NSX National Stock Exchange

January 26, 2005

VIA ELECTRONIC MAIL & FEDERAL EXPRESS

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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

Dear Mr. Katz:

The National Stock Exchange[SM] ("NSX[SM]" or the "Exchange") respectfully submits the following comments to the Securities and Exchange Commission's ("SEC" or the "Commission") reproposed Regulation NMS ("Reg NMS").[1] NSX appreciates the SEC providing this opportunity to offer additional comment.

In the Exchange's initial comment letter[2] regarding the original Reg NMS proposal, our discussion primarily focused on the trade-through and market data revenue allocation portions of the proposal. We are again focusing our comments herein on those two aspects of the reproposal. In particular with respect to trade-throughs, we understand the Commission is removing its proposed "opt-out" exception in favor of eliminating coverage for manual quotations. We also understand the Commission is considering "top of book" and "depth of book" alternatives to the scope of quotations covered under the reproposed trade-through rule. With respect to market data revenue, we understand the Commission has revised the proposed formula by eliminating any revenue allocation for manual quotations, removing the "NBBO Improvement Share" portion of the allocation algorithm, and amending the "Trading Share" portion to allow for all sizes of transaction reports to contribute to a self-regulatory organization's ("SRO") "Trade Rating." We address each of these items in more detail below.

This comment letter contains our belief that there is no need to adopt a national market system trade-through rule. Instead, we believe that the Commission should consider the implementation of a pilot program that would suspend the operation of the Intermarket Trading System ("ITS") trade-through rule in exchange-listed securities. However, if a trade-through rule is ultimately adopted, we believe that the applicability of any trade-through rule should be limited to automated quotations in exchange-listed securities, with a safe harbor provided for trade-through and best execution purposes for manual quotations.

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[1] Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004).

[2] Letter from David Colker, Chief Executive Officer and President, NSX, to Jonathan G. Katz, Secretary, SEC (June 29, 2004).

We also believe that the changes to the formula for allocating market data revenue among the SROs set forth in the reproposal continue to be unnecessarily complex and burdensome to administer. However, we would support an amendment to the revenue sharing portion of the national market system plan for exchange-listed securities (the "CQ/CTA Plan") that would allocate revenue based equally on volume and trades, similar to what is already done under the national market system plan for Nasdaq-listed securities (the "Nasdaq UTP Plan"). These alternatives are consistent with the Commission's objective of improving the fairness and efficiency of the national market system, while offering more flexibility for competing markets and market participants. We believe that these alternatives will ultimately benefit investors.

Trade-Through Reform

The Commission has indicated that the objective of the proposed trade-through rule is to strengthen the protection of displayed and automatically accessible quotations. Our position was, and remains, that in today's marketplace a trade-through rule is not necessary to advance this objective so long as we continue to hold a broker to its fiduciary duty of best execution. The success of this approach is readily demonstrated through the Rule 11Ac1-5 statistics for the trading of Nasdaq-listed securities, for which best execution obligations apply but a trade-through rule does not, and by the three cent *de minimis* exemption to the ITS trade-through rule that applies to certain exchange-traded funds ("ETFs").

At the time the ITS trade-through rule for exchange-listed securities was adopted in 1981, it was intended as a safeguard to facilitate a broker's ability to provide best execution by discouraging executions at prices inferior to those available through the ITS system. While it served a useful function at the time, the Commission has recognized the advancements in order routing and execution capabilities, increases in intermarket competition, and decreases in minimum quotation increments over the past 25 years. There has also been increased transparency of quotation and trading information made available through the consolidated tapes and through Rule 11Ac1-5 statistics. Given these changes, coupled with a broker's fiduciary obligation to provide best execution to its customers, a provision for trade-throughs is no longer needed for trading in ITS securities and certainly should not now be introduced for trading in Nasdaq-listed securities. In fact, we believe the Commission should take steps to eliminate the ITS trade-through rules applicable to exchange-listed securities. To adopt a national market system trade-through rule in today's environment would only burden markets and market participants with unnecessary regulation. Instead, we believe that the Commission should follow the lead it has taken in considering short sale reform through the Regulation SHO ("Reg SHO") related pilot program.[3] Accordingly, we respectfully suggest that the Commission consider a pilot that provides for the suspension of the ITS trade-through rule for a group of ITS securities before taking the steps contemplated in Reg NMS.

If a trade-through rule is preserved in some form, we reiterate our prior request that the Commission continue to limit its applicability to ITS securities and consider a further expansion of its *de minimis* exception to include additional securities beyond the two ETFs. We also reiterate our position that, if a trade-through rule is extended to Nasdaq-listed securities, the Commission should make it explicit that the rule extends to *intramarket* as well as *intermarket*

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[3] *See* Securities Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004).

trade-throughs so as not to continue to preserve the advantage over-the-counter markets such as the Nasdaq Stock Market now have over competing exchanges.[4]

We do appreciate the consideration the Commission has made to the role (or rather lack thereof) that manual quotations would have in a trade-through rule. If indeed trading in ITS securities must continue to operate with a trade-through rule in place, elimination of manual quotations from the equation is recognition of the need for brokers to have flexibility, speed and surety of execution in fulfilling their best execution obligations. The difficulties would lie in defining what is not "manual," and the need to facilitate the brokers' and the public's ability to readily discern what quotations are not "manual." Further, we would need to provide the brokers with the latitude to determine whether it is in the best interest of their customers to consider manual quotations. With respect to the latter, while manual quotes would not be subject to the trade-through rule, we understand that they would continue to be part of the national best bid or offer ("NBBO"). This inconsistent treatment of manual quotations could place a broker in an impossible situation: On the one hand, the broker may trade through a manual quote without violating the trade-through rule. However, on the other hand, because the manual quote may be displayed in the NBBO, trading through the manual quote may not be consistent with the broker's obligation to provide best execution. In order for the manual quotation exemption to have utility, it is imperative for the Commission to provide safe harbor protections for manual quotations both with respect to trade-throughs and best execution. In that context, a broker has the freedom to determine how to best to achieve an execution for its customer. Otherwise, the removal of the Commission's originally proposed opt-out exception in favor of the manual quotation exception is rendered meaningless.[5]

To be truly effective, any change needs to also exclude manual quotations from the NBBO or provide a safe harbor respecting a broker's obligation of best execution. What is more, to be consistent, manual quotes should also be excluded from the ITS locked/crossed market provisions. Finally, in order for there to be genuine reform, we reiterate our request that the Commission require that both quotation and trade information not only be accessible but that it become more "real time" by reducing the acceptable timeframes in the national market system plans for quote and trading reporting (which can range from 60 to 90 seconds – a lifetime in today's trading environment).

In considering the notion of what quotations would actually be included within the trade-through rule should one ultimately be adopted, the Commission is weighing the alternatives of expanding trade-through coverage to the top of book for each market and of establishing a mechanism for a market to also voluntary have its depth of book protected. These options are being weighed in lieu of merely having the trade-through rule apply to the NBBO, which is what

[4] On the other hand, if a trade-through rule is not extended to Nasdaq-listed securities, we believe the Commission should permit exchanges to trade Nasdaq-listed securities without intramarket or intermarket trade-through requirements and, in that pursuant, should act to approve NSX's voluntary book proposal, which has been pending with the Commission since 2001. *See* Securities Exchange Act Release No. 45405 (February 6, 2002), 67 FR 6558 (February 12, 2002)(SR-CSE-2001-04).

[5] The Commission indicated that the elimination of coverage for manual quotations was the principal reason that the opt-out exception was not included in the reproposal. *See* SEC News Release, *SEC Votes to Publish Reproposed Regulation NMS for Public Comment and to Adopt Asset-Backed Securities Rule Proposal* (December 15, 2004). Under the opt-out exception, market participants would have been allowed to disregard displayed quotations if the customer elected to "opt-out." Under this approach of permitting customer consent to trade-through, brokers would have safe harbor protections both from the trade-through requirements and best execution.

currently happens under the ITS trade-through rule and was proposed under the original Reg NMS. Putting aside our opposition to expanding the scope of the trade-through rule generally, we feel that, with respect to the choice between top of book and depth of book, the most intellectually honest approach would be to include the depth of the book in the trade-through rule. If the goal of a trade-through rule remains the desire to discourage brokers from executing trades at prices inferior to those available through other markets, it seems that the better prices should be honored regardless of the market in which they are displayed or their relation to the NBBO, assuming they are automatically accessible. Otherwise, a broker would be permitted to trade-through the displayed better prices of one market so long as it satisfied each of the inferior tops of books of the other markets.

It seems inconsistent to argue that the need to encourage limit orders requires the protection of the best prices in each market, while simultaneously arguing that the need to encourage competition requires that a market should not honor all better limit orders in other markets. This is particularly true given the fact that the current electronic efficiency of the market could easily facilitate price protection at all levels. Fears of a virtual central limit order book or "CLOB" are unfounded because the depth of book proposal does not include time priority and, more importantly, because the national market is already "virtually," *i.e.*, electronically, centralized today. This development has added enormous efficiency to the securities market. The reality is that, in an environment dominated by a monopoly, the existence of a trade-through at all, but particularly one that protects only the top of the book, is a significant barrier to competition.

Market Data Revenue Allocation

In our initial comment letter, we challenged the assumption that the current system for allocating market data revenues generated through each of the national market system plans needs to be revised. We understand that in light of public comment, the Commission has revised the proposed formula by eliminating any revenue allocation for manual quotations, removing the "NBBO Improvement Share" portion of the allocation algorithm, and amended the "Trading Share" portion to allow for all sizes of transaction reports to contribute to an SRO "Trade Rating" (not just trades that have a dollar value of $5,000 or more). While we appreciate these modifications, our original views have not changed. We continue to believe that each of the current systems of allocating revenue among the participating SROs is a direct, objective and reasoned approach to allocating revenues.

The Commission has stated that one of its reasons for introducing a more complex formula is to allocate revenues to SROs that contribute to public price discovery by dividing revenue equally between trading activity (referred to as the "Trading Share") and quoting activity (referred to as the "Quoting Share"). However, the proposed formula appears to be misguided in its price discovery value, placing much emphasis on quotations. We respectfully disagree with the underlying premise that quoting activity is not rewarded in the existing revenue allocation programs. In fact, quotes that contribute to price discovery are already rewarded: First, when traded against and, second, when reflected in the trade (and, in the case of the Nasdaq UTP Plan, share volume) for which an SRO is compensated. That being the case, to have a separate Quoting Share portion in any revenue allocation formula seems to over-compensate for quoting activity and introduce unnecessary complexity and subjective judgments about the value of a particular quotation. If anything, we would simply suggest that the CQ/CTA Plan be amended to allocate revenue equally between trades and shares, like that of the Nasdaq UTP Plan. In factoring volume into the equation, we believe markets may be better compensated for contributions to price discovery without introducing complexity into the equation.

We believe price discovery can best be encouraged in our national market system by maintaining an open architecture that offers the freedom for competing markets, market participants and their customers to be innovative and the flexibility to accommodate change. For example, competitive initiatives such as depth of book, subpenny trading, and liquidity provider rebates all contribute to liquidity and encourage price discovery. While we understand the desire of the Commission to encourage price discovery, this should be a matter left to market forces and not to government mandate. Where we would invite government relief is in mandating the increased efficiency and effectiveness of the information made available to brokers and investors. In particular, the Commission should require that quote and trade information to become real time by reducing the acceptable timeframe for quote and trade reporting. Making the information available real-time enhances the data's usefulness for price discovery purposes.

The Commission has also stated that its reasoning for introducing a more complex formula is in part because current formulae may incent distortive behavior, such as wash sales and trade shredding. Even if one believes that these activities are encouraged by the current distribution system, we believe that such actions represent rule violations that can be effectively regulated by SRO enforcement programs, and any such perceived encouragement could be offset by the industry-wide adoption of the Nasdaq UTP Plan's methodology of tape revenue allocation.

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We appreciate being given this opportunity to again express our views on this important proposal. If the Commission or its staff has any questions, please call me at 312.786.8894.

Sincerely,

/s/ David Colker

David Colker
Chief Executive Officer and President

cc. Chairman William H. Donaldson
Commissioner Paul S. Adkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid

Ms. Annette L. Nazareth, Director, Division of Market Regulation
Ms. Lori A. Richards, Director, Office of Compliance Inspections and Examinations
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Mr. John McCarthy, Associate Director, Office of Compliance Inspections and Examinations