



David A. Herron
Chief Executive Officer

January 26, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

**Re: File No. S7-10-04
Proposed Regulation NMS**

Dear Mr. Katz:

This letter presents comments from the Chicago Stock Exchange (the "CHX" or the "Exchange") in response to the revised Regulation NMS proposal that was published in December, 2004. The CHX welcomes the opportunity to comment on the revised proposal and commends the Commission for encouraging valuable open dialogue regarding the proposed revisions to Regulation NMS.

As set forth below, the CHX appreciates the Commission's efforts to respond thoughtfully to the comments received in connection with the initial proposing release. The CHX believes that the revised Regulation NMS proposal attempts to address some of the most significant concerns raised by many national market participants. The CHX would contend, however, that the Commission still has work to do in order to finalize a comprehensive Regulation NMS that provides for a national market structure which benefits the investing public. The CHX believes that investors will be best served by preserving fundamental price protections and by continuing to afford investors the significant benefits of competition among markets.

The Exchange's comments regarding the initial Regulation NMS proposal, set forth in my letter of June 30, 2004, were fairly comprehensive and represented months of study by the Exchange's staff, professionals and its members. For the sake of brevity, the Exchange will not reiterate its initial comments in detail, but incorporates its June 30 letter by reference. This letter will instead focus on those aspects of the revised Regulation NMS proposal that represent departures from the initial Regulation NMS release.

A. The Trade-Through Proposal

The Commission's careful review and analysis of comments received in connection with the original Regulation NMS proposal is perhaps best evidenced in the significant revisions to the trade-through components of Regulation NMS. The CHX commends the Commission for its acknowledgment of widespread opposition to the "opt out" provision set forth in the initial proposal. The CHX is certain that deletion of the "opt out" provision is the most beneficial revision to Regulation NMS.

Like many national market participants, however, the CHX does not favor adoption of the newly-proposed voluntary "depth-of-book" proposal (the "Voluntary Depth Alternative") contained in the revised Regulation NMS proposal. As detailed below, the CHX strongly encourages the Commission to forego adoption of the Voluntary Depth Alternative. The CHX believes that a trade-through rule which is applied consistently across all markets, to protect each market's best-priced automatically-displayed bid or offer (the "Market BBO Alternative"), is sufficient to preserve the essential attributes of the trade-through rule, and accomodates new technologies and trading models, while avoiding the likely adverse consequences of the Voluntary Depth Alternative.

1. The Voluntary Depth Alternative Is Infeasible in Many Respects and Represents an Unwarranted Leap Toward Institution of a Central Limit Order Book.

The CHX believes that implementation the Voluntary Depth Alternative would require significant industry-wide expenditures that are not justified by any potential benefits that could result from the Voluntary Depth Alternative.

While the CHX has not had the opportunity to develop a detailed itemization of the costs associated with the Voluntary Depth Alternative, it is clear that the Voluntary Depth Alternative would involve costs, and an implementation timetable, that are exponential greater than the Market BBO Alternative. At the Commission's open meeting on December 15, a representative of the Division of Market Regulation indicated that the costs of the Voluntary Depth Alternative would be borne solely by the markets that elected to display full depth of book. Unfortunately, this conjecture is not accurate; the costs of the Voluntary Depth Alternative would not be borne solely by the electing markets. Indeed, given the significant bandwidth increases that would be required for transmission of the dramatically-increased market data, as well as corresponding increases in development and operating costs associated with the nation's two securities information processors, the costs of the Voluntary Depth Alternative would in fact be imposed on all participants in the national market system, including exchanges, ECNs, broker-dealers and, ultimately, investors.

The Exchange does not believe that the costs of the Voluntary Depth Alternative are justified, in light of the limited value of the DOB alternative. In fact, the Exchange believes that there are no real benefits to the Voluntary Depth Alternative, and that investors ultimately will be harmed, because the Voluntary Depth Alternative in fact represents a significant step toward a

national central limit order book (“CLOB”), which would strike a fatal blow to essential intermarket competition. The Voluntary Depth Alternative, if implemented in today’s highly-automated trading environment, would quickly lead to a *de facto* CLOB, because market participants would be compelled by their best execution obligation to execute against all liquidity in other market centers, without regard to the special services or attributes offered by competing market centers.

The Exchange strongly encourages the Commission to recognize the benefits to investors of competition among markets. Such benefits are significant; accordingly, threats to competition raise grave concern in the securities industry. Competition between market centers ensures that U.S. equities markets remain the most vital and vibrant in the world, with a refined focus on the needs of investors. Commission has driven markets to develop significant technological enhancements that have dramatically improved execution times and availability of liquidity, while resulting in decreased execution costs. Additional fruits of competition include enhancements such as voluntary price protections, reserve size functionality, increase capacity, smart routers and other enhancements that help firms meet their best execution requirements and provide high-quality, low-cost executions to investors. Institution of a *de facto* CLOB, and the resulting decline in intermarket competition, will almost certainly erase these and other benefits of competition.

In contrast to the likely adverse effects of the Voluntary Depth Alternative, the Market BBO Alternative provides an ideal balance; it recognizes the importance of preserving essential price protections, while permitting market centers to control costs and to preserve intermarket competition. Accordingly, the Exchange urges the Commission to adopt the Market BBO Alternative, subject to the input of an intermarket implementation committee as described below.

On a more specific related topic, the CHX notes that the revised Regulation NMS proposal would extend the protections of the trade-through rule to 100-share quotations. The CHX encourages the Commission to reconsider this ill-advised extension of the trade-through rule. While the CHX is strongly in favor of preserving a comprehensive trade-through prohibition, the CHX does not believe that 100-share orders should be eligible for trade-through protection. In today’s trading environment, many 100-share quotations are generated automatically solely for the purpose of disseminating a two-sided quotation; the market participant publishing such quotation does not, and cannot reasonably, expect such a quotation to be eligible for trade-through protection.

2. The Commission Must Provide for a Realistic Implementation Timeline, Which Should Include Intermarket Meetings to Establish Consistent Regulatory Parameters.

If the Commission adopts the Market BBO Alternative, preparation for implementation of Regulation NMS will nonetheless require a significant expenditure of resources across the securities industry. The Exchange would urge the Commission to carefully consider establishing an implementation timeline of at least twelve months. As further detailed in our June 30 comment letter, the Exchange has carefully considered the range of projects that must be completed in order to implement Regulation NMS, and we firmly believe that twelve months should be the absolute minimum considered by the Commission. Moreover, the Exchange’s existing level of automation

far exceeds that of many other national market participants. Accordingly, while the Exchange might be able to implement Regulation NMS in twelve months, we do not believe that this timetable is realistic for certain less automated market centers. One need only look to the implementation of Regulation SHO for an example of the confusion and frustration that can arise when there is a “fire drill” to implement significant regulatory change, followed by an extension of the implementation deadline because certain industry members cannot meet the original deadline. We would urge the Commission to avoid similar snafus during implementation of Regulation NMS.¹

One of the most essential components of the implementation process should be to convene intermarket meetings, at the outset of the implementation period, so that consistent regulatory parameters are established. The Exchange believes that the trade-through provisions of Regulation NMS will permit significant regulatory arbitrage, to the detriment of investors, if consistent parameters are not established. For example, the manner in which markets define a trade-through should be consistent, as should the manner in which markets designate their quotations as manual or automated. In addition to these key elements, as acknowledged by the Commissions, there is a need for “specific and objective parameters” relating to subissues such as application of the “material delay” exception proposed in revised Regulation NMS. While many critics decry the lack of action taken by intermarket committees over the past decades, the CHX believes that these committees provide the basis for constructive dialogue, particularly when they are convened with a specific goal and an implementation deadline mandated by the Commission. The decimalization and Y2K transitions are excellent examples of instances in which intermarket dialogue and cooperation yielded smooth transitions.

C. The Market Access Proposal

The CHX has not modified its stance that the Commission should not be involved in ratemaking; the CHX therefore continues to oppose imposition of a cap on access fees. Moreover, the CHX does not believe that the \$.03 cap set forth in the revised proposal accomplishes any of the Commission’s stated goals. As the Commission itself acknowledges, and as many participants testified at the Commission’s open hearings in April, 2004, competition has over time driven access fees to all-time lows, and “. . . trading centers have very few fees on their books of more than \$0.003 per share or earn substantial revenues from such fees.”² The CHX sees no reason to adopt a limitation that is essentially “toothless” and thus will not impact the behavior of market participants. The CHX recommends instead that the Commission focus on preserving fair competition among markets – competition will, among other beneficial effects, continue to ensure that access fees are not discriminatory, predatory or otherwise unfair.

¹ The Exchange’s position regarding implementation relates not only to implementation of a revised trade-through rule, but also to the other significant components of Regulation NMS.

² Reproposing Release at p. 19.

D. Market Data Proposal

The CHX applauds the Commission's revision of the market data allocation formula to preclude allocation of revenues to market centers on account of manual quotations. We believe that this revision removes an incentive that could have led to manipulative behavior, namely the repetitive publication of manual quotations that are effectively inaccessible. Such behavior contravenes the spirit of the Exchange Act, is harmful to investors, and thus should not be rewarded.

The CHX also appreciates the Commission's effort to address our previous comment relating to trade credit for orders of less than \$5,000 in value. The CHX does not believe that the revised proposal goes far enough, and urges the Commission to give one credit for each trade, notwithstanding the value of the trade. The CHX believes that "tape shredding" is better addressed through self-regulation, where exchanges can ensure that their members are not engaged in manipulative practices. The January 24 letter from Annette Nazareth to each exchange, instructing each exchange to institute rules and procedures to eliminate abusive trade shredding practices, should accomplish all of the goals of the revenue allocation formula, without the unwarranted consequences of excluding smaller trades from eligibility for revenue allocation. As an exchange which receives a significant volume of retail order flow, which is comprised of many legitimately small orders, the CHX believes that the regulatory response is better tailored to achieving the Commission's goals and will avoid unintended consequences.

Although the CHX has foregone restating significant points raised in our June 30 comment letter, the CHX must again strongly encourage the Commission to consider the impact on competition of the proposed changes to allocation of market data revenue. The CHX, like most regional market centers, relies on market data revenue to fund a substantial portion of its budget. As a result, any material decrease in market data revenue could have a significantly adverse effect on the CHX's financial plan. Indeed, the market data proposal could render it infeasible for the CHX, or any other regional market, to compete with listing markets, which can survive on listing revenues. This chilling effect on intermarket competition simply cannot benefit investors.

Finally, the CHX again urges the Commission to permit quarterly payments of market data revenue, as opposed to the annual allocation and payment that Regulation NMS contemplates. The severe hardship that would be sustained by market centers that depend on market data revenue to fund business and regulatory operations is unwarranted, and the Commission has not articulated any basis for the proposed transition to annual allocation.

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We appreciate the opportunity to share the Exchange's views with the Commission and again, we commend the Commission and its staff for their efforts to formulate reasoned solutions to complex issues.

Very truly yours,

A handwritten signature in black ink, appearing to read "DAH", with a long horizontal flourish extending to the right.

David A. Herron