



March 25, 2004

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

Re: File No. S7-10-04

Ladies and Gentlemen:

Brut, LLC (“Brut”)¹ appreciates the opportunity to provide the Securities and Exchange Commission (the “Commission”) a summary of Brut’s intended testimony with respect to Exchange Act Release No. 49325 (the “Proposing Release”),² in which the Commission solicits comment regarding a series of proposals designed to modernize equities market structure collectively known as “Reg NMS”. The summary is related to Brut’s request to testify³ at the Commission’s scheduled public hearings regarding Reg NMS, as described in Exchange Act Release No. 49408.⁴

Please do not hesitate to contact me at (917) 637-2560 regarding this summary, or any other matter related to Brut’s request to testify.

Sincerely yours,

William O’Brien
Chief Operating Officer
Brut, LLC

cc: Sapna C. Patel, Special Counsel, Division of Market Regulation

¹ Brut operates The BRUT ECN System, one of the significant electronic communication networks (“ECNs”) in the Nasdaq market. The company is headquartered in New York City.

² February 26, 2004, 69 Fed. Reg. 11126 (March 9, 2004).

³ See e-mail from William O’Brien, COO, Brut to rule-comments@sec.gov (March 12, 2004).

⁴ March 12, 2004, 69 Fed. Reg. 12876 (March 18, 2004).

SUMMARY OF INTENDED TESTIMONY – REGULATION NMS

The following is a summary of intended testimony of Brut, LLC (“Brut”) with respect to the rule proposals published for comment pursuant to Exchange Act Release No. 49325, collectively known as “Regulation NMS”. The summary is submitted pursuant to Brut’s request to testify at the Commission’s scheduled public hearings regarding Regulation NMS, as described in Exchange Act Release No. 49408.

Introduction

- The Commission and the staff should be commended for their efforts to modernize market structure regulation. No matter what the outcome of these proposals, the dialogue triggered by them is already serving to improve securities markets for the benefit of investors and intermediaries alike.
- While U.S. securities markets are currently the most competitive and liquid in the world, Regulation NMS is perhaps a unique opportunity to set markets on a path to even greater efficiency and quality. Regulatory reforms that remove impediments to competition, and that attempt to solve the challenges of competition in ways that do not diminish it, should be aggressively pursued.
- Two principles should guide the Commission in crafting Regulation NMS to improve our markets while preserving the positive attributes of competition and innovation that currently exist:
 - First, the Commission should be involved solely to the extent that market forces and the self-regulatory structure are inadequate remedies. Where commercial pressures and SRO initiatives are working to alleviate market quality issues, they should be given the chance to do so.
 - Second, any new regulation should be narrowly targeted to focus on directly prohibiting or eliminating the particular conduct or aspect of market structure that is inconsistent with national market system principles. Broad initiatives with uncertain consequences should be rejected where narrowly-tailored methods are available. Complexity should be avoided where simplicity will achieve the objective.
- When viewed in light of these two principles, Regulation NMS as proposed is at best only a partial success, a mix of simple, flexible solutions and overly complex, unnecessarily expansive and needlessly rigid new regulation. This vacillation between promoting fair market competition and imposing a mandated method of market operation needs to be remedied by revising these proposals before their adoption and giving the marketplace generously ample time to prepare.

On Trade-Through Proposal

- Brut applauds the Commission taking action in this area, which has long been warranted. The combination on the current rule's inflexibility, routine non-compliance by floor-based markets and inadequate enforcement by the ITS Plan members have combined to limit the ability of electronic markets to compete for customer order flow in exchange-listed securities.
- With respect to exchange-listed securities, Brut preliminarily believes the proposed approach strikes an appropriate balance between allowing for informed flexibility and the need for investor protection standards:
 - Bringing the rule within the purview of the Exchange Act will provide for strict enforcement against serial violators that is currently lacking.
 - The "opt out" exception, and the conditions for utilizing it, provide a fair framework for allowing informed customers to trade as they feel best serves their duty of best execution. The Commission should consider the disclosure framework of current Rules 11Ac1-5 and 11Ac1-6 when fashioning guidelines for brokers to obtain informed consent from customers.
 - The automated order-execution facility exception gives electronic markets needed leeway to minimize interaction with markets that, for one reason or another, operate on a manual basis. The price limitations on this exception in principle appear to be an appropriate safeguard that investor limit orders placed on such markets will not go completely ignored, although the level of access to these orders would still remain an issue.
 - A strict standard needs to be applied as to what is "automated" under this exception. Any aspect of a facility that could prevent an automated execution at the price and full size of a posted quote should disqualify a facility. Moreover, the Commission should consider an "all or none" approach to whether a market qualifies, given the significant additional complexity if markets only qualify for a portion of the stocks they trade.
- With respect to Nasdaq-listed securities, the high degree of automation and inter-market connectivity appear to make application of the rule irrelevant, imposing significant initial implementation costs and ongoing compliance burdens with no real incremental benefit.

On Market Access Proposal

- The title of these proposals denote the central issue is one of access, not fees. Brut concurs that a need does exist to provide efficient access to all public-displayed quotations on fair terms, both for the provider and the taker of such liquidity. This goal must be accomplished, however, with an absolute minimum level of intervention in private market competition.
- Accordingly, Brut opposes the market access proposal as currently drafted . The proposed access standards would not guarantee brokers means of efficient access to all publicly-displayed quotes. Worse yet, the proposed fee caps would needlessly implement a rate-fixing scheme that would overcompensate for certain trading behaviors and corporate structures, create an un-level playing field, and risk significant reductions in market liquidity and depth.

On Market Access Standards

- The proposed access standards for quoting market centers and quoting market participants, while admirable, would not address the most pressing access issue facing the market today – brokers being required to privately link to a quoting market participant, no matter how small. Market centers with infinitesimal amounts of order flow can currently utilize quotation-display facilities without commensurate execution capability, such as the ADF. This requires vast industry investments to establish private connectivity (or utilize vendors) to access these markets – no matter how small or potentially how fleeting – in order to satisfy best-execution obligations and avoid market disruptions. The level of effort and investment relative to the liquidity on such a market makes such accessibility standards highly inefficient.
- A solution exists to this problem, within the confines of Regulation ATS. ATSS that fall under the 5% Reg ATS threshold that choose to supply quotations to the public-quotation system should be required to do so through a SRO order-execution facility that will provide ample access to said quotation. This would give emerging market centers a fair and reasonable means to participate in the national market system without the ability to impair the operation of fair and orderly markets by their mere existence. SRO participation would also serve to rationalize the fees charged by such markets, given recent SRO initiatives such as Nasdaq’s access fee cap for SuperMontage participants.

On the de Minimis Access Fee Standard

- There is no compelling justification for the government rate-setting this proposal represents. The rationales given for the proposal are either outdated, inaccurate, or could be remedied through far-less intrusive means than this significant displacement of market and competitive forces:
 - Such fees do not cause “distortion” in the marketplace. The Proposing Release acknowledges these fees “have decreased steadily in recent years” and that current rate structures “reward market participants for submitting resting limit orders that give depth” to the market. Competition, lower prices, and greater market depth are hallmarks of market quality, not distortions. Proposed trade-through rule reforms cite encouraging the posting of limit orders as an objective. Current market rate structures do just that.
 - Access fees do not add “non-transparent costs” to securities transactions any more than similar fees charged by exchanges, commissions charged by broker-dealers, or other transaction-related charges assessed by clearing brokers, settlement facilities, and data vendors. Individual investors do not directly absorb these costs and brokers are highly aware of current rates (as the recent rate competition evidences). At most, mandated public disclosure of access-fee rate structures would easily resolve any transparency concerns.
 - The claim that access fees place non-ECN broker-dealers at an unwarranted competitive disadvantage is a myth perpetuated to mask the desire of some firms to lower their transaction costs through regulatory intervention. Market-making firms trading as principal operate under a business model entirely different from that of an electronic market center executing transactions purely on an agency basis. Moreover, said firms currently charge access fees displayed through Nasdaq’s SuperMontage system, with an advantage distinct to that of ECNs and ATSS – having their SRO serve as collection agent for these fees. Again, a far less intrusive remedy – eliminating any proscription under the Quote Rule on said firms charging for direct access to their quotations (subject to the fair access conditions ECNs currently abide by) – could once and for all remove any perceived disadvantages such firms believe exist.
 - Any concern that access fees exacerbate the occurrence of locked markets are alleviated by the proposal to require SROs to develop policies and procedures to prevent such practices from occurring. Brut strongly endorses this proposal as a measured approach to eliminate specific trading behaviors that threaten market quality, as opposed to broad efforts such as those represented by the rate-fixing elements of the proposal.

- While the need for the price-fixing is doubtful, the risks are clear. Commission intervention regarding market center pricing carries with it the possibility of a variety of unintended negative consequences:
 - Lower market liquidity as those who trade in reliance on current market pricing models reduce or refrain from trading in light of the related market disruption. These traders provide valued scale and efficiency to the marketplace, ultimately benefiting the retail investor, and should not be discounted.
 - Potentially wider spreads and less depth as this loss of liquidity translates to less aggressive market-wide quoting.
 - Higher transaction costs for the industry as lower trading volumes reduce scale and increase non-access fee execution costs.

Although the probabilities of these outcomes cannot be reasonably estimated at this time, any such risks are simply not worth running absent a compelling reason for government intervention to set prices, which does not exist here.

- Putting aside overall objections to the rate-fixing proposal, as drafted it would compound the damage by several aspects of its construction:
 - Placing undue emphasis on attributed quotations as a basis for which to grant rights to charge fees. Attribution is an aspect of a quotation which is irrelevant to the average individual investor. Moreover, the definition of “attribution” is far too vague relevant to its importance. Defining attributed quotes as those accepted by the SIP could favor Nasdaq, given the current operation of the UTP Plan.
 - Giving only SROs the ability to “layer” an additional fee on top of that already charged by a broker would give SRO order-execution facilities an unfair competitive advantage over their non-SRO counterparts. This runs counter to recent market structure regulation such as Reg ATS, which gave market centers the right to choose their regulatory classification (broker-dealer or SRO) and compete fairly with one another thereafter.

If the Commission moves forward, these aspects of the proposal must be remedied by (i) allowing all broker-dealers the right to charge for access to their publicly-displayed quotes (attributed or non-attributed) or, in the alternative, defining attributed quotes to cover all such quotes made freely available to the public, whether published by the SIP or otherwise; and (ii) explicitly allowing order-execution facilities that aggregate these quotes, whether regulated as a SRO or broker-dealer, to layer their own charge on top of said fees.

On Sub-Penny Quoting Proposal

- Brut was the first ECN to take steps to actively restrict sub-penny quoting (disallowing it for orders priced \$10 above) on a pilot basis beginning August 4, 2003. Brut further disallowed sub-penny trading for orders priced \$5 and above beginning November 17, 2003. Other market centers have recently followed suit in the wake of Brut's market leadership.
- Accordingly, the sub-penny quoting proposal may be unnecessary, as the market appears to be self-correcting. Regulation to ensure the efficiency of the participation of de minimis market centers in the public quotation (*see* comments under market access proposal) would serve to appropriately manage the risk that a minor market would proliferate sub-penny quotes.

On Market Data Proposal

- The proposed market-data revenue allocation formulas would create a significant risk of disrupting the competition that is beginning to lower the industry's net cost of market data down to reasonable levels.
- Given the Commission's stated frustrations in setting prices for market data, the optimal means to lower industry costs is to allow SROs to compete for the right to collect such data. This economic competition lowers costs for the brokers generating the data, both directly and indirectly.
- Current market data revenue allocation formulas allow SROs to value market data and compete for it with relative ease. Any incentives in these formulas that encourage unnatural trading behavior can be eliminated through outright prohibition, uncompromising enforcement and/or minor modifications to current formulas.
- Brut preliminarily believes the proposed allocation formulas would disrupt and inappropriately alter this competition, through both their general approach and their substance.
- The proposed formulas appear to be designed to encourage certain trading behaviors. Not only would this increase the likelihood of unnatural trading and quoting behavior, it signifies a desire to use market structure regulation to micro-manage market participant behavior, a departure from previous Commission policy and potentially inconsistent with the mandate from Congress under the Securities Act Amendments of 1975.

Brut, LLC
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- The complexity of the formulas may dull competition, as SROs find it practically difficult to value in real-time the market data generated by any one participant with relative comfort.
- As a means to further competition and lower costs, Brut supports the proposals to give SROs greater rights to distribute non-core data and vendors more flexibility to choose what data they display within non-trading applications.

On Implementation of Regulation NMS

- If adopted in anywhere near their current form, the securities industry would have a substantial amount of work to prepare for Regulation NMS. The following are mere examples of projects that would need to be completed before “Reg NMS +1”:
 - SROs would need to revise execution systems and member connectivity.
 - ATSS and ECNs would need to alter routing algorithms, quoting conventions, billing systems, customer communications and inter-market networking.
 - All broker-dealers would need to draft comprehensive, tailored procedures and create compliance regimen to ensure adherence to the new rule set.
 - Vendors would need to re-configure systems to account for new market data display requirements and execution priority rules, updating their time granularity to the microsecond to comply with trade-through and lock/cross rules .

The industry efforts needed for Year 2000 and decimalization compliance are fair comparables as to the scope of the anticipated industry efforts.

- As such, upon adoption of Regulation NMS the Commission should consider allowing for a six to twelve-month period for firms to make the necessary changes to their systems to allow for a fair and thorough implementation.
- During this period, the Commission should give expeditious and deferential treatment to the number of SRO rule proposals that will likely follow in the wake of Regulation NMS, as SROs re-craft their technologies and business practices to compete in the new environment. Quick Commission approval of rule changes necessary to implement these efforts is the only fair way for all parties to proceed on a level playing field.