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February 1, 2005

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

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

Dear Mr. Katz:

The Securities Industry Association[1] ("SIA") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") reproposed Regulation NMS ("Reproposal")[2] under the Securities Exchange Act of 1934 ("Exchange Act"). SIA commends the Commission and its Staff for their continued efforts to engage market participants in this complex debate of important issues. We especially appreciate the Staff's willingness to discuss these issues in an open dialogue. The Reproposal provides SIA with the valuable opportunity to provide its views on market structure issues that are critical to public investors, SIA's membership and the securities industry as a whole. As a result, we are pleased to supplement our original comment letter[3] on Regulation NMS with the following additional views.

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[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core is our Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry employs 790,600 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenues and an estimated $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[2] Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424 (Dec. 27, 2004) ("Reproposal").

[3] Letter from Marc Lackritz, President, SIA, to Jonathan Katz, Secretary, SEC (June 30, 2004) available at http://www.sia.com/2004_comment_letters/1824.pdf ("Original SIA Comment Letter").

I. Executive Summary

In response to the reproposal of Regulation NMS, SIA again assembled its Regulation NMS working groups, which are drawn from SIA's Market Structure, Trading and Federal Regulation Committees as well as the Market Data Subcommittees of the Technology and Regulation Committee and the Technology Management Committee, to study the many issues presented by the Commission. Based on its review and analysis of the Reproposal, SIA reached the following conclusions:

A. Intermarket Price Protection

SIA agrees that Regulation NMS should protect investors by facilitating competitive and innovative markets that are responsive to investor interests. Therefore, we propose to strengthen investor protection by recommending a trade-through rule with the following characteristics:

> **1. Scope of Protection.** The Commission's Reproposal asks for comments on the merits of two approaches for intermarket price protection -- a trade-through rule that protects the automated quotations at the top-of-book ("TOB") or one that protects such quotations in the depth-of-book ("DOB"). We agree with the SEC's decision to protect only automated quotations. SIA recommends that the SEC consider, as a first step, a trade-through rule that protects the automated national best bid or offer ("NBBO"). We believe that this first step would provide a material improvement in trade-through protection across all markets as well as valuable information and insight into the implementation, compliance, and possible unintended consequences of a TOB or DOB approach. Following a period of time (perhaps one year) during which the NBBO approach was in effect, we recommend that the SEC evaluate the rule's effectiveness by conducting its own studies and by requesting comment from market participants. The SEC could then consider the best next step for investors and the markets.
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> **2. Liquidity Exception.** Trade-through regulation should be focused on those securities for which it would have the greatest benefit in protecting investors. We believe that the concerns the Commission intends to address with the trade-through rule are not present in the most actively traded, highly liquid securities because the manner in which these securities trade already affords investors with effective protection. As a result, SIA recommends that the SEC except from the proposed trade-through rule the most actively traded securities. Correspondingly, we believe this exception would allow the Commission and the industry to focus on those less liquid securities that would benefit most from the new protections of the trade-through rule. Again, we recommend that the SEC utilize this exception as an opportunity to study the effect of the rule for a period of time (perhaps one year). The SEC may then consider the necessity for any further action.

3. Best Execution. Given the SEC's stated concerns with manual quotes, we recommend that the SEC explicitly acknowledge that, if a broker-dealer determines that routing to a manual quote routinely indicates that the quote is unresponsive or would impose undue costs, the broker-dealer may take that information into consideration for best execution purposes. Correspondingly, we recommend that the NBBO benchmark used for comparison purposes for the trading statistics calculated under Rule 11Ac1-5 under the Exchange Act be changed to reflect only automated quotations. Going forward and as markets continue to evolve, we urge the Commission to consider the exclusion of manual quotes from the NBBO and the related ramifications on best execution obligations.

4. Other Exceptions to Trade-Through Rule. We agree with the SEC's proposed exceptions to the trade-through rule, including, among other things, exceptions for benchmark trades, flickering quotes, systems malfunctions, intermarket sweep orders, and openings and reopenings, subject to certain important and necessary refinements.

B. Intermarket Access

1. Linkages. SIA continues to support the Commission's proposed access standards for private linkages and notes that the new cost and level of access required of Alternative Display Facility ("ADF") participants are likely to address most of SIA's previously stated concerns regarding small markets that make their quotations accessible only through the ADF.

2. Access Fees. SIA members continue to be united in their desire for a market-wide resolution of the access fee issue, but divided on the optimum solution. We commend the Commission's efforts to craft such a market-wide solution, but raise certain practical issues associated with the reproposed access fee rule. These issues include concerns about excessive fees related to unprotected quotations, the administrative difficulties of tracking whether quotations are protected or not, and the SEC's broad definition of access fees.

3. Locked and Crossed Markets. SIA continues to support the SEC's proposed rule to minimize locked and crossed markets. We suggest that the SEC include two of the proposed exceptions to the trade-through rule, the exceptions for flickering quotes and for systems malfunctions, in the anti-locking and anti-crossing provisions.

C. Sub-Penny Quoting. SIA continues to support the Commission's proposed ban on sub-penny quoting.

D. Market Data. We believe that the resolution of market data issues is of the utmost importance for the integrity of the markets. We encourage the SEC to expand its current consideration of market data issues beyond the allocation of market data fees and to address the broader market data issues as a cohesive whole. In particular, we reiterate our belief that opaque fee setting practices have resulted in market data fees in excess of the level warranted by the cost of the production and dissemination of market data. Therefore, we recommend that the SEC impose more transparent methods for establishing market data fees and require a cost-based system for determining the appropriate level of market data fees, among other things.

II. Intermarket Price Protection: Investor Protection and Efficient Regulation

The Commission long has recognized that vigorous competition and customer service are the main forces behind quality executions for investors, both large and small. Regulation plays an important role only where necessary or appropriate -- that is, when natural market forces fail to ensure that investors' interests are protected.[4] With this principle in mind, SIA believes that the Commission should address its concerns, at least initially, with a trade-through rule that is more focused in its scope and that includes an exception for actively traded securities.[5] In this manner, the SEC would ensure the greatest degree of investor protection, while minimizing the potential for significant market disruptions and unnecessary implementation and compliance efforts and costs.

A. Trade-Through Rule

1. Protect Automated Quotations Only

We agree with the SEC's proposal to limit trade-through protection to only those quotes that are immediately and automatically accessible, with no human intervention in the process. Specifically, to be considered an "automated quotation" under the SEC's proposed definition, the trading center must, immediately and automatically, (1) act on the incoming order by executing the order up to the quote's displayed size and canceling any unexecuted portion of the order, (2) send a response to the sender of an order indicating what action has been taken with respect to the order, and (3) update its quotation.[6] Furthermore, the SEC would require that the quote be

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[4] As former Chairman Douglas stated in his oft-quoted comment, "[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use, but with the hope that it would never have to be used." W. Douglas, Democracy and Finance 82 (1940), quoted in J. Seligman, The Transformation of Wall Street 185 (3rd ed. 2003).

[5] Some firms wished to re-emphasize their belief, as stated in the Original SIA Comment Letter, that "a price protection rule will become unnecessary or redundant once the market structure issues have been addressed." Original SIA Comment Letter at 11, n.35.

[6] Reproposed Rule 600(b)(3).

appropriately flagged as manual or automated.[7] SIA agrees that this definition appropriately defines an "automated quotation" for purposes of the trade-through rule.[8]

2. Protect National Best Bid or Offer ("NBBO") Only

In its Reproposal, the SEC proposed two alternatives for the scope of bids and offers to be protected under its trade-through rule: (1) the top-of-book alternative ("TOB Alternative"), which protects the automated best bids or offers ("BBOs") of the exchanges, Nasdaq and the ADF;[9] and (2) the voluntary depth-of-book alternative[10] ("DOB Alternative"), which protects the automated DOB quotations that markets voluntarily disseminate in the consolidated quotation stream, as well as the BBOs of the exchanges, Nasdaq and the ADF. We believe, however, that a trade-through rule that protects only those automated quotes that are part of the NBBO of the exchanges, Nasdaq and the ADF ("NBBO approach") is the first and most logical step for the implementation of a broad, market-wide trade-through rule.

We understand that each of the alternatives would work in the following manner:

Assume that an investor seeks to sell 1000 shares of XYZ at a limit price of $10.00 and assume that the bids for XYZ were the following, where all of the quotes are automated:[11]

Market A	Market B	Market C	Market D
100 shares @ $10.04	200 shares @ $10.03	300 shares @ $10.02	400 shares @ $10.00
100 shares @ $10.03	100 shares @ $10.01	100 shares @ $10.01	100 shares @ $9.99
100 shares @ $10.01	100 shares @ $10.00	100 shares @ $10.00	100 shares @ $9.98

1. The NBBO approach would protect the 100 shares in Market A, priced at $10.04. Best execution obligations would control the execution of the remaining 900 shares of the investor's order. Accordingly, the remaining 900 shares would be executed at prices equal to or superior to the automated quotes in the example.

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7 Reproposed Rule 600(b)(4).

8 See Original SIA Comment Letter at 6-7. In this connection, we continue to believe that it is imperative that, for a bid or offer to qualify as "protected" under the trade-through rule, all market participants must be able to obtain access to the bid or offer, directly or indirectly. Therefore, we emphasize the importance of the SEC's linkage requirements to the proper operation of the trade-through rule. See id.

9 Reproposed Rule 600(b)(57) (Alternative A).

10 Reproposed Rule 600(b)(57) (Alternative B).

11 Please note that the proposed example is a static, simplistic version of the markets for illustrative purposes only. In the real world, the markets operate in a more dynamic manner, with constantly changing prices.

2. The TOB Alternative would protect:

a) the 100 shares in Market A, priced at $10.04;
b) the 200 shares in Market B, priced at $10.03; and
c) the 300 shares in Market C, priced at $10.02.

As discussed above, best execution obligations would control the execution of the remaining 400 shares of the investor's order.[12]

3. If we assume that only Market A and Market B voluntarily include their full DOB in the protection of the trade-through rule, the DOB Alternative would protect:

a) the 100 shares priced at $10.04, the 100 shares priced at $10.03, and the 100 shares priced at $10.01 on Market A;
b) the 200 shares priced at $10.03 and the 100 shares priced at $10.01 on Market B; and
c) the 300 shares priced at $10.02 on Market C.

Again, best execution obligations would control the execution of the remaining 100 shares of the investor's order.

In light of the many significant market structure changes associated with adopting a market-wide trade-through rule, we believe that the SEC should adopt a measured approach to regulatory change in this context. Therefore, we recommend that the SEC adopt the NBBO approach as a first step. We believe that the NBBO approach not only represents a significant step forward in trade-through protection, but it also limits the many implementation problems and potential unintended consequences of the TOB and DOB Alternatives. In addition, such an approach would minimize the industry's trade-through-related efforts as it attempts to comply with the many other new requirements imposed by Regulation NMS. Once the SEC and market participants have gained experience with the NBBO approach and evaluated whether it has met its intended objectives, then the SEC, the investing public and the industry may consider, on a more informed basis, what the most appropriate next steps should be. We explore the many benefits of the NBBO approach in detail below.

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[12] A trade-through is defined to mean a purchase or sale of an NMS stock "at a price that is lower than a protected bid or higher than a protected offer." Reproposed Rule 600(b)(77). It does not include a purchase or sale at a price equal to the protected bid or protected offer. Therefore, in our example, the TOB Alternative does not provide price protection for the TOB quote in Market D.

a. The NBBO Approach Strengthens and Extends Existing Price Protection`

The SEC has proposed a trade-through rule that improves today's market structure in many ways. SIA's proposal to protect the NBBO, rather than the TOB or DOB, does not diminish the many beneficial aspects of the SEC's proposal. In particular, we believe that the NBBO approach, like the SEC's proposal, will raise significantly the level of trade-through protection currently afforded investors under the existing trade-through rule. Indeed, the NBBO approach would improve significantly upon, and expand, the application of the current Intermarket Trading System ("ITS") trade-through rule in a variety of ways. For example, the NBBO approach addresses one of the material drawbacks of the existing ITS trade-through rule. It gives teeth to the existing trade-through rule, which has been widely criticized as unenforced.[13] The ITS trade-through rule is not a prohibition; instead, it is based on a post-trade complaint process.[14] As a result, many trade-throughs occur and are left unaddressed. In contrast, the NBBO approach incorporates the SEC's trade-through provision that requires trading centers to have policies and procedures which are "reasonably designed to prevent trade-throughs."[15] This is a version of the rule that can and will be enforced.[16] Therefore, it would provide greater price protection in the listed market than currently exists.

The NBBO approach also redresses another widely-noted defect of the current ITS trade-through rule. It would recognize the difference between automated and manual markets and in a manner that encourages the automation of markets. This substantial change greatly improves not only the effectiveness of the trade-through rule itself, but also the basic market structure of the U.S. markets. Indeed, such a rule may now permit smart routers, a feature regularly praised by regulators and market participants alike, to become as prevalent in the listed market as they are in the Nasdaq market. To date, the introduction of smart routers to the listed market has been prevented by the practical realities of dealing with manual markets.

The SEC's improvements to the trade-through rule (e.g., making the trade-through rule enforceable and correcting the manual quote-related issues in the listed market) are not limited in

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[13] See, e.g., Hearing re: Regulation NMS (Apr. 21, 2004), Hearing Transcript at 52.

[14] See Section 8(d) and Exhibit B of the ITS Plan.

[15] Reproposed Rule 611(a)(1).

[16] In this respect, the NBBO approach would parallel established provisions such as Section 15(f) of the Exchange Act, which requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information. Similarly, it would parallel Section 14(e) of the Exchange Act, which requires the Commission to define and prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices in connection with tender offers. Such provisions provide strong policy statements without imposing strict liability for any failure to prevent abuses by requiring procedures to be "reasonably designed" to deter transgressions.

any way by the NBBO approach. The NBBO approach provides no less practical depth of coverage for listed markets than the ITS trade-through rule. Although the language of the ITS trade-through rule is drafted to provide TOB protection, as a practical matter, it functions as an NBBO-protection rule. Therefore, specifically focusing on the NBBO will not limit the existing investor protection in the listed markets.

The NBBO approach, therefore, strengthens investor protection in the listed markets. Of course, similar to the SEC's rule, it also takes the notable step of extending the ITS trade-through rule beyond the listed markets to the entire Nasdaq market as well. This is a significant expansion of the current reach of the ITS trade-through rule and is certainly a major step forward in the price protection afforded investors.

b. The NBBO Approach Assists Investors in Obtaining the Best Price

We believe that the NBBO approach assists investors in obtaining the best price. In contrast, we are concerned that the TOB and DOB Alternatives may undermine the investor protection purpose of the trade-through rule. We believe that neither the TOB Alternative nor the DOB Alternative will facilitate the investor's receipt of the best price. Instead, these two Alternatives may force an investor to miss other trading opportunities at superior prices. An example using an intermarket sweep order, an important component of the proposed trade-through rule, under the TOB Alternative demonstrates this inherent problem. Suppose that a broker-dealer sends an intermarket sweep order on behalf of the investor in our example above. Suppose also that Market A has a material number of shares in reserve at the NBBO, such as 1000 shares in reserve at $10.04. The intermarket sweep order will take out the displayed quotes at $10.04 on Market A, $10.03 on Market B and $10.02 on Market C, as required by the trade-through rule. Yet, as a result of this sweep, the execution of the investor's order has bypassed the reserve order at the better price of $10.04. So, the investor has not received the best price.

The problems raised by reserve orders in the context of the TOB Alternative will only be exacerbated by the DOB Alternative. If the DOB Alternative applied in our reserve example, the intermarket sweep order would take out the orders down to $10.01 on Markets A and B, which includes prices even worse for the investor than those required in the TOB example (i.e., $10.02). Again, the better priced reserve orders at the NBBO (i.e., $10.04) have been bypassed to the detriment of the investor.

Indeed, the TOB Alternative falls short even with regard to displayed quotes. This Alternative does not protect the best displayed quotes in the market; it only protects those displayed quotes at the TOB, regardless of their merit relative to other quotes in another market's DOB. For example, in the example set forth above, the TOB Alternative would provide price protection for the 300 shares in Market C priced at $10.02 because they are at the TOB. But, it does not provide price protection for the better priced quote of $10.03 on Market A because this quote is not at the TOB of Market A. Therefore, the operation of the TOB Alternative may deprive the investor of the better fill even among displayed orders.[17]

In contrast, none of these issues is raised under the NBBO approach. Under this approach, the market participant only must provide price protection for the very best price (i.e., the 100 shares at $10.04 on Market A) and then the market participant has the flexibility to seek to obtain best execution for the investor in the best manner possible, such as through the use of sophisticated trading strategies and algorithms. Indeed, this approach maximizes the ability of smart routers, which have been regularly praised by the SEC as beneficial for investors and the markets,[18] to obtain the best prices based on a complex analysis of the various characteristics of the relevant markets (e.g., reserve and depth), rather than on an overly simplistic TOB or DOB approach.

c. The NBBO Approach Facilitates Intermarket Competition

We also believe that the NBBO approach facilitates intermarket competition, while the TOB and DOB Alternatives undermine such competition to the detriment of the markets. One of the national market system goals is to ensure the proper balance between intermarket interactions and intermarket competition, thereby avoiding the extreme of "a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets."[19] We believe that the SEC's two Alternatives err too far in the direction of ensuring intermarket interactions, thereby threatening intermarket competition, discouraging innovation, and limiting investor choice. As a result, we are concerned that the TOB and DOB Alternatives ultimately may cause significant harm to investors and imperil the preeminence of the U.S. markets.

Specifically, we believe that the TOB and DOB Alternatives will drive the markets toward one uniform market model. Indeed, both proposals push the markets toward intermarket competition that is based solely on displayed price. For example, as the above reserve order discussion describes, the TOB and DOB Alternatives would require reserve orders to be bypassed. This would effectively change the internal price-time priority rules of the markets and encourage the end of the use of reserve orders on the markets. By unifying the markets' variable rules in this regard, the SEC's proposal drives away a significant point of competitive differentiation between markets. Indeed, we believe that both Alternatives raise the specter of competition-stifling, micro-management of market structure by the government. While the two

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[17] Moreover, we note that the TOB Alternative will only protect the best quote of the ADF Participants, while protecting each of the exchange SROs' best quotes. Reproposal at 77440. This inconsistency also would be resolved by the NBBO approach.

[18] See Reproposal at 77425; Securities Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126, 11155 (Mar. 9, 2004) ("NMS Proposal").

[19] Reproposal at 77426.

Alternatives would not impose the price-time priority of a virtual Central Limit Order Book or "CLOB," they would lead to the same excessive rigidity in order routing and execution processes, with the same deleterious effect on competition and innovation, as a CLOB.

In sum, the NBBO approach does not cause the negative effects that are produced by the inflexible parameters of the TOB and DOB Alternatives. The NBBO approach provides the appropriate balance between intermarket interaction and competition. Reliance on the duty of best execution after the NBBO has been protected provides market participants with the flexibility to exercise their trading judgment in the investor's best interest, while still providing price protection for the best quotes.

d. The NBBO Approach Incentivizes Appropriate Quoting Practices

The NBBO approach is the only alternative that both protects investors and facilitates competition and innovation by creating incentives for appropriate quoting practices. Under the NBBO approach, investors are -- quite rightly -- provided strong incentives to display their best bid or offer at the national best bid or offer. In contrast, under either the TOB or DOB Alternative, a series of incentives are inadvertently created for "investors" to game the system by being at the "top" of an otherwise immaterial market or to ladder a book in an effort to disrupt block executions in a decimal environment. We believe the Commission should give serious consideration to the unintended consequences that may flow from such incentives. In this regard, we note that the Commission itself has recognized in the context of market data fees the distortive effect of such incentive structures.[20]

e. The NBBO Approach Minimizes Implementation Challenges

The adoption of a market-wide trade-through rule will pose many implementation challenges. In fact, we believe that this proposed regulation, with all of its implementation requirements, has the potential to create compliance problems far in excess of those seen in relation to Regulation SHO.[21] The implementation challenges, however, will be intensified

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20 Reproposal at 77429.

21 On this point, we note that the Commission recently decided to delay by four months the effective date of the Regulation SHO "Pilot Program," i.e., the one-year period during which short sale price regulation will be suspended for certain liquid securities ("Pilot Securities"). As adopted, Regulation SHO would require broker-dealers accepting/entering short sale orders in Pilot Securities to mark such orders as "short exempt" rather than "short." The Commission delayed the Pilot Program because: (i) order entry firms represented that it would be inefficient and unduly expensive for them to make changes to their order-marking systems for Pilot Securities; (ii) order execution venues, such as national securities exchanges, offered to make changes to their execution systems to suspend appropriately the short sale price tests for orders in Pilot Securities regardless of whether such orders are marked "short" or "short exempt;" and (iii) such order execution venues represented that their proposed voluntary system changes could not be effected by the original compliance date of the regulation, January 3, 2005. See Securities Exchange Act Release No. 50747 (Nov. 29, 2004), 69 Fed. Reg. 70480 (Dec. 6, 2004). In addition, the complexity of Regulation SHO has necessitated the issuance of extensive interpretive guidance in question and answer format, and such guidance is still in the process of being updated. See Division of Market Regulation:

greatly by the adoption of the TOB or DOB Alternatives, rather than the NBBO approach. Specifically, the TOB Alternative complicates the programming and compliance issues of the NBBO approach by requiring the protection of the best quote in each market, rather than just the very best quote. The DOB Alternative takes this issue even further by requiring the protection of every protected quote in the full DOB of each market that volunteers to have its DOB protected. Clearly, the DOB Alternative represents an enormous undertaking to collect, and react to, all possible market data for the entire marketplace.[22] Therefore, in addition to the substantive benefits of the NBBO approach described above, the NBBO approach will minimize the implementation challenges posed by the trade-through rule and help to avoid unintended consequences related thereto.

The breadth of changes required to implement the market-wide trade-through rule is extraordinary. The routing and execution of orders pursuant to the proposed trade-through rule implicates, among other things, disseminating market data across markets, recognizing manual and other quote flags, utilizing intermarket sweep orders, and ensuring appropriate access to the relevant markets. Each of these will require significant upfront programming changes and the costs attendant thereto. Correspondingly, the market participants must establish supervisory and compliance policies and surveillance methods, including electronic exception reports, to ascertain whether they are in compliance with the trade-through rule on an ongoing basis. The NBBO approach, as compared to the other Alternatives, will minimize the extent of these programming and compliance changes.

In addition, with all the significant market structure changes being made, the possibility for unintended consequences to the markets is extremely high.[23] Indeed, evaluating the extent of possible consequences at this time is difficult because many of the details of the implementation of the trade-through rule have been postponed until the implementation phase.[24] The details of how the trade-through rule will be applied depends on to-be-determined "policies and procedures" to be adopted by the markets. In addition, many practical issues related to the

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Frequently Asked Questions Concerning Regulation SHO at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

[22] The DOB Alternative also compounds the already contentious market data fee discussion because it requires the dissemination of, and corresponding payments regarding, a significantly greater number of quotes. Indeed, the potential for a significant increase in market data fees is huge.

[23] See Deborah Solomon, et al., Tough Tack of SEC Chief Could Relent, Wall St. J., Jan. 12, 2005 at C1 (noting SEC fears about unintended consequences of the SEC's two proposed trade-through alternatives on the overall market).

[24] For instance, the Commission has indicated that it will need to issue further interpretive guidance on details such as the specific parameters of the market access provisions and the trade-through exceptions, what sources market data participants can rely upon for purposes of the DOB Alternative, and how many accidental trade-through occurrences constitute an unacceptable level. See Commission Open Meeting, Dec. 15, 2004, webcast available at http://www.sec.gov/news/openmeetings.shtml.

market data aspects of the trade-through rule, such as quote flags and tape reports, remain subject to future interpretation and guidance. Even once these policies are determined, however, we cannot predict how the markets will respond to all the proposed changes.

Furthermore, we emphasize that the trade-through-related changes must be made concurrently with all the other many regulatory changes imposed by Regulation NMS. Market participants must expend the time, effort and significant funds to comply with requirements related to locked and crossed markets, access fees, linkages and sub-pennies. Taken as a whole, Regulation NMS will usher in a new era of intermarket trading, even without a trade-through rule. Therefore, adopting the more measured NBBO approach as a first step would allow the industry to better observe and analyze the resulting market behavior, without some of the unintended consequences that could occur with the TOB or DOB Alternatives.

We cannot emphasize enough the extent of this global undertaking. We believe that the markets and market participants would need at least one year, if not two, to implement all the changes, and we are concerned that this time allotment may even be insufficient.

B. Liquidity Exception

SIA believes that the concerns that the Commission intends to address with the trade-through rule are not present in certain actively traded, highly liquid securities. Therefore, we recommend that the SEC except from its proposed trade-through rule transactions in these actively traded securities. An "actively traded security" could be defined variously as a security whose quotes are updated, on average, every few seconds or less,[25] as a security that is included in the S&P 400 or other top index, as a security that has some minimum daily trading volume, or in some other similar manner. The trade-through rule, then, would focus solely on those securities for which it would have the greatest benefit for investors.

We believe that a trade-through rule would be redundant for highly liquid securities. One of the goals of Regulation NMS is to encourage greater use of limit orders, which would, in turn, increase market depth and liquidity.[26] We believe a liquidity exception is consistent with this goal because the markets for this subset of securities already are extremely deep and active, thereby obviating a need to enhance the trading further. Indeed, the SEC has reasoned in a variety of contexts that actively traded securities, because of their volume and, consequently,

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[25] For example, if a two-second quote update average were used, based on our calculations, this exception would capture approximately 250 stocks in the S&P 500 as well as a handful of other stocks. Or, in the alternative, we could utilize a three-second quote update average, which is the time period the SEC itself relied on in its trade-through study. See Reproposal at 77433, n.59 (citing the SEC's Office of Economic Analysis, Analysis of Trade-throughs in Nasdaq and NYSE Issues (Dec. 15, 2004) available at http://www.sec.gov/spotlight/regnms/analysis121504.pdf (noting that the Staff calculated trade-through rates using a three-second window to eliminate false positive trade-throughs) ("Trade-Through Study")).

[26] Reproposal at 77430.

their constant exposure to market scrutiny, provide greater market information and, therefore, require less regulatory protection than less actively traded securities.[27] Correspondingly, the trade-through rule would continue to apply to less liquid securities, where measures to increase market depth and liquidity would have the most benefit.

In addition, based on the historical trading patterns of actively traded securities, we know that trading in these securities is likely to demonstrate significant instances of flickering quotes. As a result, much of the trading activity in these securities would be subject to the window provided by the Commission's flickering quote exception. Therefore, the proposed liquidity exception would not diminish investor protection. It would, however, relieve market participants of significant and unnecessary regulatory expenditures. These securities, with their heavy quote traffic, would account for a disproportionate share of the surveillance and technology resources related to compliance with the trade-through rule. Although the flickering quote exception provides protection to market participants against liability for false positive trade-throughs, it does not limit in any way the trade-by-trade compliance requirements related to the rapid quote changes. Therefore, with only the flickering quote exception in place, market participants will still be responsible for expending significant time and money to track and analyze the rapid quote changes in these liquid securities. With the addition of the liquidity exception, however, firms will be relieved of an obligation to analyze the data for the many false positives that we know will occur with these securities, with no loss of investor protection.[28]

The examination of available data regarding the trade-through exception for highly liquid exchange-traded funds ("ETFs") confirms that an exception for such actively traded securities will benefit investors by providing more efficient executions. When the SEC provided a *de minimis* three cent exception for the most actively traded ETFs in 2002,[29] no significant change in trade-through rates was noted. For example, the Commission's Office of Economic Analysis conducted an analysis of trading in QQQs, comparing the day after implementation to the day before implementation, and found that the percent of trades executed outside the NBBO did not

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[27] See Securities Exchange Act Release No. 38067 (Dec. 20, 1996), 62 Fed. Reg. 520 (Jan. 3, 1997) ("Regulation M") (eliminating the trading restrictions for underwriters of actively traded securities because the costs of manipulating such securities generally are high, they are widely followed by the investment community so aberrations in price are more likely to be discovered and quickly corrected, and they are generally traded on exchanges or other organized markets with high levels of transparency and surveillance); Securities Exchange Act Release No. 50831 (Dec. 9, 2004), 69 Fed. Reg. 75774 (Dec. 17, 2004) ("Amendments to Regulation M") (reiterating reasons for excepting actively traded securities from trading restrictions). See also Securities Exchange Act Release No. 50104 (Jul. 28, 2004), 69 Fed. Reg. 48032 (Aug. 6, 2004) (pilot order for Regulation SHO suspending operation of the short sale rule for certain actively traded securities) ("Regulation SHO Pilot Order").

[28] The difficulty and expense of tracking trade-throughs cannot be underestimated. The SEC itself noted, when it attempted to study trade-throughs, 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." Trade-Through Study at 1.

[29] See Securities Exchange Act Release No. 46428 (Aug. 28, 2002), 67 Fed. Reg. 56607 (Sept. 4, 2002).

increase and that less than 1% of total trades were executed more than three cents away from the NBBO.[30] Furthermore, the exception relieved the market participants of the significant regulatory and compliance burdens associated with applying the full trade-through restriction to such actively traded securities.[31]

We recommend that the SEC utilize this liquidity exception as an opportunity to study the operation of the markets without the application of a trade-through rule and to evaluate whether the trade-through rule is necessary going forward. Specifically, we recommend that the SEC evaluate the operation of the markets with this exception for a one-year period. By the end of the year, the SEC will have obtained sufficient empirical data on the exception's effect on the market (including the number of trade-throughs, the use of limit orders, any unintended collateral effects, etc.) to help assess whether trade-through regulation is necessary for actively traded securities as well as the less liquid securities. Once that data has been evaluated thoroughly, the SEC may consider what further action, if any, should be taken. In that sense, we have borrowed a useful idea from the Commission, who implemented a similar study with regard to actively traded securities in the short sale context.[32] Just as the SEC concluded in the short sale and other contexts, an exception for actively traded securities poses little risk to investors and the markets given the nature of the trading in these securities and will provide the SEC with important information regarding the operation of the markets.[33]

C. Best Execution and Manual Quotes

Regulation NMS calls into question the value of manual quotes in a variety of ways. For example, not only does the trade-through rule permit market participants to ignore manual quotes, but the SEC's revised market data allocation formula also suggests that manual quotes are not useful to investors.[34] The SEC, however, states in the release that the adoption of the reproposed trade-through rule "would in no way lessen a broker-dealer's duty of best execution."[35] We are concerned that this statement regarding best execution in effect requires

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30 See NMS Proposal at 11134, n.50.

31 We also note that the SEC excepted ETFs because they are highly liquid and the SEC recognized that market participants may value an immediate execution at a displayed price more than the opportunity to obtain a slightly better price. Securities Exchange Act Release No. 47950 (May 30, 2003), 68 Fed. Reg. 33748, n.6 (June 5, 2003).

32 See Regulation SHO Pilot Order at 48032.

33 Id. at 48032-3 ("The risk of any adverse impact on the Pilot securities is expected to be small, particularly relative to the benefits of obtaining empirical data regarding trading behavior in the absence of a short sale price test. A large number of Pilot stocks are actively traded, and as we have previously stated, we believe that actively traded securities are less susceptible to manipulation.").

34 Reproposal at 77464.

35 Reproposal at 77447.

broker-dealers to provide price protection to manual quotes, notwithstanding the trade-through rule's contrary intent in that regard. Therefore, we are concerned that broker-dealers will be required, as a business and legal matter, to take account of the full depth-of-book as well as manual quotes in providing best execution to their customers. Although the SEC states only that best execution standards will not change, the SEC will have changed the entire market structure, which would appear to necessitate a re-evaluation of best execution standards. Indeed, based on the language in the release, we are concerned that broker-dealers will be held liable by customers and regulatory examiners, far beyond the requirements of the trade-through rule, to a best execution standard based on manual quotes.

We recognize that one of the largest equities markets in the United States is in a state of flux and many of its quotes are still currently manual quotes. Therefore, at a minimum, for the immediate future, we request that the SEC explicitly clarify its position on best execution in any adopting release for Regulation NMS. In particular, we recommend that the SEC acknowledge that if a broker-dealer determines that routing to a manual quote routinely reveals that the quote is unresponsive or would impose undue costs, the broker-dealer may take that into consideration in determining best execution.[36] In addition, in the short term, we recommend that the SEC change the benchmark in the Rule 11Ac1-5 statistics. The comparison benchmark should be calculated based on automated quotes only.[37] In this way, customers may be provided with a more accurate picture of the quality of their executions. Going forward and over time, as markets evolve, however, we urge the Commission to consider the exclusion of manual quotes from the NBBO and the related ramifications on best execution obligations.

D. Other Exceptions to Trade-Through Rule

We generally agree with the exceptions to the trade-through rule that the SEC has included in the Reproposal.[38] Given, however, that the SEC has not reproposed its original opt-out exception or included a block exception as advocated by SIA,[39] we believe that it is all the more important for the SEC to tailor carefully its more narrow, proposed exceptions to avoid disrupting existing legitimate and beneficial market activities. Therefore, we offer suggestions on ways to improve upon the exceptions related to benchmark trades, flickering quotes, systems malfunctions, and openings.

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36 Indeed, certain SIA members believe that, if such clarification is not provided, then the trade-through rule should not be implemented.

37 See Rule 11Ac1-5(a)(7) under the Exchange Act (definition of consolidated best bid and offer).

38 In addition to the various exceptions discussed in this Section, we note that we continue to support the SEC's proposed exceptions for transactions other than regular way contracts and crossed markets. See Reproposed Rules 611(b)(2) and (4), respectively.

39 See Original SIA Comment Letter at 7-10.

1. Exception for Benchmark Trades

a. In General

We continue to believe that a benchmark trade exception to the trade-through rule is essential[40] and, therefore, we fully support the SEC's decision to include such an exception. The SEC would except from the trade-through rule the execution of an order at a price that was not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made.[41] This proposed language is drafted sufficiently broadly to capture a variety of different trading strategies that are important to many investors. For example, as the SEC notes,[42] a common example of a benchmark trade is a volume weighted average price ("VWAP") order. We believe that other examples of benchmark trades include VWAP-plus or VWAP-minus trades.[43] We also believe that the benchmark exception should apply to contingency trades, which include, for example, but without limitation, certain risk arbitrage strategies and linked transactions, where the trade in the equities market is linked to a derivative trade.

b. Stopped Orders

We disagree with the SEC's preliminary view that stopped orders should not be subject to an exception from the trade-through rule.[44] Contrary to the SEC's concerns, stopped orders are a valuable tool for today's investors. Such an exception would encourage market makers and block facilitators to continue to provide capital commitments to institutional orders in situations of insufficient disseminated liquidity in the marketplace. When liquidity in the marketplace appears insufficient to execute an institutional customer's block order in full, the institution should be allowed to obtain best execution for the order by securing a stopped order guarantee from a market maker or block positioner. Without such a capability, liquidity providers will be driven from the marketplace, thereby eroding execution quality for these orders.

The following example illustrates the value of a stopped order. Assume a customer places an order to buy 100,000 shares of XYZ stock with a liquidity provider while the stock is 20.33 bid - 20.38 ask, 5000 by 5000. Assume that the average daily volume in the stock is approximately 1,000,000. As a result, the customer may have a legitimate concern that the

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40 See Original SIA Comment Letter at 9.

41 Reproposed Rule 611(b)(7).

42 Reproposal at 77446.

43 This means, for example, negotiating a price at VWAP plus five cents or VWAP minus six cents.

44 Reproposal at 77446, n.149.

average price of the purchase could be considerably higher than $20.50. Therefore, when the liquidity provider agrees to provide the stopped order guarantee of $20.50, the customer is confident that he or she has obtained best execution on the order. When the stock subsequently trades at $20.95 before the liquidity provider can execute the order in full in the market, the stopped order guarantee becomes "qualified" and can be executed and printed at the stopped price of $20.50. Such a print raises issues under the trade-through rule because the print will trade-through the current market price.

In the above example, the customer's inclination to accept the guarantee was validated by the subsequent trading in the security. Yet, if all the stock were obtainable at prices less than $20.50, there would have been no need to avail upon the stop order guarantee. In that case, the customer would have received the better price nonetheless. Therefore, approving a trade-through exception for stopped order guarantees assures the customer the best of both worlds. Indeed, while Regulation NMS strives to improve order execution by providing a mechanism for quick and efficient access to displayed quotes, the stopped order guarantee in the above example is essentially "better than the best" as it executes the order at a price that was better than what was then available in the market.

We recognize, however, that the SEC is concerned about the possible abuse of the proposed exception. Therefore, we suggest that the SEC build into the exception certain qualifiers that would discourage abusive practices. Specifically, we recommend that a stopped order guarantee should only qualify for the proposed stopped order exception from the trade-through rule if it meets the following criteria:

1. The stopped order guarantee may only be provided to a non-broker-dealer or to a broker-dealer for the benefit of a non-broker-dealer customer.

2. The customer must agree to the stopped price on an order-by-order basis.

3. If the stock price trades through the guaranteed price and the facilitating firm elects to execute the order at the guaranteed price, the facilitating firm may then print the trade at a price outside the disseminated market at any time thereafter on that day <u>only</u> if the customer who received the guarantee is on the advantaged side and the liquidity provider who gave the guarantee is on the disadvantaged side (<u>i.e.</u>, thus, all out of range stopped order guarantee prints will be to the benefit of the customer).

4. The stopped order guarantee print should be identified on the tape as an excepted transaction, using, for example, the .PRP or .W modifier.

5. As with all orders, the liquidity provider must maintain a complete and accurate record of when a stopped order guarantee is provided to a customer.[45]

2. Flickering Quote Exception

Similar to the SEC, we continue to be concerned about the possibility of false positive trade-throughs resulting from, among other things, flickering quotes, clocks that are not synchronized, and delays (even very minor ones) in the dissemination of quotation information.[46] We note, at the outset, that our proposed liquidity exception for actively traded securities would address these concerns for trading related to actively traded securities. The liquidity exception, however, would not address flickering quote problems in other securities. The SEC's proposal provides this additional, and necessary, relief related to false positive trade-throughs.

The SEC has proposed to address false indications of trade-throughs that are attributable to rapidly moving quotations with an exception to the trade-through rule that provides relief in the form of a one-second window.[47] Specifically, this provision would except a transaction if the trading center displaying the protected quotation that was traded through had displayed within one second prior to execution of the trade-through a best bid or offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction.[48]

We agree with the SEC that such a window would provide much-needed practical relief from the basic trade-through provisions. We question, however, whether the proposed one-second window is unduly narrow for today's markets[49] and, indeed, whether prescribing a specific timeframe in the rule itself is the best way to proceed. Therefore, we recommend that the SEC eliminate the time requirement entirely from the rule, replacing it with a more general statement that the trade-through rule would not apply to flickering quotes. The SEC then could provide interpretive guidance regarding the appropriate timeframe to define a flickering quote.

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[45] We believe that the SEC also should clarify that prints of stopped order guarantees are excepted from the short sale tick test.

[46] Original SIA Comment Letter at 10.

[47] See Reproposal at 77445-6.

[48] In other words, suppose an investor would like to sell 500 shares of XYZ at $10.00. Market A was displaying a bid of 100 shares at $10.01. Market B was displaying a bid of 100 shares at $10.02, but within one second prior to the transaction, it had displayed a bid of 100 shares at $10.00. The flickering quote exception would permit the investor to bypass the $10.02 quote in Market B and only take out the $10.01 bid in Market A. See Reproposed Rule 611(b)(8).

[49] Original SIA Comment Letter at 10.

In this way, the SEC would not codify technology speeds within the rule; it would provide the SEC with flexibility to allow the time requirement to evolve as technology evolves.[50]

3. Self-Help Exception

The SEC has proposed to except a transaction from the trade-through rule if the trading center displaying the protected quotation that was traded through was experiencing a failure, material delay, or malfunction of its systems or equipment when the trade-through occurred.[51] The SEC further explains in its release that this exception would give trading centers a self-help remedy if another trading center repeatedly fails to provide an immediate response to incoming orders attempting to access its quotes. We fully support the concept of this exception. Certainly, the trade-through rule, with its emphasis on automated quotations, should not hold market participants hostage to inaccessible or slow quotes masquerading as automated quotations. We are concerned, however, that the exception, as it is described in the release, will not obtain this goal.

This proposed exception imposes the obligation to identify and resolve systems issues on the routing trading center, rather than the trading center that is experiencing systems problems. The SEC would require the routing trading center to discover systems problems at another trading center by trial and error. Specifically, the routing trading center must repeatedly attempt to access a trading center's quotations before halting its efforts to obtain access to those quotations.[52] And, then, when the problem is discovered, the SEC states that "a trading center should attempt to resolve the problem by contacting the other trading center that has failed to respond immediately."[53] In our experience, placing these responsibilities on the routing trading center is unworkable.

We believe, instead, that the primary responsibility for alerting markets to when systems problems occur, and when they are resolved, should fall on the shoulders of the trading center experiencing those problems. Therefore, the SEC should require that a trading center experiencing systems problems that prevent its quotes from meeting the definition of "automated" should tag its quotes as manual. Or, if the problems prevent access to the quotes entirely, the trading center should remove them from the quote stream. In addition, if that

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[50] The SEC took a similar approach with regard to the Limit Order Display Rule (Rule 11Ac1-4 under the Exchange Act). The Limit Order Display Rule itself only requires bids and offers to be published "immediately." The SEC then later defined "immediately" through interpretive guidance.

[51] Reproposed Rule 611(b)(1).

[52] Reproposal at 77445.

[53] Specifically, the SEC notes that a single failure to respond within one second would not justify future bypassing of another trading center's quotations; however, many failures to respond within one second during a short period clearly would warrant use of the exception. Id. at 77445.

trading center fails to alert the market to its systems problems, we believe the securities information processor ("SIP") should have the capability to do so on the market's behalf. Once the systems issue has been resolved, then the malfunctioning trading center should alert the marketplace to the resolution of the issue.

The self-help remedy, then, would only be necessary as a supplement to the obligations imposed on the malfunctioning trading center. If a trading center failed to meet its obligation to immediately alert the market to its systems problems, then the routing trading centers may bypass that trading center's quotations.

To inform the malfunctioning trading center of its duties under our proposal and to inform the routing trading centers of their self-help rights if the malfunctioning trading center fails to satisfy its duties, the SEC must provide greater guidance as to when this exception would apply. A simple statement that the requirement would apply somewhere between a single failure to respond and repeated failures to respond is insufficient. Consistent, market-wide guidance will help prevent problematic trading centers from disrupting the flow of orders in the national market system.

4. Exception for Intermarket Sweep Orders

We continue to believe that an exception for intermarket sweep orders is imperative for the proper functioning of the trade-through rule and for the facilitation of various beneficial trading strategies, including smart routing and block trading.[54] Therefore, we applaud the SEC's decision to include such an exception in its Reproposal. We believe that the SEC has appropriately defined an intermarket sweep order, including the need to flag the order as such,[55] and appropriately set forth the requirements of the exception for the intermarket sweep order.[56] Therefore, we agree with the SEC that the proposed requirements regarding intermarket sweep orders should be included in any final rule.

5. Exception for Opening/Reopening/Closing Transactions

The SEC has proposed an exception from the trade-through rule for single-priced opening, reopening, or closing transactions by a trading center.[57] We agree with the need for such an exception, but seek clarification on its intended reach. For example, we are concerned about the treatment of intra-day imbalances under the proposed exception. To demonstrate,

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54 See Original SIA Comment Letter at 8-9 (advocating an exception for intermarket sweep orders).

55 See Reproposed Rule 600(b)(30).

56 See Reproposed Rule 611(b)(5) and (6).

57 See Reproposed Rule 611(b)(3).

suppose an imbalance constitutes a reopening under the exception. Suppose also that Market A experiences an imbalance while trading continues on other markets. When trading commences again on Market A, then Market A may trade through the other markets at that time. Such a broad interpretation may lead to disruptive trading activity. Therefore, we support this exception, but remain concerned about its broad application to all circumstances related to imbalances and related to operational halts. We agree, however, that the exception should apply to regulatory halts.

III. Intermarket Access

We continue to believe that national market system objectives generally,[58] and the objectives of any trade-through protection more specifically, cannot be met without fair and efficient access to the various trading centers. Therefore, we are pleased that the SEC has continued to consider means for enhancing intermarket access in its Reproposal. We express our views below on the proposals regarding linkages, access fees, and locked and crossed markets.

A. Linkages

We believe that efficient access is a critical aspect of today's national market structure and that the existing standards governing the manner of access are insufficient given the existence of various competing market centers. Therefore, we agree with the SEC's intent to enhance such access through its reproposed access rules. In particular, we agree with the SEC's approach of encouraging fair and efficient market access through private linkages. Private linkages, as opposed to ITS-type linkages, will provide the flexibility -- technologically and otherwise -- that is vital to the continued development of the markets.

We also note that the SEC revised its access rule to address concerns under the private linkage approach about assuring efficient linkage to trading centers with a small trading volume that make their quotations accessible only through the ADF.[59] Specifically, the SEC proposed requiring those ATSs and market makers that choose to display quotations in the ADF to bear the responsibility of providing a level and cost of access to their quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.[60] We believe that this proposal may provide the necessary access at a reasonable cost, provided the NASD appropriately assesses the extent to which the ADF participants have met the access standards of the reproposed rule. We continue to have concerns, however, about the potential cost of creating numerous connections to such small markets.

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[58] See, e.g., Section 11A(a)(1)(C)(iv) of the Exchange Act (assuring the practicability of brokers executing investors' orders in the best market possible); and Section 11A(a)(1)(C)(1) of the Exchange Act (assuring efficient execution of securities transactions).

[59] See Original SIA Comment Letter at 16-17.

[60] See Reproposed Rule 610(b)(1).

B. Access Fees

Although SIA member firms continue to hold strong views both opposing and supporting access fees, SIA generally is united in its desire for a market-wide solution. Therefore, SIA supports the SEC's willingness to address this issue, even if SIA cannot offer a consensus view on the SEC's proposal. Nonetheless, SIA members request that the Commission consider several practical issues related to its access fee proposal.[61]

Limiting access fees to protected quotations only does not resolve the problem of broker-dealers forced to pay excessive fees on non-protected quotations as a result of regulatory requirements. Broker-dealers may still be required to obtain access to non-protected quotations to fulfill their best execution obligations.[62] Furthermore, broker-dealers may be forced to a market that charges excessive fees by the trade-through rule, but receive a fill from an unprotected quote due to an intervening change in the market. Therefore, we recommend that the SEC consider how to resolve the problem of excessive fees under these other circumstances.

In addition, SIA members are concerned about the tracking and billing requirements of the reproposed rule. The reproposed rule contemplates billing market participants different access fees based on whether a quotation is protected or unprotected. We believe that tracking whether a quote is protected or not for billing purposes is unworkable because it will be difficult to determine *ex post* which quotes were protected and which were not. Therefore, at the very minimum, this provision will raise a significant administrative issue.

Finally, SIA members request further clarification from the Commission regarding the definition of what constitutes an access fee. The reproposed rule broadly characterizes access fees as "fees for the execution of orders."[63] The release further states that this definition is intended to "encompass a wide variety of fees," including access fees charged by ECNs and transaction fees charged by SROs, but not including fees unrelated to the execution of orders (e.g., monthly or annual fees).[64] This definition could be interpreted to include any fee that is charged on the basis of the transaction (e.g., clearing fees or bandwidth fees). Therefore, SIA seeks additional clarification from the SEC regarding the types of fees covered by this provision.

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[61] See Reproposed Rule 610(c).

[62] See Section II(C) above for a more detailed discussion of best execution issues.

[63] See Reproposed Rule 610(c).

[64] Reproposal at 77454.

C. Locked and Crossed Markets

We continue to support a rule that would discourage market participants from locking and crossing markets.[65] We believe that the SEC's proposal requiring each SRO to promulgate rules that would discourage market participants from engaging in locking and crossing markets, but that tolerate some minimal incidence of locked and crossed markets, is appropriate.[66] In particular, we approve the proposed change to the rule that would distinguish between automated quotations and manual quotations.[67] To ensure a workable operation of the provisions, we would recommend, however, that the SROs' anti-crossing and anti-locking provisions incorporate an exception for flickering quotes and for systems malfunctions, similar to those provided in the trade-through rule. We also would ask for further clarification regarding the operation of the Commission's proposed "ship and post" procedures (i.e., procedures that require a market participant to attempt to execute against a relevant displayed quotation while posting a quotation that could lock or cross such a quotation).[68]

IV. Sub-Penny Quoting

Most SIA member firms believe that quoting in sub-penny increments does not contribute to the maintenance of stable and orderly markets, but instead encourages stepping ahead, creates loss of depth, and decreases price clarity.[69] As a result, SIA member firms are in favor of the SEC's ban on sub-penny quoting, as reproposed.[70] In particular, we believe that the changes the SEC made to the sub-penny rule in the Reproposal -- basing the sub-penny restriction on the price of the quotation, rather than the price of the stock itself,[71] and providing for a four decimal place cut-off for securities quotations below $1.00[72] -- appropriately address SIA's concerns, as set forth in the Original SIA Comment Letter.

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65 Original SIA Comment Letter at 19-20.

66 See Reproposed Rule 610(d).

67 "Protected quotations could not be crossed or locked by any other quotations. Manual quotations, in contrast, could be locked or crossed by automated quotations, but could not themselves lock or cross any other quotations included in the consolidated data stream, whether automated or manual." Reproposal at 77454.

68 Id. at 77454.

69 Original SIA Comment Letter at 20-21.

70 See Reproposed Rule 612. A minority of SIA member firms continue to believe that competitive forces, not the SEC, should determine the minimum increment. Indeed, some believe that market forces are presently addressing the sub-penny issues without regulatory intervention and, therefore, SEC intervention is unnecessary.

71 See Reproposal at 77457-58.

72 See id. at 77458.

V. Market Data

We continue to believe that the current level of market data fees is too high and that greater transparency concerning the costs of market data and the fee-setting process is necessary.[73] We are encouraged that the Commission agrees with this view.[74] We remain concerned, however, that the Commission has incorporated the most important market data issue -- the level of market data fees -- in a separate, concept release,[75] rather than addressing all market data issues as a cohesive whole within the context of the market data discussion in the Reproposal. Such a comprehensive approach is the best way to ensure that market data fees are "fair and reasonable" and "not unfairly discriminatory."[76] To this end, we address the market data issues raised in the various SEC releases in this letter.[77]

Accordingly, we continue to believe that revising the revenue allocation formula for market data prior to evaluating the level of market data fees is putting the cart before the horse. Addressing the problem of serious economic and regulatory distortions in the market data arena should not be attempted, we believe, indirectly by changing the allocation formula. The best way to address these distortions, without creating additional possibilities for gaming the data, is to resolve the source of the problem directly -- that is, by addressing the high level of market data fees.[78]

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73 Original SIA Comment Letter at 21-28.

74 "Many commenters recommended that the level of market data fees should be reviewed and that, in particular, greater transparency concerning the costs of market data and the fee-setting process is needed. The Commission agrees." Reproposal at 77461 (citations omitted).

75 See Securities Exchange Act Release No. 50700 (Nov. 18, 2004), 69 Fed. Reg. 71256 (Dec. 8, 2004) ("SRO Concept Release"); Reproposal at 77461.

76 Sections 11A(c)(1)(C) and (D) of the Exchange Act.

77 In this letter, we believe that we provide the SEC with a cohesive structural framework for the market data issues raised in the Reproposal as well as those raised in the rulemaking and concept releases related to self-regulation. See generally Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 Fed. Reg. 71126 (Dec. 8, 2004) ("SRO Governance and Transparency Proposal"); SRO Concept Release. To further assist the Commission's deliberations in this regard, we may supplement this analytical framework with greater detail on certain market data points (e.g., details regarding (1) specific costs to be included in a cost-based assessment of market data fees; (2) any limitations of access caused by current market data policies; and (3) the possible effect of a reduction in market data fees on self-regulatory conflicts) in our forthcoming comment on the other releases.

78 With regard to the level of fees, we also note that the value of the NBBO -- the cornerstone of the market data system -- is less than what it was prior to decimalization. We believe that the SEC has a responsibility to address this issue in light of the operation of its Quote and Display Rules (Rules 11Ac1-1 and 11Ac1-4 under the Exchange Act), which require broker-dealers to purchase this data and distribute it to their clients. We urge the Commission to study this issue to ensure that its market data policies further the important goals of the national

As we described in the Original SIA Comment Letter, we believe that the best way to address the fee issue is to institute a cost-based approach to market data fees. Specifically, we believe that market data fees should be used solely to cover the costs of collecting and disseminating market data. We understand that such an approach would be a significant change to current practice and that such a change will affect the current revenue streams of the SROs, including funds necessary for appropriate self-regulation. We, of course, are not advocating diminished regulatory funding in any way, but instead a revised method for funding regulation that does not depend on revenue from market data fees.[79]

If, however, the SEC chooses not to address market data fee levels at this point, we believe that the Commission should act now to implement measures aimed at increasing the transparency of market data fees and reducing the administrative burdens related to market data fees.[80] Improved transparency of the market data fee process, with established standards for fee changes and the meaningful input of all interested participants, will add significant credibility and legitimacy to the process. Such transparency will remove the concern that market data fees are established by the exchanges without meaningful SEC review and without meaningful input from broker-dealers and investors. There is no reason to delay in taking these reform steps that SIA and its members have advocated for the past five years in response to previous requests for comments by the SEC.[81] We discuss a variety of ways in which the SEC may improve the transparency and administration of market data fees below.

A. Increased Transparency

SIA believes that greater transparency in the market data context will alleviate a variety of the problems associated with market data fees. Specifically, we recommend an improved process for establishing market data fees, better governance of the joint industry market data

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market system, including market transparency, a level playing field among market participants, and best execution of investors' orders.

[79] We note that the full issue of funding regulation will be addressed in the context of SIA's comment letter regarding the SRO Concept Release and the SRO Governance and Transparency Proposal.

[80] We believe the Commission should move forward expeditiously with our proposed measures aimed at increasing the transparency of, and reducing the administrative burdens related to, market data fees. We are not suggesting, however, that the Commission resolve all market data issues (e.g., how to appropriately fund regulation if market data revenue is no longer available) before addressing the more limited market data issues discussed in this letter and the areas of Regulation NMS unrelated to market data (i.e., trade-through, access and sub-penny considerations). Instead, the Commission should move forward with these other regulatory improvements while it continues to deliberate other issues surrounding market data.

[81] This has been an ongoing concern for SIA. See, e.g., Original SIA Comment Letter and Letter from Marc Lackritz, President, SIA, to Jonathan Katz, Secretary, SEC (Apr. 11, 2000) available at http://www.sia.com/2000_comment_letters/pdf/market_info_fees.pdf.

plans ("Plans"),[82] and enhanced disclosures regarding market data generally. Such increased transparency will provide market participants with a clearer understanding of the reasoning behind changes in market data fees and, therefore, enable market participants to evaluate whether market data is being provided on terms that are "fair and reasonable" and "not unreasonably discriminatory."[83]

1. Improved Process for Setting Market Data Fees

We believe that the SEC could alleviate certain market data concerns if it improved the process by which rates are established. The process should provide all interested parties (exchanges, broker-dealers, vendors, and investors alike) a real opportunity to evaluate, and to provide informed input regarding, any proposed fee changes. To do so, the Commission must eliminate rules that permit fee changes to be made effective upon filing or through pilot procedures.[84] Such provisions allow for only a perfunctory public review of the proposed fees. We do not believe that the Commission's ability to abrogate such proposals translates into a substantive review or challenge to the proposed fees.

In addition to this procedural change, we also believe that the SEC should require the fee filings to provide a detailed description of the purpose of the fee change and a detailed justification for the need to change the fee. To date, market data fees have been changed regularly based on a token description of the need for the change.[85] As a result, we recommend that the SEC adopt a specialized form for fee filings that requires a detailed discussion of relevant fee information, including the amount of the proposed fee, how this differs from existing fees, how the fee will impact different market participants, how this fee will impact revenues received, the need for the fee, and how any additional revenues will be used (or, if it is a reduction, how this will impact operations and, for the time being, regulation).[86] The SEC may then reject any filing that does not provide the requested information in full.

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[82] The three joint industry plans are the CTA Plan, the CQ Plan and the Nasdaq UTP Plan. <u>See</u> Reproposal at 77429, n.21.

[83] Sections 11A(c)(1)(C) and (D) of the Exchange Act.

[84] <u>See</u> Rule 11Aa3-2(c)(3) under the Exchange Act (allowing fee changes, among other things, to be effective upon filing).

[85] <u>See</u>, <u>e.g.</u>, Securities Exchange Act Release No. 44614 (July 30, 2001), 66 Fed. Reg. 41057 (Aug. 6, 2001) (requesting immediate effectiveness of a CTA fee amendment).

[86] We believe that market data revenues should not subsidize regulation. In acknowledgement, however, of the use of market data fees for regulatory purposes to date, we believe that such information would be important for the Commission and other interested parties to consider in connection with a fee filing at this time and until other sources of regulatory funding are agreed upon.

Moreover, going forward, we believe that fee filings should provide a detailed, cost-based discussion of the rationale for any change in fee rates. Specifically, we recommend the SEC require the same type of detailed fee evaluations provided in the 1984 Instinet proceeding against the NASD concerning quotation information for certain OTC securities.[87] This type of information will not only actively engage market participants in the process, but also will encourage the active involvement of the SEC in the process. The accountability created in such a transparent process will help to provide a check on the constant pressure to increase fees.

2. Better Plan Governance

We continue to believe problems related to the level of market data fees are caused, in part, by the opaque governance structure of the Plans. The SEC recognizes this problem and has proposed to address it by amending the Plans to create a non-voting advisory committee.[88] The advisory committee would have the right to submit its views regarding new and modified Plan products, fees, contracts and pilot programs to the Plan operating committee and to attend operating committee meetings (other than executive sessions). The advisory committee would be selected by the Plan operating committee and consist of one representative from each of the following five categories: (1) a broker-dealer with a substantial retail investor customer base, (2) a broker-dealer with a substantial institutional investor customer base, (3) an ATS, (4) a data vendor, and (5) an investor.

We agree with the SEC that broker-dealers, investors and others must have a meaningful way to participate in market data decisions.[89] We believe, however, that the proposed advisory committee is insufficient to reform the operation of the Plans in any material way. Working in a merely advisory capacity, the proposed committee will not have sufficient power to influence the entrenched interests of the operating committee members; the change will be purely cosmetic. The committee must be empowered with the ability to affect the decision-making of the Plans. In addition, the selection of advisory committee members should not be left in the hands of the operating committee. Advisory committee members hand-picked by the operating committee

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87 Instinet brought a proceeding before the Commission asserting that the NASD's fee for full quotation information from all Nasdaq market participants was an unwarranted denial of access to the information. The SEC required the NASD to submit not only the financial statements of Nasdaq for the past five years, but also more detailed data in a number of areas, including a breakdown of the costs of collecting and storing quotation information and a detailed breakdown on how it derived its monthly vendor fee. The Commission found in favor of Instinet, primarily because the NASD had failed to submit an adequate cost-based justification for the fee. See SRO Concept Release; Securities Exchange Act Release No. 20874 (Apr. 17, 1984), 49 Fed. Reg. 17640 (Apr. 24, 1984) (finding for Instinet in NASD fee inquiry).

88 Id. at 77468.

89 Indeed, as exchanges become less member-oriented (through demutualization or through greater board and committee independence requirements), the market cannot rely on the fact that exchanges are member organizations to ensure broker-dealer participation in the process. See, e.g., SRO Governance and Transparency Proposal.

may not be sufficiently impartial to provide the hoped-for checks on the operating committee's actions.

We believe that a more substantial governance change is necessary to genuinely affect the manner in which the Plans operate. As a result, we recommend that the Commission amend the governance structures of the Plans to incorporate the types of changes that have been implemented recently in corporate governance generally.[90] Given the Plans' unique role in the production and dissemination of data that is integral to the proper functioning of the markets, we believe that such good governance of the Plans is of the utmost importance. Specifically, we recommend that the SEC broaden the composition of the Plans' operating committees to include broker-dealer and vendor representation, as well as significant independent investor representation, and amend the Plan voting procedures to recognize this change.

3. Enhanced Disclosure

Information regarding the cost of producing market data and how those revenues are used is closely held by the Plans and their participants. Given that market data is a public good that is an integral part of the national market structure, we believe that this information should be widely disseminated. For instance, SIA believes that annual filings should be made by the Plans and their participants that describe market data expenses and revenues as well as their market data fees, and provide user information (including impact analyses for different categories of data users) and audited financial statements. Such information could be supplemented by independent audits of the networks that disseminate consolidated market information ("Networks").[91] This enhanced disclosure of market data information would allow greater insight into market data fees and better enable market forces to address those fees should conditions so warrant.

The Commission has proposed greater disclosure requirements for SROs in its proposed new Rule 17a-26 and revised Form 1.[92] New Rule 17a-26, for instance, requires quarterly reporting of surveillance program information such as complaints received, investigations, examinations, and enforcement actions; annual reporting of additional items such as regulatory policies and procedures; and the inclusion of an independent third party audit report assessing the

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90 See Securities Exchange Act Release No. 48745 (Nov. 4, 2003), 68 Fed. Reg. 64154 (Nov. 12, 2003) (approving new NYSE and Nasdaq corporate governance listing rules establishing a more comprehensive definition of "independence" for directors, requiring the majority of members on listed companies' boards to satisfy the new independence standard, and mandating and facilitating independent director oversight of functions relating to corporate governance, auditing, director nominations, and compensation). See also SRO Governance and Transparency Proposal.

91 For a description of the Networks, see Reproposal at 77460.

92 SRO Governance and Transparency Proposal.

compliance of electronic SRO trading facility operations.[93] Revised Form 1 requires disclosure of a variety of items relating to regulatory structure, such as a description of the regulatory program, the composition, structure, and responsibilities of committees and executive boards, and a copy of governance guidelines and codes of conducts and ethics, and audited financial statements. [94] The primary focus of the audited financial statements requirement is the budget and revenues devoted to regulatory activities. Although the audited financial statements must disclose revenue related to market information fees, including market data fees, itemized by product,[95] this detail does not require SROs to explain specifically the use of and need for those data fees. In particular, the disclosure requirements fail to adequately account for all market data expenses, both regulatory and non-regulatory, separate and apart from more generalized information technology costs.[96] As a result, we do not believe that these disclosure requirements provide the transparency of market data information at a level necessary to understand the use of and rationale for market data fees or to permit participants to comply meaningfully with the "fair and reasonable" and "not unreasonably discriminatory" statutory requirements. Furthermore, these requirements only apply to the SROs, not the Plans themselves.

As a result, SIA recommends that the Commission enhance the disclosure requirements for market data fees for both the SROs and the Plans. Disclosure related to just the SROs is insufficient. Specifically, we believe that such disclosure requirements should include a complete description of all fees as well as audited financial statements setting forth revenues, expenses, and revenue distributions across SRO and Plan functions. The SROs' and Plans' audited financial statements should set forth financial data itemizing, at a minimum, the revenues earned from market data fees (broken down into fees charged to professional subscribers and retail investors), and the direct and indirect expenses associated with the collection and dissemination of market data.

B. Reduced Administrative Burdens

SIA continues to believe that the SEC needs to address the administrative burdens associated with market data in order to improve market data operations and to bolster the efficacy of steps taken to increase transparency.[97] SIA continues to recommend the creation of a

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93 See Proposed Rule 17a-26 under the Exchange Act, SRO Governance and Transparency Proposal.

94 See Proposed Form 1, Exhibits H, E, F, and I, SRO Governance and Transparency Proposal.

95 See Proposed Form 1, Exhibit I, Section 1.c.i.D, SRO Governance and Transparency Proposal.

96 See Proposed Form 1, Exhibit I, Section 1.c.ii.E, SRO Governance and Transparency Proposal (requesting an accounting of direct regulatory expenses related to information technology, including "data center costs"); Proposed Form 1, Exhibit I, Section 2, SRO Governance and Transparency Proposal (requesting "[a]n itemization of non-regulatory expenses" related to "systems and technology expenses").

97 Original SIA Comment Letter at 27-28.

uniform Network contract, subject to periodic review, and the formation of uniform definitions of fee categories, uniform access, and a uniform system of billing and collection to reduce the inconsistencies across SROs. The SEC can encourage such uniformity by adopting a rule that requires the Plans to work together to create a uniform proposal that would be submitted for public notice and comment. This process also would reveal the significant hidden costs of administering market data systems borne by broker-dealers, thereby increasing transparency for broker-dealers and investors alike. Reducing administrative burdens and costs would be consistent with the general requirements of rulemaking to consider and minimize where possible paperwork burdens[98] and the costs of compliance.

C. Revenue Allocation Formula

SIA appreciates the SEC's efforts to simplify the revenue allocation formula. We believe, however, that the revenue allocation formula, as reproposed, may only serve to create new opportunities for gaming the formula. In particular, it may increase the burdens on Plans, SROs, and firms to process quotes, while failing to address some of the key problems that exist with the current Plan formulas. Therefore, we are concerned that the revised revenue allocation formula will create as many, if not more, market disruptions as the current formulas.

For example, the reproposed formula allocates a portion of market data revenues based on an SRO's quotations in each Network security.[99] SIA is concerned that granting credit for quote generation will create incentives for market participants to game the formula through increased quote traffic. An unwarranted increase in quote traffic will impair market data transparency to the detriment of the markets. Moreover, such increased quote traffic will greatly affect the ability of Plans, SROs, and firms to process these quotes and add to their implementation and administration burdens.

In addition to this increased burden, SIA believes that the revenue allocation formula will not resolve current issues, such as trade shredding. For instance, the trading share calculation excludes transactions that generate less than $5000 in volume, as measured in dollars. This calculation means that a transaction that involves a 100 share trade for a $50 security will be included while a 1000 share trade for a $4 security will be excluded. As a result, this sort of valuing does not reduce the incentive to "shred" trades overall, but shifts the focus to shredding higher priced securities. Such an allocation formula also may encourage higher trading activity in higher priced stocks and discourage trading in lower priced stocks, reducing liquidity in those stocks and thereby impeding price discovery.

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98 See, e.g., 44 U.S.C.A. §§ 3506(c), 3507 (requiring the SEC to consider the burdens of paperwork requirements imposed by the agency).

99 See Reproposal at 77467-68.

These concerns about the revised allocation formula serve to highlight SIA's concerns about the SEC's piecemeal approach to market data issues. Indeed, a revised formula may be entirely unnecessary if other regulatory aspects of market data are addressed. Therefore, we urge the Commission to consider all regulatory issues related to market data as a cohesive whole.

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SIA appreciates this opportunity to address the many issues raised by the Reproposal. We look forward to working with the members of the Commission and the Staff to enhance the U.S. market structure in the months ahead. If you have any questions concerning these comments, or would like to discuss our comments further, please feel free to contact me at 202.216.2000, Don Kittell, Executive Vice President, at 212.608.1500, or Ann Vlcek, Vice President and Associate General Counsel, at 202.216.2000.

Sincerely,

Marc E. Lackritz
President

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