



Goldman
Sachs

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July 19, 2004

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

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

Dear Mr. Katz:

Goldman, Sachs & Co. (“Goldman”) welcomes the opportunity to provide the Securities and Exchange Commission (“SEC” or “Commission”) with comments on proposed Regulation NMS (“NMS Proposal”) under the Securities Exchange Act of 1934 (“Exchange Act”).¹ We agree with the Commission that recent market developments, which have generated enormous benefits for investors, present new challenges for the national market system (“NMS”). We commend the Commission and its staff for advancing the dialogue on how best to ensure that these vitally important market structure issues are resolved in the manner most beneficial to investors. We appreciate the opportunity to share our vision of the future of the U.S. securities markets.

I. Summary

Like the Commission, we have a broad interest in ensuring that “our markets retain their position as the deepest and most efficient in the world—markets that offer a fair deal to all types of investors, large and small”.² We perform a wide range of services in the financial markets, from capital raising to secondary trading to advising investors. We participate in the market in many ways, including as upstairs block positioners and Nasdaq market makers, exchange floor specialists and electronic trading service providers. We bring the perspectives of these varied trading businesses to our consideration of the SEC’s proposal and its effect on our national

¹ Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126 (Mar. 9, 2004) (“NMS Proposal”) and 49749 (May 20, 2004), 69 Fed. Reg. 30142 (“NMS Supplemental Release”).

² NMS Proposal at 11128.

markets. We believe that the core principles of the national market system — efficiency, competition, transparency, best execution and direct interaction of investor orders³ — have provided, and continue to provide, an excellent guide for the Commission in fashioning a regulatory structure that generates the greatest benefits to investors. With this background, and relying on these principles, we advocate the following:

- We support intermarket price protection. An order should not be executed on a market at a price that is inferior to a superior priced “accessible” order displayed on another market. We respectfully contend, however, that the SEC’s proposed trade-through rule, which protects quotes at the top-of-book, may lead to further fragmentation of the market. Our alternative proposed model, as described more fully below, would protect quotes that meet defined standards of “accessibility” no matter where the quotes reside – top-of-book or depth-of-book.
- We believe that, as a predicate to any price protection model, the SEC must define standards for quote “accessibility.” Quotes must satisfy these standards before they are entitled to price protection. Manual quotes and other quotes that are not accessible should not be entitled to price protection.
- We believe that there should be no access fees associated with quotes entitled to price protection. The price you see should be the price you get.
- We endorse the Commission’s proposal to prohibit sub-penny quoting for NMS stocks trading above \$1.00 while continuing to allow trades that result from a mid-point or volume-weighted algorithm.
- We urge the Commission to address directly the significant issues related to the level of and the manner of setting market data fees, rather than revising the market data fee allocation formula.

II. Accessible Limit Order Protection

Although Section 11A of the Exchange Act is a complex provision, the basic objective of the NMS principles is simple and clear: markets should be designed to facilitate the best execution of investors’ orders. We believe that the most effective way to accomplish this NMS goal is to establish a new and more robust model for market integration, a model which we refer to as “accessible limit order protection.” Accessible limit order protection would provide intermarket price protection for those quotes meeting specific standards of “accessibility,” including the minimum requirements that the quotes: (a) are visible to other market participants; (b) are available through linkage to the marketplace; (c) provide an automated response without human intervention; and (d) are not encumbered by access fees. In an environment with

³ Section 11A of the Exchange Act.

competing markets, intermarket price protection for accessible quotes is a vital component in ensuring the best execution of investors' orders and vigorous price discovery. Indeed, we believe such price protection encourages market participants to display more limit orders and to quote price and size more aggressively, thereby enhancing both liquidity and price discovery.

We believe that investors, as well as broker-dealers based on their best execution obligations, will quickly conclude that customer limit orders should be placed on markets that meet access standards and, accordingly, orders will be routed to those markets, simultaneously encouraging innovation and investor protection. Accordingly, at this time, we do not believe it is necessary to mandate how and when markets achieve these standards. Rather, we believe that, if the Commission creates the positive incentives of standards for an accessible, price protected environment, competitive pressure alone will drive markets to achieve these standards.

We believe that the accessible limit order protection model will achieve the benefits of a linked market while allowing for robust market competition. Unlike a consolidated limit order book, accessible limit order protection does not require that all market participants route orders through a centralized platform or adhere to strict price/time priority. Rather, the accessible limit order protection model could be achieved through linkages sponsored by SROs or private providers (such as individual broker-dealers, market consortia, or marketplace-built linkages), which would foster competition for the further development of technology and, consequently, lower trading costs. In addition, accessible limit order protection will be a catalyst to market competition because it will motivate market centers to distinguish their business models by providing more value-added services, such as specialized order types or innovative order handling and execution technology. In sum, accessible limit order protection furthers the core principles of the NMS without the undesirable effects of market fragmentation.

A. Standards of Accessibility

We believe that, in order to qualify for price protection, a quote⁴ first must be deemed "accessible". Consequently, under our proposed model, the SEC first must set standards of accessibility, and then describe how market participants should meet them. Our proposed model allows markets to elect on a quote-by-quote basis whether or not to make their quotes accessible by adhering to the standards set out below. Once that election has been made, however, the obligation to protect accessible quotes becomes mandatory for all, and no market participants of any type may trade-through accessible quotes or orders as defined. This means that market participants are entitled to trade-through protection for their accessible quotes, provided they maintain that accessibility and do not charge access fees, discriminatory linkage fees or unreasonable market data fees for those quotes.

In this regard, a market only provides an "accessible" quotation if that quotation, at a minimum, satisfies the following characteristics:

⁴ A "quote" consists of price, publicly-broadcasted quantity and a marker to indicate whether it is automated.

(i) Displayed. The quotes must be visible to market participants, meaning that the data must be available to all comers in electronic form and at a reasonable price. We are neutral as to whether this quotation information is disseminated through a public utility, multiple competing vendors or both.⁵

(ii) Available for Linkage. The market must be open to linkage in an effective manner to market participants and other markets, so that other market participants are capable of obtaining access to the quote. To ensure appropriate access to the markets displaying quotes, we believe reliance on private or some form of self-regulatory organization (“SRO”) supported or endorsed linkages between the markets is the most effective technique. Therefore, we believe that, to be considered accessible, markets should be required to provide adequate access, directly or indirectly, on a non-discriminatory basis, to other markets and market participants through private or SRO-approved initiatives (i.e., not through government-mandated linkages).⁶

Reliance on private linkages is entirely practicable.⁷ As the existing over-the-counter (“OTC”) market demonstrates, private routing mechanisms (which themselves are subject to a robust, competitive market) are readily available to market participants of all sizes.⁸

A non-discriminatory linkage would include linkage fees that are the same for all users of the linkage, including both subscribers (or members) and non-subscribers (or non-members). At a minimum, the linkage should support responding to an “intermarket sweep” or a “take out” order, as more fully described below. The ability to link effectively to a quoting market will minimize any negative effects of fragmentation of trading interest among competing market centers (e.g., the inappropriate isolation of orders, as well as the interference with vigorous price competition, public price discovery, best execution of investor orders, and market liquidity).

(iii) Automated Response. The market must provide the certainty of an automated and instantaneous response to the quotes. Quotes must be immediately and automatically executed (or cancelled) up to the displayed amount within not more than one second and without manual or human intervention. Similarly, the market must update its quotes automatically.

⁵ See also discussion of market data costs in Section V of this letter.

⁶ NMS Proposal, Proposed Rule 610(a).

⁷ We recognize that for at least the last 30 years, if not 40, the market structure debate has been haunted by the apparent dilemma of whether to “build the linkage” first or “create-the-duty” first. In other words, should a linkage be built to facilitate intermarket price protection before requiring market participants to provide such protection, or should market participants be obligated to provide such protection, and then they will create the necessary linkages. Today we believe that so long as only accessible quotes must be protected, then private forces will develop the linkages.

⁸ In contrast, the conflict and delay associated with the development and implementation of the options linkage demonstrates that the government-mandated linkage is not the best model going forward.

The quoting market center must support a special order type (designated as either a “take-out order” or an “intermarket sweep order”) designed to comply with the price protection rule, meaning that the order interacts with the displayed quote and the market does not route the orders to another market center for the purpose of complying with the price protection rule.

(iv) No Quote Fees. The market must not append any quote access fees to its displayed prices, so that the quoted price is the real price and not a disguised different price. For a quote to be “accessible,” it is critical that a “take out” or “intermarket sweep” order executing against that quote be free of any access fees, so that those placing, and paying for, orders transact at the actual displayed price.⁹ Quote access fees obscure the true price of the quote and undermine the value of the accessible NBBO as a benchmark for measuring price and execution quality. If we are going to rely on the NBBO as a benchmark for price discovery and best execution, the NBBO quote must be an accurate representation of the true price.¹⁰ In addition, fees imposed solely for the purpose of passing rebates back to the limit order provider are clearly too high. The result is that the order provider receives an incrementally higher price for their order, which effectively amounts to *de facto* sub-penny trading (something the majority of market participants oppose).

We emphasize that the definition of “accessible” focuses on the characteristics of a quote, rather than the market as a whole.¹¹ Therefore, any quote that fails to satisfy all the criteria listed above would not be considered “accessible.” For example, according to our proposed standards, reserve quotes are not “accessible” because they are not displayed and manual quotes are not “accessible” because they are not subject to immediate execution.

B. Intermarket Price Protection

Once a quote has been deemed “accessible” according to the standards described above, it should be afforded intermarket price protection (both for stocks traded on an exchange and OTC). By intermarket price protection we mean that, apart from the exceptions noted below, market participants will be obligated to “take out” all accessible quotes before trading at an inferior price. Indeed, we believe that the SEC should explicitly recognize the value of accessible quotes to the market by revising additional regulatory obligations. In particular, the duty of best execution should be redefined to exclude specifically inaccessible quotes from the best execution analysis. In other words, market participants should be able to bypass quotes that

⁹ Market participants, however, will continue to be free to charge agency commissions and exchange member fees.

¹⁰ We believe that certain other aspects of the market, like locked and crossed markets and sub-penny quoting, work to degrade the markets as well. Therefore, we support the SEC’s proposed rules regarding locked and crossed markets and sub-penny quoting, which is more fully discussed in Section IV. NMS Proposal, Proposed Rules 610(c) and 612.

¹¹ In this context, we agree with the Commission’s suggestion in the NMS Release that the quote, rather than the market, should be deemed “manual” (i.e., slow) or automated (i.e., fast). NMS Supplemental Release at II A.

do not meet the definition of “accessible” without concern that they may be violating the duty of best execution. Correspondingly, the SEC should permit market participants to ignore inaccessible quotes when computing their trading statistics pursuant to Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act.

Unlike the SEC proposal, however, we believe that an accessible quote should be afforded price protection whether it resides at the top-of-book or in the depth-of-book to the extent accessible. Accordingly, although we agree that the SEC should mandate price protection, we strongly disagree with limiting these price protections to top-of-book quotes only. Confining protection to the top-of-book could have deleterious effects. Bypassing better priced orders that are displayed at price points below the top-of-book may discourage the posting of limit orders. In addition, this approach would encourage the proliferation of small (even single participant) markets established for the goal of achieving price protection for the participant’s quotes because those quotes would be top-of-book in that market all the time, even if priced away from the current national best bid and offer (“NBBO”).

The following example illustrates that a top-of-book approach to price protection is counter-productive and encourages fragmentation. Assume that two markets are displaying the following bids:

<u>Market A</u>		<u>Market B</u>	
21.01	1000	20.75	1000
20.90	1000	20.25	1000
20.00	1000		

Firm C wants to purchase 5,000 shares from a customer seller at 20.50. In order to comply with the trade-through rule as proposed, Firm C must first sell 1,000 shares to the top-of-book at Market A (21.01) and Market B (20.75), respectively. Although the next best bid in Market A (20.90) is superior to the best bid in Market B (20.75), Firm C may bypass the better priced bid and, instead, must satisfy the inferior bid because it is displayed at the “top-of-book” in another market. It simply cannot be the case that the market structure for our nation’s future will protect the 20.75 bid, but leave the 20.90 bid unfilled because the investor made the “mistake” of placing an order in Market A. Such a result not only would encourage market fragmentation (by rewarding multiple venues), but it also would discourage placing limit orders, which are widely recognized as providing stability and liquidity to the markets.

We emphasize, however, that our proposal does not mandate depth-of-book display. Instead, each market may choose which quotes receive price protection by making the depth of quotes “accessible,” with display being one element of accessibility.¹² We provide this

¹² In this regard, we believe that the standard of selecting quotes must be reasonable and that the SEC must, as part of the standards, expressly prohibit markets from engaging in any practice designed to arbitrarily exclude otherwise “accessible” quotes, such as cherry picking intermittent quote levels.

flexibility to choose which quotes are displayed and accessible because we recognize that currently there are technological limitations to how much depth may be displayed. As we stated above, we believe that marketplaces and market participants will be encouraged to develop the technological capacity to display depth or to provide their depth to be displayed by private consolidators – and that competitive forces, driven by investors’ preferences for “accessible” limit orders, inevitably will compel these advances in value-added services.

1. Order Handling in a Price Protected Environment

Once the standards for accessible limit order protection are established, we envision that, as a practical matter, market participants will handle orders, broadly speaking, in one of two ways. First, broker-dealers will route orders to existing markets and those markets will execute orders following appropriate intermarket price protection standards. In other words, the receiving market will comply with price protection on behalf of the broker-dealer. Second, broker-dealers themselves may choose to route orders directly to various markets using so-called “smart routers” or other variations that may be developed over time. In that case, the broker-dealers choose to comply with price protection themselves.

We believe that the use of “intermarket sweep orders” is pivotal to this intermarket price protection model. Accordingly, we endorse the Commission’s proposal to address sweep orders in its NMS Supplemental Release. Such an order will reduce the market disruption that will occur when the receiving and transmitting market participants are simultaneously attempting to route to the same displayed quotation. These orders would carry a flag or marker that alerts other market participants that the order is taking out all other relevant quotes and, therefore, the receiving market center can execute the order without regard to whether a better price is displayed on another market center.¹³

2. Excepted Transactions

We firmly believe that a broad application of the price protection principles is most beneficial for the markets. For this reason, it is our view that any exceptions to intermarket price protection should be very limited in scope and indispensable to effectuate a particular trading strategy. For instance, we do not advocate a block exception because we view blocks as providing needed liquidity to the marketplace. Because blocks are priced away from the current NBBO due to size, they are exactly the type of trade that should interact with already-posted limit orders closer to the NBBO, both to reward the posted limits and, in a marketplace with “accessible” quotes, allow the block firm to access those quotes for the benefit of its customers. Similarly, we do not support a price protection exemption for stops and other types of trades that can be executed at a time when they are related to the current market price of a stock.¹⁴

¹³ NMS Supplemental Release.

¹⁴ We recognize that some may argue that stops involve principal risk to the executing firm and should therefore be exempted. We believe, however, that, because a firm is able to control timing of stop execution and therefore mitigate its risk by executing when the stop price will not involve trade throughs, price protection should

Exceptions to the intermarket price protection rule should be limited to those types of transactions that clearly would be frustrated were no exception available.¹⁵ Permitted exceptions should include those transactions for which an intermarket price protection rule effectively would preclude execution of the trade, such as trades for which the executing firm has no control over execution timing and, at the time of execution, the price at which the trade will be executed is unrelated to current market prices. Average price trades (e.g., volume weighted average price or VWAP trades), stock transactions in connection with certain derivative-linked transactions, such as exchange-for-physicals (“EFP”), and program and portfolio trades are some examples. These types of transactions are common in today’s marketplace. Intermarket price protection would so hinder the ability to execute these types of transactions that market participants might be unable to satisfy client preferences for these types of trading strategies.¹⁶

Finally, we do not support the “opt-out” exception. In a marketplace in which only accessible quotes (as we have defined them) are entitled to price protection, there should never need to be an opt-out and allowing one would undermine the incentives to display liquidity and quote aggressively that price protection provides. As mentioned above, we recognize that our model allows markets effectively to opt out of price protection by making their quotes inaccessible. We believe, however, that the forces of best execution and competition should drive marketplaces to make their quotes accessible in order to attract customer order flow. Accordingly, there is no need for a trade-by-trade opt-out.

C. Non-Discriminatory Fee Regime

Essential to building a market model that is fair and encourages linkage and participation in the price-protection regime is a fee model that minimizes unnecessary charges and encourages fair access. Under our proposal:

- to be accessible and qualify for price protection, a quote must not carry quote access fees;
- to be accessible and qualify for price protection, a quote must be displayed to the marketplace at reasonable, non-discriminatory cost;
- to have accessible quotes that qualify for price protection, a market participant may not charge non-members and non-subscribers linkage fees that exceed the linkage fees it charges to subscribers and members; and

be provided. We would be pleased to provide the Commission with examples that illustrate this timing point and accordingly distinguish between risk trades that should be provided with exceptions from the price protection rule and those that should not be provided exceptions.

¹⁵ This exception clearly differs from the proposed opt-out exception. See Proposed Rule 611. In contrast to our proposed limited exception, the opt-out would, if allowed, be entirely driven by customer preference.

¹⁶ For each of these excepted transactions, the trades should be reported to the consolidated transaction reporting system with an appropriate modifier in order to inform the market that the reported transaction was based on a benchmark or reference price and was not indicative of the current market price for the security.

- market centers are free to charge members membership and transactional fees.¹⁷

Because it is voluntary, this regime avoids involving the SEC in setting prices. At the same time, we believe that investors seeking price protection will reward with orders those market participants that live under this non-discriminatory regime.

D. Implementation

Our proposed model (indeed any Commission initiative to set new standards for market accessibility, put in place effective linkages and afford price protection to a wider range of quotes) is a significant undertaking. Accordingly, we urge the Commission to take account of the systems and frameworks under which markets currently operate and their relative capabilities, in order to avoid a “one size fits all” approach to this important phase of market evolution.

We are concerned that implementing the proposals in their entirety and simultaneously may over-burden the markets. Therefore, rather than attempting to address all the different regulatory issues at the same time, we recommend that the SEC consider an approach to implementation of the proposals that takes into account the different evolutionary stages of the various markets that will be affected. Such an approach could directly address the most critical market structure issues first, while limiting unintended consequences of extensive regulatory change and imposing more manageable costs and system changes on market participants.

In this regard, because many of the issues the SEC seeks to address in its NMS Release arise out of the disconnect between manual and automated markets, we believe that, in order to establish accessibility as the ground-floor standard for the provision of price protection, the Commission should concentrate in the near term on enhancing electronic trading on the exchange floors and integrating the open-outcry model with the more automated trading systems. Specifically, the floor-based exchanges must establish a fully automated execution capability for orders participating in the NBBO. In addition, they will have to put in place systems through which multiple price points may be swept up. The floor-based exchanges must integrate the trading crowd with the automated book by imposing standards on the use of manual quotes. Starting with the exchange-listed market makes sense in light of our proposed model — a large part of that market is already subject to price protection in order to comply with the trade-through requirements of the Intermarket Trading System.

Once these changes are fully digested, market participants would be in a position to implement intermarket price protection standards in the OTC market.

¹⁷ We believe that members will willingly pay the fees of market centers that provide services, such as unique, value-added order types.

III. Sub-Penny Quoting

We endorse the Commission's proposal to prohibit sub-penny quoting for NMS stocks trading above \$1.00 while continuing to allow trades that result from a mid-point or volume-weighted algorithm.¹⁸ Sub-penny quoting reduces market depth and thereby liquidity, and it encourages market participants to step ahead of existing quotes or limit orders. Sub-penny quoting also creates a two-tier market system because retail investors do not have access to sub-penny quotes while professional investors do. At the same time, we appreciate the Commission's recognition that certain types of trades, specifically those that use a mid-point pricing system, will need to use sub-pennies to achieve a true mid-point price that is fair to both parties to the trade.

Nevertheless, we urge the Commission to clarify its language on sub-penny usage for price improvement to stipulate that a broker-dealer or an exchange *guarantee* of sub-penny price improvement violates the sub-penny quoting prohibition. Such a guarantee functionally would allow a customer to receive a sub-penny quote because a customer would know, per such a guarantee, that the quote in penny increments carries with it the explicit sub-penny improvement. It, therefore, would constitute a *de facto* sub-penny quote. Allowing such a guarantee would bypass the purpose of prohibiting sub-penny quotes in the first place and it would reopen the market depth, liquidity, and step-ahead problems that sub-penny quoting poses at present.

IV. Market Data

We support the Commission's efforts to ensure that investors — both professional and non-professional — are ensured fairly priced and timely access to market data of sufficient depth and quality to allow informed investment decisions. We fully endorse the pivotal position of price transparency in efficient price discovery. We believe, however, that the Commission, in lieu of focusing on a revised formula for allocating market data revenues in its market data proposals, should reexamine the fee setting process and fee levels themselves. Both of these issues have been of significant concern for a broad spectrum of market participants for some time.

A. Market Data Fees

We share the belief that market data is the foundation of the national market system. The need to preserve the integrity of market data is paramount, and it is this need that should drive any revisiting of the fee arrangements for access to market data, whether that results in a requirement that the data be available on equal terms to all who wish to use it, or the Commission chooses to mandate a fee-based solution.

¹⁸ NMS Proposal, Proposed Rule 612.

Currently, the volume of market data fees generated by the networks,¹⁹ and the rebates made to market participants, suggest that the fee level is significantly in excess of the costs to the networks of collecting and distributing the data.²⁰ When market data fees are too high they can be an obstacle to quote access and, therefore, best execution.

In addition, we believe that market data should not be used to fund regulatory costs of the SROs. We want to make it very clear that we are in no way advocating cuts to regulatory funding. We do, however, believe that it is inappropriate for this cross-subsidization to persist, not only because of the excessive levels of market data fee charges, but because using market data fees to pay for regulatory costs obscures the true levels and needs of the latter. A fully transparent, cost-based system for charging for market data only can help to clarify the actual costs of regulation, and we would strongly support any reasonable initiative that would help ensure a well-funded regulatory process as a fundamental element of investor protection and confidence.²¹

In order to best achieve the objectives of reducing costs and eliminating the use of market data for regulatory funding, a mandated cost-based provision of market data would be the ideal solution.²² Indeed, because of the critical role the NBBO plays to all investors and the market as a whole, we believe that the existing collection and distribution of market data should be an exclusively cost-based system. Therefore, we believe that a re-examination by the Commission of the “flexible cost-based approach” described in its concept release on market data,²³ or another similar cost-based approach would result in adjustment of market data fees to a more appropriate level.²⁴

¹⁹ In 2003, the networks collected \$424 million in revenues derived from market data fees.

²⁰ We also believe that the current, excessively high, market data fee rates reflect inefficiencies in network administration. The administrative burdens imposed upon firms are considerable and could be ameliorated through modifications to the contractual processes involved when becoming a vendor of or subscriber to market data.

²¹ For more detail on this point, please see the Securities Industry Association’s letter to the Commission regarding the NMS Proposals, dated June 30, 2004.

²² By “cost-based” we mean set by reference to the cost of data collection and distribution alone.

²³ Exchange Act Release No. 42208 (December 9, 1999), 64 Fed. Reg. 70613 (Dec. 17, 1999). This approach suggests: (1) the calculation of direct market information costs; (2) the calculation of a “gross common costs pool” of costs contributing substantially to the value of market information, which categories can include the costs of market operation and market regulation, but not member regulation or other direct costs of services other than market information; (3) the application of a standard allocation percentage to its gross common costs pool by each SRO to arrive at its net common costs pool; and (4) the allocation by each SRO of its total costs, being direct costs plus net common costs, to the networks whose securities it trades.

²⁴ We have limited our voluntary proposal to depth of book quotes. We note that, in theory at least, it also would be appropriate to make so-called “top-of-book” quotations voluntary (and subject to our non-discriminatory pricing regime), so long as the benefits of price protection only were provided to markets which displayed accessible

We also believe that markets should be allowed the flexibility to distribute their market information, including the NBBO and depth-of book, outside of the current collection and distribution network.²⁵ We believe that the ability to charge for privately disseminated quotations (i.e., quotations distributed other than via the networks) should depend on whether the quotation at issue receives price protection. On one hand, if a quotation seeks to take advantage of price protection standards and is distributed privately, then it should not be subject to any extraneous fees other than reasonable, non-discriminatory charges.²⁶ On the other hand, the private distribution of any quotation that is not subject to price protection can be priced at a level determined by competitive forces. This flexibility would ensure continued innovation, with commensurate customer benefits, through competitive forces.²⁷ Competition to have accessible quotes would also lower the cost of market data.

B. Transparency of Fee Setting and Use

Whether or not the Commission elects to revisit the actual level of market data fees themselves, and/or presses ahead with a form of reworked fee allocation formula, we believe that the way in which market data fees are set, altered and spent by the SROs must be made more transparent.

Transparency would be enhanced significantly were the fees themselves openly accounted for through annual filings by, and independent audits of, the networks so as to identify the exchanges' operating costs, and how they use market data revenues. We believe oversight of market data fees also should include a rule filing process upon the setting or amendment of fees which allows for genuine comment and participation by interested parties. The current process for fee changes, whereby proposed fees are submitted to the Commission and are effective upon filing, does not allow for sufficient examination of, and comment on, the proposals. Effective and transparent network governance also would assist in enhancing transparency — while we welcome the Commission's proposals for the establishment of Advisory Committees to the

top-of-book quotations. Nevertheless, we recognize that the development of the firm quote rule, Rule 11Ac1-1, has been a long and arduous process that has resulted in important transparency benefits to the markets as a whole. Accordingly, we believe it only would be appropriate for the Commission to revisit the question of a voluntary top-of-book display in the future, after substantial progress has been made on other, more pressing, market structure issues.

²⁵ The Commission also advocated this in Exchange Act Release No. 42208 FR (December 9, 1999), 64 Fed. Reg. 70613 (Dec. 17, 1999).

²⁶ If competitive forces did not preclude a dominant liquidity pool from charging unreasonable fees, the SEC would have to consider a mandated solution.

²⁷ This model would allow competing consolidators to charge market rates for market data based on value-added services.

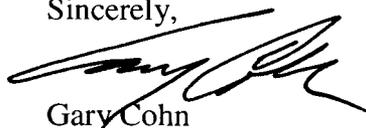
networks, their non-voting status will not allow them sufficient authority to participate actively in governance and fee setting.

C. Allocation Formula

The SEC has proposed a revised market allocation formula that is intended to “incorporate a more broad based measure of the contribution of an SRO's quotes and trades to the consolidated data stream.”²⁸ Assuming that there remains a mandatory consolidation of market data, we believe in the value of firm, visible and accessible quotes. Accordingly, any reworking of the allocation formula for market data that factors in quotes as a multiplier only should reward firm, visible and accessible quotes. Slow quotes that are not accessible should not be rewarded.

We again thank you for the opportunity to comment on these important issues concerning our national market structure. We remain available to discuss any aspects of this letter. In that regard, if you have any questions or comments, please feel free to contact the undersigned at (212) 902-7616.

Sincerely,



Gary Cohn
Managing Director

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
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