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January 26, 2005

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

Re: File No. S7-10-04 – Regulation NMS

Dear Mr. Katz:

In a letter dated January 12, 2005, the New York Stock Exchange commented on the trade-through rule alternatives that re-proposed Regulation NMS put forward. In this letter, the Exchange wishes to comment on the regulation's market data proposals.

In proposing Regulation NMS, the Commission indicted the revenue-allocation formulas of the data consortia as "caus[ing] a variety of economic and regulatory distortions."<sup>1</sup> The Commission's indictment continues:

[T]he trade-based formulas create an incentive for SROs to operate "print facilities" that report a large number of trades. . . . As a result, the purely commercial consideration of maximizing market data revenues, rather than the quality of an SRO's regulatory expertise or trading services, may determine which SRO is responsible for reporting (and regulating) a trade. . . . Finally, the exclusively trade-based formulas create an incentive for fraudulent or distortive practices, particularly by reporting a large number of very small trades. As a result, market participants have engaged in illegal wash trades solely

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<sup>1</sup> See Section VI(C)(1) of Release No. 34-49749; File No. S7-10-04 (May 20, 2004).

to generate market data revenues. Some market participants also “shred” their total trading volume into the smallest possible trade sizes to maximize the amount of data revenues such trading can generate.<sup>2</sup>

Inexplicably, after posting this indictment of formulaic revenue sharing, Regulation NMS fails to prosecute it. Rather than attack the root causes, the regulation proposes to continue to mandate joint data dissemination and tinker with the formula.

We think the Commission draws the wrong lesson from its 30-year experiment with competitor consortia. We think gaming is intrinsic to mandated joint action and formulaic revenue allocation.

Indeed, the proposed formula will not only fail to eliminate gaming, it will open up new gaming opportunities. On the one hand, while the proposed formula reduces the reliance on Trading Shares, it does not eliminate the incentives for the distortive practices that reliance on prints breeds. Wash sales, tape shredding and the use of markets as print facilities can still generate undeserved revenues.

On the other hand, the addition of Quoting Shares to the formula opens new gaming opportunities. Indeed, quotes may prove easier to game than trades. We anticipate that some markets and their members will exploit the formula by deriving quote-based algorithms that permit them to enter quotes that bear little risk of being “hit,” yet which will receive the same Quoting Share credits as quotes that meaningfully contribute to price discovery. For instance, a market participant may enter a buy order at the bid on a market that rebates market data revenue at a time when the stock already has depth at the bid. If the order carries an instruction to “cancel” upon the execution of buy orders earlier in the queue, the market will nevertheless receive Quoting Share credits.

Moreover, the proposal’s “more of the same” prescription ignores the advice of the industry experts that the Commission gathered together four years ago as its Advisory Committee on Market Information. The “Seligman Committee” experts concluded that dismantling the market data consortia was the best way to eliminate the distortions and abusive practices that the consortia breed. More generally, they recognized that allowing markets to withdraw from the consortia would eliminate the government allocation of data revenue, substituting the value proposition that each market’s data presents as the allocator of revenue flows. This harnessing of market forces to allocate data revenues would also relieve the markets from their joint administration problems and antitrust exposure; end artificial cooperation among competitors (thereby enhancing the forces of competition); remove incentives for tape shredding, wash sales and the use of exchanges as print facilities; starve payment for order flow, thereby reducing the classic conflicts with their customers that such payments create for brokers; and end inter-market

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<sup>2</sup> Id.

subsidies, cross-network fee distortions<sup>3</sup> and other market dislocations. Permitting competing consolidators would also bolster business continuity by creating consolidator redundancy, a benefit whose value has only become more evident since the Committee issued its report a few days after the destruction of the World Trade Center.

We urge the Commission to embrace the recommendations of its own expert advisors by authorizing markets to withdraw from the market data consortia and thereby to permit and foster competing consolidators. Its consideration of the responses to its SRO concept release offers the next opportunity to do so. We urge the Commission to seize it.

So long as the Commission continues to mandate a revenue-allocation formula, we support the proposed use of quotes in the formula, the formula's use of square roots and dollar values (i.e., price X size), and the deletion of the NBBO Improvement Share.<sup>4</sup> In that context, we offer five suggestions to mitigate gaming and other distortions, and to facilitate the application of the formula. While we do not pretend to be able to predict, let alone propose ways to curb, all manner of gaming behavior, we believe that these adjustments will dampen it. We also offer one suggestion regarding clarification of Regulation NMS's roll back of the display rule to "trade and order-routing contexts."

### **Zero Credit for Sub-Second Quotes**

First, the formula's inclusion of sub-second quotes is particularly ripe for abuse. Permitting "flickering" or "phantom" quotes to generate Quoting Share will usurp system capacity and direct market data revenue away from markets engaged in meaningful price discovery. It also adds considerable calculation complexity and significant cost while providing minimal offsetting, *bona fide* benefits. Thus, we recommend that the Quoting Share calculation exclude sub-second quotes.

### **Reduced or Zero Credit for Off-Hours Quotes and Reports**

Second, we recommend that the proposed formula calculate the Trading Share and the Quoting Share only with respect to quotes and trade reports occurring during the primary markets' trading hours. With the possible exception of "news" stocks, the off-hours quotes and trade reports do

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<sup>3</sup> As evidenced by the January 24, 2005 letters to the SROs regarding tape shredding from Annette Nazareth, Director of the Commission's Division of Market Regulation (the "Tape Shredding Letter"), the cross-network fee distortions have subsequently emerged as a significant factor in tape shredding. Her letter's footnote 2 describes how tape shredding abuses greatly diminished when the Nasdaq-100 Index Tracking Stock ("QQQ") transferred from the American Stock Exchange to the Nasdaq Stock Market. (For 2003, before the tape shredding reached its zenith in QQQ and helped bring down the per print revenue of Tape B (Amex), Tape B yielded approximately ten times the revenue per print as Tape C (Nasdaq).)

<sup>4</sup> The Commission's proposal also rewards a fractional portion of trades that have a value of less than \$5000. While we understand the Commission's rationale, we note that partially crediting these trades undermines the Commission's efforts to reduce incentives for tape shredding.

not generally provide useful information about company valuation. The markets that elect to stay open typically widen their bid/ask spreads and reflect execution mechanisms that contribute little or nothing to price discovery.

Off-hour quotes are of particularly little value. They typically bear little relationship to the last sale or closing quote of the regular trading session, and are unreliable indicators of the next trading session's opening quote or price. Including off-hour quotes in the Quoting Share would violate the Commission's goal of rewarding meaningful quoting activity.

The use of off-hour trades in the formula also raises troubling public interest questions. Even if the markets are generally allowed to pay for order flow, is it appropriate to reward a market for purchasing tape prints that may mis-price companies? Is it appropriate to include trades that reflect so many inter-day stops? Or trades at prices that are out of line with activity that took place during the regular trading session? Is it appropriate to include trades that circumvent the limit order protection that the trade-through rule provides during the regular trading session?

### **Reduced Credit for Block Trades**

Third, in our view, the formula is disproportionately weighted in favor of large block trades. One 50,000-share trade in a security does not provide market information that is 5, 10 or 50 times more valuable than one 10,000-share trade, one 5,000-share trade or one 100-share trade. Moreover, although block traders use displayed liquidity as a benchmark, they often complete block trades outside of the auction process and print them on regional exchanges or through Nasdaq in order to avoid direct interaction with orders that they do not control.

In addition, the Securities Exchange Act of 1934 (the "Exchange Act"), SEC rules, the market data plans, and the markets' contracts with consortia processors all require that trades that do not take place through exchange facilities be reported to the non-Nasdaq NASD, not to an exchange.<sup>5</sup> If block prints were properly credited to the non-Nasdaq NASD, this skewing would have the virtue of funding NASD Regulation. However, since the Commission instead permits the auctioning of tape prints to the highest bidding exchange, this skewing rewards existing and aspiring exchanges that act as print facilities, thereby reducing the revenue available for

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<sup>5</sup> Section 6(b)(5) of the Exchange Act provides that an exchange not be registered as a national securities exchange if its rules regulate "matters not related to the purposes of this title or the administration of an exchange." Because there is no nexus between an upstairs block trade and an exchange, an exchange's rules should not permit the printing of the report of the block trade. SEC Rule 11A3-1(b)(1) requires every exchange to "file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities *executed through its facilities*" and requires every association to "file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed by its members *otherwise than on an exchange*." (Emphasis added.) Section VIII(a) of the CTA Plan requires each exchange to report all trades executed through its facilities and requires NASD to report all trades *not* taking place on the facilities of an exchange. For a more detailed description, see our comment letter on Nasdaq's application for registration as a national securities exchange (letter from James E. Buck, Secretary, New York Stock Exchange, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, August 27, 2001).

allocation to markets on which order interaction takes place. Capping the credit for blocks helps ameliorate this distortion.

For these reasons, we strongly recommend that the Trading Share calculation cap the dollar value (i.e., price X size) that any single trade can contribute to the formula at \$300,000. \$300,000 represents the rounded product of (1) the traditional 10,000-share definition of a block trade and (2) the approximately \$30 average price per share<sup>6</sup>

### Calculation Frequency

Fourth, we recommend that Regulation NMS specify daily calculation of the Trading Share, the Quoting Share and the “Volume Percentage” portion of the Security Income Allocation. We also recommend a quarterly determination of the Security Income Allocation’s “distributable net income.” We make these recommendations for practical reasons: it is simpler to accommodate corporate mergers, symbol changes, changes in listing markets and similar corporate actions as they occur, rather than waiting until the end of a longer period. On the other hand, it makes sense to tally distributable net income in accordance with quarterly distributions.

### Plan Authority for Adjustments

Inherent in any governmental intervention into markets is the inability to anticipate all issues that may arise. We ask that the rule enable the markets to make adjustments through Commission-approved amendments to the data plans as issues arise.

### Circumscribing the Consolidated Display Requirement

Regulation NMS begins to deregulate data displays by proposing to limit the application of the consolidated display rule to “trade and order routing contexts.” We recommend that the proposal state clearly that the display rule applies only to the order-routing and trading functions of brokers, other market professionals and investors. This universe of displays supports the decision of *where* to trade. Thus, it would not apply to displays that registered representatives, money managers and investors use to monitor trading activity, or to displays that a vendor provides through a market data service that requires a separate log-on and password from the vendor’s execution-service offering. This latter universe of displays supports the decision of *whether* to trade. Limit order protection and best execution concerns do not arise in the buy, sell or hold decision. Thus, the value proposition that a market’s data presents should establish the prevalence of its display.

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<sup>6</sup> Note that capping the dollar value of a block trade does not affect the trade’s contribution toward the percentage-of-qualified-trades portion of the Trading Share calculation.

We believe that our six recommendations will make the proposed formula somewhat less susceptible to gaming, better align the value proposition of data with revenue allocation, and narrow the government's intervention in data display. Nevertheless, no one can predict all of the ways in which markets will exploit the formula. Thus, we urge the Commission to closely monitor the markets' distortive behavior and to intervene quickly. The Tape Shredding Letter's request that SROs adopt rules to prohibit tape shredding is a welcome step in this direction.

Finally, we call upon the Commission to seize upon its examination of the SRO concept to recognize that the Seligman Committee had it right: any technological basis for forcing competing markets into data consortia has long disappeared, and our peculiar experiment with mandatory joint action should end.

We thank the Commission for this opportunity to express our views.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Mary Gray". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

cc: Chairman William H. Donaldson  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Harvey J. Goldschmid  
Annette L. Nazareth  
Robert L. D. Colby