January 24, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-2001

Subject: Comments to Release No. 34-53024
File No. SR-NASD-2005-095

Dear Ms. Morris:

Pink Sheets LLC ("Pink Sheets") respectfully submits the following comments on amendments proposed by the National Association of Securities Dealers, Inc. (the "NASD") to NASD Rules 6540(c) and 6750. Pink Sheets is the leading provider of pricing and financial information for the over-the-counter ("OTC") securities markets and, among other things, operates an Internet-based, electronic quotation and trade negotiation service for OTC equities and bonds for market makers and other broker-dealers registered under the Securities Exchange Act of 1934 (the "Exchange Act").

I. Introduction

In the NASD's original rule filing in connection with File No. SR-NASD-2005-095, among other things, NASD proposed to amend NASD Rule 6750 to prohibit NASD members from displaying quotations in sub-penny increments in any quotation medium for any OTC Equity Securities with a value of $1.00 or more per share.[1] In its second and most recent rule filing related to File No. SR-NASD-2005-095,[2] NASD has proposed to eliminate the current requirement of NASD Rule 6540(c) that Electronic Communications Networks ("ECNs") and alternative trading systems ("ATSs") display access fees in their displayed OTCBB quotations. NASD proposed the elimination of the access fee display requirement of Rule 6540(c) in response to one commenter on the original proposal who claimed that that the proposed prohibition of sub-penny quotations conflicted with the obligations of any ECN or ATS to include access fees in its OTCBB quotations. Pink Sheets urges the Commission to reject the proposed elimination of the access fee display requirement of Rule 6540(c). In fact, rather than

[1] *See*, Exchange Act Release No. 34-52280 (August 17, 2005).

[2] *See*, Exchange Act Release No. 34-53024 (December 27, 2005).

eliminate this rule, Pink Sheets recommends extending this salutary requirement to all NASD member firm quotations in OTC Equity Securities published in any Interdealer Quotation System, not just the OTCBB. Furthermore, rather than eliminate the requirement of Rule 6540(c) to avoid any conflict with the Rule 6750 sub-penny proposal, Pink Sheets also believes further study is required to determine whether the proposed Rule 6750 sub-penny increment system is in the public interest. As more fully discussed below, Pink Sheets believes that to the extent the elimination of sub-penny quotations in the OTCBB and the display of ECN/ATS fees are mutually exclusive, it is more important that the markets have price transparency (*i.e.*, that all fees be included in displayed prices) than that sub-penny prices be eliminated especially since it appears that the approach in Regulation NMS regarding sub-pennies may not be suitable for the OTC Equity Securities market.

II. Rule 6540(c) Access Fee Display Requirement

We generally support the NASD's efforts to impose restrictions on the display of quotes and orders in specified increments for OTC Equity Securities. We believe that certain such restrictions will promote transparency and foster fair competition in the marketplace for OTC securities. Unfortunately, the NASD's current proposal to eliminate the Rule 6540(c) access fee display requirement for ECNs and ATSs in OTCBB stocks will undermine these salutary objectives, reducing transparency and enabling ECNs, one group of market participants, to obtain an unfair advantage over other market participants. We strongly oppose this proposal and, in fact, urge the Commission to extend the access fee display requirement to all NASD members for quotations in all OTC Equity Securities published in any Interdealer Quotation System, not just the OTCBB.

Problematic History of Access Fees

ECN access fees have been the source of much contention and notoriety in the NASDAQ marketplace. For many years, ECNs enjoyed an advantage over other market participants in the NASDAQ markets because they were able to charge a fee to market makers that accessed ECN quotes. In contrast, market makers were not permitted to charge access fees. However, market makers were forced to access ECN quotes to satisfy best execution obligations.

ECNs exploited this unfair regulatory advantage to charge large fees of their market making competitors, which fees were used in part to reduce fees charged of ECN customers. By this device, orders of ECN customers were subsidized by access fees levied on ECN competitors. ECNs that relied on this business model received more orders from customers than warranted by the quality of their service or competitive pricing. Pink Sheets believes that this is an unfair practice comparable to that seen at the time of the nineteenth-century robber barons when Standard Oil obtained rebates from railroads for oil shipped by its competitors.

Regulation NMS will, among other things, end this unfair practice in the markets that trade National Market System securities. All market participants will be entitled to charge access fees, but those fees will be limited to a fixed percentage. These changes, as well as rules intended to prevent locked and crossed markets and other manipulative practices to generate access fees, will bring to an end a sorry chapter in the history of US trading.

This unfair competitive advantage that Regulation NMS will shortly remedy was corrected in the OTCBB market in 2002 with the adoption of Rule 6540(c) requiring access fees to be incorporated into posted quotes on the OTCBB. This salutary rule enforces the principle that the pricing of securities in the OTC wholesale market should be transparent and equivalent for best execution. ECNs should compete for business in the OTC Equity Securities market by offering services that will encourage customers to use them, rather than profiteering from a regulatory imbalance.

We therefore find it most disturbing that the NASD would reintroduce a regulatory imbalance to the market for OTC Equity Securities that has only now been resolved in the market for NMS securities after a decade of struggle. Pink Sheets believes that NASD's proposed elimination of Rule 6540(c) is an unnecessary accommodation of the views of Archipelago, an ECN that has never been able to successfully compete in the market for OTC Equity Securities and now seeks a regulatory advantage that will completely disrupt this market.

The Current Proposal Radically Changes the OTC Market Structure

The proposed elimination of Rule 6540(c) would fundamentally change the structure of the OTC market by impeding competition, introducing new costs and discouraging trading. The proposed elimination of the access fee display requirement would reverse course and provide ECNs with an unfair competitive advantage over market markers. Worse yet, none of the protections of Regulation NMS engineered with the benefit of hundreds of public comments will work to reduce the harm of this competitive imbalance. NASD Rule 3320 requires NASD members to trade at the prices stated in their quotes, which would appear to require market makers that charge access fees to post them in their quotes, whereas participating ECNs would be free of this burden.[3]

[3] *See*, "Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc., to Allow

The result would be an effective tax on trading with benefits flowing to ECNs, rather than accomplishing any public good. Unfair competition would be reintroduced to the market for OTC Equity Securities, market makers would suffer injury, the market would be less efficient, and the investing public would end up with the bill.

It is true that the proposed Rule 6750 ban on sub-penny amounts would prohibit access fees in sub-penny amounts. It is also true that Regulation NMS allows ECNs to charge access fees in NMS Securities. **However, Regulation NMS does not apply to OTC Equity Securities.** As a result, the protections contained in Regulation NMS to prevent unfair trade practices by ECNs are not part of the rules governing the trading of OTC Equity Securities. In contrast to Regulation NMS, the rules governing the trading of OTC Equity Securities do not level the playing field by permitting market makers to charge access fees not reflected in their quotes. Moreover, the limits on access fees in Regulation NMS intended to prevent ECNs and market makers from price-gouging do not exist in the rules governing OTC Equity Securities.

We believe it is unwise that the NASD seek to introduce such a far reaching and disruptive change to OTC market structure without any of the anti-manipulative access fee rules, the need for which was so painfully made apparent when access fees were introduced with the Limit Order Display Rules for NMS Securities.

Archipelago's Concerns are Exaggerated and Should Not be Regarded

We believe that Archipelago's concerns are exaggerated and its suggestions would disrupt the OTC market to the detriment of the investing public.

- <u>First, Archipelago's position should be viewed in light of its lack of success in the OTCBB market where it has not provided meaningful competition, garnering less than 2% of the OTCBB's share volume in December 2005.</u> Archipelago's support for the rule change appears to be nothing more than an attempt by a noncompetitive firm to acquire an unfair advantage and establish an inequitable regime that benefits it and other ECNs to the detriment of competitive market makers and the OTC market, in general.

- <u>Second, today Archipelago publishes the exact same prices in their Quotation Medium as on the OTCBB Interdealer Quotation System and does not currently charge access fees to non subscribers in the wholesale market to access those prices.</u> Therefore, since Archipelago currently does not incorporate access fees

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Electronic Communications Networks and Alternative Trading Systems to Participate in the Over-The-Counter Bulletin Board," Exchange Act Release No. 34-45915 (May 10, 2002).

in its quotations published on the OTCBB, it has no business model to protect that would be adversely affected by the proposed sub-penny rule. Instead, Archipelago would radically alter the existing OTC market structure to create a regulatory disadvantage for the market participants that trade the other 98% of the share volume in OTCBB securities.

- Finally, a conflict between the NASD's proposed sub-penny rule and the access fee display requirement will not exist in many cases, as many OTC Equity Securities trade at prices less than $1.00 per share. In general, sub-penny access fees could be charged that would be consistent with the sub-penny rule.

We urge the Commission not to introduce an uncompetitive practice into the OTC market to serve the illegitimate interests of an uncompetitive market participant. It is simply disingenuous for Archipelago to claim that market makers profit from "lucrative spreads" and therefore do not need to charge access fees. It is well-known that competition for orders causes market makers to accept risk when they buy or sell securities into inventory at quoted prices; there can be no assurance that a position taken into inventory will be profitable. With the promulgation of Rule 6541 regarding limit order protection for OTCBB securities in 2001, the NASD explicitly rejected any right to earn a spread when matching a limit order as market makers were effectively required to execute customer limit orders with offsetting market orders in OTCBB quoted securities without any spread. Further regulation of market maker limit order handling of limit orders through NASD Rule 2110, IM-2110-2, and market orders through recently adopted Rule 2111 eliminated the possibility that a market maker can profit from a spread by simply matching orders. Accordingly, a market maker's profits must be derived either by charging explicit commissions for order handling or by assuming risk on the order by providing liquidity and taking the customer's position into its inventory.

The fact is that ECNs and market makers each have the ability in the OTC Equity markets to charge customers a commission for order handling, thereby ensuring the receipt of some revenue for handling an order; the decision not to charge customers, or to give them rebates, for submitting an order, as compared to accessing an order, is a matter of business judgment. Competitive pressures may indeed make it difficult to collect sufficient commission revenue to make a profit; but this fact in a free market economy does not justify a regulatory mandate that enables ECNs or market makers to finance their business from access fees levied on non-customers. In contrast to the market for NMS securities, no ECN has a business model that requires it to charge access fees to market participants in the OTC Equity markets. There is no good reason to introduce this anti-competitive practice into the OTC market.

Furthermore, eliminating the access fee display requirements of Rule 6540(c) will serve to undermine the salutary purposes of NASD Rule 6750. Generally, the proposed amendments to Rule 6750 would prohibit firms from quoting prices in increments smaller than $0.01 if such quote is at least $1.00 per share and from quoting prices in increments smaller than $0.0001 per share if such quote is between $0.01 and $1.00 per share. In the first place, the existence of Rule 6540(c) does not conflict with charging sub-penny access fees for OTC Equity Securities priced at less than $1.00 per share, provided that such fees are displayed in the quote. For securities priced at greater than $1.00 per share, sub-penny access fees would result in sub-penny execution prices, thereby defeating the purpose of proposed NASD Rule 6750. For example, if an ECN charges a $0.003 access fee and quotes a $1.00 share price, market makers forced to access this quote would see a price of $1.00, but pay $1.003 for that share. Presumably, market makers would pass this cost along to their customers. This would negate the intended benefit and effect of the proposed amendments to Rule 6750, as investors would pay for their shares in sub-penny increments.[4] Hence, by proposing the elimination of Rule 6540(c), the NASD's proposal drastically weakens its proposal with respect to Rule 6750.

Matters would not be improved by permitting all market participants to charge access fees, even if the elaborate fee limitations of Regulation NMS are applied to the entire OTC market. The removal of Rule 6540(c) would require Pink Sheets to provide a billing facility for market makers to collect access fees that would be charged on top of quoted prices. While the introduction of access fees would be a revenue generating business for Pink Sheets, we are against the introduction of access fees because it would increase transaction costs in the OTC equity securities market. Pink Sheets believes these charges would invariably be passed on to investors, thereby reducing opportunities for profitable trades without any corresponding benefit to the investing public.

We urge the Commission to reject the introduction of an unfair, uncompetitive practice to the OTC market. Hidden access fees are diametrically opposed to the public interest.

III. Rule 6750 Sub-Penny Increments

Pink Sheets believes the NASD's proposal regarding sub-penny increments for OTC Equity Securities, mimicking the approach taken in Regulation NMS, is premature. The

[4] Even if Rule 6750 used a different increment, the deletion of Rule 6540(c) would effectively allow an ECN to charge an access fee of *any* increment on top of their posted quote. Thus, no matter what increment is used, the elimination of Rule 6540(c) would allow ECNs to avoid conforming to the general purpose of that particular increment system of Rule 6750.

OTC market is a negotiated market, so it is preferable that the prices at which broker-dealers receive orders from customers be controlled by business forces and not determined by regulation. Nevertheless, we understand the need to deter uncompetitive practices that artificially resulted in large spreads, as was the case with spreads in the mid-1990s that frequently had increments of $0.25 to $0.50 per share. We generally support the Rule 6750 scheme of requiring quotes to be charged in certain increments. However, we believe that the specific prohibition on sub-penny increments should be modified to reflect a more nuanced approach and provide as much pricing latitude as possible.

Any Sub-Penny Restrictions Should be Applied Only to Display in Interdealer Quotation Systems and not to the Acceptance of Orders nor the Display in a Quotation Medium

The publication of quotations for stocks priced at greater than $1.00 per share should be restricted to $.01 increments in Interdealer Quotation Systems, but there should be no price increment restrictions on the publication of quotations in ECNs and other Quotation Mediums or on the acceptance of orders by market makers.

We do not believe that NASD Rule 2230(g)(2), which prevents NASD members from publishing different quotes for OTC Equity Securities in different quotation mediums, prevents ECNs from charging access fees that can be published in Interdealer Quotation Systems, provided that these access fees are equal to those that are charged to ECN customers. In that case, the price shown in the ECN's Quotation Medium would effectively be equal to the price displayed in the Interdealer Quotation System because the net price shown by the ECN in its own system would reflect its agreement with its customers. It should also be noted that in 2004, the NASD repealed NASD Rule 4613A(e)(1), which similarly prohibited the display of different priced quotations in different Quotation Mediums for NASDAQ securities, on the grounds that these different prices reflected different pools of liquidity and were required to be aggregated under Exchange Act Rule 11Ac1-2 (now NMS Rule 602).[5] Similarly, to the extent that an ECN's published quotation in an Interdealer Quotation System only reflects the same fee that it charges its own customers for access, such quotations and their related access fees are effectively visible to the public, thereby promoting transparency and best execution.

We do not perceive a public benefit from preventing market participants in the OTC markets from accepting orders at any price. For business and competitive reasons,

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[5] See "Notice of filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Repeal Rule 4613A(e)(1) Requiring Same-Priced Quotations on Multiple Markets," SEC Release No. 34-49152 (January 29, 2004).

market participants should be entitled to accept orders in sub-penny increments, rounding the order up or down if they choose to make their quote publicly accessible by displaying it in an Interdealer Quotation System. Market participants may also, for business reasons, refuse to accept such orders. Regulation is not required in this area to protect the markets.

Similarly, ECNs should also be entitled to receive orders in any denomination and publish those orders in their Quotation Medium; however the prices they publicly display in Interdealer Quotation Systems should be rounded up or down to the nearest increment. Any revenue received by the ECN above its customary price for such order execution should be passed along to the customer who submitted the order, thereby encouraging more subscribers and orders; an ECN should only be entitled to retain the same access fee that would be charged to its own customers, which is reflected in its contract with customers and is made a part of its quote for access by non-customers. This would leave ECNs free to develop their own business model without restriction, but would prevent profiteering from a regulatory imbalance. ECNs can elect to charge access fees for non-subscriber access and incorporate those fees when creating the price they publish in Interdealer Quotation Systems, or not charge access fees to non-subscribers, as is the case with Archipelago at the present time. ECNs could also refuse to accept orders outside certain increments to increase liquidity, improve system functioning or for other business reasons.

More Study is Necessary Regarding Tick Sizes in the OTC Market

Pink Sheets believes that tick sizes in the OTC market need to be better understood before the adoption of specific pricing restrictions with respect to OTC Equity Securities such as those restrictions in the NASD's proposed amendment to Rule 6750. Pink Sheets does believe that pricing limitations are necessary. Market participants can communicate trading interest in both price and size in Interdealer Quotation Systems; however, without any limitations on price increments the value of communication with size is overshadowed by the ease at which prices can be marginally topped by a scalper. Regulated increments should balance the competing goals of increasing the display of size while not artificially widening spreads. In the OTCBB and Pink Sheets, market participants rarely publish greater than the minimum quotation size, indicating that larger quote publication increments could increase displayed size and thereby improve the liquidity of the OTC market.

Pink Sheets is working with Professors William G. Christie and Nick Bollen of the Vanderbilt University Graduate School of Management to conduct a test to determine the effect of quote increments on OTC market liquidity. The test will commence during February 2006 in Pink Sheets securities beginning with the letters A through D by implementing tick sizes based on the OTC markets' natural price points. Professors

Christie and Bollen will monitor and study the effects quotation tick sizes have upon liquidity. Based upon preliminary evaluations, it appears that the NASD's proposal regarding Rule 6750 (copying the approach to sub-pennies taken in Regulation NMS) may be overly simplistic and unnecessarily restrictive. Our initial calculations indicate that, for quote prices above $10.00 per share, 97.5% of the inside spreads use whole increments of $0.05, and nearly 91% of trade prices are in whole increments of $0.05. For quote prices above $1.00, but at or below $10.00, 97.4% of the inside spreads use increments of $0.01, and 98.4% of trades use $0.01 increments. For quote prices between $0.10 and $1.00, an increment of $0.005 should be used, as quote and trade clustering is 96.6% for $1.00 quotes and 92.9% for $0.10 quotes. Quote prices at or below $0.10, but above $0.001 use increments of $0.0005 about 84% of the time. Finally, quote prices at or below $0.001 generally use increments of $0.0001.

We do not believe that Regulation NMS accurately reflects OTC Equity Securities market conditions or the needs of market participants. Most NMS stocks do not trade at prices below $1.00 per share, while many OTC Equity Securities trade at such prices. Public discussion and academic studies are lacking in this significant part of the OTC market. There is no need to extend the same logic used in the adoption of Regulations NMS to the market for OTC Equity Securities by adopting the proposed amendments to NASD Rule 6750. The public would benefit from further study with a view to adopting quoted increments that best meet the needs of the investing public.

IV. Recommendations

While we applaud the Commission's efforts to improve the OTC market, we believe that the existing access fee display requirements of Rule 6540(c) prevent an unfair practice and should not be eliminated, but rather extended to include all quotations in OTC Equity Securities displayed in Interdealer Quotation Systems. The Rule 6540(c) display requirements increase transparency, promote fair competition, and facilitate trading. The deletion of Rule 6540(c) will change market structure for the benefit of only a few ECNs at the expense of market makers and investors. It will also weaken Rule 6750, as ECNs can skirt the general intent of the sub-penny prohibition by charging sub-penny access fees on top of their publicly posted quotes. We urge the Commission to reject the proposed changes to NASD Rule 6540(c).

Second, any implementation of increments should only restrict the publication of quotations in Interdealer Quotation Systems, not the acceptance of orders or the publication of quotations in Quotation Mediums.

Third, we believe that the NASD's proposed sub-penny rule may not fit the current needs of the OTC Equity Securities marketplace. It has been argued that the penny increment has destroyed price competition in the NMS market and acts as a "disincentive to submit limit orders of any real size."[6] Whether or not that is true, more study is needed to determine the quote increment that best serves the needs of the investing public in the OTC markets. It is possible that a larger minimum increment would benefit investors by enabling the efficient execution of larger trades.[7] The data we have gathered to date suggests that different quote increments are needed for stocks with different liquidity. Thus, while we support the general idea behind the sub-penny increment, we think further study is required to more accurately reflect the nuances of stock pricing and the needs of the current OTC market.

V. Conclusion

Pink Sheets appreciates the opportunity to provide the Commission with these comments. Please call me if you have any questions or otherwise wish to discuss the views of Pink Sheets expressed in this comment letter.

Very truly yours,

/s/ R. CROMWELL COULSON

R. Cromwell Coulson
Chief Executive Officer

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[6] William G. Christie, *A Minimum Increment Solution*, TRADERS MAGAZINE ONLINE, *available at* http://tradersmagazine.com/articles.cfm?id=1&aid=1743&searchTerm=christie (last accessed January 12, 2006).

[7] *See id*.