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7/29/2004

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Via Electronic Mail



Attention: Mr. Jonathon Katz, Secretary

Re: File No. 34-49325 Proposed Regulation NMS and Release No. 34-49749 Extension of Comment Period

NexTrade Holdings, Inc., welcomes the opportunity to provide the Securities and Exchange Commission (the "Commission") with its comments to the above referenced filings. The filings enumerated above describe the plans of the Commission to, along with routine matters, incorporate into law four substantive proposals purported to "modernize the regulatory structure of the U.S. equity markets."¹ These proposals include the following initiatives:

"(1) a uniform trade-through rule for all NMS market centers that would affirm the fundamental principle of price priority, while also addressing problems posed by the inherent difference in the nature of prices displayed by automated markets, which are immediately accessible, compared to prices displayed by manual markets;

(2) a uniform market access rule with a de minimis fee standard that would help assure non-discriminatory access to the best prices displayed by NMS market centers, but without mandating inflexible, "hard" linkages such as the Intermarket Trading System ("ITS");

(3) a sub-penny quoting rule establishing a uniform quoting increment for NMS stocks to promote greater price transparency and consistency;

(4) amendments to the arrangements for disseminating market information that would reward self-regulatory organizations ("SROs") for their contributions to public price discovery, as well as implement many of the recommendations of the Commission's Advisory Committee on Market Information."²

The Trade-Through Rule

On April 14, 2003 NexTrade submitted a petition for rulemaking to the Commission requesting that the Commission promulgate a rule that extended trade-through protection beyond the Listed market into the entire market, with consideration for the speed

¹ Release, No.34-49325; February 26, 2004

² Id.

discrepancies generally found between electronic and manual markets. Specifically, we stated, “NexTrade has crafted a proposed rule to prevent trade-throughs and locked or crossed markets similar to the existing rules of the Listed market. However, NexTrade’s proposed rule has been modernized to eliminate the problems associated with the Listed version of the trade-through rules, mainly the disparity of processing speed between market centers.”³

As NexTrade understands the Commission’s proposal, it appears the Commission has proposed a substantially similar rule to that forwarded by NexTrade last year. As such, we largely support the implementation of the rule as proposed.

However, we take issue with the concept of the proposed “opt-out” clause. After review of multiple comment letters and testimonies submitted regarding proposed NMS, it appears that the primary, meritorious arguments may be delineated into two camps: on the one hand, those that wish to protect their liquidity argue that the retail investor that first accepted market risk by posting a firm quote deserves the execution; and, on the other hand, those that wish to lower their utility costs argue that informed, sophisticated investors have the right to trade as they see fit.

Largely, both arguments hold water, but a fundamental precept of our market structure is that the risks taken by all parties, once committed to, must be fair, regardless of order size or expertise of the end investor. It is our opinion that the investor that submitted a displayed, firm quote has embraced market risk, even before execution. To permit another investor to usurp the time priority position of the first investor does not properly compensate the first investor for risk. Whereas, the second investor would be permitted to trade with reduced risk due to the enhanced data provided by the first investor; this preferred position is fundamentally unfair.

Certain large fund managers have argued that forcing executions at smaller, displayed prices could increase the total “all-in” costs for their transaction, redounding to the detriment of the individual investors they represent. We believe this may well be true, but this increased cost is not the fault of the investor that first embraced risk, it is the fault of the fund manager that did not embrace the risk soon enough.

In addition, it is unclear how such an “opt-out” clause would address reserve orders, particularly those of size. It is not uncommon for a reserve order to show only 100 shares, yet truly be deep for 100,000. Permitting a fund manager to trade-through the displayed size may in fact be doing a disservice to that fund manager. It would be quite the fund manager indeed that knew where all the liquidity was at any given moment in time. NexTrade believes that it is at least as likely that the fund manager does not know where large blocks of liquidity may be found at any given moment, and to claim that circumnavigating displayed quotes will reduce total costs cannot be universally true.

We believe the “opt-out” clause as proposed unnecessarily undermines the value of standing limit orders, creates an escape hatch for firms to avoid best execution

³See letter from NexTrade to the Commission, April 14, 2003

obligations that will be difficult to police, and does not facilitate a more perfect market. As such, we do not believe it should be adopted as proposed.

Along with the “opt-out” clause, NexTrade has some concerns within proposed Regulation NMS regarding the final definition of a “fast” market versus a “slow” market. In recent press, NYSE CEO John Thain has been quoted as saying, “How do you define automatic fast markets? I think the simplest way is that they provide automatic execution, which basically means computer-to-computer execution,”⁴ NexTrade disagrees with adopting such a vague definition.

From NexTrade’s perspective, whether or not the interfaces are computer-to-computer is wholly irrelevant as to if the market is, in fact, “fast”. The speed of execution is the KEY litmus test, whether the trade is between a customer and a specialist, an institution to an institution, or an institution to a customer; the important element is a sub-second response. Alternatively, it is easy to argue that most order transactions handled today on ITS are “computer-to-computer”, yet no reasonable mind would call a 30-second response time as “fast” under the light of today’s technologies.

The Commission is not unfamiliar with establishing time frames within rules for order response and should look to do so again for defining a “fast” market versus a “slow” market. Current precedent exists within the ADF demanding a 3 second response time. The BOX has a 3 second PIP feature, also Commission sanctioned. NexTrade would recommend to the Commission that in order for a market to enjoy the privilege of trade-through protection, it must be able to respond, in full, to marketable limit orders in three seconds or less.

If, for example, a market receives an order for 20,000 shares, but is only able to fill 1,000 of those shares within the 3-second window, that market should no longer have trade-through protection for the remaining 19,000 shares. Such a simple, clean definition would go a long way toward alleviating the general concerns raised by the currently unclear definition of a “fast” market.

Access Fees

The Commission proposes to standardize access fees among all market participants to \$.001 per share. NexTrade opposes this proposal.

ECNs originated for a specific purpose: to display and execute blind agency orders. It is in exchange for this unfettered, unbiased and automatic service, among other reasons, that ECNs are permitted to charge a fee.

In its response to SEC release No. 34-41128, the “Agency Quote Proposal”, NexTrade stated:

⁴ See Securities Industry News, May 17, 2004, page 18.

*“Further, NexTrade asserts that ECNs are not allowed to charge Access fees simply because they clearly conduct Agency business. Rather, ECNs are allowed to charge the Access Fees because they are the **‘functional equivalent of an exchange (emphasis added).’**⁵ As cited in former Director Lindsey’s letter to Joseph Hardiman 09/06/96, **“The ECN, however, may impose charges for access to its system similar to the communications and systems charges imposed by various markets (emphasis added).”** NexTrade reminds the Commission of the arduous screening process through which each ECN has passed to validate that its procedures were functionally equivalent to an exchange.*

Each approved ECN has demonstrated that its electronic functionality, free from human corruption, provides transactions without bias, delay, or encumbering profit motive. NexTrade would oppose any such Proposal that allowed market makers the ability to position inventory, review trades, and conduct trades at the highest cost to the investor.

*Conversely, NexTrade would not oppose a Proposal to allow market makers to charge Agency fees if they functioned in a manner equivalent to an exchange. Like ECNs and exchanges, the market makers would have to blindly accept and match each order, without prior knowledge of its impact to Proprietary positions, and process the trades accordingly. **To function in a manner similar to an ECN, a market maker would need ‘established, non-discretionary methods’ under which its buyers and sellers entering orders could agree to terms.**⁶ Moreover, each market maker would have to demonstrate its procedures that prevent corruption, human and otherwise, of the system.”⁷*

The roles that market makers play vis-à-vis ECNs in the market are not the same, and a broad-stroke attempt to level the playing field would be as inappropriate in this setting as it would be to tell the NYSE that it must force its’ Specialists to the same charge structure as market makers in the ISE. ECNs provide the investing community an absolute assurance that the Agency trade is, in fact, an Agency trade; this assurance is important to investor confidence in the market and removing that assurance is not a logical step toward creating a more perfect market.

Over the years, many have argued that this access fee grants ECNs an unfair competitive advantage over market makers. This is a myth, as evidenced by the total refusal of most significant market makers to become ECNs.

Does anyone honestly think that if ECNs had a special, unfair, economic advantage over market makers that a sophisticated firm, beholden to public shareholders, such as Knight Securities would not have become an ECN? Does anyone honestly think that ECNs have this alleged advantage, are therefore a better business model, and that’s why there are

⁵ See SEC Release No.34-40760 Regulation of Exchange and Alternative Trading Systems. File No. s7-12-98.

⁶ Ibid.

⁷ See Letter from NexTrade, Inc. to the SEC March 8, 1999.

numerous market makers and a handful of ECNs? Certainly, the market makers have fallen on hard times over the last few years, but no more so than most ECNs, the largest of which have burned hundreds of millions of dollars running trades at loss leader rates.

ECNs have served perhaps the most valuable role since the inception of the NASDAQ. The improvement in market quality ECNs have brought to the investment community cannot be argued. The access fee proposal, if adopted as proposed, will destroy the ECN community and, in turn, damage the market substantially.

The Commission must ask itself, "if one can run an ECN and only get \$.001, why would anyone ever do that when one can run a market-maker, get spread capture AND the \$.001?" If the Commission honestly feels that permitting market-makers to charge an access fee is in the public interest, then the Commission should consider permitting ECNs to act in Principal capacity for spread capture. To allow market makers to perform in this function, and not ECNs, would clearly create a competitive disadvantage for ECNs and a distortion to the entry in the market of agency orders, creating a market manipulated by the greed of the operator and not the service of a transparent and unbiased execution that the Commission is required to uphold.

The Proposed Rate Cap is Outside the Commission's Role, is Capricious, Fails to Address the Locked and Crossed Concerns, and is Unnecessary

The SROs through which the various ECNs operate can set the ECN Access Fee through a rulemaking of their own. It is unnecessary, and NexTrade feels it is also inappropriate, for the SEC to set fee caps for the SROs. Such action diminishes the authority of the SRO and oversteps the true role of the Commission, which is most certainly not designed to be a ratemaking body.

In attempting to set a global fee-cap, the Commission dramatically overlooks the differences in cost involved for market participants operating in divergent market centers. Operating in the ADF, for example, with no execution system and only an amorphous network of interconnected, privately owned nodes to provide access is far more expensive than operating under the confines of a traditional market center, such as Nasdaq, which requires only one connection to the market center to satisfy execution access requirements.

NexTrade questions, "Where did the Commission come up with a \$.001 rate level?" It almost appears from the release that the Commission took the position that since the largest ECNs and market centers have a \$.003/\$002 model, the gross profit from transactions fees is \$.001; why not just cap the fees at that gross?

NexTrade is unaware of any economic studies conducted by the Commission with respect to an appropriate access fee cap. NexTrade is further unaware of what consideration the Commission gave to the proposed cap's impact on competition. NexTrade can assert, with reams of academic information, that ECNs under the even higher access fee limits

once permitted, dramatically improved the market, and saved investors billions of dollars. Academic research shows:

- “We find that the recent growth of trading through ECNs has resulted in tighter bid-ask spreads, greater depths, and less concentrated markets. Overall, our results support the hypothesis and electronic communication networks have improved Nasdaq liquidity.”⁸
- “Specifically, we find that spreads decline with an increase in ECN trading”⁹
- “Consistent with our results on trading costs, we find that quoted depths are, *ceteris paribus*, positively related to the level of ECN activity”¹⁰
- “...we find that realized execution costs are generally lower on crossing systems and ECN’s”¹¹
- “ECNs, on the other hand, provide active price discovery...”¹²
- “...execution costs are lower for crossing systems and ECN-executed trades”¹³
- “Other empirical papers examine the role of ECNs in price discovery. Huang (2001) uses quote data from the Nasdaq database and concludes that ECN’s are important contributors to price discovery. Barclay, Hendershott and McCormick (2001) examine ECN trades and find that average quoted, realized and effective spreads are smaller for ECN trades than for market makers (see also Barclay and Hendershott (2000) for an analysis of after-hours trading, some of which takes place on ECNs)”¹⁴
- “We...find that orders sent to traditional brokers have higher execution costs than those executed by alternative trading systems”¹⁵
- “ECN’s, which aid in price discovery, have the lowest execution costs”¹⁶
- “We find that increased trading through ECNs results in tighter quoted, effective, and relative bid-ask spreads, greater depths, and less concentrated markets”¹⁷
- “We find that ECNs have a significant negative impact on spreads. Specifically, we find that quoted, effective, and relative spreads are lower when an ECN enters the market. Further, we find that spreads are negatively related to the market share of ECNs. That is, the more ECN activity there is in a given stock, the lower the spread and greater the depth”¹⁸
- “In addition to reducing spreads, ECNs also demonstrate a positive relationship with average quoted depth. We find that the presence of an ECN in a stock

⁸ See “Electronic Communication Networks and Liquidity on the Nasdaq,” written by James P. Weston in April of 2001.

⁹ *Ibid.*

¹⁰ *Ibid.*

¹¹ See “Institutional Trading Costs and Alternative Trading Systems,” by Jennifer Conrad, Kevin M. Johnson, and Sunil Wahal, in November of 2001.

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ See “Competition on the Nasdaq and the Growth of Electronic communication Networks,” by James P. Weston, in July of 2001.

¹⁸ *Ibid.*

increases the quoted depth by 11.6 percent while a one percent increase in ECN activity improves the quoted depth by 0.27 percent. Both results support the hypothesis that ECNs have improved the overall quality of the Nasdaq market”¹⁹

- “Overall, these results support the hypothesis that ECNs have a significant effect on lowering transactions costs in dealer markets like Nasdaq. We find that spreads decline and depths increase with both the presence of an ECN and with an increase in ECN market share”²⁰
- “In addition, we find that ECNs compete directly with traditional Nasdaq dealers and force lower average quoted, effective, and relative spreads over all dealers. We also find that ECNs improve the average quoted depth”²¹
- “Overall, we find that the emergence of Electronic Communication Networks has significantly improved competition on the Nasdaq. The ability of investors to trade with each other directly is a clear benefit to investors without any noticeable deterioration of market quality along other dimensions”²²
- “An analysis of the most active Nasdaq stocks shows that ECNs not only post informative quotes, but also, compared to market makers, ECNs post quotes rapidly and are more often at the inside. Additionally, ECN quoted spreads are smaller than dealer quoted spreads”²³
- “The evidence presented ... shows that quoted spreads on the ECNs are less than half the width of quoted spreads posted by Nasdaq market makers”²⁴
- “Therefore, quoted spreads on ECNs are more like the smaller effective spreads”²⁵
- “This suggests that the ECNs’ market structure is conducive to the timely dissemination of an asset’s intrinsic value. The evidence also indicates that the ECN quotes do not free ride off Nasdaq market maker quotes”²⁶
- “...ECN quotes contribute substantially to quote quality on the Nasdaq quote montage”²⁷
- “Average quoted, realized, and effective spreads are smaller for ECN trades than for market-maker trades even though ECN trades are more informative than trades with market makers. Increased trading on ECNs also improves most measures of overall market quality. In the cross section, more ECN trading is associated with lower quoted, effective, and realized spreads, both overall and on trades with market makers”²⁸
- “Consistent with our model, we find that ECN trades have lower average effective spreads than trades with market makers”²⁹

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ *Ibid.*

²² *Ibid.*

²³ See “The Quality of ECN and Nasdaq Market Maker Quotes,” by Roger D. Huang.

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ See “Electronic Communications Networks and Market Quality,” written by Michael J. Barclay, Terrence Hendershott, and D. Timothy McCormick on January 22, 2001.

²⁹ *Ibid.*

- “Consistent with our model, we find that ECN trades are more informative and have lower realized spreads than trades with market makers”³⁰
- “Finally, we find that an increase in ECN trading activity improves most measures of market quality”³¹
- “In contrast, we find that trades on ECNs have lower effective and realized spreads and are more informative than trades with market makers”³²
- “ECN trades have lower effective half-spreads than market-maker trades in every volume category”³³
- “As predicted, quoted spreads are narrower at the time of ECN trades than at the time of market-maker trades for every volume category and every trade-size category”³⁴
- “The information content of ECN trades is larger than the information content of market-maker trades for every volume category and for every trade size...”³⁵
- “For each volume category, the difference in information content between ECN and market- maker trades increases with trade size. In fact, for medium and large trades (large trades in the low-volume and inactive categories), the information content of **market-maker trades is negative** (emphasis added)”³⁶
- “As predicted by our model... increased ECN trading improves market quality as measured by effective, realized, and time-weighted quoted spreads overall...”³⁷

For the Commission to risk dismantling ECNs, which save investors billions of dollars, dramatically improve market quality, and act as a firewall against the collusive pricing intrusions of market makers without sound evidence, academic backing, and economic rationale would be capricious. NexTrade recognizes that the comment periods provided by the Commission during such rulemakings are designed so industry participants may share knowledge with the Commission to avoid just such a whimsical result. NexTrade strongly encourages the commission not to set access fees so low, nor to return control of spreads to a Principal driven business, which would be the result of making uniform the ability to charge access fees.

It must also be noted that one of the primary reasons the Commission cited for reducing access fees and extending the power to charge access fee across all quoting market participants, the problem of locked and crossed markets, is not cured by the proposed change to the economics of access fees. In fact, the logical extension of the release, if implemented as proposed, is a rampant exacerbation of the current problem.

Today, between a handful of ECNs and exchanges, there exist only a few mediums through which a broker dealer may be economically induced to lock or cross a market.

³⁰ *Ibid.*

³¹ *Ibid.*

³² *Ibid.*

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ *Ibid.*

By empowering every market participant to charge an access fee, EVERY MARKET PARTICIPANT WILL BE FACING A HUGE ECONOMIC CONFLICT OF INTEREST TO AVOID RESTING LIMIT ORDERS IN FAVOR OF POSTING THEIR OWN LIMIT ORDER. Coupled with the “opt-out” clause for trade-throughs, and countered only by the vagaries of a suggested, future “Ship or Post” standard, the proposed solution will both totally undermine the value of resting limit orders and only increase the critical problems of locked or crossed markets. The Commission needs to rethink its proposal to set access fees so low, and must definitely rethink its proposal to allow market makers the privilege to engage in spread capture and access fees, ultimately at the cost of the investor.

Finally, the proposed rate cap is totally unnecessary. ECN’s have been quite successful in eliminating all profit margins from the access fee by charging low, loss-leader rates. As a consequence of such brutal competition, most major ECNs rely on “shredded” market data prints to attempt to squeeze some profit from the transaction business.

The role of the Commission is to govern the market, not govern market forces. Setting an artificial and capricious access fee rate is not the business of the Commission; these prices have already been capped by market forces and should not be further regulated.

Sub-Penny Quoting

“The art of government consists in taking as much money as possible from one class of the citizens to give to the other.”

Voltaire (1694 - 1778)

Any government-enforced reform of quoting practices inevitably impacts the zero-sum exchange of funds inherent in spread capture. At an immediate, micro level, money from the spread is either collected to the benefit of the dealers, or paid to the detriment of the individual investors. Therefore, from a micro level, it clearly benefits the investor to allow multi-decimal place quotes so as to further reduce the spread.

However, the Commission asserts that sub-penny quoting may result in infinitesimal gains for a handful of investors, at a greater cost to market integrity, and therefore should be banned. NexTrade agrees, but would suggest to the Commission that perhaps the true damage was done to the market in the shift from a fractionalized environment to a penny spread environment; that, in fact, sub-penny quoting does little, if anything, to degrade the market from its current state.

From a systems standpoint, most modern systems are equipped to handle 6, 8, 10, or more decimal places. People with actual trading experience know that market speed is the true limiting factor as to where “a line in the sand” will be drawn to set a practical limit of decimal places. Simply put, at a certain point, it takes too much time to calculate and set the 5th or 6th decimal point; this means the trader, or the trader’s system, dickering around with 1/10,000th of a cent may cause a miss of the trade altogether.

Rather than waste time banning sub-penny quotes, the Commission should raise the question, “Did decimalization help the individual investor?” If not, the Commission should consider implementing a nickel minimum increment for stock trading.

In a letter to Securities Industry News 04/01/03 we stated:

*“While decimalization clearly further reduced the ‘spreads’ on Nasdaq stocks, little empirical evidence exists that investors have in any way benefited from its implementation... When the spreads collapsed following decimalization... premiere dealer desks across the country closed or were reduced to negligibility. **The integrity of the Nasdaq’s dealer market fell into the sink and it is no coincidence that the stock market followed. Arguments can be made that such a gut-wrenching change would ultimately lead to a better market, and, admittedly, investors were assured of tighter spreads as a consequence. However, that the market lost so much of its value through the conversion from fractions to decimals calls into question the totality of benefits to the investors, which were left well behind the curve.**”³⁸*

If adopted as proposed, Regulations NMS will seriously upset that sector of broker dealers that handle the lion’s share of trading activity, the ECNs. Consequently, the integrity of the market could again be derailed as it was following decimalization. Without economic rationale to support such a decision, the Commission would be operating far outside its Congressional mandates.

The Commission, if it is to act, must do so from a sound, logically consistent basis. From NexTrade’s perspective, there appears to be something incongruent with the logic that stipulates access fees, which are always Sub-penny, have so great an economic impact on the market that rulemaking is in order; whereas, Sub-Penny quoting may be deemed to be so economically irrelevant that a rulemaking is in order.

The Commission cites in its release that access fees may skew the true quote. Logically speaking, if an investors wants to place a sub-penny quote, would not denying that investor the ability to display that quote skew the quote to the same degree? Why would the **presence** of a sub-penny access fee skew the quote anymore than the **absence** of a sub-penny price? As the Commission knows, it would not.

Market Data Revenue

We support the Commission in restructuring the manner in which market data is redistributed. We also think it appropriate that distribution of market data revenue remain the sole province of the exchanges.

³⁸ Chairman Donaldson raised the possibility of reconsidering nickel minimum increments. See URL http://story.news.yahoo.com/news?tmpl=story&u=ft/20030515/bs_ft/1051390033820

However, we are inclined to believe that a more simple formula for the distribution would better serve the public. The proposed formula, while mathematically impressive, is daunting and largely incomprehensible to the investing public which fathers the feed.

If the formula simply distributed the revenue in direct correlation to volume proportions, the exchanges would have an incentive to quote and execute at the inside. As the Commission has seen, and in fact referenced via its expressions of concern over shredded and washed trades, the economics of market data can drive market behavior. In this case, simpler is better.

Additional Requests for Comment

In its extension of the comment period, the Commission requests additional comments on certain matters. Specific to NexTrade, the Commission states in pertinent part, “panelists at the NMS Hearing indicated that access could remain a problem at relatively inactive ATSS or market makers with little trading volume whose quotations were displayed only in the ADF...Market participants could obtain access to such quotations only through direct connections...Panelists suggested that such an entity should be **REQUIRED to publish its quotations in an SRO execution facility.....(emphasis added)**”

To refresh the Commission's memory, the Alternative Display Facility was created for an express purpose, to make participation in NASDAQ's SuperMontage system **VOLUNTARY**.³⁹ NexTrade stated, ad nasueum, that the ADF construct was a preposterous design, destined for failure and utterly inconsistent with the Commission's mandates, **thereby rendering participation in SuperMontage mandatory; in turn, voiding the Commission's condition precedent of SuperMontage approval, its voluntary nature.** NexTrade stated:

“ The Commission cannot simply accept the NASD's statement that ‘private sector solutions’ exist.⁴⁰ It may seem mundane, but the fact of the matter is there is not a single ADF participant linked to another ADF participant by virtue of its unapproved status. Nevertheless, the NASD continues to paint the picture with one hand that upon approval of the ADF, the network connectivity between ADF participants will somehow appear, while using the other hand to foil the ease of such connectivity with draconian contracts,⁴¹ poor project planning,⁴² and non-standard protocols.⁴³

³⁹ See letters from NexTrade to the Commission dated January 18, 2002, and April 8, 2002

⁴⁰ *Timpinaro v. SEC*, 2 F.3d 453 (DC Circuit 1993).

⁴¹ See letters from NexTrade to the Commission dated January 18, 2002, and April 8, 2002

⁴² See letters from NexTrade to the Commission dated January 18, 2002 and April 8, 2002. See also letter to the SEC from William O'Brien (Senior Vice President and General Counsel) of Brut, LLC on March 20, 2002. See also letter to SEC from Instinet Group Incorporated on April 1, 2002.

⁴³ NASD systems have been developed using a proprietary protocol from the OM Group. It is generally accepted industry practice to include the FIX protocol in such systems. To date, NASD has not included FIX.

*In previous letters to the Commission regarding ADF,⁴⁴ NexTrade argued that Rule 4300 as proposed unfairly discriminated against smaller firms. In its recent filing, the NASD amended 'its proposal to clarify that market participants must provide **both** direct electronic access to those who want it and also allow for indirect electronic access through their customer broker-dealers. In addition, NASD is amending the rule filing to require market participants to provide the **same combination of direct and indirect electronic access to members of national securities exchanges that seek access to quotes in the ADF (emphasis added).**'⁴⁵ As a consequence of these amendments, the potential cost discrimination NexTrade articulated in previous letters has increased exponentially. As a consequence of these amendments, smaller firms that wish to participate in the ADF must stand ready to deliver direct lines to essentially every broker dealer in the country if so asked, and indirect lines to essentially every broker dealer in the country whether necessary or not. This is a burden too great for many mid-size firms and its effect will be to preclude many firms from considering ADF participation.⁴⁶*

*NexTrade finds the following statement from the NASD's rule filing particularly edifying, 'The rule is intended to ensure access to quotes displayed in the ADF for all broker-dealers and exchange members that are not market participants. NASD believes that this purpose can only be achieved effectively if broker-dealers have the option to access quotes through indirect electronic access. **If indirect access were not available, the NASD believes it could be overly burdensome and prohibitively expensive on the members – particularly smaller broker-dealers – if they were obligated to link directly to every market participants (emphasis added).**'⁴⁷ How the NASD can argue that such burdens placed upon smaller broker dealers in other markets is unacceptable while such burdens placed upon smaller broker dealer members of its **own market** is acceptable confounds, but does not surprise, NexTrade. In fact and in form, Rule 4300 as proposed will prove to be 'prohibitively expensive on the members – particularly smaller broker-dealers,' and it has been intentionally structured to dissuade smaller firms from participating in the ADF. NexTrade **strongly urges the Commission to analyze this admission of cost disparity on behalf of the NASD** and asserts that it cannot be reconciled under the Association's obligations for equal treatment of members under the Exchange Act.⁴⁸*

⁴⁴ See letters from NexTrade to the Commission dated January 18, 2002, and April 8, 2002

⁴⁵ Proposed Rule Change Relating to Nasdaq Separation for the NASD and the Establishment of the NASD Alternative Display Facility; Withdrawal and Replacement of response to Comments and Amendment No. 2, on May 24, 2002..

⁴⁶ "Even institutional investors, with economies of scale and technology budgets that allow use of multiple ATS's, will be paralyzed in their search for best price as they are forced to go from screen to screen to screen in an attempt to fulfill their fiduciary duty. The small investor, with limited technological resources will be at an even more distinct disadvantage." See letter to the secretary of the U.S. Securities and Exchange Commission from Mike Cormack at American Century Investments on August 12, 1998.

⁴⁷ See Note 4, *supra*.

⁴⁸ The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; **and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers**, to fix minimum profits, to

*The language within the filing from NASD clearly expresses its belief that belonging to the ADF will be an expensive proposition for its participants. The NASD states 'Within the ADF, broker-dealers will be able to satisfy their best execution obligations because **all market participants would be directly linked** (emphasis added).'⁴⁹ As articulated by the NASD itself, such a proposition could prove overly burdensome and prohibitively expensive. Moreover, the NASD asserts that it believes the ADF will be 'predominantly an application programming interface ("API") environment,'⁵⁰ which translates to an environment of firms with the necessary programming resources to participate. If rule 4300 is approved as amended, the ADF will prove to be an illusory alternative for smaller firms and that cannot be viewed as an acceptable alternative under the Exchange Act⁵¹ or the Commission's SuperMontage Approval Order.*

The Commission must not lose sight of the fact that the additional costs the NASD cites as burdensome and prohibitively expensive, would be costs initially incurred by members of the ADF, but inevitably transferred to the investor. Moreover, such additional explicit costs on transactions contrast sharply with the objectives of the NMS. 'Accordingly, one of the principal Exchange Act objectives for the national market system is to assure the 'economically efficient execution of securities transactions.' Investor transaction costs can be divided into two categories – explicit costs, which are separately disclosed to investors, and implicit costs, which often can be greater, though less visible, than explicit costs.'⁵²

NexTrade worked diligently to try to communicate to the Commission the obvious shortcomings of the ADF proposal, meeting in person with Commissioners and members of the department of Market Regulation on June 14, 2002. In those meetings, NexTrade detailed the deficiencies of private sector solutions, the cost disparities ADF would

impose any schedule or fix rates of commissions, allowances, discounts or other fees to be charged by its members, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the association. (Emphasis added) *See also*, that the rules of the association do not impose any **burden on competition not necessary or appropriate** in furtherance of the purposes of this title.

⁴⁹ Proposed Rule Change Relating to Nasdaq Separation for the NASD and the Establishment of the NASD Alternative Display Facility; Withdrawal and Replacement of response to Comments and Amendment No. 2, on May 24, 2002.

⁵⁰ *Ibid.*

⁵¹ See letter to SEC from Junius W. Peake (Monfort Distinguished Professor of Finance), April 24, 2000. "What is fair competition? Isn't it providing all market participants equal information and access to market facilities at equivalent cost for services?... The system must execute orders quickly, cheaply and accurately... The system must treat all market participants-brokers, market makers, investors and market center operators-equally.... The system must, by its design, allow all bids and offers in the same security to interact with each other to provide the lowest cost for the buyer and the highest sale proceeds for the seller."

⁵² See NYSE Rulemaking: Notice of Filing of Proposed Rule Change to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation. February 23, 2000. "Section 11A(a)(1) of the Exchange Act expresses the Congressional mandate that investor protection and the maintenance of fair and orderly markets require assurance of economically efficient execution of securities transactions in the best market for those transactions, and, consistent with these considerations, for investors' orders to be afforded the opportunity to be executed without the participation of a dealer."

present to the investing community, and, finally, NexTrade failed to persuade the Commission that the huge problems with the ADF would ultimately render participation in the SuperMontage as involuntary.

NexTrade reminds the Commission that a lawsuit was filed in Federal Court regarding the SuperMontage Approval Order, challenging the Commission's decision to approve SuperMontage. In that lawsuit, the Attain ECN argued, among other things, that the existence of a voluntary system was a condition precedent to the approval order of the SuperMontage. The Federal Court Dismissed that suit because it found that Attain's filing was not timely.

Now, the Commission requests comment on whether or not participation in SuperMontage should be voluntary for smaller firms.

“Wow.”

That said, the Commission should re-evaluate whether or not “private sector” solutions for SROs without an execution mechanism are sufficient for the investment community to satisfy its various obligations under the Act. If, as NexTrade warned – again, and again...and again – these solutions are not sufficient, then the Commission must also determine that its fundamental precept for approval of the SuperMontage system, the availability and necessity of a VOLUNTARY display alternative has also not been satisfied. Under these conditions, abrogation of the SuperMontage approval would be appropriate.

Even if the Commission now agrees with NexTrade, however, we recognize that the Commission is unlikely to take such a bold measure. NexTrade instead forwards to the Commission that an appropriate resolution to this dilemma is fairly simple, mandate that all SROs support an execution system. NexTrade encourages the Commission to review all the papers it submitted on the ADF. In so doing, the Commission may refresh its memory that the deficiencies of an SRO system with a “Rule 4300” structure are not limited to cost, but include control deficiencies, surveillance deficiencies, and private sector influences outside the purview of the Commission.

The Commission is seeking a regulatory solution with a “sound basis.” If the Commission mandated that small firms must remain connected to an SRO with an execution system until such time as the small firm had sufficient volume, how would the Commission propose that a market maker in a low volume stock make market in the ADF? Would the Commission then mandate to the SRO that it could only accept markets being made in high volume issues? How would the Commission propose that such SROs handle IPO's? Would such SRO's be precluded from IPO activity unless the broker-dealer underwriters involved in specific offerings agreed not to trade on said SRO?

If the Commission mandated that small firms must remain connected to an SRO with an execution system until such time as the small firm had sufficient volume, where would

the Commission set that standard? Any such threshold would prove a slippery slope and unfairly discriminatory against the smaller firms. .

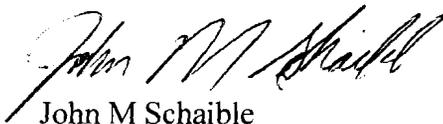
As detailed in our numerous previous comment letters on the ADF, only by having an execution facility, NexTrade contends, can an SRO adequately fulfill its obligations under the Act. If this is true, then it should already be a mandatory obligation of SROs to support such an execution venue.

NexTrade would be happy to meet with the Commission at any time to review this position at length.

Summary

- NexTrade supports the trade-through proposal, but does not support the “opt-out” clause.
- NexTrade opposes an access fee cap and believes such an act would be outside the Commission’s Congressional mandates.
- NexTrade opposes allowing market makers to charge access fees, unless they function as a double-blind agent and satisfy all the requirements of an ECN, or, in the alternative, that ECNs are permitted to spread capture.
- NexTrade believes that the Commission is wasting time with a sub-penny prohibition and should instead re-evaluate implementing a nickel minimum increment.
- NexTrade believes the Commission is correct in looking to make a better market data distribution formula, but NexTrade encourages a more simple solution.
- NexTrade warned the Commission that the ADF was not sufficient to be approved. The regulatory approach with a sound basis that should be adopted by the Commission mandates SROs to support an execution facility.

Sincerely,



John M Schaible
President
NexTrade Holdings, Inc.
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