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James T. Brett
Managing Director

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January 28, 2005

Re: **Regulation NMS Reproposal, File No. S7-10-04, Release No. 34-50870 (Dec. 16, 2004)**

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

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Dear Mr. Katz:

J.P. Morgan Securities Inc. ("**JPMSI**") appreciates the opportunity to provide the Securities and Exchange Commission ("**SEC**") with comments on proposed Regulation NMS under the Securities Exchange Act of 1934 (the "**Exchange Act**") as reproposed in Release 34-59870 (the "**NMS Reproposal**"). As expressed in previous comments, JPMSI agrees with the SEC that sweeping market and technological changes in recent years present new challenges and opportunities for the national market system ("**NMS**"). For this reason, JPMSI commends the SEC for its continued commitment to advancing the state of regulation to protect the investing public and enhance the functioning of our markets.

JPMSI shares the SEC's interest in ensuring market efficiency by fostering depth and liquidity, while also ensuring that our markets "offer a fair deal to all types of investors, large and small."[1] JPMSI provides a wide variety of services in the securities markets as one of the U.S.' largest broker-dealers serving both institutional and retail investors. We therefore consider the interests of varied types of investors and trading strategies in considering proposed revisions to the NMS and their likely effects on the market. In considering whether Regulation NMS would advance the regulatory framework of the U.S. equity markets, JPMSI believes that the appropriate standard continues to be the five goals expressed by Congress in Section 11A of the Exchange Act; (1) efficiency (2) competition among markets, (3) market transparency, (4) best execution and (5) opportunity for direct interaction of investor orders.

JPMSI believes that investors' interests and Congress' goals for the NMS are best served by regulations that foster competition among transparent and accessible markets while balancing the needs of varied investors. We therefore

[1] Release No. 34-49325 (Feb. 26, 2004) ("**NMS Proposal**").

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support certain aspects of the NMS Reproposal, but we are not in agreement with others in their current form.

In particular, we support the market access proposal and the proposed ban on sub-penny price quotations. We also support the modified market data proposal to rebalance the allocation of market revenue. On the other hand, we believe that any trade-through rule necessarily creates burdens on market competition and creates certain adverse incentives. JPMSI is open to a demonstration by the SEC that a trade-through rule may be used as a limited, but on balance beneficial, tool to encourage greater use of limit orders. However, JPMSI believes that any trade-through rule could only strike a balance that is both fair to all investors and beneficial to the market place if such a rule provides flexibility for investors with large orders to negotiate price and the manner in which those orders will be executed. JPMSI believes that without such flexibility, a trade-through rule would not strike a beneficial balance because such a rule would be disproportionately costly to institutional investors, would prohibit efficient transfers of risk from such investors to financial intermediaries with trading expertise, would unnecessarily reduce competition among trading centers, and would mandate execution strategies that would tend to increase market volatility.

Executive Summary

Our comment letter dated July 8, 2004 continues to describe our general position on each of the areas covered by Regulation NMS other that the proposed trade-through rule. We therefore limit our comments in this letter to the reproposed trade-through rule. With respect to this reproposal, JPMSI has reached the following conclusions:

1. JPMSI believes that the most effective means to promote the goals of the NMS is to require markets to provide broad access to limit orders rather than through use of mandatory trade-through protection. However, we agree that a trade-through rule may provide a useful supplement to the duty of best execution, provided that such a rule is appropriately tailored.

2. Our support for a trade-through rule is conditioned on provision of adequate means for institutional investors to manage the risks associated with large trading positions. We do not believe that the exemptions for benchmark orders and market sweeps contained in the NMS Reproposal are adequate in this regard. We therefore propose a general carve-out for block-sized orders that are "not held" or subject to special handling instructions. Such an approach would provide the flexibility required by institutional investors while avoiding many of the administrative costs associated with the general "opt-out" exemption originally proposed by the SEC.

3. In the absence of a large-order carve-out or similar exemption, JPMSI also believes that any trade-through rule is likely to impose excessive costs on

investors as a whole through the distortive effects such a rule will have on competition.

4. If the SEC does not provide for a large order carve-out or similar exemption, JPMSI supports expansion of the benchmark exemption or creation of an additional exemption to cover stopped orders. Such orders are consistent with price protection, and provide an economically efficient means for investors with large positions to transfer trading risk to intermediaries with the skills to most effectively manage such risk.

5. If the SEC does not provide for a large order carve-out or similar exemption, JMPSI would also advocate limiting trade-through protection to the national best bid or offer (the "**NBBO**") in each security rather than protecting the best bid or offer ("**BBO**") of each trading center (the "**Top of Book Alternative**") or permitting such trading centers to choose protection for quotes below their BBOs (the "**Depth of Book Alternative**"). An NBBO alternative would provide significantly increased protection for limit orders as compared to the status quo, but would avoid many of the problems of the Top of Book and Depth of Book Alternatives.

We elaborate on each of these conclusions in the discussion below.

I. The NMS Reproposal Provides Improvements in Tailoring the Scope of the Trade-Through Rule.

JPMSI believes that the most effective way to promote the goals of the NMS is through a regulatory framework that provides for transparent and accessible markets. Given broker-dealers' obligations to provide best execution, an NMS that provides efficient linkages between trading centers that are required to make limit orders accessible would provide substantial incentives for the display of limit orders critical to price discovery and liquidity.

However, while JPMSI believes that the touchstones of price discovery and liquidity are transparency and accessibility, we also agree with the SEC that an inter-market trade-through rule, if properly structured, can be a useful reinforcement to the duty of best execution. As noted by the SEC, principal agent conflicts can lead to less than best execution, particularly for retail investors who may not have the sophistication or resources to assess the quality of the trades provided by their agents. By prohibiting the execution of orders at prices inferior to those displayed, a trade-through rule can therefore help provide protection to limit orders and further encourage their use.

JPMSI also considers several aspects of the reproposed trade-through rule to be significant improvements over the initial proposal. JPMSI agrees with the SEC that trade-through protection for manual quotes would potentially lead to

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undue delays in execution[2] and therefore supports limiting the trade-through rule to automated quotes. JPMSI also agrees with the principal of equal treatment for Nasdaq and the exchanges, and agrees that a "quote-by-quote" approach is a feasible one that preserves flexibility for trading centers to develop innovative hybrid platforms. JPMSI further supports exemptions from the trade-through rule for flickering quotes, inter-market sweeps and benchmark orders as tools to help provide for fair and orderly trading and facilitate trading strategies that are important for large orders.

II. Any Trade-Through Rule Should Be Balanced by A General Exemption for Large Orders.

A. Informed Freedom of Choice is Requisite to Best Execution for Institutional Investors.

While JPMSI generally recognizes the potential benefits of the reproposed trade-through rule, our support is conditioned on provision of an exemption for the large orders often presented by institutional investors. Although the SEC has previously proposed a general opt-out for consenting customers that could cover this condition, we believe that such an approach would be unnecessarily broad and administratively burdensome. Therefore, we do not propose that the SEC should reintroduce the general opt-out. Rather, we propose the addition to reproposed Rule 611 of an exemption for "not-held" and customer directed orders where such orders are for at least 10,000 shares or $200,000 (a "**large order carve-out**"). Such an exemption would be consistent with the parameters of orders that are excluded from the statistics disclosed to the public pursuant to Exchange Act Rule 11Ac1-5.

In the first instance, such a large order carve-out is critical to ensuring that the NMS promotes the interests of all investors. As the SEC has repeatedly acknowledged, execution against the best displayed price is not equal to best execution. For any particular trade, multiple factors may bear on the quality of execution, including speed, certainty of execution, liquidity and depth, opportunities for price improvement, anonymity, error rates, and the quality of a trading center's program of self-regulation. These factors all relate to costs that are not captured by quoted prices, such as market access and transactional fees, market impact costs, costs of broken or erroneous trades, and indirect costs such as market data costs. A trade-through rule without a large order carve-out would effectively privilege the displayed price as the overriding factor in best execution analysis, thereby foreclosing or seriously hampering the ability of investors to manage costs that are frequently more significant for them.

In the case of retail investors, JPMSI recognizes that the need for an opt out may not be significant. Such investors are generally not concerned with speed beyond a few seconds and are not likely to suffer from market impact costs. The

[2] NMS Reproposal at p. 44

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burdens associated with an opt-out to such investors, including the cost and potential for confusion and manipulation, generally outweigh any benefits that retail investors would receive from such an option. Therefore, JPMSI has not advocated extending the option to trade-through posted quotations to retail investors.

By contrast, institutional investors are frequently concerned with issues such as speed, ability to accommodate size, and prevention of frontrunning. Notwithstanding the fact that trade-through protection under the NMS Reproposal would be limited to automated quotes, institutional investors will continue to need the ability to forego trade-through protection for a variety of reasons. For example, institutional investors may need to execute in block-size quickly or lock-in a block at a certain price. Such investors would likely prefer to forgo executing a portion of a large trade at the best displayed price (whether through a sweep or otherwise) because such benefit could be insignificant compared to substantial market impact costs of signaling the nature of their orders (and the dealer's subsequent facilitation position) to the market. Similarly, it may be in the interest of such investors to forgo the benefit of hitting inside quotes for a portion of a block trade where the price benefit is outweighed by the transaction costs of executing against multiple counterparties across markets or doing business with particular markets.

B. Without a Large Order Carve-Out or Similar Exemption, the Burden on Institutional Investors will be Disproportionate to the Market Benefits.

In the NMS Reproposal, the SEC staff concluded that "advocates of the opt-out exception have failed to consider the interests of…both those who submit marketable orders and those who submit limit orders." JPMSI respectfully disagrees with the assessment. While the benefits of a trade-through rule are limited, the costs to investors with large marketable orders who would be restricted in the manner in which they could manage the risks associated with such orders would be substantial. We therefore submit that without a large order carve-out, the benefits of a trade-through rule are unlikely to justify the costs for institutional investors and the retail investors that they frequently represent.

Consider the limits of the benefit proposed. While a trade-through rule may provide some protection for limit orders beyond that provided by enhancing market access and transparency, inter-market trade-throughs are only one of several practices that may cause a displayed limit order to be bypassed. Other significant factors include internalization or price-matching, "pennying" by market participants whose presence in the market creates structural advantages over most investors, and intra-market trading rules of some exchanges that diverge from true price-time priority. In the face of these practices, the effect of an inter-market trade-through rule on incentives to post limit orders will be limited. Conversely, a large order carve-out for institutional investors will do relatively little to blunt incentives to post such orders.

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Moreover, while the NMS Reproposal asserts that transactions that trade through a published quote "free-ride" on price discovery, we believe that the SEC has overstated the extent of any "economic externalities" created by trade-throughs. As a general matter, a large order will either directly or indirectly interact with (or contribute to) displayed liquidity. In cases where a market maker or dealer executes a block transaction with a customer at a price that is away from the NBBO, the market maker or dealer will then itself generally trade against displayed orders or provide its own limit orders reflecting the block. In other cases, an investor may choose to bypass the "best" displayed limit order to interact with a limit order (or orders) displayed on a different market. In such cases the investor is not "free riding" on price discovery, but is rather interacting with the limit orders it considers to actually be the best, taking into account factors such as certainty of execution and the characteristics of the market on which the limit order resides. Rather than creating economic externalities, this creates incentives for investors to place their limit orders in the most efficient trading centers.

Conversely, a trade-through rule that does not provide flexibility for providers of large marketable orders to manage the risks associated with such orders would impose large and disproportionate burdens on institutional investors. While sweep orders and VWAP trading may be used to place large orders in some cases, such strategies will frequently be inadequate. Institutional investors often buy and sell relatively illiquid stocks in block sizes. Such orders may be time sensitive, and are unlikely to be fully accommodated by a single sweep of limit orders. In such cases, investors forced to sweep the market in order to satisfy trade-through requirements would be exposed to potentially large market impact costs as they are forced to disclose the size of their interest to market insiders. Such a result would also interfere with the economically efficient transfer of trading risks from institutional investors to broker-dealers who are best able to manage such risks.

We also note that forcing investors with large marketable orders to perform sweeps is likely to impose costs on retail investors beyond those who are represented by institutions that place large marketable orders. A trade-through rule that essentially forces investors to perform sweeps is likely to increase volatility in the marketplace, particularly for relatively illiquid securities. Such volatility will be especially costly to retail investors who are relatively uninformed about short-term price movements.

A fundamental tenet of our markets is that all participants are free to exercise their informed judgment in determining how when and where to execute an order. To disenfranchise institutional investors for whom best execution frequently diverges from best posted quotes by limiting their strategies for managing risk would be to create a burden that is both unfairly distributed and disproportionate to the limited benefits of trade-through protection.

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C. Without a Large Order Carve-Out the Trade-Through Rule is Likely to Impose Excessive Costs Through Effects on Competition.

In addition to the disproportionate burden imposed on orders for which best execution does not equal best displayed price, a trade-through rule without a large order carve-out is likely to dampen the benefits of competition.

In the NMS reproposal, the SEC rebutted arguments that the proposed trade through rule would essentially eliminate inter-market competition and freeze market development. In essence, the SEC argued that since the trade through rule would not mandate time priority along with price priority, it would permit providers of market orders to choose between trading centers displaying limit orders at equal prices. Such freedom of choice would create incentives for markets to innovate and compete to attract these orders. Although there is merit to this analysis, we respectfully submit that it fails to address the ultimate issue.

Notwithstanding the potential for competition where limit orders are equally priced, it is also clear that a trade-through rule would create a limited regulatory license or monopoly whenever a market center can post quotes with superior displayed prices. The availability of such a regulatory license will create adverse incentives for trading centers to realize monopoly profits from the ability to force market participants to execute orders against their displayed quotes.[3] Such profits could further be used to pay rebates to limit orders in order to attract such orders, fueling a cycle that could generally be harmful to the market as a whole.

As an empirical matter, it is unclear how these adverse incentives will interact with competition. However, such incentives would likely be stronger the greater the extent of the regulatory license provided by the trade-through rule. Thus, the impact on competition is likely to be greatest in the event of adoption of the Depth of Book Alternative. Conversely a large order carve-out would tend to enhance competitive incentives by permitting investors to exercise their judgment to bypass markets that are inefficient or attempt to impose extra direct or indirect fees.

In the face of a choice between limit order protection and protection of free competition, JPMSI sees no compelling evidence that the benefits of aggressive limit order protection will justify the costs. Moreover, JPMSI opposes such an approach on prudential grounds. The NMS involves complex and evolving market structures that are likely to respond to regulatory interventions in unpredictable ways. Such conditions call for delicate balancing and a measure of conservatism in the face speculative costs and benefits. We believe that the regulatory philosophy in this instance should be to "first do no harm," and to

[3] Such monopoly profits would be produced by the imposition of direct or indirect fees. For example, adoption of a trade-through rule would create incentives to maximize access fees within the limits established by Regulation NMS.

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impose the risk of substantial costs only when they can be justified by clear benefits. We believe that inclusion of a large order carve-out would be more consistent with such an approach because it would mitigate the market distorting effects of a trade-through rule while largely preserving beneficial incentives for limit orders.

III. In the Absence of a Large Order Carve-Out, Stop Orders Should be Exempted under the Exception for Benchmark Orders.

In the event that the SEC adopts a trade-through rule without providing for a large order carve-out, JPMSI believes that it should provide a specific exemption for stop orders or broaden the benchmark order exemption to cover such orders.[4] Such orders are consistent with price protection and market efficiency where the orders are "not-held" orders that are stopped at a price that is superior to the corresponding national best bid or offer at the time the order is entered.

To illustrate the desirability of an exemption for such stopped orders, assume a broker-dealer receives a "not held" order to sell 100,000 shares of XYZ stock at a time when the market for the stock is 19.90 bid by 20.00 offer. The customer wants to ensure that it receives an execution that is no lower than 19.00 and the broker-dealer is willing to stop the customer at that price because it is confident that it can use its expertise to work the order without pushing the market below the stop price. Such an arrangement represents an economically efficient transfer of risk from the risk averse client to a party that is capable of bearing the risk at lower cost due to its expertise. Moreover, such an arrangement is consistent with price protection and does not "free ride" on price discovery. So long as the market remains above the stop price, the broker-dealer will, as with any "not-held" order, execute the order through a combination of hitting limit orders on the bid side and offering the position piecemeal through posting limit orders on the offer side. If the market goes beyond the limit price, the broker-dealer may be forced to take the remainder of the customer's order as principal at the stop price.

However, a trade-through rule would increase the cost of this arrangement and could be prohibitive in the absence of an exemption since it would impose additional risk on the broker-dealer. In our example, assume that the broker-dealer was unable to complete the order before the market moved past the stop price. Further assume that the market was at 18.50 by 18.55 by the time the broker-dealer needed to complete the customer's order. In order to complete the customer's order, the broker-dealer would first need to sweep the displayed offer

[4] In footnote 149 of the NMS Reproposal, the SEC states that as a preliminary matter, it does not believe that stop orders should be excepted from reproposed rule 611 under the benchmark order exemption because such orders are indirectly based on the quoted price of stock at the time of execution and their material terms are known when the commitment to order was made.

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at 18.55 and each additional protected offer in the NMS up to 19.00 (including the full depth of any displayed limit book under the proposed Depth of Book Alternative). In essence, these limit orders would "free-ride" on the stop order, capturing the benefit of the transfer of risk between the broker-dealer and the customer. Moreover, any such sweep would make the broker-dealer increase its long exposure beyond the customer commitment acquired as a result of the stopped execution. Thus, without an exemption, liquidity providers would have little incentive to guarantee customer orders through use of the "stop" and the rule would create disincentives for the provision of liquidity.

IV. If the SEC Does Not Provide a Large Order Carve-Out or Similar Exemption, the Scope of Limit Order Protection Should be Limited to the NBBO.

JPMSI also advocates limiting the scope of trade-through protection to the NBBO rather than adopting either the Top of Book Alternative or the Depth of Book Alternative. Without such a carve-out, JPMSI believes that the Depth of Book Alternative would represent the least desirable balance of costs and benefits, since such an alternative would maximize both the costs for those with large marketable orders and distorting effects on market competition. While the Top of Book Alternative would avoid some of the problems of a Depth of Book Alternative in theory, JPMSI is concerned that "top of book" would mean "depth of book" in practice. Moreover, the Top of Book Alternative may create unique unintended consequences. An NBBO approach would be less likely to lead inevitably to depth of book protection and would avoid many of the unintended consequences of the Top of Book Alternative while still providing improved limit order protection compared to the current regime.

JPMSI believes that the Depth of Book Alternative would be the least desirable because it would maximize the negative effects described in sections II A through D above. Such an alternative, would minimize choice for investors with large marketable orders and maximize their forced exposure to markets that they may have reason to wish to avoid. It would thus minimize the flexibility needed to obtain best execution. The Depth of Book Alternative would also likely increase market impact costs for many orders, since it would require sweeps that would produce strong signals as to the nature of an investor's trading interest. Moreover, the Depth of Book Alternative would maximize the monopoly value of the regulatory license provided by the trade-through rule. It would thus also maximize the incentive to compete to take advantage of this regulatory license rather than provide the best service.

While the Top of Book Alternative is intended to strike a different balance between limit order protection, investor choice and competition, there are at least two reasons why "top of book" is likely in practice to mean "depth of book." First, once a large marketable order is forced to sweep the BBOs of multiple markets (and thus signal order size to the market), it will arguably be inconsistent with best execution, not to sweep the depth of book of those markets that make additional quotes accessible. Second, even if it is permissible not to sweep the full depth of each market consistent with best execution, sweeps of each market's BBO will lead to irrational results as quotes in one market that are worse than market's BBO may be bypassed in favor of still worse quotes that happen to be at the top of another market. This result will lead to regulatory pressure to move to depth of book protection both because the Top of Book Alternative fails to provide rational protection for limit orders, and because it will result in inferior prices for those forced to conduct sweeps.

Moreover, we believe that the Top of Book Alternative is likely to have several unintended consequences. Because the Top of Book Alternative would only protect the best displayed order of each market, it would create incentives for providers of limit orders to move orders from market to market in order to place those orders in a market where they will be displayed as the best bid or offer. The result would likely be that market participants would engage in an economically inefficient competition to develop costly computer systems that route and re-route limit orders to various markets based on the probability of achieving trade-through protection. Such routing activity in order to "game" the trade-through rule would likely degrade the quality and accessibility of quotes. Similarly, by skipping over quotes, the Top of Book Alternative would provide opportunities for market insiders to make short-term trading gains on market sweeps at the expense of long-term investors.[5]

Finally, the incentive structure created by the Top of Book Alternative could also lead to increased market fragmentation despite the SEC's intent to the contrary. The Top of Book Alternative would create incentives to disperse quotes across trading centers. Moreover, it would also create incentives to open additional trading centers in order to provide additional space for limit orders to find protection under the rule.

By contrast, an NBBO alternative would provide enhanced protection for limit orders without many of the problems raised by the Top of Book and Depth of Book Alternatives. An NBBO alternative would provide appropriate incentives for encouraging aggressive limit orders by protecting the most valuable orders, those that are at the best price for any given security. Moreover, unlike the current regime, an NBBO alternative would provide an enforceable rule by requiring market centers to develop policies and procedures to prevent trade-throughs rather than relying on the complaint procedure that is currently in effect for the ITS and it would expand protection to a wider range of securities.

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[5] For example, assume that the top bid on Exchange A is 18.00 and the second bid in the queue is 17.95 while the top bid on Exchange B is 17.85. A market participant looking to make a short-term trading profit could post a bid on Exchange B of 17.9, thereby getting trade-through protection requiring a marketable limit order to execute against this bid in any sweep of displayed bids beyond this price. Once such a sweep occurs, the person posting the bid on Exchange A would then be able to sell the newly acquired stock against the formerly second best bid on Exchange A, locking in the 5 cent difference. Since this strategy depends on speed, the likely result would be to benefit market insiders at the expense of long-term and retail investors.

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At the same time, the NBBO alternative would provide reasonable flexibility for providers of large marketable orders to manage the risks associated with those orders. Unlike the Top of Book and Depth of Book Alternatives, an NBBO alternative would not require such investors to conduct market sweeps alerting market insiders to their positions. Such an approach would also create limited adverse incentives for markets and would avoid the irrationalities of the top of book alternative. Finally, such an approach would also not create incentives to "game" the rule by strategically moving displayed quotes from market to market, since only the best quote in any security would be protected, regardless of its location. We thus believe that, in the absence of a large order carve-out, an NBBO approach would provide the most reasonable balancing of the interest of those providing market and limit orders, while providing the least danger of creating economic externalities that harm the securities markets as a whole.

* * * *

JPMSI appreciates the opportunity to comment on these important and timely provisions proposed in Regulation NMS. We look forward to continuing to work with the SEC to develop and implement improvements to the U.S. markets in the months and years ahead. If you have any questions concerning these comments, or would like to discuss these comments further, please feel free to contact Julius Leiman-Carbia at (212) 622-6592 or myself at (212) 622-2778.

Very truly yours,

James T. Brett
Managing Director,
J.P. Morgan Securities Inc.

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

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To:	Johnathan G. Katz, Secretary Securities and Exchange Commission	Fax:	202-942-9651
FROM:	Julius Leiman-Carbia	**PHONE:**	(212) 622-6592
DATE:	January 31, 2005		

Number of Pages Transmitting following Cover Sheet: 11

RE: **Regulation NMS Reproposal, File No. S7-10-04, Release No. 34-50870 (Dec. 1, 2004)**

If you do not receive all of the pages, please contact the above phone number as soon as possible or my assistant Louise Friello at 212-622-5669.

Dear Mr. Katz,

On behalf of J.P. Morgan Securities Inc., I am enclosing the comments of James T. Brett, Managing Director, to the Commission's re-proposal of Reg NMS (Rel. 34-50870).

Regards,

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