices cited above. We agree that the ban should not prohibit, under certain circumstances, trades from being executed in sub-penny increments (*i.e.*, those resulting from sub-penny price improvement or from mid-point or volume-weighted pricing systems).

With regard to the low-priced exception, Citigroup agrees that exempting securities trading under \$1.00 is appropriate. We suggest that the Commission clarify that the ban on sub-penny quoting should apply anytime a security is trading over \$1.00, but the exception would only be available when the security has traded for under \$1.00 for the last 30 consecutive trading days, similar to the minimum bid test under exchange and Nasdaq listing standards. Moreover, to limit the abusive practices and ensure uniformity in the treatment of orders, we believe that there should be a limit on the number of decimal places for low-priced securities. We suggest that four decimal places would be the appropriate cut-off point.

V. Market Data Proposal

Citigroup supports a rationally and clearly priced market data system, free of rebates. Before the Commission determines how market data revenues should be allocated, the Commission should address the fundamental issue that tape fees are too high and not related to the cost of providing the data. We believe that fees should be limited to the cost of collecting and disseminating the data required by regulation, they should be set and changed through a process that involves market participants, and they should be accounted for transparently (supported by independent audits of the Networks).

A. Costs

Citigroup believes that before the Commission determines how market data revenues should be allocated, it first must address whether the present utilization of market data fees to cover regulatory and other costs above and beyond costs incurred when gathering and disseminating market data is consistent with the statutory purpose. We believe that market data fees should be used solely to cover the costs of disseminating and collecting market data. Limiting market data fees to the cost of collecting and distributing the data would, we believe, have the effect of eliminating the practices the Commission's proposals seek to address. We see no reason why a cost-based fee structure for market data would in any way undermine the funding for regulation.

We recognize that SROs must adequately fund their regulatory programs. Clearly, well-regulated markets and strong enforcement programs build integrity in our markets and ensure investor confidence in the markets. Certain SROs claim that they use market data fees to fund regulation, yet there is no transparent way of verifying the practice. To address the issue of transparency, we suggest that SROs create regulatory

fees that are separately approved, and earmarked for the funding of regulation.²⁰ This would ensure that SROs would receive adequate funding for all important regulatory programs while bringing transparency to the process.

As to tape fees, we note that tape-sharing programs have spawned practices that are not beneficial to the market, such as tape shredding and wash sales. We believe that the Commission's focus on crafting an alternative formula to share fees amongst SROs is misplaced because new formulas will not stop these current practices nor will they prevent new abusive practices from developing. Additionally, we believe that it is better for the market to eliminate these programs and to adopt a more transparent cost-based approach. Eliminating tape sharing by SROs should curtail the incentive to create tape volume, which leads to inappropriate behavior. Citigroup believes that the Commission should specifically ban the negative conduct that tape sharing has caused either through Commission or SRO rule making.²¹ We believe that if SROs can afford to share fees, then fees are too high.

Data that is directly tied to firm compliance with regulatory requirements -- NBBO and last sale data -- must be priced at cost. We see no reason why each of the exclusive securities information processors ("SIPs") cannot determine the cost of collecting, aggregating and disseminating NBBO and last sale information. Once they achieve this goal, the SIPs should price the regulatory data at cost. This will reduce costs to all market participants -- professional and non-professional (*i.e.*, individual investors) investors alike. Additionally, if the data is priced at cost, there will be no excess revenue to share, which will curtail revenue sharing programs. Re-pricing the regulatory data to cost should be the first step. After that, the members of the joint industry plans with the guidance of an advisory committee should address the issue of whether the current allocation formulas for the respective plans are fair and equitable.

Citigroup believes, though, that markets should be able to provide non-regulatory or "enhanced" data products (*i.e.*, those that provide information beyond NBBO and last sale) at market rates. Market forces will drive these fees. We believe that markets should be able to create innovative data products for investors and market professionals, and that if a product is useful and valuable, market participants should be willing to pay for these products at market rates. Lastly, while we do believe that SROs should be able to competitively price these enhanced data products, SROs should not be able to discriminate or significantly restrict the use by data vendors or market participants of these products.²²

²⁰ These fees would be filed pursuant to Rule 19b-4(f)(1) and would be effective upon filing.

²¹ We find it troubling that certain market centers take the view that tape shredding and tape churning is appropriate and/or not a violation of the federal securities laws.

²² See Securities Exchange Act Release No. 44138 (December 7, 2001), 66 FR 64895 establishing fees for NYSE's OpenBook.

Mr. Jonathan G. Katz

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B. Governance and Administration

As a general matter, Citigroup believes plan governance should be transparent with advisory committees reflecting industry and investor involvement. We support the Commission's proposal, which would provide for wider industry and investor involvement in plan governance. We believe an independent advisory committee that is empowered to make decisions and implement changes is ultimately necessary to ensure an effective governance structure. The industry would benefit as a whole if the primary users of the regulatory data have a voice in the fee-setting process as well as administration of the joint industry plans. As such, we encourage the Commission to adopt a structure that would ensure broad participation of market participants that differ in size and customer base. We believe that the industry will benefit through broader participation in the process of setting market data fees and policy.

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We thank the Commission for this opportunity to comment on these important issues. We look forward to working with the Commission and the industry on these difficult, but important issues. If you have any questions, please feel free to contact John Malitzis at 212-723-5875, Amy Reich at 212-723-5781, or the undersigned at 212-723-4921.

Very truly yours,

C. Thomas Richardson

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
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