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January 25, 2005

Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington D.C. 20549-0609

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

Dear Mr. Katz:

UBS Securities LLC ("UBS") respectfully submits this letter in response to the U.S. Securities and Exchange Commission's ("Commission's") re-proposal of Regulation NMS[1] ("Re-Proposing Release"), which supplements our earlier comment letter[2] to the original Regulation NMS proposal ("Original Proposing Release").[3] We appreciate the opportunity the Commission has provided in soliciting additional comments to this important re-proposal.

At the outset, we wish to express our substantial agreement with the areas of the Re-Proposing Release concerning access, sub-penny quotations, and market data,[4] and propose instead to concentrate our comments herein upon the re-proposed version of the trade-through rule. We continue to oppose this aspect of proposed Regulation NMS, and respectfully request that the Commission carefully consider the following comments in formulating its final Regulation NMS.

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1 Securities Exchange Act Rel. No. 50870, File No. S7-10-04, 69 FR 77424 (Dec. 27, 2004) ("*Re-Proposing Release*").

2 June 30, 2004 letter from Huw Jenkins to Jonathan Katz re: Regulation NMS.

3 *Regulation NMS*, Securities Exchange Act Rel. No. 49325 (Feb. 26, 2004), 69 FR 11125 (Mar. 9, 2004) The Commission also issued a supplemental request for comments. Securities Exchange Act Release No. 49749 (May 20 26, 2004), 69 FR 30142 (May 26, 2004). (Collectively: "*Original Proposing Release*").

4 However, we believe that market data fees, in general, are excessive, and urge the Commission to act promptly to reduce these fees.

Summary

At UBS, we believe that a fundamental tenet of our securities markets is the responsibility of market professionals to seek and reasonably obtain the best possible execution for each and every customer order. We also believe, as discussed in our comment letter to the Original Proposing Release, that a market-wide trade-through rule, though well-intentioned, inappropriately imposes an inflexible definition of the concept of Best Execution. Moreover, we are unaware of any evidence demonstrating the need for such a rule, and therefore fail to comprehend the rationale and economic justification for the imposition of the rule. In its current form, the trade-through rule appears to be a solution in search of a problem. As discussed more fully below, evidence prepared by the Commission's staff indicates that the number of trade-throughs is only 1.9% and 1.2%, respectively, for Nasdaq and NYSE securities, and we believe that these low numbers may themselves be overstated.[5] We are also concerned that the proposal ultimately will prove difficult, if not impossible, to enforce.

Though we support the goals and objectives of the rule -- to allow all orders to achieve the best possible execution– we disagree with the Commission's contention that a market-wide trade-through rule is the best method by which to achieve this goal. A trade-through rule such as that proposed by the Commission places all emphasis upon price and fails to recognize that a definition of "best possible execution" will naturally differ among various types of orders, investors, and securities. The Commission itself has previously recognized this necessity of execution choice by asserting that "execution price and speed are not the sole relevant factors in obtaining best execution of investor orders. . . . [O]ther factors may be relevant . . . "[6]. In fact, while adopting rules to require disclosure of market center execution statistics, the Commission correctly noted benefits of investor choice in that "the rules will help customer (sic) weigh the trade-off between a market center that provided immediate executions at the quote, and a market center that executed orders on average in under 30 seconds, but that consistently generated prices resulting in average effective spreads that were a significant amount per share better than those paid by investors at other market centers."[7] Furthermore, the Commission's stated intention in adopting these disclosure rules was that they would "spur more vigorous competition among market participants to provide the best possible prices for investor orders." [8] Why, then, does the Commission now seek to eradicate investor choice and market competition in favor of an archaic and restrictive "one-size-fits-all" model of Best Execution?

[5] "Analysis of Trade-throughs in Nasdaq and NYSE Issues," SEC Office of Economic Analysis (December 15, 2004) "OEA Study".

[6] Release adopting SEC Rules 11Ac1-5 and 1-6. "Disclosure of Order Routing and Execution Practices," Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414 (December 1, 2000).

[7] Id.

[8] Id.

Rule Justification

We believe that the Commission has yet to offer any evidence that would justify the necessity or the benefits of a trade-through rule. Section 3(f) of the Exchange Act requires that the Commission, when engaging in rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and to consider not only the protection of investors, but whether the action will promote efficiency, competition, and capital formation.[9] Furthermore, Section 23(a)(2) of the Act prohibits the Commission from adopting any new rule that would impose a burden on competition unless necessary or appropriate in furtherance of the purposes of the Act.[10] These and other statutory requirements compel the Commission to justify the necessity of proposed rules. Yet we are unaware of the existence of any reliable evidence to demonstrate that the proposed rule will further the purposes of the Act. Furthermore, we believe that the proposed rule would be inefficient and reduce competition among market centers.

At the open meeting to re-propose Regulation NMS, Chairman Donaldson stated his personal reasoning for adopting a trade-through rule. In doing so, he began by correctly acknowledging that "there may be times when it is not in the individual interest of a trader to trade with an order showing a better price."[11] He continued, however, by stating that the purpose of the trade-through rule was not to force this trader or customer to trade at the better price, but to protect the limit order that was posted at the best price -- that such protection would increase market liquidity by encouraging the posting of additional limit orders.[12] With all due respect to the Chairman's opinion, it is not supported by statistical evidence, empirical studies, or scholarly research. Are we to believe, then, that a comprehensive transformation of our capital market system is to be predicated entirely upon this valued, yet unsupported, theory?

Contrary to these views, the Nasdaq market continues to serve as the most extensive and obvious evidence that a trade-through rule is entirely unnecessary. As the Commission itself noted in the Original Proposing Release, despite the lack of a trade-through rule "the Nasdaq market does not appear to lack competitive quotations in the most actively traded securities."[13] In fact, by reviewing the NYSE and Nasdaq markets, we have already had the unique opportunity to witness the impact of similar markets existing both with and without a trade-through rule. In reviewing this long-running "experiment," the near-universal consensus has been that the ITS trade-through rule has been a complete failure. Why then, after recognizing the failures of the ITS trade-through rule, is the Commission now proposing to continue with a modified version of this rule, and to expand the rule to Nasdaq, a market that has unquestionably demonstrated that the rule is unnecessary?

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[9] 15 U.S.C. 78c(f).
[10] 15 U.S.C. 78w(a)(2).
[11] Opening Statements by SEC Chairman: December 15, 2004 Open Meeting, by Chairman William H. Donaldson, U.S. Securities and Exchange Commission, Washington, D.C. *http://www.sec.gov/news/speech/spch121504whd.htm*
[12] Id.
[13] Original Proposing Release at B.2.c.

OEA Study

The recently released study by the Commission's Office of Economic Analysis ("OEA Study"),[14] which was expected to provide support for the proposed rule, actually offers more support for a contrary conclusion. The most striking aspect of this study is that it makes no effort to analyze the impact of the rule upon "unprotected" limit orders, and thus fails even to address Chairman Donaldson's stated purpose for the rule.[15] Instead, the study focuses upon the potential "harm" to orders that trade through the best quoted price -- a group that Chairman Donaldson acknowledged may have a legitimate purpose for not seeking the best possible price. ***Thus, a study that analyzes (imperfectly) the frequency and associated costs of orders that are not executed at the best posted price has been offered as justification for a conclusion that it fails to address.***

Taken at face value, the OEA Study is based upon several improper assumptions, and thus results in a fundamentally flawed analysis. Specifically, the OEA Study, in reaching the "conclusion" that 2% to 13% of share volume is traded-through, acknowledges that the higher numbers can only be obtained by ignoring the size of displayed quotations. However, with quotation size appropriately included in the analysis, the number of trade-throughs is only 1.9% and 1.2%, respectively, for Nasdaq and NYSE securities. These numbers themselves are inflated in that they include institutional block trades, market sweep trades, "net" trades that are negotiated and correctly reported at prices away from the current NBBO, manual trades that may be reported to ACT up to 90 seconds after the actual trade is priced, and AMEX trade reports that could be as slow as the AMEX quotes, which were ignored by the OEA study.

The most informative portion of the OEA Study is found in Table 6, Panel B, which clearly demonstrates that when quotation size, share size, and market timing issues are factored into the calculations, the rate of trade-throughs is less than 1% for orders of 1,000 shares or less. A rate of less than 1% can easily be attributed to imprecise data and statistical anomalies, a fact that the OEA Study directly acknowledged by stating that "[w]hile trade-through identification seems straightforward, in practice it is complicated by quickly changing quotes, system time lags, data limitations, and imperfect access to markets."[16] Furthermore, and not insignificantly, the Commission's proposed exceptions to the trade-through rule, if enacted, would likely yield a trade-through occurrence of 1% or more, a likelihood that is indicative of the futility of the proposed rule.

This futility can be demonstrated by an existing illustration in the form of ArcaEx, a market center currently utilizing smart routing technology in a manner quite similar to the

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[14] *Supra*, note 6.

[15] Table 7 of the OEA Study examines market center quotes that are "traded through," but this table is discounted by the later statement: "It is difficult to assign a cost to the bypassed orders, as the orders may or may not subsequently be filled, and the cost of a delayed fill would need to be considered."

[16] In fact, the quotation data relied upon for a portion of the study proved to contain a 1% margin of error, further demonstrating that some margin of error is unavoidable and must be attributed to imperfect data rather than to a market-wide "problem" that requires remediation by rule-making.

proposed trade-through rule. Despite employing such "trade-through technology," ArcaEx still experiences, according to the OEA Study, a trade-through rate of 1.6%. We believe, for the foregoing reasons, that this study fails to support a conclusion that orders trading through the best price should or could be protected (or that they require such protection), and makes no attempt, whatsoever, to support the avowed purpose for the proposed rule.

Unenforceability

Without any demonstrated need for a trade-through rule, the Commission is recommending the imposition of a rule that will require significant system changes and expenditures, not only for broker-dealers and the various trading markets, but for regulatory surveillance systems as well. Moreover, the Commission is proposing a rule that has been proven in the ITS context as one that is impossible to enforce. As one ITS participant has noted, "we do have a trade-through rule for New York listed stocks, and that rule is routinely violated. . . . [Y]esterday, in one four-minute period . . . we actually had 37 outstanding complaints with no resolution. But our concern is that the [proposed] rule is too complex to enforce when you consider the rule today, which is very, very simple."[17] Moreover, enforceability will be unachievable (correctly noted by the OEA Study) due to the inability to accurately identify when, due to quotation changes, system imperfections and data discrepancies, a trade-through has even occurred.

If a trade-through rule were to be adopted, we expect this lack of enforceability to result in an expensive, yet entirely inefficient and unwarranted examination process. More specifically, we foresee a process, not unlike many current "sweep" regulatory actions in which the SEC (or a SRO) will provide each firm with a list containing hundreds of "exceptions" for which the regulatory surveillance systems have detected a potential trade-through violation. In following current examination practice, a firm will be given an opportunity to demonstrate to the regulator why it believes that it did not trade through the best posted price (thus the firm will be deemed guilty of these violations unless it can satisfactorily demonstrate its innocence). Due to exceptions to the rule, technological limitations, and latency in delivery and receipt of market updates and quotations, there will be a substantial number of "false positives" that would have to be disproved. The likely end result of this review will be a justifiable reason for 98% of the exceptions, but firms such as UBS would, most likely, receive a regulatory sanction for their inability to demonstrate guilt or innocence for the remaining 2%. We strongly believe that this would be an immense and unproductive use of limited, yet tremendously valuable, regulatory and compliance resources for an unnecessary and unjustified rule.

[17] Statement of Gerry Putnam, CEO, Archipelago, Hearing Re: Proposed Regulation NMS, April 21, 2004. *http://www.sec.gov/spotlight/regnms/nmstrans042104.txt.*

Recommendations

Should the Commission choose to implement a market-wide trade-through rule over these objections, we would urge the following:

(1) A trade-through rule should apply only to the top-of-book of each market. A depth-of-book approach would prove to be entirely unworkable from both a practical and technological perspective. Any attempts to impose a depth-of-book rule should be considered only if and when the markets have had the opportunity to experiment with a top-of-book approach.

(2) The benchmark exception should be expanded to allow for the reporting of "net" trade reports. Due to the inability and impracticality of assessing disclosed commissions or commission equivalents for routed broker-to-broker trade execution services (namely "wholesale" transactions), the use of agreed-upon "net" trade pricing has been a long-standing and necessary method of compensating wholesale firms for their execution services. "Net" trading is also utilized by a number of institutional clients that prefer to receive a single price report, inclusive of any execution service fee. Such "net" trades should be reported by utilizing a special trade modifier (perhaps the ACT .W modifier) to distinguish them from normal trade reports and to avoid any perceived confusion of trade-throughs.

(3) "Stopped" orders should be included within the "benchmark exception."[18] Stop orders are another valued and beneficial type of order for institutional customers in which the order is executed on a "best efforts" basis, with the addition of a "guarantee" that the customer will receive no worse than the "stopped" price. We believe that this order-type should be included within the benchmark exception because, like a VWAP order, it is based upon a price agreed-upon at the time of order receipt and not upon the price at the time of execution. We would concede, however, that this exception should only apply to stop orders in which the "stop" is "in the money" when elected (below the current market for buy stops, above the current market for sell stops) and thus the trading firm is required to commit capital at a disadvantageous price (which would be greatly exacerbated if the broker had to also satisfy existing markets).

(4) As we stated in our letter commenting upon the Original Proposing Release, we strongly believe that quotations from "slow" markets, or those without an automated response, should be excluded from the NBBO. This exclusion should apply, not only to a trade-through rule analysis, but also to any Best Execution analysis, including the statistical analysis applied in producing reports under Rule 11Ac1-5.

(5) The Commission should establish a reasonable implementation period (at least one year) for a trade-through rule to recognize the substantial and complicated technological modifications that such a rule would engender.

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[18] Re-proposing Release, Footnote 149. Benchmark exception - Proposed Rule 611(b)(7).

(6) The Commission should preclude the right of private litigation against firms for failing to meet trade-through requirements.

Conclusion

In summation, we urge the Commission to give due consideration to our comments and to reassess the prudence of imposing a market-wide trade-through rule where no necessity nor justification has been proffered. Should the Commission ultimately determine, however, that the enactment of such a rule is necessary, we request that it include the exceptions we recommend in order to allow for the continued and efficient operation of the markets. We welcome the opportunity to respond to any questions from the Commission or Commission staff that may arise from the views expressed in this letter. Please direct any inquiries to our Legal Department, attention Scott W. Anderson, at 203-719-6974.

Sincerely,

Daniel Coleman
Managing Director
Head of Equities for the Americas

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