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June 30, 2004

BY ELECTRONIC MAIL AND U.S. MAIL

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

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

Dear Mr. Katz:

The American Stock Exchange LLC ("Amex") welcomes the opportunity to offer our observations and comments on the important issues raised by the four interrelated proposals contained within proposed Regulation NMS. We applaud the Commission's goal of exploring ways to modernize the national market system so that the U.S. equity markets will retain their position as the deepest, most liquid and best regulated in the world.

EXECUTIVE SUMMARY

After a brief description of the Amex and its unique role in the U.S. equity markets, we discuss our views on each of the four substantive topics that make up Regulation NMS: (1) trade-through protection, (2) inter-market access, (3) market data, and (4) sub-penny pricing.[1]

I. Background

The Amex has had a long history not only as the premier auction-based market for small- and mid-cap companies, but also as the creator and nurturer of innovative financial products. Companies choose to list on the Amex because of the unique benefits offered by our market structure, which is designed to maximize price discovery and the potential for price improvement, while minimizing volatility caused by temporary order imbalances or the lack of natural liquidity. Our market offers dedicated liquidity providers that enhance liquidity and stability through affirmative obligations to ensure continuous and orderly trading. These liquidity providers are required to maintain a continuous two-sided market (i.e., a fair bid and offer). They are also required to

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1 *See* Exhibit A for a detailed discussion of each of the substantive proposals of Regulation NMS.

moderate price changes between transactions and buy, using their own capital, when there are not enough buyers, and sell from their inventory when there are not enough sellers. Thus, these dedicated liquidity providers are traders of last resort that moderate price movements until natural price equilibrium is reached where, once again, buyers and sellers can meet directly without an intermediary.

For many of the same reasons that companies list on the Amex, our market structure creates an environment that nurtures the growth of new and innovative financial products. These innovative financial products range from a vast array of structured products to exchange-traded funds (commonly known as "ETFs"). Eleven years ago, Amex pioneered the ETF with the introduction of an ETF based on the Standards & Poor's 500® Index, known as the Spiders (Amex: SPY). Since then, ETFs have become a whole new class of securities growing to more than $166 billion in assets. More than ninety-percent of all ETFs are listed on the Amex, including the two most actively traded securities in the world: the Spiders and the ETF based on the Nasdaq 100® Index (Amex: QQQ)). Since the beginning of the year, the Spiders and QQQs on average have combined for daily trading volume in excess of 147 million shares. ETFs were not an instant, overnight success, but thrived, we believe, as a result of being listed and traded on a market with dedicated liquidity providers that have affirmative obligations to enhance liquidity.

II. Trade-Through Protection

A. Uniform Trade-Through Rule

In 1975, when Congress directed the Commission to facilitate the establishment of a national market system, Congress envisioned an eclectic, rather than single monolithic, system that would draw on the strengths of each type of market place.[2] Without specifying a structure, Congress articulated the basic tenets of the national market system as fostering efficiency, enhancing fair competition, increasing price transparency, achieving best execution, and facilitating direct interaction of investor orders, when consistent with the other four principles.[3] Three years later, to facilitate best execution, provide nationwide price protection, and to increase quote competition, the first "trade-through" rules were adopted for securities listed on the Amex and New York Stock Exchange. These rules generally prohibit one market from executing a trade

[2] Securities Exchange Act of 1934, § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2)(2004)(added by the Securities Act Amendments of 1975, Pub. L. No. 94-29, § 7, 89 Stat. 111 (1975)); Securities Exchange Act Release No. 15671 (Mar. 22, 1979), 44 Fed. Reg. 20360 at note 3 (Apr. 4, 1979) ("Congress did not intend that the Commission dictate the ultimate configuration of the National Market System or, through regulatory fiat, force all trading into a particular mold").

[3] 15 U.S.C. §11A(a)(1)(2004).

for a security at an inferior price when another market displays a better price for the same security.[4]

The Amex supports the Commission's proposal to extend trade-through protection beyond exchange-listed securities to all national market system ("NMS") stocks. For exchange-listed stocks, trade-through protection currently guarantees that investors—large and small, sophisticated and novice, trading for their own account or trading through a representative—all obtain the best price regardless of the market where those orders are sent. Equally important, trade-through protection encourages competitive price discovery across markets by ensuring that an investor that posts the national best-priced limit order does not have his or her order ignored. At its core, a trade-through rule provides essential customer protection by ensuring that investors always get the best price available for their trades. Such a rule also facilitates a fair and orderly market by decreasing the harmful effects of market fragmentation and the disorder caused by different groups of traders paying different prices for the same securities at the same, or virtually the same, time. Thus, we believe that a uniform trade-through rule, with the best-price assurance it affords, provides critical investor protection and enhances investors' confidence in the fairness and integrity of the U.S. equity markets. This is the heart of the national market system.

B. Proposed Exceptions to the Uniform Trade-Through Rule

In addition to establishing a uniform trade-through rule, the Commission also proposes codifying a number of existing exceptions to the current trade-through rules as well as creating two new exceptions. One proposed new exception turns on whether a particular market or its quotes are automatically accessible. The other proposed new exception would allow "informed" investors to "opt-out" of the best-price protection of the trade-through rule.

1. Exception for Markets or Quotes that are Not Automatically Accessible

As to the exception related to whether a particular market or its quotes are automatically accessible, the Commission initially proposed allowing "automated execution facilities" (or so-called "fast" markets) to trade through, up to certain price limits, the better prices posted on non-automated execution facilities (or so-called "slow" markets). The SEC maintains that this "exception is designed to reflect the comparative difficulty of accessing market quotes from non-automated markets, and to adjust the trade through requirements to these differences."[5] In its supplemental release, the Commission

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4 E.g., Amex Rule 239, Amex Guide (CCH) ¶9359 (2004).

5 Securities Exchange Act Release No. 49325, *Regulation NMS* (Feb. 26, 2004), 69 Fed. Reg. 11125, 11140 (Mar. 9, 2004).

also requested comment on whether the proposed exception should apply to individual quotes, rather than entire markets.[6]

We oppose the version of the exception that would allow all "fast" markets to trade through better priced quotes of "slow" markets regardless of whether the particular quote at issue is, in fact, readily accessible. The "fast market-slow market" dichotomy is overbroad and not sufficiently tailored to address the Commission's articulated concern: inaccessible quotes. In contrast, the alternative version of the exception, which focuses on individual quotes (the "quote-by-quote" exception) appears more appropriately gauged to address the Commission's concern regarding the inaccessibility of quotes and the related impact of that inaccessibility on effective and efficient integration of pools of liquidity across different markets. Therefore, subject to an appropriate and responsible industry-wide rollout through a pilot program, we support a quote-by-quote exception that would require all markets to indicate whether a particular quote is immediately accessible through an automated execution facility. If a quote is not designated as immediately accessible, then the party routing the order could trade through, up to certain limits, the better priced but inaccessible quote of another market.[7] Of course, the party routing an order that trades through another market pursuant to the quote-by-quote exception would still have to otherwise fulfill his or her best execution obligations.[8]

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6 Securities Exchange Act Release No. 49749, *Regulation NMS: Supplemental Request for Comment* (May 20, 2004), 69 Fed. Reg. 30142, 30143 (May 26, 2004).

7 For purposes of the quote-by-quote exception, we support defining an "automated execution facility" as one that provides an immediate, automated response (i.e., a response without any human or manual intervention) to the router of an incoming order. For purposes of this exception, we believe a "response" should include either (1) an order execution (in full or in part) or (2) a reply that the order was not executed. However, we oppose the Commission dictating performance standards as part of this exception. We believe that rule-based performance standards (1) would set a floor, not a ceiling, (2) would rapidly become antiquated, (3) would lead to endless disputes and litigation even if meticulously drafted, and (4) would remove competitive incentives to innovate and differentiate based on speed. In our view, while aspirational industry standards may initially provide useful rules of thumb, only as a last resort should the Commission mandate performance standards by rule. In any event, if the Commission determines to impose rule-based performance standards, we request the phasing in of such standards to give all market participants sufficient time to develop and implement technology to meet those standards.

8 As is clear from the Commission's proposing release, any proposed exceptions to the trade-through rule would not provide a safe-harbor from broker-dealers otherwise fulfilling their fiduciary duty to obtain best execution for their customers. The duty of best execution predates the federal securities laws and stems from common law agency obligations whereby an agent owes his or her principal undivided loyalty and reasonable care. *Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 270 (3d Cir. 1998) ("Since it is understood by all that the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected

We support a pilot program for the quote-by-quote exception not only for public policy reasons, but also for practical considerations. First, in addition to being more appropriately gauged to address the Commission's concern regarding the inaccessibility of quotes, the quote-by-quote approach implicitly recognizes that securities with different characteristics trade differently (e.g., actively-traded or derivatively-priced securities trade differently from inactively-traded securities). By focusing on quotes rather than entire markets, the SEC appropriately allows more flexibility for market centers to compete more fairly with one another notwithstanding different market structures that may cater to different types of listed companies and securities. Such an approach is also more consistent with the Commission's mandate from Congress to facilitate fair competition between and among markets.

Second, the quote-by-quote approach can accommodate hybrid markets and lends itself more easily to responsible industry-wide rollout. Requiring immediate, automatic accessibility of quotes as a pre-condition for trade-through protection is a dramatic industry-wide change. In some regards developing and implementing the relevant technology is the easy part. The more difficult challenge is to create an effective hybrid model that responsibly integrates automatic execution functionality into market models, like the Amex, that are designed to maximize price discovery and improvement, while minimizing price volatility. Further, one type of hybrid model may not be optimal for all securities. For example, the appropriate hybrid model for the most actively-traded and derivatively-priced securities is unlikely to be the optimal model for less liquid securities, which rely more heavily on price discovery and stability offered by dedicated liquidity providers.

Therefore, we propose phasing in the quote-by-quote exception through a pilot program, starting with the most actively-traded securities and progressively expanding the exception, in traunches, to less actively-traded securities.[9] Sequencing the implementation of the quote-by-quote exception provides two benefits. First, sequencing allows all market participants to make required technological and business model changes. Second, of equal importance, industry-wide phasing in of the exception through a pilot program would provide the Commission with empirical evidence on whether the

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to use reasonable efforts to maximize the economic benefit to the client in each transaction."). Therefore, broker-dealers must continue to meet their basic best execution obligations to regularly and rigorously review the execution quality of markets to which they direct orders and must direct orders to the markets with the best execution quality. And, even with a quote-by-quote exception, we believe that broker-dealers would still have to regularly and rigorously assess the executions offered by markets whose quotes are not immediately accessible, in whole or in part.

[9] We propose starting with the most actively-traded securities because they are generally less reliant on dedicated liquidity providers except at times of market stress; and, at least for actively-traded ETFs, may rely on price discovery in the futures, rather than the securities, markets.

exception creates unintended consequences, such as increased spreads for illiquid securities, decreased execution quality, or increased volatility and perceived disorder. Armed with empirical data while phasing in a pilot program for the exception, the Commission would have the opportunity to respond to, and adjust for, any unanticipated consequences that might undermine investor confidence, increase the cost of capital for small- and mid-cap companies, or discourage the development of new, innovative products.

2. Exception for "Informed" Investors to "Opt-Out"

As to the proposed exception for "informed" investors, we have serious concerns about, and oppose, the SEC's proposal to allow institutions and other traders to "opt out" trade-by-trade of the best-price protection provided by the trade-through rule. We believe that there is no justification to adopt this exception, especially if traders know (as they would with the adoption of the quote-by-quote exception) before an order is sent whether a displayed price is immediately accessible; and, once the order is sent would receive an immediate, automatic response as to whether the order was filled.

As the Commission concedes in its proposing release: "The price at which an order can be executed is of paramount importance for most investors…."[10] In fact, the American Association of Retired Persons recently conducted a survey of investors aged 50 and over and found that nearly two thirds said that price—not the balancing of price with speed—was the number one priority when conducting transactions.[11] However, under the current proposed opt-out exception, institutions and traders wanting to sacrifice the best price (for themselves or their ultimate customers) for idiosyncratic reasons could. And those trades would occur at the expense of other investors who, without their consent, would have their better-priced limit orders passed over. Thus, in effect, the proposed opt-out provision allows the interests of a small group of traders who prefer speed to trump the interests of the vast majority of investors who expect to receive the best price.

We also believe that the opt-out exception would undermine market integrity and investor confidence by increasing disorder and confusion caused by disjoined groups of traders paying different prices for the same security at the same time. Thus, the opt-out exception would undermine one of the fundamental purposes of the trade-through rule: to ensure that buyers and sellers in one market compete head-to-head, based on price with buyers and sellers in other markets. The proposal also creates an economic incentive for an unscrupulous broker to convince an investor to opt out so that the broker can fill the

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10 *Regulation NMS Release* at 11153.

11 AARP, *Investor Perceptions and Preferences Toward Selected Stock Market Conditions and Practices: An AARP Survey of Stock Owners Ages 50 and Older* (Mar. 2004).

investor's order internally at an inferior price, pocketing the difference. Finally, if the Commission adopts the quote-by-quote exception to the trade-through rule, we see no reason why anyone should be allowed to trade through an automatically accessible better price. Simply stated, we think the proposed opt-out is unnecessary if the quote-by-quote exception is adopted and wrong as a matter of public policy.

III. Inter-Market Access

Amex agrees with the Commission that fair access to the best prices available across competing market centers is essential to achieve an efficient, transparent national market system where markets vigorously compete and, as a result, investors' orders have the opportunity to interact directly and receive best execution. Essential to that competition is the ability for one market to see and have fair and efficient access to another market's best bids and offers. Hidden markets with hidden prices or undisclosed fees undermine fair competition and access. Thus, we agree with the Commission that even when quoted prices are not hidden, published quotes do not necessarily reflect the true price available to investors because of access fees charged by electronic communication networks ("ECNs") to non-subscribers. These types of access fees not only undermine transparency, but also—when used to fund liquidity rebate programs—degrade market quality by encouraging the locking and crossing of markets. Such behavior undermines the basic tenets of the national market system.

However, we believe that the Commission's proposed solution of placing a "de minimis" cap on access fees fails to address the fundamental problem with access fees imposed on non-subscribers and is over-inclusive, as drafted. First, we question whether the Commission's proposed solution of fixing maximum rates for access to quotes moves us any closer to true fair access across markets. Instead, we believe that the proposal not only places the Commission in the unfamiliar role of rate maker, but also fails to directly address the fundamental problem: ECNs charging market participants, ***with whom they have no contractual or other relationship***, a surcharge to access the ECNs' quotes. Then, pursuant to what these market participants perceive as their best execution obligations to their customers, they believe that they are, in effect, forced to access the ECNs' prices and pay any additional charges that the ECNs wish to impose. This is akin to a private entity placing a toll booth on a public highway.

Second, rather than focusing on the questionable activity—imposing a surcharge on parties unilaterally—the proposed rule also appears to reach transaction and other fees charged by self-regulatory organizations ("SROs") and other market centers to their members and subscribers. Transaction and other fees charged by SROs (or even access fees charged by ECNs to their subscribers) are fundamentally different from access fees ECNs charge to non-subscribers. At the most basic level, transaction and other fees charged by SROs and other market centers to their members and subscribers are consented to (i.e., bi-lateral) and tied to services provided. For example, the Amex has a market structure and applicable rules designed to establish fair prices on open and close, facilitate single-priced auctions, manage market imbalances, reduce daily stock-price volatility, and provide dedicated liquidity. And unlike ECNs, SROs like the Amex have obligations not only to ensure that their members comply with the federal securities laws, but also to adopt and enforce rules to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors and the public interest.

Thus, we believe it is fundamentally unfair to allow market centers to access the quotes of other market centers at prices set by the Commission—and not the marketplace itself—without commensurate obligations to provide dedicated liquidity and regulatory services. Such an approach fails to acknowledge that there are different levels of service and responsibilities (regulatory and otherwise) provided by market centers for which members, subscribers, and investors are willing to pay.

As to the Commission's proposal related to Regulation ATS, we oppose merely lowering the fair access standard of Regulation ATS from 20 to 5 percent of trading volume. Instead, we believe that the first step in true fair access is to mandate fair access by all alternative trading systems ("ATSs") regardless of the percentage of their trading volume. And, to minimize the cost to other market participants for obtaining access to ATSs with trading volume below 5 percent we propose requiring that those ATSs display and make available their quotes through an SRO. Finally, to facilitate fair access and enhance transparency, we urge the Commission to eliminate the loophole in Regulation ATS that allows an ATS to avoid disseminating its quotes into the national market system by "going dark" (i.e., not even displaying subscribers' quotes to other subscribers). We believe that the above-described steps would advance the goal of eliminating hidden markets with hidden prices, which undermines fair competition between market centers and fair and efficient access to all best bids and offers.

IV. Market Data

A. Collecting, Consolidating, and Disseminating Market Data

One of the fundamental achievements of the national market system is wide-spread, public accessibility of reliable consolidated market information, including real-time access to the national best quotes for, and trades in, NMS stocks. Collecting, consolidating, and disseminating real-time market information across all market centers nationwide enhances transparency and competition. Of equal importance, real-time dissemination of market data arms investors with information essential to (1) make more informed decisions when placing limit orders, (2) monitor the quality of their trade executions, and (3) evaluate the performance of the market professionals executing trades on their behalf.

As such, we support codifying the requirement that all SROs must participate in, and act together through, joint-industry plans that ensure the collection and dissemination of real-time "core" consolidated market information—the national best bid and offer ("NBBO") and time and sale data—to the public through a single processor for each NMS stock. However, we oppose (1) reducing the type of information included in the consolidated display, (2) limiting the circumstances under which investors must receive consolidated market information, or (3) allowing market centers to sell duplicative core market data independent of the joint-industry plans. We believe that these three proposed changes will not enhance transparency for investors, but will increase the risk of disseminating incomplete, non-sequential market data that will confuse investors and complicate the management of market data for vendors and broker-dealers.

First, as to the proposed definition of "consolidated display," the Commission suggests eliminating the current requirement that the display must include a complete montage of quotes from all reporting market centers trading a particular security. We oppose this change because we believe that the complete montage provides valuable information to investors, especially in the era of decimalization. For example, two market centers could be quoting minimum depth at the NBBO, while a third market center is quoting substantial depth not at, but close to, the NBBO. An investor wanting to execute a large trade but only receiving information constituting the newly defined consolidated display would arguably lack the most significant piece of information to that investor: the substantial depth being offered close to the NBBO by the third market center. Thus, we believe that requiring the consolidated display to include a complete montage of quotes from all reporting market centers provides essential transparency to investors and should continue.

Second, the Commission appears to have potentially narrowed the circumstances under which investors must receive the consolidated display to only situations "in which a trading or order-routing decision can be implemented."[12] In our view, any display of market data can lead to a trading decision (including a decision not to trade), and we believe that investors should make all trading decisions based on market information that is as complete as possible. Therefore, we are concerned that broker-dealers or others could unintentionally provide incomplete or skewed market data to investors upon which those investors may make preliminary investment decisions. And only when those investors actually access a system to place or route an order (if they are able to do so at a reasonable cost under this new regime) would the complete picture of the market come to light through the consolidated display.[13]

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12 *Regulation NMS Release* at 11209.

13 In the alternative, if the Commission continues to believe that it is appropriate to narrow the circumstances under which investors must receive the consolidated display, we believe that the Commission should make explicit that broker-dealers must provide their customers with

Third, we support fostering innovation and competition between markets by allowing market centers to develop and independently sell ancillary, non-core information (such as their depth of book) with as little regulation as possible and without requiring dissemination through a specific consolidator. However, we are concerned that allowing market centers to independently sell duplicative core market data will diminish transparency for investors. For example, notwithstanding best intentions to the contrary, a risk exists that independently disseminated, unconsolidated quotes would not reach vendors simultaneously with the consolidated NBBO. As a result of mismatches between the NBBO and independently disseminated quotes, we believe that the appearance of a disorderly, incongruent market will increase as will investor confusion.

In addition, combining the proposed independent sale of core data with the narrowing of the definition of the consolidated display creates the risk of anti-competitive practices with respect to the joint-industry plan for NASDAQ securities. Unlike the plans for exchange-listed securities, the joint-industry plan for securities traded on NASDAQ allows subscribers to either purchase (1) the last sale and the NBBO (so-called "Level 1" service) or (2) the quotes of each market maker and exchange with unlisted trading privileges in addition to Level 1 data ("Level 2" service). Thus, not requiring the quotes of other market centers as part of the consolidated display could lead to a scenario where NASDAQ charges little or nothing for the quotes of its market makers. This could create a strong economic incentive for subscribers to only purchase Level 1 data and obtain market maker quotes directly from NASDAQ. As a result, these subscribers would not obtain the quotes of exchanges with unlisted trading privileges. We believe that such an outcome would deprive investors of essential information from exchanges with unlisted trading privileges, such as substantial depth being offered close to the NBBO, and would lessen competition among markets in NASDAQ securities to the detriment of investors.[14]

B. Governance of Market Data Plans

The Amex supports the creation of non-voting advisory committees to participate in network operating committee meetings. We believe that advisory committees will give a formal voice to the key constituencies that have historically provided informal input: investors and their representatives, alternative trading venues, and data vendors.

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information from the consolidated display every time a registered representative deals directly with a customer in connection with a trading or order-routing decision or a customer receives market data directly from the broker-dealer.

[14] No similar problem exists for exchange-listed stocks because the joint-industry plans for these securities provide all subscribers with the same data (i.e., last sale and all quotation information together) and the current governance structure of these plans make changes unlikely because unanimity of plan participants is required.

To make the advisory committees as effective as possible, we also support granting advisory committee members the ability to receive the same materials as operating committee members and to attend and participate in all operating committee meetings (with the exception of executive sessions).

C. Distribution of Market Data Revenue

As to the distribution of market data revenue, the Amex strongly endorses the Commission's goal of revising existing distribution formulas to remove or diminish economic incentives for trading practices that degrade the accuracy and usefulness of market data, confuse investors, and unnecessarily increase message traffic for all market participants. The current distribution formulas, with their myopic focus on trades alone, create incentives for "gaming" through fraudulent, deceptive, or market-distorting trading practices driven by the desire to capture data revenue.[15] Thus, we strongly support the Commission's proposed revisions to the distribution formula, with some minor adjustments, as a thoughtful, innovative mechanism to discourage deceptive and market-distorting trading practices while encouraging enhanced liquidity and price discovery.[16]

We agree with the Commission that the proposed formula appears relatively complex. Nevertheless, the network processors already capture all of the essential data needed to implement the formula (except for the portion of the formula related to price improving quotes, which we recommend that the SEC not adopt). Likewise, the formula easily can be programmed into a computer without the component related to price improving quotes. And, regardless of its perceived complexity, the only parties that need to deal directly with the formula are the network processors and the professionals auditing the calculation and distribution of market data revenue. What must not be lost in the debate on the details of the proposed formula is its most compelling attribute: The formula encourages market transparency and liquidity by rewarding quoting at the national best price.

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[15] Such practices include: "wash trading," "tape shredding," and "print facilities." Wash trading occurs when traders purchase and sell the same security at the same time or within a short period of time in non bona-fide transactions to create the false or misleading appearance of active trading. Trade shredding occurs when a single order is divided into multiple, smaller orders to increase the allocation of market data revenue. And, a so-called print facility is an SRO that rebates a portion of its market data revenue to market makers and ATSs for reporting their trades through the SRO, but those entities otherwise have little or no relationship with the SRO and may even display quotes through a second SRO. Thus, print facilities not only confuse investors about the actual location of liquidity, but also complicate regulatory and surveillance efforts by obscuring where a trade actually occurred.

[16] *See* Exhibit A at 17-20 for a detailed discussion of the suggested adjustments to the revised formula.

V. Sub-Penny Pricing

Amex believes that the Commission's proposal that would prohibit market participants from ranking, displaying, or accepting orders, quotes, or indications of interest in sub-pennies does not go far enough. Sub-penny quoting diminishes market transparency and depth and degrades price priority by allowing orders offering economically meaningless price improvement to step in front of resting limit orders. Therefore, we believe that the prohibition against sub-penny quoting should extend to all NMS stocks, including stock trading below $1.00. We also believe that the Commission should ban trading in sub-pennies except for the reporting or "printing" of trades resulting from pricing mid-point, volume-weighted average, or other similar trades, so long as the trades do not otherwise violate the prohibition against quoting in sub-pennies.

In addition to banning sub-penny quoting and allowing sub-penny trading only under limited circumstances, we believe that the Commission should take this opportunity to reassess whether "one-size-fits-all" with respect to minimum tick size. Professor William Christie who, along with Professor Paul Schultz, in 1994 suggested that NASDAQ market makers were maintaining artificially wide spreads, is now suggesting re-evaluating the penny tick size.[17] He contends, and we believe, that a penny creates such a small pricing increment that it destroys the critical roles played by price priority and limit orders. A penny tick size, like sub-penny quoting, encourages gaming whereby economically meaningless price improvement is used to step in front of existing limit orders. Professor Christie has suggested considering a minimum tick size of $0.05.[18] We agree, especially for appropriate, high-priced securities.

VI. Conclusion

Thirty years ago when setting out the basic tenets of a national market system, Congress knew then—and it is equally applicable today—that when it comes to market structure "one-size-does-not-fit-all" and neither Congress nor the Commission should pick winners and losers, either explicitly or implicitly. In the coming weeks and months as the debate on market structure and Regulation NMS continues, we urge the Commission to turn back to these core principles and remember the important and unique role that auction markets and their dedicated liquidity providers play in facilitating capital formation for small- and mid-cap companies and in nurturing innovative financial products. Ultimately, investors, listed companies, and innovative financial products all benefit from vigorous but fair competition between diverse market centers offering value-added services.

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17 William G. Christie, *A Minimum Increment Solution*, TRADERS, Nov. 2003, at 40.

18 *Id.*

Thank you for giving us the opportunity to express our views on these important proposed rules. If the Commission or members of its staff have questions concerning any matters raised in this letter, please contact me at (212) 306-1000.

Sincerely,

/s/ Salvatore F. Sodano

Salvatore F. Sodano

cc: The Hon. William Donaldson, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Cynthia Glassman, Commissioner
The Hon. Harvey Goldschmid, Commissioner
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation

EXHIBIT A

To Regulation NMS Comment Letter
Of
American Stock Exchange LLC

Re: **<u>File No. S7-10-04 (Regulation NMS; Proposed Rule)</u>**

The American Stock Exchange LLC ("Amex" or "Exchange") respectfully submits the following comments with respect to File No. S7-10-04 (Regulation NMS; Proposed Rule)[1], in which the Securities and Exchange Commission (the "Commission") proposes new Regulation NMS. This rule would redesignate the existing national market system ("NMS") rules adopted under Section 11A of the Securities Exchange Act of 1934 (the "Exchange Act") and would incorporate four substantive proposals relating to changes in the regulatory structure of the U.S. equity markets. Specifically, the Proposing Release addresses and seeks comments on (1) a uniform trade through rule for all NMS market centers ("Trade Through Rule"); (2) amendments to the rules and joint industry plans for disseminating market information to the public, including modification of the formulas for allocating plan net income; (3) a market access rule regarding the terms of access to quotations and execution of orders in the NMS; and (4) a prohibition against sub-penny quoting. The Amex has arranged its comments herein to address each of these substantive proposals separately

For the convenience of the reader who only wishes to review the comments relating to a specific substantive area, the following page index may be helpful:

Uniform Trade Through Rule Proposal

1. <u>The Exchange Supports the Proposed Uniform Trade Through Rule for Exchange and Nasdaq Listed Securities with Minor Modifications to the Automated Order Execution Facilities Exception and the Elimination of the Opt Out Order Exception Since a Uniform Trade Through Rule Would Enhance Investor Protection, Market Integrity and Price Discovery</u>

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[1] Securities Exchange Act Release No. 49325 (February 26, 2004), 69 Fed. Reg. 11125 (March 9, 2004) (the "Proposing Release"). Securities Exchange Act Release No. 49749, (May 20, 2004), 69 Fed. Reg. 30142 (May 26, 2004) (the "Supplemental Release").

Proposed Regulation 611 (the uniform Trade Through Rule) would require order execution facilities, exchanges and securities associations to establish and enforce procedures to prevent trade throughs in their markets, subject to nine exceptions. In most respects, the proposed Trade Through Rule and its exceptions resemble the Exchange's existing ITS trade through rules that were adopted in 1981.[2] Exceptions (b)(1) through (b)(7) to the proposed Trade Through Rule, in fact, track existing exceptions to the Exchange's ITS trade through rule.[3] The Exchange, accordingly, already operates largely in compliance with the proposed uniform Trade Through Rule and we, therefore, will direct most of our comments towards (1) the two proposed exceptions that do not find their origin in the ITS trade through rule (the "opt out orders" and "automated order execution facilities" exceptions) and, (2) other new features of the proposed rule. In sum:

(1) We support the proposed uniform Trade Through Rule;

(2) We support the proposed "automated order execution facilities" exception, provided: (a) it is structured as a "quote by quote" exception, and (b) the implementation of the exception is delayed for an appropriate period to time to allow markets and participants to develop systems to comply with the new rule, and (c) the exception is implemented as a pilot program that is phased in over time so that the Commission can assess its impact on investors and the market;

(3) We oppose the opt out exception as contrary to basic principles of investor protection, price discovery and market integrity;

(4) We believe that the proposed Trade Through Rule should extend to trading in Nasdaq securities.

The absence of a trade though rule in the Nasdaq market is a historical accident that dates to the time when there was no last sale reporting in Nasdaq and quotes were indicative and "one-up." Since Nasdaq is no longer a disorganized "over the counter" telephone market and seeks exchange registration, it should be subject to the same rules applicable to other exchanges. The "law" governing Nasdaq, thus, should catch up with the economic reality that Nasdaq is a securities exchange. We see no principled reason why the customer protection, price discovery and market integrity principles which underlie the Trade Through Rule should not extend to the market for Nasdaq stocks and the investors that trade them.

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[2] Amex Rule 236.

[3] Proposed exceptions (b)(1) and (b)(2) are comparable to existing Amex rule 236(b)(3)(B); proposed exception (b)(3) is comparable to Amex rule 236(b)(3)(C); proposed exception (b)(4) is comparable to Amex rules 236(b)(3)(D) and (E); proposed exception (b)(5) is comparable to Amex rule 236(e); proposed exception (b)(6) is comparable to Amex rule 236(b)(3)(F); proposed exception (b)(7) is comparable to Amex rules 236(a)(4), Commentary .01 and 236(b)(3)(G).

2. The Proposed "Order by Order" Formulation of the Automated Order Execution Facilities Exception Will Encourage Floor Based Exchanges to Develop Hybrid Markets that Combine the Best of Automatic Execution with the Ability of Auction Markets to Protect Investors by Providing Liquidity and Minimizing Volatility

The Exchange has heard the Commission's call to automate order processing embodied in the proposed Trade Through Rule and other provisions of Regulation NMS, and we are diligently working to create a hybrid market that automates the execution of trades that can be executed within the displayed bid and offer while maintaining the key benefits of the auction market, including the ability to minimize volatility by providing liquidity when there are temporary order imbalances, and provide market clearing single price call auctions on openings, reopenings and closings. The hybrid market that will result from this effort will preserve the price discovery that occurs on agency auction markets, protect investors by providing automatic execution against displayed quotes, and provide vigorous competition against other markets and market structures to the benefit of investors.

The proposed enhancements will require significant changes to the Exchange's systems. For example, floor brokers and registered traders will have to interact directly and electronically with the order book, the quote and other market participants, auto-ex functionality will have to be enhanced to reduce the situations when it is unavailable, and quote updates will have to be automated. These changes will be made in a way that preserves the ability of auction markets to provide liquidity, minimize volatility and produce single price, market clearing trades. The changes, moreover, will require changes to the Exchange's existing trading rules. The Exchange, therefore, urges the Commission to delay the implementation of the proposed automated order execution facilities exception to the Trade Through rule until the Exchange and other agency/auction markets have had sufficient time to implement required rule and system changes necessary to create new hybrid markets. As the Commission noted in the proposing release, "if ultimately adopted, the rule proposals would effect fundamental innovations in the nation's equity markets."[4] In view of the fundamental changes contemplated by the proposed rules, the Commission needs to give the most affected markets sufficient time to make the necessary changes to adjust to the new regimen.

Significant regulatory actions can have significant unintended consequences. For example, the adoption of the ECN Display Alternative[5] along with the order handling rules fundamentally changed the trading of Nasdaq stocks, and the Commission's belated enforcement of the requirement in Regulation ATS that Island make its quotes available resulted in Island "going dark" and creating a true invisible market. In addition, while the Commission previously permitted trades throughs in the three most actively traded ETFs, the common stock of business corporations is not a derivative security and the

[4] 69 Fed. Reg. at 11127.

[5] Rule 11Ac1-1(c)(5)(i).

Commission's experience with the three ETFs is not a meaningful indicator of the effects of the proposed rule. Therefore, the Commission should apply the automated order execution facility exception on a pilot basis to a selected group of actively and inactively traded common stocks and compare changes in market quality against a control group of similar securities to assess the results of the changes on different securities.[6]

The following section of our discussion will respond to various questions that the Commission asked in the Proposing and Supplemental Releases about the automated order execution facility exception.

Question: The Commission requests comment as to whether the exception from the proposed Trade Through Rule should apply to quotes that are not immediately accessible through an Auto-Ex Facility (a manual or non-automated quote), rather than providing an overall exception for a manual market.[7]

Response: Exception (b)(9) to the proposed Trade Through Rule as originally proposed would have allowed an "automated order execution facility" (an "automated" market) to trade through a non-automated order execution facility (a "manual" market) up to specified "trade through limit amounts" that varied according to the price of the security. In the Supplemental Release, the Commission suggested that it might be better to distinguish between manual and automated quotes,[8] rather than manual and automated markets.

The Exchange supports the "quote by quote" formulation of the automated order execution facility exception to the proposed Trade Through Rule. The quote by quote exception addresses both the Commission's concern that displayed quotations should be available to automatic execution and avoids inflexible and overbroad classifications of markets as either "automated" or "non-automated." If a quote is not designated as auto-ex eligible, then the party routing the order could trade through the better priced but manual quote of another market up to the trade through limit amount, subject to that party

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[6] We believe that there is less need for an exception to the proposed Trade Through Rule for quotes in securities that are neither actively traded nor experience rapid quote changes. In these securities, the need for rapid executions is secondary to executions at the best possible price. To trade a common stock like a derivative in a hyper-continuous ECN/Nasdaq trading model rather than in an auction market will increase volatility in these securities. While professional traders like volatility because it creates profitable trading opportunities, investors and issuers do not benefit from volatility. We have conducted numerous studies comparing the close in Nasdaq securities traded on Nasdaq and on the Exchange pursuant to unlisted trading privileges which demonstrate the superiority of the Exchange's auction market closing process to the Nasdaq's dealer close in terms of price discovery, reduced volatility, and ability to minimize the effects of manipulative trading practices like "spraying." We would be pleased to discuss the results of this research with the Commission staff.

[7] 69 Fed. Reg. at 30143.

[8] An "automated quote" is a displayed quotation that is available to automatic execution against an incoming system order; a "manual quote" is not available to automatic execution against an incoming system order and requires human intervention to execute.

otherwise fulfilling his or her best execution obligations. Even with a quote-by-quote exception and trade through limit amount, however, broker-dealers would still have to regularly and rigorously assess the executions offered by markets whose quotes are not immediately accessible, in whole or in part.[9]

The automated order execution facilities exception as originally proposed would have eliminated many of the key benefits of agency/auction markets since it would have inflexibly categorized entire markets as either "automated" or "non-automated" and thus would have precluded the possibility of hybrid markets where there is both automatic execution and human interaction with orders. Auction markets like the Amex currently provide valuable price discovery and investor protection functions in connection with conducting openings, reopenings, closings, and the execution of orders that are larger than the displayed size. In each of these situations, the Amex members match buy and sell orders of numerous market participants, both sophisticated professionals and public investors, to create a single market clearing price that minimizes volatility and the possibility of manipulation. This would have been impossible under the automated order execution facilities exception as originally proposed since the Exchange either would have been forced to abandon its agency/auction market structure in favor of the ATS/Nasdaq market structure or face marginalization, since investors likely would not place their orders on a market where they would be traded through systematically. A quote by quote exception to the Trade Through Rule, thus, is necessary to both preserve the key benefits of agency/auction markets while providing investors with the benefits of an automatic execution against the displayed market – a hybrid market. The preservation of an auction market structure also is consistent with the intent of Congress in establishing the NMS to have competition among different markets and market structures so that this competition may benefit investors.

<u>Question:</u> The Commission requests comment as to the best way to effectuate a quote-by-quote exception to the proposed Trade Through Rule for manual quotes. Panelists at the NMS Hearing stated that it would be possible to attach an identifier to manual quotes in the consolidated quote stream so that all market participants would know the quote was a manual quote. The Commission requests comment on the feasibility of this approach, and how it would work in practice.[10]

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[9] As is clear from the Commission's Proposing Release, any proposed exceptions to the Trade Through Rule would not provide a safe-harbor from broker-dealers otherwise fulfilling their fiduciary duty to obtain best execution for their customers. The duty of best execution, predates the federal securities laws, and stems from common law agency obligations whereby an agent owes his or her principal undivided loyalty and reasonable care. *Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 270 (3d Cir. 1998) ("Since it is understood by all that the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transactions."). Therefore, broker-dealers must continue to meet their basic best execution obligations to regularly and rigorously review the execution quality of markets to which they direct orders and must direct orders to the markets with the best execution quality.

[10] 69 Fed. Reg. at 30143.

Response: The Exchange believes that the best way to effectuate a quote-by-quote exception to the proposed Trade Through Rule for manual quotes would be to attach an identifier to manual quotes in the consolidated quote stream so that all market participants would know the quote was a manual quote. A quote would be assumed to be auto-ex accessible to an incoming system order unless it were tagged with the manual quote identifier. This identifier would have to be "side specific" because there may be a manual quote on one side of the market and an automated quote on the other.

The Exchange currently does not have facilities for sending a "manual" quote identifier and developing message protocols will require joint industry action. Users of market data also will have to modify their systems to "read" the identifier. This is another area where potentially significant system changes will be required to adapt to Regulation NMS which will require time to implement following approval of any rule change.

Question: The Commission requests comment on whether it should specify what "immediate" means in terms of providing an automated response, and if so, whether it would be appropriate to impose a minimum performance standard with respect to response times. Specifically, the Commission requests comment on whether it should require that an order execution facility's system that provides automated functionality have the capability to respond to an order from another market participant within a certain limited time period. If commenters believe that the Commission should specify a performance standard for "immediate," what should that standard be? Should the performance standard require that a certain percentage of all incoming orders receive an execution within a very short time frame, and allow a longer time period for the remaining percentage? For instance, should the performance standard require that 98% of orders receive execution in less than one second, and all orders receive an execution in three seconds? Or should the performance standard require that all orders receive an execution within the same time frame? If so, should that time frame be within one or two seconds after order receipt? Or should another similar standard be used?[11]

Response: "Immediate" should mean automatic and without human intervention. That is, a market should provide a person sending a marketable order either with an execution report or a message that the quote in unavailable automatically and without any human intervention. The Commission should not adopt a time standard for immediacy since market users should determine the rapidity with which they want their orders processed and a time standard also would set a floor on performance that would become antiquated over time and would minimize competitive incentives to innovate based upon speed.

Question: The Commission … requests comment on whether, in order for a market center or quote to be considered automated, the market center posting the quote should be required to provide for an automated update to the quote it is executed against. The Commission also requests comment on whether it should impose a performance

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[11] 69 Fed. Reg. at 11141.

standard, such as one second, on the time within which the order execution facility would be required to update its automated quote. Finally, comment is requested on whether the Commission should require market centers to provide an automated cancellation functionality that would allow a market participant that has put a limit order on the market center's limit order book to automatically cancel the limit order. If so, should the Commission require that cancellations be honored within a certain time frame, such as less than one second?[12]

Response: The adoption of the quote-by-quote formulation of the automated order execution facility exception to the Trade Through Rule would eliminate most of the public policy purposes to requiring an automatic refresh of a market's quote following a trade since, if the market is displaying a "manual" quote, other markets may continue trading. The common stock of business corporations, moreover, is not a derivative that can be priced formulaically the way options, warrants and other derivatives can be priced with reference to trades and quotes generated in an underlying, price discovery market. While third market dealers and regional exchanges have the luxury of being able to price their markets for Amex listed stocks off the Exchange's quotes, the Amex, as the price discovery market for its listed companies, cannot do so. Price discovery can take time as when the Exchange conducts opens, closes and executes an order that is larger than the displayed size. In these instances, a rigid time to requote is inconsistent with price discovery and the interests of investors, as it will result in increased volatility and poor executions for investors.

The Exchange believes that competitive pressures will force markets to allow investors to cancel their orders electronically so that there is no reason for the Commission to engage in rule making in this area. In this regard, the Exchange already allows investors to automatically cancel orders that are sent to the Amex electronically. The Exchange also is modifying its "fill or kill" and "immediate or cancel" order qualifiers so that orders with these qualifiers either receive an automatic execution or cancellation without any human intervention.

3. For the Protection of the Vast Majority of Investors, Registered Dealers and Other Persons Should Not Be Permitted to "Opt Out" of the Best Price Provisions of the Trade Through Rule

We oppose allowing persons the ability to "opt-out" of the best-price provisions of the Trade Through Rule. As the Commission states in the Proposing Release, "[t]he price at which an order can be executed is of paramount importance for most investors…."[13] Under the current proposal, however, traders wanting to sacrifice the best price for idiosyncratic reasons, such as speed, could. Those trades, however, would occur at the expense of other investors, who without their consent, have had their orders involuntarily opted out. Thus, in effect, the proposed opt-out provision allows the

12 69 fed. Reg. at 30144.

13 69 Fed. Reg. at 11153.

interests of traders who prefer speed to trump the interests of investors who expect to receive the best price. The opt-out provision would implement and institutionalize disorderly trading of exchange-listed securities in the NMS and eviscerate the benefits of extending a trade through rule to Nasdaq stocks. If the Commission were to adopt the quote-by-quote formulation of the automated order processing facility exception, moreover, persons seeking an immediate execution of their orders could by-pass manual quotes in seeking an automatic execution. The stated reason for the opt-out provision, rapid order processing, thus, would no longer exist.

If nothing else, the Commission should prohibit broker-dealers and ATS subscribers from opting out of the Trade Through Rule when effecting proprietary trades. Congress has limited principal trading by exchange members since the adoption of the Exchange Act in 1934. As originally adopted in 1934, Section 11(a) was intended to curb opportunistic floor trading by members that increased volatility. In 1975, Congress amended Section 11(a) to also prohibit off-floor trading by members as a result of concerns with member time and place advantages.[14] Both of these policy concerns logically should extend to principal trading by broker-dealers and ATS subscribers on markets that would be required to register as exchanges but for the exemption from exchange registration contained in Regulation ATS and the operation of the Nasdaq Stock Market as a facility of a national securities association.[15] While Congress has specifically exempted certain types of proprietary trading from the general prohibition of Section 11(a) that are beneficial to the market (*e.g.*, bona fide arbitrage), or do not implicate the policy reasons behind the prohibition (*e.g.*, transactions that yield priority, parity and precedence), we do not see how broker-dealer principal trading through customer limit orders benefits the NMS. Trading through limit orders is contrary to the interests of investors, undermines confidence in the market and harms price discovery. It is inconsistent with the policy objectives underlying Section 11(a) and the public interest to allow broker-dealers and members of ATSs to trade through limit orders in other markets for convenience without first attempting to access them.

4. <u>If the Commission Adopts the Opt-Out Exception, the Commission Should (1) Define "Informed Consent" to at Least Require Disclosure of the Size and Price of the Better Quote Being Traded Through and (2) Limit the Size of Opt-Out Trade Throughs</u>

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[14] "The advanced communication systems of today enable exchange members to trade from off the floor with many of the same advantages over individual public investors that were enjoyed by floor traders in times past. In its 1967 Report on Trading on the New York Stock Exchange by Off-Floor Members, the SEC found that the off-floor trader has many informational and market proximity advantages similar to those of the floor trader. He is apparently more quickly aware of developing market trends since he has a direct wire to the floor to keep him posted. Once having made an investment decision, the off-floor trader is able to execute the decision faster than a public investor." Report on H.R. 5050, at 49-50. A similar analysis is presented in the Report of S. 470, at 16.

[15] Members of Nasdaq and the ATSs both are currently exempt from the prohibitions of Section 11(a) and rules thereunder since Nasdaq is not a registered exchange and the ATSs are exempt from exchange registration.

In the event that the Commission approves some form of the opt-out exception, the Commission needs to strengthen and define the "informed consent" requirement. Currently, "informed consent" is not defined in the text of the rule and it needs to be. At a minimum, a customer whose consent is being sought should be advised of the size and price of the better quote (not just its existence) prior to initiating the trade through. It is an oxymoron to say that consent was "informed" when the price and size of the better quote are not disclosed. The magnitude of the trade through also should be limited in the case of the opt-out exception in the same manner that it is limited in the Automated Order Execution Facility exception. Thus, for example, trade throughs of five cents or more in an opt-out order should not be permitted in a stock trading for more than $100.00 per share.

5. <u>If the Commission Adopts the Opt-Out Exception, the Commission Should Require Opt-Out Trades to Be Printed with a Special Identification Code to Facilitate Surveillance and Inform Investors Why Their Orders Were Traded-Through</u>

If the Commission adopts the opt-out exception, the Commission should require opt-out trades to be printed with a special identification code to facilitate surveillance and inform investors why their orders were traded-through. ITS rules currently allow a market to complain when it believes that another market has traded through its quote. If a complaint is made on a timely basis, the market that traded through the complaining market center is obliged to satisfy the complaining market. If the opt-out exception is adopted as proposed, a market that is traded through by an opt-out order will have no way to determine whether it is entitled to complain about the trade through since it will have no way to distinguish between an opt-out order and an inappropriate trade through. The Commission, accordingly, should require opt-out trades to be reported with a special identification code so that a market, which is traded through, can determine whether it has cause to complain. The special identification code also will allow SROs to conduct surveillance of trade throughs and will facilitate informed analysis of the opt-out exemption by the Commission and others.

6. <u>The Commission Needs to Clarify the Responsibilities of Markets Sending and Receiving Orders in Satisfaction of a Potential Trade Through and Require that ITS be Modified to Become an Auto-Ex Facility Rather than an Order Routing System</u>

Exception (b)(7) to the proposed Trade Through Rule provides that the Trade Through Rule is not violated if "at the same time or prior to executing a transaction that constitutes a trade through, the order execution facility sent an order or orders to trade with each bid or offer of another order execution facility that was disseminated pursuant to an effective national market system plan and that was priced better than the price at which such transaction was executed." The proposed Trade Through Rule, thus, would protect the attributable quotes of all quoting participants, not just the BBO of all quoting market centers. This will require persons affecting a trade through to send multiple orders at different price levels to one or many market centers. In the aggregate, many thousands of orders will be routed through the NMS chasing ephemeral quotes. ITS, as it is currently structured, likely would be insufficient to facilitate compliance with this aspect of the rule, and we believe that ITS should be restructured as an automatic execution system rather than an order routing system. As the Commission was advised at the NMS hearings, there is nothing wrong with ITS technology. The problems with the system arise from the handling of commitments after a market receives them.

It also is unclear how the presence of reserve size orders on the receiving market centers or instantaneous requoting will be treated under the rule. For example, assume that market A sends two orders to market B at two price levels to satisfy market B's displayed interest. If the better priced order in market B is a reserve order, will all of market A's satisfaction orders go against the reserve order or will part of it go against the displayed interest at an inferior price and trade through the reserve order? Is market A's responsibility discharged under the proposed Trade Through Rule by sending the initial two orders, or must it send additional orders when market B immediately requotes? We believe that the Commission needs to clarify the responsibility of markets to send orders to markets displaying superior quotes, and the responsibility of markets receiving these orders.

7. <u>The Exchange Supports the Proposal to Define an "Order Execution Facility" Broadly to Include Persons that do not Post Orders or Quotes in the Public Quote and Believes that the 30-Year Old Definition of a "Block Trade" Needs to be Revised to Reflect the Liquidity Currently Available in the Market</u>

Existing ITS trade through rules only apply to exchange members and registered OTC market makers that trade NYSE and Amex listed securities. Thus, OTC block positioners (who are excluded from the definition of OTC market maker and, thus, are not subject to the ITS trade through rule), ATSs that do not post quotes in the consolidated quotation system, and others may trade outside the best bid and offer. In contrast, the proposed Trade Through Rule in Regulation NMS would require all "order execution facilities" to establish policies to prevent trade throughs and would define the term "order execution facilities" broadly to include any registered exchange or securities association that operates a facility that executes orders, ATSs, exchange specialists or market makers, OTC market makers, block positioners and any other broker or dealer that executes an order internally by trading as principal or crossing orders as agent. The Exchange agrees with the Commission that broker dealers that do not post orders or quotes in the public quote but that nevertheless execute orders internally should be included within the scope of the Trade Through Rule to protect limit orders posted in the NMS, preserve market integrity, and prevent fragmentation. We thus support the broad definition of the term order execution facility.

Proposed Regulation 600(b)(8) carries forward the 30-year old definition of a block trade (10,000 shares of stock or stock worth $200,000). This definition is completely antiquated and needs to be modified to reflect the liquidity that is available in the market today. There is simply no reason today for treating a 10,000-share trade in IBM, Microsoft or QQQ as a block trade. In addition, since the definition of an OTC market maker excludes persons who make markets in greater than block size (i.e., 10,000 shares or stock worth $200,000) these persons are exempt from the "1% mandatory quote requirement" of Rule 11Ac1-1 under the Exchange Act. Whatever the public policy benefits of excluding OTC block positioners from disseminating their quotes, transparency, price discovery and market integrity considerations dictate that these quotes should be disseminated in the quote stream unless the quote is for "bona fide" block size; not a size that may have once been a block in what is now the distant past. We, therefore, believe that the definition of a block should be revised to equal 50,000 shares of stock or stock worth $1 million.

Market Data Proposal

1. Each of the Alternative Models for Market Data Dissemination is Seriously Flawed and Should Not be Seriously Considered for Adoption

The Amex concurs with the Commission's view, expressed in the Proposing Release, that there are substantial risks associated with each of the three alternative models considered for market data dissemination that far outweigh any theoretical benefits that might result from the adoption of any one of them. The current model has functioned well for many years, providing investors and other data users with high-quality data at fees that have not changed in many years[16] and allowing access to a complete set of the best trades and quotes from all SROs by dealing with a single processor for each of the three major data networks. There are no serious problems with market data dissemination, as there are with, for example, market data revenue distribution. Consequently, radical changes are not appropriate, and any problems can be addressed through adjustments to the existing model. Expressed in "plain English", "If it ain't broke, don't fix it."

We believe that the Commission has accurately catalogued some of the potentially severe consequences that could result from adoption of one of the alternative models. These consequences include, depending on the particular alternative: (1) confusion and harm to retail investors due to elimination of the consolidated display requirement; (2) the exercise of market power by a dominant securities market and consequent charging of excessive fees, with negative consequences for both investors and other market centers; (3) the loss of data quality; (4) increased processing costs; and (5) the entanglement of the Commission in highly contentious fee disputes that would lack an objective standard on which to base a resolution.

2. Maintaining the Current Consolidated Display Requirements is the Best Alternative for Investors and Other Market Data Users

The Commission has proposed amending the rules regulating the display of market data by eliminating or limiting many of the current requirements. For many of the very same reasons cited by the Commission for rejecting the alternative market data

[16] Tape B, for example, has had only one price change over the past 15 years, which averaged approximately 7.5%, whereas the consumer price index increased about 52.9% over that same period.

dissemination models, we believe these proposed amendments run contrary to the intent of the 1975 amendments. The proposal would in pertinent part (i) allow market centers to sell trade and quotation information that is required to be collected and disseminated pursuant to joint industry plans independently of the plans, without consolidation; and (ii) eliminate the current requirement that any quotation montage include quotations from all market centers. The Amex does not believe that the proposed changes to the consolidated display requirement will add transparency to the markets. To the contrary, we believe that the proposed changes will fractionalize and potentially distort the market data and compromise its quality, thereby leading to investor confusion and further complicating the management of market data for vendors and broker-dealers.

The independent sale of core market data may cause a variety of problems. For example, the rule would require the simultaneous dissemination of data by the SIP and a market that independently sells its data. However, we know of no way that a market can assure that its quotes are being sent to vendors at the same time as the consolidated quote. Similarly, the amount of time it takes for an unconsolidated quote and the consolidated NBBO to reach a vendor could differ, resulting in a mismatch of the NBBO with the individual market's quote.

More importantly, we believe that the end result of this change and the amendment of the rule that will permit incomplete montage displays will have dramatic effects on the economics of market data. For example, today, Nasdaq is required to disseminate quotes of each market maker to the SIP and the SIP, in turn, transmits these to vendors. Subscribers to this data can either purchase Level 1 service, which includes just the last sale and the NBBO, or Level 2 service, which additionally includes the quotes of each market maker and those of any UTP exchange. Under the proposal, subscribers would be free to purchase Level 1 from the SIP and the Nasdaq market maker feed directly from Nasdaq. This would have several effects. First, Nasdaq could easily price its data feed lower than the SIP Level 2 data feed, thereby creating incentives to carry only Nasdaq quotes in the montage. This would not only reduce the revenue stream available to distribute pursuant to the UTP Plan, but would also reduce the amount of information available to these subscribers. We would anticipate that Nasdaq might in turn rebate portions of its market data revenues to UTP exchanges as a way of motivating them to participate in SuperMontage. Thus, Nasdaq will be in a position to create its own market data allocation scheme that simply ignores the Commission's proposed system.

The market for listed stocks presents the opposite problem. Currently, the CTA distributes a unified data stream that includes all last sale and quotation information for Network A and Network B stocks. Subscribers are not given the option of purchasing just the NBBO and last sale information as they do for Nasdaq stocks. Given the governance structure of the CTA, which requires unanimous approval to change the CTA Plan, we do not believe it is at all likely that either the NYSE or Amex will be able to convince the other participants to amend the CTA Plan to permit a Level 1 type data stream. Thus, the current status of the market data plans and the effects of the proposal will allow Nasdaq to materially benefit while depriving any other market of the same opportunities.

We are quite surprised that the Commission would propose rules that would have such a profound effect on the economics of the securities industry without any discussion in the Proposing Release of the financial impact of the changes.

The Amex also questions the wisdom of adopting the provision of proposed Rule 603 that would require that a consolidated display be provided only in situations "in which a trading or order-routing decision can be implemented."[17] At the very least, this terminology would need to be more precisely defined if the provision were to be adopted, in order to clarify the situations in which it would, or would not, apply. For example, we assume that every registered representative dealing with customers and every display of market data directly to customers would still be required to include consolidated data, although the language of the rule is somewhat ambiguous in this regard. More importantly, we question whether these are meaningful distinctions. Any display of data can, in fact, lead to a trading decision (including a decision not to trade), and we believe that such decisions should not be made based on a partial, and perhaps skewed, view of the markets, as would be the case with the much more limited consolidated display requirement being proposed in Rule 603.

In response to the Commission's question concerning the impact of the proposed standards that would be applicable to the independent distribution of information by market centers (i.e., "fair and reasonable" and "not unreasonably discriminatory")[18], our view is that these standards will not effectively protect investors and weaker and newer markets from predatory actions by stronger markets or the potential loss of data integrity. While it is possible that there might be more market data disseminated, the data could potentially be less easy to use, less accurate, less complete in crucial areas, or otherwise less valuable.

The Amex does favor the provisions of proposed Rule 603 that would make explicit the requirement that all SROs must act through the joint-industry plans and through a single processor per security to distribute consolidated market information on NMS stocks. This proposal would formally adopt some of the best elements of the current model. We also favor allowing market centers to develop and independently sell some of their ancillary, non-core information, such as the depth of the limit order book, with as little regulation as possible (including regulation of contracts, pricing and policies) and without requiring that the data be disseminated through a specific consolidator. This would be an excellent place to foster innovation and competition between markets.

In sum, with the exceptions noted in the prior paragraphs, the Amex's overall reaction to the Commission's proposals on the consolidated display requirement and the independent distribution of information by market centers is one of surprise given the

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[17] 69 Fed. Reg. at 11209.

[18] 69 Fed. Reg. at 11184-85.

Commission's recognition of the potentially serious problems with alternative models. Many of those same problems also arise in connection with these proposals.

3. <u>The Proposed Distribution Formula for Market Data Revenues, With Some Adjustments, Will Encourage Participants to Provide More Liquidity and Maintain the Best Possible Markets; the Commission Should Specifically Outlaw the Practice of "Shredding" Trades</u>

The Amex strongly concurs with the Commission's judgment that the existing formulas for allocating the net income of the market data networks, because of their exclusive focus on the number of trades, and (in the case of Network C) the share volume of trading, "do not reward those market centers that generate the highest quality quotes" (i.e., those with "the best prices and the largest sizes").[19] Thus, the strength of a market center's contribution to public price discovery is not recognized in the network net income distribution. One consequence of the current arrangement is that it creates incentives for "gaming" the system to capture additional data revenues through such practices as "shredding" of trading volume into much smaller individual trade sizes and engaging in illegal wash sales.

While the proposed distribution formula for market data revenues reduces the incentives to shred trades for stocks below $5.00, many of the securities that have had problems with shredding activity currently trade over $25 and are virtually unaffected by the minimum. Even with the total revenue for these securities reduced by the square root formula contained in the Commission's proposal, there still is an incentive to shred trades.[20]

The Commission is justifiably concerned with shredding and wash sales because these activities mischaracterize the level of trading interest in a market, akin to painting the tape, and shredding often results in automated quotes temporarily misrepresenting the true level of supply and demand in the security (a/k/a "spraying"). When an order for 2,000 shares is sent to a market as twenty simultaneous 100-share orders for the same terms, the entering firm is effectively entering nineteen orders for a purpose other than to buy or sell stock. This is no different than a wash sale, but is much harder to prosecute than a wash sale because current regulations do not specifically ban shredding and require proof of intent.[21]

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[19] 69 Fed. Reg. at 11176.

[20] For example, as of April 8, 2004, the minimum size of a "qualified" trade in QQQ and SMH is 200 shares, and the minimum size of a "qualified" trade in SPY, DIA and IWM is 100 shares. In SPY, DIA and IWM, each additional piece that a trade is shredded into could yield as much as $0.22, $0.40 and $0.60, respectively, in market data revenues.

[21] In the recent past, customers of The Island ECN engaged in extensive trade shredding activity, and, at one of these firms, this activity resulted in some wash sales. Not one individual was prosecuted for shredding trades, but the specific ban on wash sales allowed prosecution of that one firm to the extent that their misleading trades led to wash sales. On numerous occasions over the past few years, the Amex has brought to the attention of the Commission the problem of trade shredding and other abusive trading

The Commission should outlaw, or require all SROs to adopt regulations outlawing, the practice of trade shredding. An example of a rule that should result in more effective surveillance for shredding activity, yet provide flexibility in complying with best execution obligations, is the following: *In no event may a single trading decision for a single account result in more than one order being sent simultaneously to a single venue for that account if the terms of the orders are identical (excluding volume), and if the terms of the orders are all determined at the time of the single trading decision, unless the execution rules of the receiving venue would imply different execution terms for each of the orders*.[22]

Having such a rule in place and actively enforced by all market centers may address the Commission's concerns with shredding. Another step the Commission could take is to ban the practice of reporting only netted trades to a recognized clearing agency such as DTCC. This would make the practice of shredding trades less profitable, as well as simplify monitoring for compliance with Section 31(a) of the Exchange Act.

The proposed formula in Regulation NMS represents a reasonable approach to realigning the market data income allocations with the relative utility of an SRO's trades and quotes in a given security. For example, the formula's utilization of a square root adjustment to the dollar volume of trading in each security, as a mechanism for the initial step of allocating a network's total distributable net income among the network's securities, would appear to be a better choice than the use of unadjusted dollar volume alone. The problem with the latter approach is that some securities have enormous volume relative to others.

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practices engaged in and fostered by The Island ECN. *See, e.g.,* (1) correspondence dated September 6, 2001 from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex to Annette Nazareth, Director of Market Regulation, Securities and Exchange Commission, (2) correspondence dated November 14, 2001 from Salvatore F. Sodano, Chairman & Chief Executive Officer, Amex to Harvey L. Pitt, Chairman, Securities and Exchange Commission, (3) correspondence dated November 19, 2002 (the "November 19, 2002 Letter") from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex to Harvey L. Pitt, Chairman and Cynthia A. Glassman, Harvey J. Goldschmid, Paul S. Atkins, and Roel C. Campos, Commissioners, Securities and Exchange Commission, and (4) correspondence dated January 31, 2003 (the "January 31, 2003 Letter") from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex to Harvey L. Pitt, Chairman and Cynthia A. Glassman, Harvey J. Goldschmid, Paul S. Atkins, and Roel C. Campos, Commissioners, Securities and Exchange Commission. All of these letters are provided as attachments to this Exhibit A.

[22] For example, it would not be inconsistent with the above rule to split a 4,000-share order into one 1,000-share order and one 3,000-share order (or even four 1,000 share orders) if the receiving venue has an auto-ex threshold of 1,000 shares (and if the venue does not have rules that would prohibit such a split). It would be inconsistent, however, to simultaneously send forty 100-share orders to the same venue based on the same single trading decision. It would not be inconsistent with the rule to split a partial round lot into one odd-lot order and one round-lot order if the venue has different execution rules for odd lots and round lots. It would be inconsistent with the rule to simultaneously send to a venue multiple orders for the same account with the same execution terms and a price limit that is not immediately executable on that venue (shredding the bid/offer) unless the execution venue's rules provided higher execution priority to smaller orders on its book.

Thus, if a direct linear relationship with dollar volume is used in the formula, (a) the market data revenue payment stream is distorted due to the funneling of a disproportionate amount of network revenue into a few securities where the marginal contribution to price discovery of each additional trade or quote is very small, and (b) other securities in the network that could benefit from additional liquidity are ignored. While artificial caps could be applied to the amount or percentage of a network's revenue that could go to an individual security or into a particular tier of securities, this approach would have the major disadvantage of being seen as purely arbitrary and changing the relative relationship of value among securities.

The advantage of using the square root of the dollar volume traded in a security is that it reduces the disproportionate impact of any one security but maintains that security's relative relationship to all other securities. In this way, the chance that a disproportionate number of dollars will be funneled to that security, or that other securities might be unfairly neglected, is reduced. Even though some securities may have more or fewer dollars attributable to them than under today's system, the proportionality of the relationship is better maintained than if purely artificial caps are applied to individual (or groups of) securities. In response to the Commission's question about the possible use of the square root of trades rather than dollar volume, we oppose that idea on the grounds that trades are a less meaningful measure of the degree of activity (and risk) than is volume.

Similarly, reflecting the Commission's reasonable judgment that "generally trades and quotes are of approximately equal importance for price discovery purposes,"[23] the proposed formula's presumptive allocation of 50% of a security's share of network net income to trading activity and 50% to quoting activity seems to us to be a satisfactory compromise between two activities that are both clearly of great importance to investors. In addition, it also seems reasonable to provide a mechanism for shifting a portion of the trading activity allocation over to the quoting activity allocation, as the formula does, by limiting the dollar amount per qualified transaction that is allocated to trading activity (which will impact securities with a low number of qualified trades during a year).

By providing such an additional reward for the display of competitive quotes in otherwise thinly traded stocks, the formula thereby has the potential to attract liquidity (capital) in quote activity to such stocks and thereby possibly encourage more trading activity to occur than would otherwise be the case. The additional division of the quoting activity allocation into 35% (plus any percentage shifted from the trading activity allocation) for matching the NBBO in a security and 15% for improving the NBBO of the security, while theoretically appealing, appears very problematic, as we discuss at length in the next item below. In addition, there are still many unanswered questions about how the accounting for both NBBO Improvement Share and Quoting Share will work in practical application.[24]

[23] 69 Fed. Reg. at 11181.

[24] For example, the quote-based credits are based on dollar value times the number of seconds. If a quote were at the NBBO for less than a full second, would any quoting credit be given? If so, what increments of

The Amex also believes that the use of a combination of total dollar volume and the number of "qualified trades" in a security during the year is an appropriate measure to use in determining an SRO's proportion of that security's income allocation resulting from trading activity. It is a significant improvement over the current methodology, whose utilization solely of the number of trades (in Tape A and Tape B) has proven to be an easily "gamed" measure. In view of the significant problem caused in recent years by those market centers that determined that "shredding" trades could bring them a larger allocation of market data revenues (while simultaneously creating a misleading picture of real activity in the market), a minimum size requirement (e.g., $5,000) for a "qualified trade" in the trading allocation formula could reduce the potential for such manipulative activity. The end result should be an improvement in the quality of (and data about) the market. Whatever minimum size(s) is chosen for a "qualified trade," we would argue against weakening the primary appeal of such a minimum by giving fractional credit for smaller trades. If the objective of a minimum size were to be to discourage "gaming" the system solely to augment market data revenues, a compromise allowing partial credit for smaller trades would seem to be contrary to this objective and should not be adopted.

In response to the Commission's question as to whether a cap should be placed on the size of individual trades (e.g., $500,000 dollar volume) to prevent the allocation for exceptionally large trades from swamping the allocation for smaller trades, we oppose this idea because (1) it might encourage breaking large trades up into smaller trades in order to have a large trade's total value included in the calculation (i.e., a higher value level of trade shredding), and (2) it could discourage a market center from putting up more than that amount of capital within which it or its members could legitimately earn market data revenues.

The Amex also urges the Commission to exclude from an allocation of market data revenues any market that is not a full participant in the NMS,[25] based on the accessibility of that market's quotes to all other market participants, including non-members and non-subscribers.

4. <u>Some Adjustments to the Distribution Formula Will be Required in Order to Achieve the Underlying Objectives</u>

Despite our generally favorable reaction to the Commission's proposed new allocation formula, we do see some specific problems that will need to be addressed through adjustments to the formula. In particular, we call the Commission's attention to the following items.

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a second would be involved? This and similar questions would have to be resolved by either the plans or the Commission.

[25] In the context of Amex listed securities, a "full participant in the NMS" is a market center that publishes its quotes and trades through the Consolidated Quote and Consolidated Trade Plans and is a participant in the Intermarket Trading System.

- The use of a $2 fixed per-trade cap on the network net income allocated to trading activity for a given security is too inflexible. The Commission should consider a more dynamic method of ascertaining an appropriate per-trade allocation. At the very least, a different fixed value would seem to be required for each major data network, given the variation across the networks in the amount of net income available for distribution and in the different trading characteristics (e.g., average volume and size of trades, as well as prices) of stocks in each network.

  In addition, if one purpose of the new methodology is to provide incentives to improve the quality of the market, then attracting liquidity (capital) in quote activity to otherwise relatively neglected securities should be part of the decision process in determining the proper level for a per-trade cap. This, again, is suggestive of the need for a different cap value for each network, since the per-trade cap level that may be appropriate and that may provide an incentive to supply more capital (liquidity) to one network's securities may not be appropriate for another's.

  To the extent that the value per trade of a security (defined as the ratio of 50% of a security's Security Income Allocation (as defined in the Proposing Release) to the number of qualified trades) is much higher than the proposed $2 trade cap, capital trying to capture market data revenues will tend to flow into that security, and the value per trade will fall rapidly as the number of trades increases.[26] Thus, the goal of attracting capital to a security will have been accomplished, and the final value per trade is not likely to significantly exceed the desired cap level.

  In attempting to evaluate the impact of the factor in the proposed formula that would adjust the relative allocations between trading and quoting activity in a security, the Amex ran simulations involving the Tape B securities, using the proposed $2 per-trade cap and the proposed $5,000 definition of a qualified trade. We found that, on average, the proposed adjustment factor would move the trade/quote ratio from a balanced 50/50 relationship suggested as desirable in Regulation NMS to less than a 30/70 effective relationship for this universe of stocks, which we believe would over-weight quoting share relative to trading share across a wide range of stocks, at least on Tape B.

[26] A high value per trade means that (1) the share of network net income allocated to trading, at least if the determination were made at that point in time based on then-current statistics, would be equal to the product of $2 and the number of qualified trades, and this will be the case as long as the value per trade stays above $2, and (2) a significant number of additional qualified trades will be required to cap that trading share allocation at 50% of the Security Income Allocation. Under these circumstances, each additional qualified trade sent by an SRO not only increases that SRO's proportion of qualified trades (and hence its share of net income allocated to trading activity), but it also directly increases the dollar amount of net income allocated to trading activity that is being divided. In other words, it increases the size of the pie as well as increasing that SRO's share of the pie. This will tend to attract capital trying to capture market data revenue. Once the fixed cap of 50% of a security's Security Income Allocation is reached, however (if indeed it is reached), the incremental revenue to an SRO from each additional qualified trade declines (since the pie is now fixed in size), and capital is no longer so strongly attracted to that security.

- Based on some of the same considerations discussed in the previous bullet point relating to a per-trade revenue cap, the Commission might consider the use of a more flexible value, perhaps a different one for each network, for the minimum size of a "qualified trade." We applaud the concept of a minimum size requirement as part of the solution to the shredding of trades, and the $5,000 level seems as good a level as any with which to begin the analysis. However, more work might be done to create a dynamic equation that will recognize different trading characteristics and price levels of different securities, including differences between networks.

- Whether in the calculation of a) the Quoting Share or b) the NBBO Improvement Share (should that provision be part of the formula that is finally adopted), consideration might be given to allowing no market to receive credit for a quote that fails to make the minimum dollar size (e.g., $5,000) required for a Trading Share credit. The reasoning for such a quote-size floor is that a) permitting small quote sizes could encourage some participants to "flash" small quotes where risk is minimal because of the size, but the reward is there for being at the NBBO first (or forcing another market to re-quote to remain at the NBBO); and b) it would appear to make no sense to disallow credit for trades that do not make that threshold and yet reward quotes with a size that, if they were accessed and traded upon, would not qualify for the Trading Share credit. Before applying such a floor, however, thought should be given to whether it could discourage participants from adding liquidity to inactive securities.

- The formula for calculating the NBBO Improvement Share is very complex, is not fully defined, and would require extensive testing before including it in the overall methodology. While the basic concept of rewarding quotes that improve the price of the NBBO in a security is sound, the complexity of the formula and the potential for "gaming" this particular measure, as discussed in the Proposing Release, are good reasons for eliminating it from the formula entirely.

  One issue that would have to be examined particularly closely in connection with any NBBO Improvement Share calculation is the complexity of the issue of time units. The first question that would need to be answered is, "What amount of time do most investors need in order to react to a quote?" There are certainly computer-driven trading systems that can access quotes from different markets in under a second, but the degree to which the vast majority of investors and their brokers utilize such systems must be questioned. Since the NMS is supposed to benefit all investors, the choice of a minimum time for the quote to be in place to count as a new NBBO and receive a credit for improving the NBBO must revolve around the time needed by most investors to react to a quote and have an order sent for execution. What that number should be is difficult to assess. Some automated execution facilities may argue that any minimum is too much time, while some non-automated execution facilities may argue that minimums below certain levels are insufficient time.

In response to the Commission's question as to whether the threat of enforcement action and sanctions would be sufficient to deter "gaming" activity with respect to an NBBO Improvement Share allocation, the Amex notes that the successful prosecution of cases involving "gaming" of the NBBO Improvement Share would be document-intensive and would require significant time and resources to investigate and prosecute. It also would require proof of a motive to game the NBBO Improvement Share formula for the purpose of improperly gaining market data revenue, which would be difficult to prove in an adversarial proceeding. These cases, consequently, would be difficult to prosecute and would tend to lose out in decisions where to allocate scarce regulatory resources. In light of the experience with the NASD's failure to prosecute The Island ECN or any of its customers for shredding trades done by those customers for the purpose of obtaining a share of the network data revenues that Island was receiving and was willing to rebate to its customers, it is unclear whether gaming of the NBBO Improvement Share formula would be prosecuted at all.

5. <u>The Issue of Quoting Credit for Non-Automated Quotes Needs to be Further Explored</u>

The Proposing Release proposes that, "[w]ith respect to SRO quotes that are not fully accessible through automatic execution," the formula for the Quoting Share would cut off any further credit for quotes "when such quotes are left alone at the NBBO as a result of quote changes by other SROs."[27] The purpose of this cutoff is to help assure that stale or non-firm quotes are not rewarded. Under current rules at floor-based (non-automated) execution facilities, to the degree that the specialists are given time to "refresh" their quotes and are not held to them, those quotes would have to be considered not "fully accessible." However, were a floor-based market to alter its rules to make any standing quote "fully accessible" in some size, even if at a minimum 100 shares (as long as the quote met the $5,000 test required for a trade credit as we suggest above), the Commission's proposed exclusion of floor-based markets may be overly simplistic and may need to be altered.[28] In addition, one result of the imposition of such a "fully accessible" rule would be an increase in "gaming" opportunities.[29] For example, an ATS

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27 *See supra* note 23.

28 This flaw could possibly be addressed by requiring that, unless a participant's quote in the new NBBO were available for a specific period (unless accessed first), its removal from the NBBO would not cause all others at the NBBO to re-quote.

29 For example, an automated market center could sabotage a non-automated market center that is alone at the NBBO with a valid quote by "flashing" a quote equal to the NBBO for a split second. After the "flashed" quote is withdrawn, the non-automated market center is "left alone" at that NBBO and would have to re-quote in order to continue to receive credit. During the time that it takes for the non-automated market center to react to the "flashed" quote and re-quote, the non-automated market center would not receive any credit for its presumed-stale quote, and it is not clear whether the "gaming" automated market center would also be rewarded for its activity, with its quote now being considered the new NBBO. It is likely that if this behavior were to be permitted, the "gaming" automated market would flash repeatedly in response to the non-automated market's re-quotes. In general, the Commission should assume that if such "gaming" opportunities were available, they would be taken advantage of to the maximum degree possible.

could flash an ephemeral, inaccessible bid for a millisecond, establish the national best bid, and then fade on the bid. If the bid previously displayed by an exchange again becomes the national best bid as a result of the faded ATS bid, it should not be excluded from the determination of the Quoting Share.

Further, if the Commission were to adopt the proposal, supported by the Amex, to effectuate a “quote by quote” exception to the proposed Trade Through Rule for manual quotes by attaching an identifier to all manual quotes (i.e., those requiring human intervention in the execution of an order), then the Commission’s proposed cut off of credit for a quote left alone at the NBBO would not be appropriate if that quote were not flagged as manual by an attached identifier. As the Amex moves to automate its quote updates, this situation will become the norm for us rather than the exception.

Finally, even in situations where stock quotes have identifiers attached when they are not available for automatic execution against incoming orders (i.e., under the proposal discussed in the prior paragraph), the Amex believes that giving credits for quoting activity would be justifiable under many circumstances. For example, in connection with securities that are not actively traded and whose quotes are not normally subject to rapid change, manual quotes (with human intervention) can contribute value, and therefore be deserving of quoting credit, by contributing to minimization of volatility and lowering the possibility of manipulation in connection with those orders that are larger than the displayed size. At a minimum, if the Commission adopts our recommendation for a phase-in period or pilot program with respect to adoption of a “quote by quote” formulation of the automated order execution exception to the proposed Trade Through Rule, then manual quotes should be given full quoting credit (assuming the formula is then in effect) during that period to allow the Commission to evaluate the results and determine the circumstances under which it might be appropriate to continue giving such credits for manual quotes of securities whose normal trading activity is below a certain threshold.

6. The Creation of Non-Voting Advisory Committees to the Joint-Industry Plans Could Broaden Participation in Their Governance in a Useful Way

The creation of advisory committees to participate, but not vote, in network operating committee meetings will give formal voice to users that have provided input informally before, and in that respect is positive, but the differing agendas of the advisory committee participants will determine the new committees’ effectiveness. The extent to which the proposed advisory committees might broaden participation in plan matters in a constructive way depends, to a great extent, on whether they understand what their role is, and whether the Commission leaves the door open for them to become actual decision-making bodies. The former is crucial, while the latter could lead to chaos. The likely differing agendas among not only the advisory committee constituencies, but also differing agendas within a particular constituency, are likely to be troublesome. The Commission will face the problem of how to choose the representatives of many, if not all, of the advisory committee constituencies so that all members of a constituency feel that "their" advisory committee member is representing them and not a competitor or some entity with little in common with them.

Although a case can be made that other entities might be included in the advisory committees, the five categories suggested in the proposal should suffice until the contemplated expansion proves that it is workable in helping to reach consensus (and not contentious) decisions.

For those network operating committees that meet infrequently (e.g., quarterly), the terms for members of the new advisory committees should be three years, at a minimum. The first year is likely to be mostly a learning period. If the individual then only has a year to use this knowledge, the learning period would seem to have been wasted. It would improve the process if the individual were able to use the knowledge gained in the first year for at least the next two years. Advisory committee members should be allowed to express their opinions on all matters and should be able to attend operating committee meetings (with the exception of executive sessions) and receive the same information that the operating committee receives.

Market Access Proposal

1. The Problems Caused by Access Fees are Occurring in the Market for Nasdaq Securities; the Commission Must Differentiate Between Fees Charged by ECNs and Nasdaq to Non-Subscribers for Access to Quotes and Standard Exchange Transaction Charges to Members or Subscribers for Value-Added Services

The Amex agrees with the Commission's view that the access fees currently being charged by ECNs and Nasdaq are causing distortions in the market for Nasdaq securities, particularly with respect to the way that rebates of those fees are providing incentives for some ECNs and their customers to automatically lock the quotes of other market participants instead of shipping orders to them. Fee rebates used in this way effectively constitute payment for order flow, a practice publicly opposed by the Amex for many years and which is equally reprehensible under these circumstances.[30] In addition, unlike the prices displayed by other market participants, the prices displayed by these ECNs and Nasdaq are not the true prices that customers will pay. This creates confusion by making it extremely difficult for market participants to compare quotations and for broker-dealers to fulfill their "best execution" duties to customers.

However, because non-member access fees are currently a phenomenon limited to the ECNs and Nasdaq that does not exist in the Amex's marketplace, we are concerned that certain of the measures proposed by the Commission with the justification of improving market access are extreme and unnecessary and could have adverse unintended consequences. In particular, the proposed definition of the term "access fee"

[30] *See, e.g.*, attached January 31, 2003 Letter, at p. 2.

is so sweeping that it seems to encompass traditional exchange transaction fees as well.[31] Access fees charged by ECN's to non-subscribers are in no way comparable to the standard transaction charges utilized by the exchanges for value-added services provided to members or subscribers. Most notably, exchange transaction charges are assessed upon exchange members that have representation in the management of the exchange's affairs[32] and have a right to comment on the fees as they are reviewed by the Commission.[33] In contrast, ECN access fees are non-consensual assessments upon persons that are required by best execution principles to access the quotes even if they are not subscribers to the system, have no representation in the management of the ECN, and have no opportunity to comment upon the fees since ECN fees are not subject to Commission review. In fact, ECN access fees represent an additional layer of fees, on top of the standard SRO charges, and each such fee is effectively a hidden per-share surcharge on the quote itself that distorts the accuracy of that quote.

2. <u>The Commission Should Not Establish Itself as a De Facto Ratemaker by Setting a De Minimis Cap on Access Fees; Competition Between Markets and Participants Offering Different Services Should be the Primary Determinant of Such Fees, With the Commission Utilizing the Rule 19b-4 Filing Process to Review the Fees</u>

Despite the obvious problems caused by access fees, the Amex opposes the <u>de minimis</u> solution proposed in Regulation NMS because, among other things, it would involve the Commission in a direct ratemaking role. Adopting the role of ratemaker would be a regulatory overreaction by the Commission to a problem that is currently confined to Nasdaq.

Further, we note that the Commission's proposal for a single <u>de</u> <u>minimis</u> fee standard lacks a satisfactory basis for applicability to all markets and market participants. The proposed maximum standard of $.001 per share is apparently based on the ECN business model and its associated costs.[34] However, there are varying business models and structures among markets and market participants and, consequently, it would be inequitable to apply the same numerical rate standard to all these parties. Any attempt to homogenize the U.S. markets in this manner would end up favoring one market model at the expense of others. ECNs and other ATSs have regulatory advantages over SROs with

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[31] Exchange Act Release No. 49749 (May 20, 2004), 69 Fed. Reg. 30146 (May 26, 2004) at note 39. "[The term 'access fee'] therefore encompasses both the specific fees charged by ATSs to non-subscribers for access to their quotations as well as any other fees charged by SROs and ATSs to their members and subscribers that are based on the execution of orders against their displayed quotations."

[32] Exchange Act Section 6(b)(3).

[33] Exchange Act Section 19(b)(3)(A).

[34] 69 Fed. Reg. at 11156. "Indeed, several of the largest ECNs currently pay $.002 per share to order providers upon the execution of their limit orders, and simultaneously charge $.003 to the "liquidity takers" whose orders execute against resting limit orders in the ECN." Consequently, the net per transaction to these ECNs is $.001.

regulatory costs and obligations, such as the Amex.[35] To the extent that the proposed de minimis access fee were to be deemed applicable to any of the various transaction charges that the Amex applies to its members, this would further add to the list of existing ECN and ATS regulatory advantages that threaten the viability of the membership exchange market model.

To adequately and fairly set a proper access fee limitation for each market and market participant, the Commission would likely have to involve itself in the type of contentious adjudicatory rate regulation proceedings that we believe it would prefer to avoid.[36] Further, it is likely that markets and market participants will find other ways to pass along their costs to customers if prevented from doing so by an access fee cap. So while the Amex acknowledges the importance of procedures to protect the very important principle of fair access, our position is that an access fee cap is not the best approach.

The Amex believes that competition between markets and market participants offering differing services should be the primary determinant of fees and other charges. To the extent that the Commission is concerned with access fees, it should require that these fees be filed with it for review and public comment, utilizing the same Rule 19b-4 rule filing process under the Exchange Act that is applicable to exchange transaction charges. This could be accomplished through a simple amendment to Regulation ATS to require ATSs to file their access fees with the Commission pursuant to Section 19(b)(2) of the Exchange Act and Rule 19b-4 thereunder. The Commission's review and oversight of access fees in this manner would constitute an appropriate and sufficient regulatory response to the current access fee problem.

3. The Appropriate Criterion for Exclusion From Trade Through Rule Protection or From an Allocation of Market Data Revenues is Whether or Not a Market is a Full Participant in the NMS, Based on Accessibility of the Market's Quotes to All Other Market Participants; Using the Level of Access Fees as the Criterion for Exclusion Does Not Address the Basic Issue of Access

The Commission has also requested commentary on related alternatives to an access fee cap, such as excluding quotations with fees greater than a de minimis amount from trade through rule protection or from an allocation of market data revenues. The

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[35] Among other regulatory advantages, ATS rules are not subject to public comment and approval by the Commission, ATS fees are not subject to public comment and approval by the Commission, ATS order execution systems are not subject to public comment and approval by the Commission, ATS governing boards do not need to comply with standards applicable to the governing bodies on registered exchanges, ATS membership is not limited to registered broker dealers, ATSs can deny membership to anyone they choose, and ATSs have no obligation to enforce compliance by their members with the securities laws and their rules..

[36] The Amex agrees with the manner in which the "ratemaking" approach to regulation was characterized by the September 14, 2001 report of the Commission's Advisory Committee on Market Information. In rejecting a cost-based approach to regulating market information fees, the report stated, "The 'public utility' cost-based ratemaking approach is generally disfavored today. It is resource-intensive, involves arbitrary judgments on appropriate costs, and creates distortive economic incentives." http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm at p. 58 of 91.

Amex opposes such alternatives as well because they in essence constitute a less direct, but equally unsatisfactory, means of applying an access fee cap. In each case, a single numerical rate standard would be inappropriately applied to markets with differing structures and business models and which are subject to different regulatory standards and requirements. The end result could be to harm competition among markets rather than to enhance it.

Instead of fees greater than a de minimis amount, the Amex believes that the appropriate test for exclusion from trade through rule protection or from an allocation of market data revenues is whether or not a market is a full participant in the NMS, based on the accessibility of that market's quotes to all other market participants, including non-members and non-subscribers.[37] Using the level of fees for this purpose does not directly address the basic issue of access itself.

While greater transparency with respect to access fees is desirable, the Amex concurs with the Commission's conclusion that reflecting access fees in the displayed quotes of market participants is an undesirable alternative solution to the problems caused by access fees because it would lead to sub-penny pricing and the related problems as discussed elsewhere herein. In addition, we share the Commission's view that the "quote normalization" approach of applying a universal rounding convention to all access fees is not the answer either because it would further distort the accuracy of market information.

4. If Strictly Interpreted, Rule 610(a) Could Undermine Membership Organizations Such as the Amex and Force Market Centers to Subsidize Competitors

As part of proposed Rule 610, the Commission would prohibit quoting market centers ("QMCs") and quoting market participants ("QMPs") from imposing "unfairly discriminatory terms" that inhibit non-members, non-subscribers or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers or customers. While the Amex favors the underlying concept of the proposed rule and believes that the participants in its own market have effective and efficient access to the Exchange's order execution facilities, we call the Commission's attention to the important qualifier "unfairly" in section (a) of the proposed rule, whose implications are not discussed in the Proposing Release. The Amex believes that there are situations in which, for competitive reasons, a QMC may legitimately and fairly utilize differential pricing. For example, the Amex should be able to utilize differential pricing (whether through rates or rebates or otherwise) to distinguish between an order from a public customer and an order from a market maker desiring to access the liquidity of our order book for competitive purposes that are advantageous to the market maker and disadvantageous to the Amex (e.g., liquidation of the market maker's undesirable inventory). If the Amex is unable to use differential pricing in the latter situation, we could be put at a competitive disadvantage, as could an Amex specialist, who would be

[37] *See* (1) attached correspondence dated October 28, 2002 from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex to Jonathan G. Katz, Secretary, Securities and Exchange Commission, at p. 5 and (2) attached November 19, 2002 Letter, at p. 2.

required to yield to an agency order from the competing market maker. In sum, the proposed rule should not be interpreted in such a way that would require us, in effect, to subsidize our competitors.

Another example of the legitimate (in our view) competitive use of differential pricing is provided by Amex's current fee schedule. The Exchange does not charge a transaction fee for customer orders of a certain size (2,099 shares or less for equities and 5,099 shares or less for Exchange Traded Funds) that are electronically delivered to the specialist. This pricing is not available, however, to broker-dealers.

We are further troubled by the potential of this section of the rule, depending on how it is interpreted, to cause serious harm to a membership organization such as the Amex. Our members are required to pay various fees to the Exchange, so it is both fair and reasonable for the Exchange to offer them discounts or rebates on certain transactions that are not available to non-members. Likewise, it is fair and reasonable to charge non-members higher transaction charges to offset the fact that they do not pay other dues or fees. In addition, those members who perform the role of specialist have duties and responsibilities that non-members do not have, so it is reasonable for them to pay discounted fees or no fees.[38] Therefore, to the extent that the proposed rule undermines our right to differentiate between members (who pay fees and have duties and responsibilities to the Exchange) and non-members in our charges, it could effectively remove any incentive for Amex membership. Non-members would effectively be free riding on members, with the former having all of the benefits available to the latter while bearing none of the costs.[39] More generally, businesses not only treat customers who pay for services differently from those who do not, but they may also differentiate among customers by offering special services and incentives to their best customers that they do not offer to others. A requirement, therefore, that a market center treat all other market participants without any discrimination whatsoever would be anti-competitive. The Amex believes that competition among markets on fees and services is healthy.

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[38] At an auction market like the Amex, our specialists not only assist buyers and sellers to trade directly with one another, but they also participate in the market as "responsible" dealers, buying and selling for their own accounts. As such dealers, specialists have affirmative obligations to provide liquidity for the securities for which they are responsible and to maintain a fair and orderly market in such securities. They are obligated to buy or sell, using their own capital to moderate trade-by-trade price movements when there are not enough other buyers or sellers in the market. Their role is particularly crucial at times of market stress and disruption and high volatility. In short, specialists play a critical role in the capital formation process by reducing daily stock-price volatility, providing liquidity, managing temporary market imbalances, and establishing fair market prices on openings and closings.

[39] If the Amex is required to provide the benefits of membership to non-members that do not pay regular member dues and fees, we may have no choice but to begin charging those non-members for certain services. For example, it has been suggested by some market participants that, in the event that ITS becomes an auto-ex facility, it might be necessary to impose exchange membership requirements on non-member market participants whose transactions constitute more than a certain percentage of outbound orders on ITS (for which there is currently no charge).

While the foregoing concerns could be relieved by proper interpretation of the distinction between fair and unfair discrimination with respect to terms, certain language in the Proposing Release is not reassuring in this regard. For example, the Proposing Release states that a QMC or QMP "would not be permitted to treat orders from non-members, non-customers or non-subscribers that are communicated indirectly through a member, customer or subscriber any differently than it treats the orders of that member, customer or subscriber."[40] This explanation would seem to disallow any discrimination in terms whatsoever, regardless of the circumstances and degree of fairness involved. In addition, "membership requirements" is included in a list of "barriers to intermarket access,"[41] suggesting a lack of appreciation of the important positive role that membership organizations such as the Amex play in the NMS. We have previously called on the Commission to "give serious consideration to freeing exchanges from their outdated regulatory burdens and apply a regulatory regime more relevant to today's capital markets."[42] Consequently, we are concerned that the proposed rule may be even more burdensome for exchanges than the current rules, and we call on the Commission to clarify its intentions with regard to the impact of the rule on the structure of membership organizations such as the Amex.

The Amex also calls on the Commission to spell out in more specific terms what is encompassed by the phrase "unfairly discriminatory" in section (a) of proposed Rule 610 and, in doing so, to directly address issues regarding (1) the ability of the Amex and other market centers to use differential pricing when allowing direct access to its order book by a competing market maker and (2) the degree to which a membership organization such as the Amex may continue to differentiate between its members who pay dues and have other affirmative obligations in our marketplace and non-members.

5. <u>Additional Regulation and Enforcement Will Probably be Necessary to Eliminate the Problem of Intermarket Locking and Crossing of Quotes; No Market Participant Should be Allowed to Lock or Cross the Quote of Another Participant Having Auto-Ex Functionality Unless That Quote is Flagged to Indicate That It is Not Available for Auto-Ex</u>

The Amex shares the Commission's concern "that repeated or continual locking or crossing of a market may raise concerns about the orderliness and efficiency of the markets."[43] More specifically, locked or crossed markets are a clear indication of inefficiencies in the marketplace and provide no market benefit that we are aware of. We also agree that some locking and crossing occurs inadvertently and can be tolerated to the extent that such incidents are minimal. However, we have serious concerns about the practice of some ECNs and other market participants that deliberately lock markets

[40] 69 Fed. Reg. at 11157.

[41] 69 Fed. Reg. at 11154.

[42] *See* attached November 19, 2002 Letter, at p. 7.

[43] 69 Fed. Reg. at 11159.

instead of routing orders to the better quote elsewhere, as a strategy to attract market-clearing orders from systems that will allow the locking market to collect an access fee. This abusive practice should be labeled as such and prohibited by the Commission because of its potential to confuse investors and inhibit the ability of market participants to meet best execution responsibilities.

The Commission has requested comment on "the necessity of adopting restrictions on locked markets in light of the proposed provisions governing intermarket access and access fees."[44] As discussed above, the Amex does not support the Commission's proposed de minimis fee standard to deal with the problem of market distortions due to access fees, and it is our view that desired improvements in intermarket access alone probably cannot and should not be relied on to eliminate the problem of locked markets. The economic incentives to engage in such market-distorting behavior are still likely to continue to exist unless, of course, payment for order flow is totally eliminated. Consequently, we support the type of regulatory scheme proposed in Rule 610, under which SROs would be required to establish and enforce rules that would require members reasonably to avoid locking or crossing quotes of other market centers and participants and would prohibit members from engaging in a pattern or practice of locking and crossing.

In response to the Commission's question "as to whether there should be an exception from the locking provisions of proposed Regulation NMS for quotes of automated markets that lock quotes of manual markets,"[45] we refer the Commission to our views expressed herein regarding the criteria applicable to the determination of whether a particular quote should be considered available for automated execution. Applying those principles to this issue leads to the conclusion that no market participant should be allowed to lock or cross the quote of another participant having auto-ex functionality (regardless of whether the Commission chooses to label each market as either "automated" or "manual") if that quote appears to be available for auto-ex (as signified by the lack of a "flag" on the quote affirmatively indicating that it is not available for auto-ex). Adoption of this constraint as part of the anti-locking and anti-crossing provisions of Regulation NMS would harmonize those provisions with the approach to the proposed Trade Through Rule that we have advocated herein.

6. Regulation NMS Represents an Opportunity for the Commission to Finally Correct Some of the Obvious Deficiencies of Regulation ATS and Level the Playing Field

Consistent with our views expressed in past written correspondence with the Commission, the Amex believes that the proposal in the Proposing Release to amend Regulation ATS to merely lower the threshold in the fair access standard from 20% to 5% of the trading volume in a security is inadequate. We have previously advocated the

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[44] *Id.*

[45] *Id.*

repeal of Regulation ATS and continue to urge the Commission to move in the direction of harmonizing the regulation of exchanges and ATSs – organizations that perform identical economic functions.[46] We believe that a good first step in achieving true fair access would be to require that every ATS adhere to the fair access standard, regardless of its percentage of the trading volume in a security.

Similarly, to further repair the current imbalance between the minimal regulatory regime applicable to ATSs and the much more burdensome regulatory requirements (including fair access) to which exchanges have long been subject, we would go further than the Commission's alternative proposal and would also eliminate the 5% threshold for the transparency standard of Regulation ATS (in addition to eliminating any percentage threshold for the fair access standard, as advocated above). The elimination of the transparency threshold would mean that any ATS displaying its subscriber orders to any person would be required to provide its best bids and offers to a national securities exchange or a national securities association and provide broker-dealers with the ability to effect a transaction with such orders.

Finally, we would eliminate the loophole in Regulation ATS that allows an ATS to avoid disseminating its quotes into the NMS by "going dark" (i.e., to no longer even display its subscribers' orders to other subscribers). The Island ECN has blatantly demonstrated how such a loophole can be "gamed" to produce the precise result that the Commission sought to avoid with the adoption of Regulation ATS – the presence of a two-tiered market, with one tier only accessible by the ATSs' customers and the official market existing within the NMS that is available to public investors. Hidden markets with hidden prices undermine fair competition between market centers and fair and efficient access to all best bids and offers.

Sub-Penny Quoting Proposal

1. The Commission Should Prohibit Sub-Penny Quoting for All Securities, Including Those Priced Below A Dollar

The Exchange supports the Commission's proposal to prohibit sub-penny quoting. In addition, securities priced below a dollar also should be subject to the prohibition since sub-penny quoting in these securities is subject to the same abuses and creates the same problems for the NMS as sub-penny quoting in higher priced stocks. There is no reason why there should be a potentially infinite number of price points for securities trading for less than a dollar. Derivative securities like ETFs also should be subject to the prohibition on sub-penny quoting; the evils of sub-penny quoting in common stocks of business corporations that the Commission identified in the proposing release apply equally to derivatives.

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[46] *See* attached November 19, 2002 Letter, at p. 2. *See also* attached statement of Salvatore F. Sodano, Chairman, Amex delivered at the Commission's market structure hearings on October 29, 2002.

We also believe that the Commission should take this opportunity to reassess whether one-size-fits-all with respect to minimum tick size. Professor William Christie who, along with Professor Paul Schultz, in 1994 suggested that Nasdaq market makers were maintaining artificially wide spreads, is now suggesting re-evaluating the penny tick size.[47] He contends, and we believe, that a penny creates such a small pricing increment that it destroys the critical roles played by price priority and limit orders. Professor Christie has suggested considering a minimum tick size of $0.05.[48] Professor Daniel Weaver also has proposed that the Commission consider increasing the minimum tick size to $0.05.[49] We agree that the Commission should consider requiring a $0.05 minimum trading increment for high priced securities.

2. <u>The Commission also Should Prohibit Sub-Penny Trading to Avoid Continuation of the Problems Identified With Sub-Penny Quoting</u>

The Proposing Release identifies many of the problems associated with quoting and trading in sub-pennies. These include:

- Trading abuses (e.g., quoting in sub-pennies to gain priority over limit orders for economically insignificant amounts),[50]
- Disincentives to the use of limit orders,[51]
- Reduced market depth at each price level. This also degrades market transparency since most customers cannot see what liquidity is available beyond the NBBO, [52]

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[47] William G. Christie, *A Minimum Increment Solution*, TRADERS, Nov. 2003, at 40.

[48] *Id.*

[49] Correspondence from Daniel G. Weaver to Jonathan G. Katz re: File No. S7-10-04.

[50] 69 Fed. Reg. at 11169-70. "OEA concluded…that the use of sub-penny pricing for most stocks is more likely relate to traders' attempts to gain precedence over competing orders that to legitimate price discovery."

[51] 69 Fed. Reg. at 11165 and 11170. "If investors' limit orders lose execution priority for a nominal amount, over time, investors may cease to use them, which would deprive the markets of a vital source of liquidity."

[52] 69 Fed. Reg. at 11170. "Furthermore, the Commission believes that wide-spread sub-penny quoting could exacerbate a number of the disadvantageous aspects of decimal pricing. For example, sub-penny pricing could decrease depth (i.e., the number or shares) available at the best displayed prices." The Commission stated that both the NYSE and Nasdaq found that depth at the inside price declined substantially with the implementation of decimals.

- Increases in flickering quotes which makes it harder for customers to access the best price and delays order executions as orders chase ephemeral quotes,[53]

- Strains on quote and order routing systems capacity,

- A two-tier, fragmented market where certain market participants can trade in sub-pennies and others cannot.

Given the manifold problems caused by sub-penny transactions, the exclusion of sub-penny trading from the prohibition in proposed regulation 612 significantly undercuts the benefits of the proposed rule without any accompanying gain to market integrity or quality. Only market professionals have access to sub-penny trading so that permitting it to continue validates the existence of a professional market that is inaccessible to most investors. The Commission's decision to permit sub-penny trading also would continue to allow wholesale "sub-penny jumping" of customer limit orders by market makers and other dealers. The Proposing Release states:

> The proposed rule would not prohibit an exchange or association from reporting or 'printing' a trade in a sub-penny increment, as most markets currently permit. Therefore, a broker dealer could, consistent with the proposed rule, provide price improvement to a customer order in an amount that resulted in an execution in an increment below a penny so long as the broker-dealer did not accept orders that already were priced in increments below a penny. (Emphasis supplied)[54]

The footnote that accompanies this quote states that, "Such price improvement would also need to be done in a manner that was consistent with the broker-dealer's obligations under other Commission and SRO rules, (*e.g.*, best execution and Manning)." We agree that the NASD's "Manning" rule[55] reduces the economic incentives for Nasdaq

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[53] *Id.* "Moreover, the Commission believes that the increase in flickering quotes that could result from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities…The Commission is concerned that a trend toward widespread sub-penny quoting could make it a practical impossibility for brokers to determine with reasonable certainty whether displayed prices are likely to be available."

[54] 69 Fed. Reg. at 11171.

[55] NASD IM-2110-2 "Trading Ahead of Customer Limit Order." In relevant part, this rule provides:

> …A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasadq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation or Rule 2110…
> For Nasdaq securities, authorized for trading in decimals pursuant to the Decimals Implementation Plan For the Equities and Options Markets, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis in a security trading in decimals when holding an unexecuted limit order in that same security, an not be required to execute the held limit order, is as follows:
> 1) For customer limit order priced at or inside the best inside market displayed in Nasdaq, the minimum amount of price improvement required is $0.01; and

market makers to “sub-penny jump” their own customer orders. Manning, however, only applies to Nasdaq market makers trading Nasdaq listed stocks and only protects customer orders held by the market maker that effects the trade; it does not apply to (1) persons other than Nasdaq market makers (e.g., firms internalizing their customer orders flow or firms that are not NASD members), (2) third market market makers trading exchange listed stocks, (3) regional stock exchanges trading Nasdaq or exchange listed stocks, and (4) Nasdaq market makers trading at a sub-penny better than customer orders held by other market participants that are displayed in the Nasdaq BBO. We are unaware, moreover, of “other Commission or SRO” rules that prohibit market makers and dealers from sub-penny jumping customer limit orders. Unlike Nasdaq, the Amex and NYSE both neither quote nor trade in sub-pennies and, consequently, do not have rules that specifically address practices associated with trading or quoting in sub-pennies. Sub-penny trading and quoting are phenomena that belong exclusive to the third market, Nasdaq and the regional exchanges. Therefore, under the Commission’s proposed rule, market makers that are not covered by the NASD’s “Manning” Rule could, for example, program their automatic executions systems to automatically sub-penny jump a customer limit order that they hold when their systems determine that a profitable trading opportunity exists. If the Commission wishes to stop sub-penny jumping of customer limit orders, it should prohibit both quoting and trading in sub-pennies.[56]

3. Regulation NMS Should Not Extend Sub-Penny Trading and Quoting to the Options Market

The Exchange is particularly concerned with the suggestion in the Proposing Release[57] that proposed Regulation 612 might be extended to listed options. If this were done, all options could be traded in sub-pennies, options with a premium of less than $1.00 could be quoted in sub-pennies, and all options with a premium above $1.00 (presumably) could be quoted in pennies. Extending penny quoting to options with a premium above $1.00 per contract and sub-penny quoting to options priced less than $1.00 would overwhelm the already taxed capacity limits of existing option quote processing systems. Due to the derivative pricing of options and the hundreds of thousands of options series listed by the six options markets, there are many, many more quote changes in options than there are in equities. (The Amex, alone, lists more than 100,000 option series as opposed to approximately 1,000 equity securities.) Sub-penny quoting and trading in options also would cause significant harm to the options markets

> 2) For customer limit orders priced outside the best inside market displayed in Nasdaq, the market maker must price improve the incoming order by executing the incoming order at a price at least equal to the next superior minimum quotation increment in Nasdaq (currently $0.01). (Emphasis supplied.)

As can be seen, IM-2110 only applies to Nasdaq market makers trading Nasdaq securities.

[56] We believe that the printing of an average price trades at a sub-penny increment (e.g., the printing of a volume weighted average price trades) does not raise the same customer protection issues as sub-penny trading. We, thus, do not have any objection to the reporting of average price trades at sub-penny intervals.

[57] 69 Fed. Reg. at 11172.

as described in our response[58] to the Commission's Concept Release on "Competitive Developments in the Options Market" (the "2004 Options Concept Release").[59] We believe, moreover, that many participants in the options market are unaware that the Commission is considering rule making in connection with proposed Regulation NMS that could extend sub-penny trading and quoting to options while the 2004 Options Concept Release is out for comment. The Commission, accordingly, should not extend sub-penny trading and quoting to the options market as part of its Regulation NMS initiative.

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[58] Correspondence dated April 8, 2004, from Salvatore Sodano, Chairman and Chief Executive Officer, Amex to Jonathan G. Katz, Secretary, Securities and Exchange Commission, p. 12-13.

[59] File No. S7-07-04, Release No. 34-49175 (February 3, 2004), 69 Fed. Reg. 6124 (February 9, 2004).

Attachments to Exhibit A

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September 6, 2001

Annette Nazareth
Director of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: American Stock Exchange's Request for the Securities and Exchange Commission to Require Island ECN's Compliance with Rule 301(b)(3)

Dear Ms. Nazareth:

The American Stock Exchange ("Amex") respectfully requests that the Commission require Island ECN ("Island") to comply with the provision of Rule 301(b)(3) of Regulation ATS, and in particular the requirement that it display its best priced bids and offers in the Nasdaq 100 Index Tracking Stock (QQQ) in the consolidated BBO. This request is made in follow-up, and indeed is largely an outgrowth, of our meeting with you and members of your staff on July 23, 2001.

Island's failure to comply with the rule prevents individual investors from receiving complete quotation information on the best possible price at which they can buy or sell QQQ. Furthermore, Island's failure to participate in the national market system precludes broker-dealers' from gaining access to its superior priced orders, and thereby, fulfilling their best execution obligation. The privilege of viewing and gaining access to these superior priced orders is limited to paying subscribers. Conversely, a public investor order routed to Island may receive an execution at an inferior price because it is not linked to other market centers offering the best price in QQQ. The SEC must maintain the efficiency, fairness and transparency within the market by compelling Island to integrate its activity into the national market system.

Island became subject to the display and access requirements of Rule 301(b)(3) ("Rule") on May 1, 2001, as a result of garnering more than 5% of the consolidated volume in QQQ in each of the four preceding months. It is our understanding that Island, both before and after becoming subject to the Rule, has taken no affirmative steps to come into compliance with the Rule, and it remains openly in non-compliance at this time. As you know, we actively considered working with Island to formulate a mechanism for disseminating its quotations through the Amex. During our meeting with you, we laid out a possible framework for seeking to integrate Island, over a phase-in period, into the national market system in a way that would comply with Rule 301(b)(3) while also attempting to reconcile the markedly different structure of the Island ECN market with more conventional markets. We had hoped that such an approach might hold some appeal to the Commission, especially since it involved integration of the primary market for the QQQ with the primary third market participant. At the meeting, the Commission staff clearly rejected this approach, in particular expressing concern that it would compromise traditional exchange auction mechanisms.

The Amex continues to be hopeful that Island's activity can be integrated into the national market system, and we stand ready to work with the Commission staff and Island in any manner the Commission believes would be constructive. However, at the same time, it is very disconcerting that, in the very first instance that an ECN has triggered the 5% threshold in Rule 301(b)(3) for an exchange listed security, the requirements of the rule have been ignored, with no apparent resolution in sight. As a result, we request that the Commission take immediate action to require Island to come into compliance with the Rule or cease operation with respect to all securities for which Island is in violation.[1]

1. <u>Regulation of Exchanges and Alternative Trading Systems</u>

The Commission published a concept release in May 1997 requesting comment on the efficacy of the established securities regulatory structure as it applied to exchanges and other markets given the advancement of technology, and in particular, the growth of alternative trading systems.[2] During this time, alternative trading systems were performing exchange-like functions, such as matching and executing orders, but were regulated as broker-dealers.[3] The Commission was concerned that these disparities would affect the operation of the market including market transparency, the ability of an SRO to perform surveillance functions, the ability of investors to obtain fair access, and the stability of the alternative trading system.[4] In April 1998, the Commission proposed a new regulatory framework that supported technological innovation while ensuring basic investor protections.[5]

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[1] The focus of this letter is on Island trading activity in the QQQ, because it is the only listed security of which we are aware in which Island activity has crossed the Rule 301(b)(3) thresholds. The same analysis would apply to any other securities that triggered the Rule.
[2] "Concept Release: Regulation of Exchanges," Release No. 34-38672, 62 FR 30485 at pgs. 30486-30487 (June 4, 1997) (the "Concept Release").
[3] Id.
[4] Id., at pgs. 30491-30494.
[5] "Rule Proposal: Regulation of Exchanges and Alternative Trading Systems," Release No. 34-39884, 63 FR 23504 at p. 23506 (April 29, 1998) (the "Proposing Release")

On December 8, 1999, the Commission adopted new rules and rule amendments intended to integrate significant alternative trading system activity into the national market system.[6] As part of this structure, the Commission adopted Rule 3b-16 and introduced an updated interpretation to the statutory definition of an exchange.[7] This provided alternative trading systems with the choice of registering as a national securities exchange or as a broker-dealer and complying with the requirements of the newly adopted Regulation ATS.[8] The Commission noted that alternative trading systems opting for exchange registration were obligated to participate in the national market system mechanisms.[9]

2. Regulation ATS

Regulation ATS requires the integration of an alternative trading system's quotations in the consolidated NBBO when its trading volume is significantly impacting the market.[10] Alternative trading systems trigger integration requirements when they surpass established volume limits of 5% and 20% of average daily share volume in a particular security during four out of a preceding six month time period. These provisions integrate an alternative trading system's activity by requiring: 1) the display of orders and execution access under SEC Rule 301(b)(3) upon meeting the 5% volume threshold; and 2) fair access and evidence of the automated system's stability under SEC Rules 301(b)(5) and 301(b)(6) upon meeting the 20% volume threshold.[11] These provisions address the Commission's market impact concerns and work to close the gaps between exchanges and significant alternative trading systems in market transparency, equitable access and automated system stability.

As of May 2001, Island triggered SEC Rule 301(b)(3) by executing 5% or more of the average daily volume in the QQQ for four out of the preceding six months. Island has since remained above the 5% level. The Commission should note that Island traded more than 20% of QQQ's average daily volume in July 2001. Accordingly, Rule 301(b)(3) requires the integration of Island's orders into the public quotation system and requires that it provide equivalent access to its publicly displayed orders.

A. Rule 301(b)(3)(ii) - Quote Integration

SEC Rule 301(b)(3)(ii) requires alternative trading systems to provide their highest priced buy order and lowest priced sell order (unless these orders are displayed to

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[6] "Final Rule: Regulation of Exchanges and Alternative Trading Systems," Release No. 34-40760, 63 FR 70844 at p. 70846, (December 22, 1998) ("Final Release").
[7] Id., at p. 70847.
[8] Id.
[9] Id., at p. 70858.
[10] Id., at p. 70859.
[11] Rule 301(b)(3), 17 CFR 242.301(b)(3); Rule 301(b)(5), 17 CFD 242.301(b)(5); Rule 301(b)(6), 17 CFR 242.301(b)(6).

only one system subscriber) to an exchange or national securities association for inclusion in the market data provided to quotation vendors pursuant to Rule 11Ac1-1.[12]

At the time that the SEC adopted the new regulatory framework, there was no mechanism for alternative trading systems to disseminate their quotations in listed securities. As a result, in a release modifying the compliance dates, the Commission noted that alternative trading systems would not be violating Rule 301(b)(3) if a mechanism was not available to display their best orders in exchange listed securities.[13] However, it was noted that upon the development of such a mechanism, Rule 301(b)(3) "requires them to cooperate in linking with the market or markets providing that mechanism."[14]

Since the publication of the Revised Compliance Release, the NASD has developed a mechanism that provides alternative trading systems with the ability to publicly display their best priced orders in exchange listed securities.[15] The NASD amended its rules to allow the registration of alternative trading systems as ITS/CAES market makers. As ITS/CAES market makers, alternative trading systems can disseminate their best priced orders and allow non-subscribing broker-dealers the ability to access those orders. In fact, Archipelago LLC has registered as an ITS/CAES market maker and is currently disseminating quotations in listed securities.

B. <u>Rule 301(b)(3)(iii) - Order Access</u>

The SEC noted in the Final Release that the public investors' ability to access an alternative trading systems best priced orders is an essential element of the national market system.[16] Access to these orders can also aid broker-dealers in satisfying their duty of best execution. Consequently, SEC Rule 301(b)(3)(iii) requires alternative trading systems that publicly display their best priced orders to provide equivalent access to non-subscribing broker-dealers that are members of the SRO (exchange or securities association) with which it is linked.[17] Equivalent access requires an alternative trading system to provide member broker-dealers with the ability to access its quotes to the same extent that such broker-dealers can access other public quotes displayed by the SRO.[18]

The SEC indicated in the Final Release that alternative trading systems could comply with this standard by providing access in the same manner that ECNs are currently linked to the Nasdaq market.[19] Currently, Nasdaq broker-dealers access ECN quotes that are publicly displayed in the Nasdaq montage through SelectNet. The SEC

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[12] Rule 301(b)(3)(ii), 17 CFR 242.301(b)(3)(ii).
[13] "Final Rule: Technical Amendment and Revised Compliance Date," Release No. 34-41297, 64 FR 19450 at p. 19451 (April 21, 1999) (the "Revised Compliance Release").
[14] Id.
[15] SEC Release No. 34-42536, 65 FR 15401 (March 22, 2000).
[16] SEC Release No. 34-40760, 63 FR 70844 at p. 70869 (December 22, 1998).
[17] Rule 301(b)(3)(iii), 17 CFR 242.301(b)(3)(iii).
[18] Rule 301(b)(3)(iii)(A), 17 CFR 242.301(b)(3)(iii)(A).
[19] SEC Release No. 34-40760, 63 FR 70844 at p. 70870, (December 22, 1998).

did not provide a comparable illustration of equivalent access for exchange listed securities. However, a similar method of providing access to NASD quotes in exchange listed securities is through the use of the ITS/CAES linkage. Alternative trading systems can provide access to their quotes by registering as ITS / CAES market makers. [20]

Finally, Rule 301(b)(4) prohibits an alternative trading system from charging unreasonable access fees that are inconsistent with equivalent access.[21] The SEC stated in the Final Release that an alternative trading system's access fees would not be considered a barrier to equivalent access if they were comparable to the communications or systems fees charged by other markets. [22]

3. <u>The Importance of Applying SEC Rule 301(b)(3) to Island</u>

As mentioned above, during the month of January 2001, Island surpassed the 5% average daily volume threshold in QQQ. Island triggered the order display requirement of Rule 301(b)(3) on May 1, 2000 after trading the following percentages of the average daily volume in QQQ during the four preceding months: 5.7% in January 2001; 6.5% in February 2001; 9.9% in March 2001; and 12.3% in April 2001. Island's share of the average daily volume continued to grow to 13.5% in May 2001 and 17.6% in June 2001. Island's average daily volume in July 2001 rose above the 20% threshold to 20.2%. To date, Island is not complying with SEC Rule 301(b)(3) because it does not provide its best priced orders to a national securities exchange or national securities association for inclusion in the consolidated quote stream.

Island is currently facilitating the execution of a significant percentage of the volume in the most actively traded exchange listed securities in the United States. For example, Island traded over two hundred and forty million (240,000,000) shares of QQQ during June 2001. As noted above, this constituted 17.6% of average daily volume. In addition, because of the vast number of retail sized orders handled by Island, this activity constituted over 40% of the total trades in the security. As a result, an alternative trading system that is not integrated into the national market system is effecting more transactions, and far more retail-sized trades, than any single market center in the national market system.

The fact that Island accounts for such a significant percentage of the volume in QQQ raises policy concerns regarding Island's impact on public investors and the market, particularly with respect to market fragmentation and transparency. According to information published on Island's official website, the orders residing on Island's book were priced at or better than the consolidated BBO for over half of the trading day during the week of June 25, 2001 through June 29, 2001.[23] If Island's analysis is correct, the

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[20] SEC Release No. 34-42536, 65 FR 15401 (March 22, 2000).
[21] Rule 301(b)(4), 17 CFR 242.301(b)(4).
[22] SEC Release No. 34-40760, 63 FR 70844 at p. 70871, (December 22, 1998).
[23] According to Island, during the week of 6/25/01 through 6/29/01, the best bid on Island's book was better than the inside market more than 50% of the trading day, 13.85% of the time it was equal to the inside

absence of Island's best priced orders from the consolidated BBO has hindered competitive quoting and impaired the quality of the secondary equity market. The Commission recognized these risks and noted in its Proposing Release that "it may be inconsistent with congressional goals for an NMS that the best trading opportunities are made accessible only to those customers who, due to their size or sophistication, can avail themselves of prices in alternative trading systems not currently available in the public quotation system."[24]

Island's refusal to join the national market system, and thereby avoiding the ITS trade-through rule, allows it to provide investors with an immediate execution but it does not allow investors or brokers to access better priced orders on other exchanges. Since the introduction of ITS in 1978, the Commission has consistently emphasized the importance of intermarket linkages as a means for one exchange to access better prices on another exchange and, thereby, promote the best execution of investors' orders.[25] Most recently, for example, in October 1999 the Commission ordered the options exchanges to develop an inter- linkage plan with an accompanying uniform trade-through rule for the multiple trading of listed options.[26] The Commission noted that the linkage plan would assist investors in obtaining the best price available by reducing the number of intermarket trade-throughs of published quotations.[27]

The Amex performed a trade through analysis in QQQ for the month of July 2001 which revealed that nearly sixty (60%) of the third market executions, the majority of which are Island transactions, traded through the national BBO. Reviewing the trade through analysis along with Island's 11Ac1-5 execution quality report for the same time period reveals that public investor orders executed through Island receive inferior prices. Comparatively, marketable limit orders executed on Island have a greater effective spread, due to less trades receiving price improvement and more trades executed at inferior prices, than executions occurring on the Amex. The Amex believes that Island's failure to join the national market system linkage plan prevents brokers from obtaining the best execution for their customer orders.

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market, and 35.91% of the day it was outside of the market. In addition, during the same time period, the ask posted on Island's book was better than the inside market 41.77% of the trading day, 14.17% of the time it was equal to the inside market and 44.05% of the time it was outside of the inside market. The following information is available at www.island.com/qqq/index.asp.

[24] SEC Release No. 34-39884, 63 FR 23504 at p. 23515 (April 29, 1998).

[25] SEC Release No. 34-42029, 64 FR 57674 (Oct. 26, 1999).

[26] Id.

[27] SEC Release No. 34-43086, 65 FR 48023 (Aug. 4, 2000) (the "Amex/CBOE/ISE Approval Order"). In the order approving the joint plan submitted by the Amex, the Chicago Board Options Exchange and the International Securities Exchange, the Commission stated that "The absence in the options markets of firm quotes and intermarket linkages makes it more difficult for broker-dealers to ensure the best execution of customer orders for multiply-traded options."

Conclusion

The integration of Island's significant trading activity into the national market system is necessary to maintain the integrity of the pricing mechanisms and efficiencies within the public market. This integration must not only require Island to display orders and provide equivalent access, it must also ensure that Island complies with the rules that span across all market centers, including the ITS trade-through rule, locked / crossed market rule and block trading rule. The Amex strongly supports the Commission's objective of providing regulatory flexibility to emerging technologies in order to foster market innovation. We believe, however, that the continued substantial trading activity by Island in the most actively traded exchange-listed security, totally outside of the national market system mechanisms, seriously undermines the national market system, harms investors and could impair investor confidence in the marketplace. As stated at the outset, we are committed to working with the Commission in any way that can help bring Island into the national market system.

We would be happy to discuss any possible solution with the Commission staff.

Respectfully submitted,

/s/ Michael J. Ryan, Jr.

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November 14, 2001

Mr. Harvey L. Pitt
Chairman
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450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Island ECN

Dear Chairman Pitt:

I would like to thank you once again for taking the time to meet with us on October 30th. It was a pleasure to have the opportunity to discuss with you the top priority items at the American Stock Exchange. We are responding to your request for the views of the American Stock Exchange ("Amex") on several issues pertaining to the Island ECN ("Island"). In particular, at our meeting on October 30, you requested that we provide you with information on the revenue impact of Island's activity in the QQQ on the Amex, the impact of Island's activity on investors, and finally, whether the Island market structure is incompatible with its participation in the national market system. I have addressed each of the items below and attached an informational packet that contains the September 6, 2001 letter addressed to Annette Nazareth, Island's press and media releases, Island promotional material, 11Ac1-5 data analysis, and a volume and trade-through analysis of Island activity.

I. Revenue Impact of Island's Activity on the Amex

The Amex's primary source of revenue includes tape revenue and transaction charges. The competition in QQQ has led to a substantial decline in both of these revenue sources, leaving the Amex in a difficult financial situation. The Amex is currently losing Tape B revenue due to Island's garnering over 40% of the consolidated trades in QQQ.[1] Furthermore, in response to the NYSE offering free executions in ETFs,

[1] Island's trade share in QQQ in the past five months was 41% in June, 42% in July, 40% in August, 42% in September, and 49% in October.

the Amex was forced for competitive reasons, to eliminate customer transaction charges in these products. These transaction charges have traditionally been the Amex's largest source of revenue.

In October 2001, the third market accounted for 65% of the QQQ trades compared with Amex's 16%. Island's activity represents roughly 75% of the third market's QQQ trades during this period, and, as mentioned above, consistently represents over 40% of the transactions in the product. The Amex estimates that the 2001 Tape B CTA revenue loss due to Island's trading activity in QQQ to be $10.6 million[2]. Going forward, we estimate that our potential annualized loss of Tape B revenue based on current Island trade share to be $14.8 million dollars[3]. At the same time, the NASD will be collecting $31.8 million in revenue from total third market trading of QQQ, of which 40% (or $12.7 million) will be rebated to third market participants under Nasdaq's tape revenue sharing program.[4] Under this program, Island would receive approximately $9.5 million. The difference between the Amex's projected revenue loss and the Island's projected revenue is due to the fact that we do not assume that the Amex would recoup all Island order flow if Island ceased trading ETF products.

With respect to transaction charges ("TCs"), while difficult to estimate, the Amex estimates a revenue loss of approximately $3.5 to $4.5 million dollars.[5] This assumes that: (a) 30% of Island order flow is new, Island specific flow that would not have existed otherwise; and, (b) the remaining volume would be reallocated based upon volume market share distributions, again taking Island out of the equation.

In summary, Amex revenue losses directly relating to Island activity in QQQ are likely to be $15 to $20 million[6] per year, and that assumes that Island does not garner additional trade share. This dollar amount is quite significant for an SRO which operates a primary market that in its most successful year has a net operating income before taxes of $10.2 million dollars and often operates much closer to break even. The transfer of revenue is also significant given that the exchange invests a tremendous amount of capital and human ingenuity in developing innovative products for the marketplace. As the primary market, the Amex must provide unparalleled support to these products with technological and regulatory infrastructures that allow our specialists to fulfill their affirmative obligation to the marketplace by maintaining a fair and orderly market and a firm, continuous two-sided quotation.

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[2] Amount includes loss from the preceding four quarters.
[3] Represents annualized amount based upon the most recent two quarters.
[4] Represents annualized amount based upon the most recent two quarters.
[5] Amount includes loss from the preceding four quarters. This (loss) number is largely eliminated going forward, at least temporarily, given the Amex's elimination of customer transaction charges.
[6] The $20 million figure assumes the possibility that, in the future, customer transaction charges could be reinstated.

II. Cost of Island QQQ Activity on Investors

The current Island activity in the QQQs harms investors in several ways. First, investors who use Island to effect transactions in QQQ may not receive the best price available. Analysis performed by the Amex indicates that during the first half of October, 60% of the trades effected on Island were executed at a price outside the adjusted ITS BBO. In addition, investors trading on Island receive the worst effective spreads available among market centers. The chart below outlines the savings to investors if all of Island's executed volume in marketable limit orders received Amex quality executions in the month of August. The data within the chart is derived from the SEC's 11Ac1-5 data for the month of August.

	Order Size				
	100-499	**500-1,999**	**2,000-4,999**	**5,000-9,999**	**Total**
Island Executed Volume	11,157,962	86,729,567	48,799,985	56,978,838	
Island Effective Spread	$ 0.0280	$ 0.0310	$ 0.0331	$ 0.0352	
Amex Effective Spread	$ 0.0048	$ 0.0066	$ 0.0089	$ 0.0118	
Amex $ Savings	$ 129,432	$ 1,058,101	$ 590,480	$ 666,652	**$ 2,444,665**

Combining the three months for which Rule 11Ac1-5 data has been available, the total savings Island users would have realized with Amex executions exceeds $10.9 million dollars using the above methodology. This yields an annual figure of over $43 million dollars. This amount does not include additional access fees Island charges "liquidity takers" that are not reflected in QQQ's quoted price.

Second, non-Island market participants are harmed by Island's activity. We are aware that Island believes its professional or "sophisticated" investors are willing to sacrifice price for speed of execution and bear the cost of its trade-throughs. While we do not have a clear understanding of the mix of investors that use Island, we have a much better sense of another class of investors harmed by Island's conduct. This class would include the public customers and market professionals (specialist, market makers and dealers) whose published limit orders and bids and offers are traded through by Island. When public customers enter limit orders that are traded-through, at best they receive a delayed execution. At worst, they may fail to receive an execution altogether. Such trade-throughs discourage the use of limit orders. Similarly, market makers who risk their capital by posting aggressive bids and offers, only to see those markets traded-through with impunity, are discouraged from risking their capital, to the further detriment of public investors.

The national market system is designed to protect investors by creating price transparency and providing linkages that effectively allow broker-dealers to obtain the best price for their customers. Market transparency is provided through joint industry plans that oversee the consolidation and distribution of quotation and last sale information. The real time distribution of the best price at which an investor can buy or sell a security allows them to make a knowledgeable and informed decision. This information also helps broker-dealers to fulfill their fiduciary obligation to reasonably obtain the best price available for their customers. Broker-dealers cannot fulfill this obligation without an effective means to access these priced orders. Investors who use broker-dealers without access to these orders may feel that it is unfair that professional or sophisticated investors with access can obtain better prices for securities. Thus, the Commission approved joint industry linkage plans and accompanying trade-through rules not only to provide investors with the best available price but to also protect limit orders with price priority from the effects of a fragmented market. Island's non-compliance with Regulation ATS affects the national market system by reducing the transparency in the pricing of QQQ and the opportunity for the best execution of investor orders.

A. Market Transparency

The Commission adopted Regulation ATS in December 1999 in order to reconcile two competing concerns.[7] First, the Commission wanted to encourage innovation by allowing alternative trading systems that shared many of the attributes of conventional exchanges to develop without all of the regulatory constraints imposed on the existing exchanges. Second, it wanted to establish a mechanism for assuring that these alternative trading systems would not, by their growth and proliferation, impair market transparency, lead to excessive fragmentation or have other adverse impacts on the overall market. To do this, the regulation set out pre-established volume limits which, once exceeded, would provide for minimum participation by larger ATSs in the national market system. Regulation ATS thus requires these alternative trading systems to integrate their top of book into the consolidated BBO, either through Nasdaq or an exchange. This, in turn, requires alternative trading systems with activity in listed securities to comply with ITS quote and trade requirements. In addition, Regulation ATS requires access be granted to other broker dealers participating in the marketplace receiving the ATS's quotations. The access requirements allow broker-dealers to obtain the best price available for their customer.

Island's failure to display its best bid and offer in the consolidated quote has degraded the pricing efficiency and the quality of distributed information for QQQ within the national market system. The increase in arbitrage activity between Island and the exchanges is evidence of this fact. As indicated in our September 6 letter, Island's official website informed the general public that orders residing on its book were priced at or better than the consolidated BBO for over half of the trading day during the week of June 25, 2001 through June 29, 2001. Assuming this were correct, individual investors may not be able to make a fully informed investment decision because they do not receive complete quotation information about the availability of better priced bids and offers. Island may suggest that the open limit order book offered on its website fulfills their obligation by displaying the best priced bids and offers to the public. However, the volatility and the frequency of quote updates in QQQ would make it impossible to view

[7] "Final Rule: Regulation of Exchanges and Alternative Trading Systems," Release No. 34-40760, 63 FR 70844 at p. 70846, (December 22, 1998).

Island's limit order book along with the consolidated quote stream to determine the best price to buy or sell QQQ.

The Amex also believes that Island has evolved into a private market for QQQ that is not accessible to public investors. This two-tiered market allows professional and sophisticated investors unequal access to those displayed orders that are better than the BBO. Broker-dealers, even though eligible as an Island subscriber, may not obtain Island's better priced orders for customers because of regulatory concerns accessing liquidity that resides outside of the national market system. The Amex believes that this is not the result intended by Regulation ATS.

B. Market Fragmentation

In February 2000, New York Stock Exchange ("NYSE") filed a proposed rule change to repeal Rule 390 that would in effect allow its members to trade all NYSE listed securities in the third market.[8] Along with the proposed rule change, the Commission requested comment on issues relating to market fragmentation.[9] The Commission indicated in this concept release that NYSE executed over 83% of the share volume in its securities during the time period in question.[10] The Commission stated that the increased competition by the other market centers could potentially fragment liquidity in listed securities and decrease order interaction.[11] The Commission feared that the lack of order interaction could result in fewer executions, and thereby, discourage investors from entering limit orders. The decrease in competitively priced limit orders prevents vigorous quote competition in the national market system and prevents investors from receiving the best price available.[12]

In the present situation, Island has now advertised in *The Wall Street Journal* and other national periodicals that it surpassed the American Stock Exchange in becoming the largest marketplace in the QQQs.[13] Island at 27% of the volume was the single largest pool of liquidity in QQQ during a one week period with Amex trading 23.6% of the volume. Compare these statistics with the fact that NYSE executed over 83% of the share volume in its listed securities for October 2001. Market fragmentation in QQQ is not a possibility but a reality. This is exactly the situation where inter-market linkage and order interaction is imperative to the proper functioning of the national market system. It may appear that a select group of professional and sophisticated customers are receiving reduced transaction costs and expedient executions, but this is occurring to the detriment of the individual investors buying and selling QQQ in the national market system.

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[8] "Notice of Filing of Proposed Rule Change to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation," Release No. 34-42450, 65 FR 10577, (February 28, 2000).
[9] Id.
[10] Id., at pg. 10579.
[11] Id., at pg. 10580.
[12] Id.
[13] See attached advertisement. Island claimed to be the largest source of liquidity in the week ending October 19, 2001.

Investors that are unable to interact with orders on Island, including retail investors whose broker-dealers may be hesitant to direct orders to Island out of best execution concerns, are paying the price for allowing Island's market model to overrun the national market system. In addition, these broker-dealers are prevented from routing retail customer limit orders to Island because of the Limit Order Display rule. Thus, the limit orders of individual investors cannot interact with the largest pool of QQQ liquidity. This fragmentation may create a dual problem for the best execution of customer limit and market orders. First, the lack of order interaction may have reduced the possibility of a limit order execution. Secondly, the lack of vigorous quote competition within the national market system allows for the internalization of order flow at inferior prices. The costs incurred by public investors from inferior executions arising out of market fragmentation are difficult to quantify but have traditionally been recognized by the Commission as one of the basic reasons to maintain a strong national market system.

III. Island's Compatibility for Integration into the National Market System

The Amex strongly disagrees with Island's position that the operation of its market is inherently incompatible with its compliance with Regulation ATS and its integration into the national market system. In fact, Archipelago ("ARCA"), the new facility of the Pacific Exchange, evidences the fact that an alternative trading system with a market model very similar to Island's is compatible with the national market system. As you are aware, ARCA joined the national market system by integrating its quotes and complying with the ITS trade-through and locked/crossed market rules.

In this regard, the Amex had extensive discussions earlier this year with Island in an earnest effort to bring about just such integration into the market. As stated in our September 6 letter to Annette Nazareth, the Amex worked with Island to develop a means through which Island could report its trades and quotations through Amex as an integrated part of the national market system. The Amex developed a three-stage proposal to bring about this result. In the first phase, Island trades would be reported through the Amex to the tape. Amex would capture the revenue from these trades, a portion of which would be shared with Island (this is exactly what occurs today with Island trades reported through Nasdaq). In the next phase, we would integrate Island's quotes with those of the Amex. And finally, we would address trade-throughs by linking Island's and Amex's automated execution systems. Thus, the Amex would act as a conduit for ITS orders to Island from other markets.

Island participated actively in discussions on this three-step proposal, although it did have some concerns. In particular, it objected to Amex's request that orders that lock or cross the ITS BBO be rejected. Island also worried about the delays, even for a few seconds, that could arise for orders that might have to reach out from Island to the Amex system to be executed.

Before attempting to fully resolve these concerns, we felt it made sense to "test the waters" by airing the outlines of the proposal before the Commission staff.

Notwithstanding the fact that Island executions reported through Nasdaq were trading through the NBBO with considerable frequency (and that its quotes were not being included by Nasdaq in the Consolidated Quote System), the Commission staff was uncomfortable with any plan that contemplated such trade-throughs via an exchange. The staff told us that it was unwilling to allow the Amex to receive any transaction revenues from Island trades until we had first fully solved the quote and trade linkage issues. Under these circumstances, we were unable to make further progress with Island.

Island's assertion that its market structure is inherently incompatible with the nation market system is a fallacy. There should be little difference between Island's integration into the Nasdaq market for Nasdaq securities and its integration into ITS for exchange-listed securities. Yet, Island complies with Regulation ATS for Nasdaq securities but refuses to join the national market system in listed equities. For Nasdaq-listed securities, Nasdaq systems are programmed to reject bids or offers that lock or cross the market. To comply with this limitation, Island is supposed to reject orders that would lock or cross the BBO. Furthermore, Island interacts with outside systems in the Nasdaq market by executing orders delivered via SelectNet. The Amex's proposed solution was analogous to Island's current market structure for Nasdaq securities. Instead, Island's refusal to work with the Amex and integrate into the national market system has harmed investors by hindering transparency and fragmenting the market.

Moreover, we note that ARCA has a market structure very similar to Island's. It too relies on a matching protocol. ARCA participants enter priced orders that result in executions when the terms of offsetting buy and sell orders match. For exchange-listed securities, ARCA complies with ITS trade-through restrictions, and has achieved considerable success as a participant in the national market system.

Island's August 14, 2001 letter to the ITS participants outlining the way it would like to participate in ITS reveals Island's real concern. It proposed a one-way participation, where other markets would send orders to Island to avoid trade-throughs when Island had the inside market. But it would not be a two-way street, and Island would continue to be free to trade through when other ITS markets had a superior bid or offer. In short, unless Island's system can itself become the central linkage facility for the market, with substantial trading volume accruing to Island in the process, it wants to be excused from the SEC rules requiring it to participate in the national market system. If the Amex and NYSE had been able to adopt a similar stance in the late 1970's, on the grounds that ITS linkage was inconvenient and could lead to loss of volume, there is no doubt that the regional exchanges, and the competition they fostered, would have withered.

We understand Island's concern that ITS's manual interface is cumbersome. In this regard, we have indicated our willingness to work with Island on an automated linkage through Amex into the national market system. Even without such a linkage, however, ARCA's success has demonstrated that a market structure such as Island's is not inherently inconsistent with the national market system.

We hope you can understand the considerable frustration we feel as an exchange having expended substantial capital and resources creating an innovative product to the benefit of our industry, including our competition, only to lose substantial market share to a competitor whose very existence as an ATS is the result of a recently adopted SEC rule that it has then refused to follow and the Commission, to date, has declined to enforce.

Conclusion

As stated above, Island's failure to integrate into the national market system has impacted the Amex's revenues and has been harmful to investors and the national market system. The Commission will not be able to protect investors from the ill effects of market transparency and market fragmentation until Island integrates itself into the national market system. Island's market model offers investors instant executions by matching orders without regard for better prices offered by other market centers and, similarly, investors' orders that are routed through the national market system mechanisms that have been adopted under the Exchange Act do not have access to orders residing in Island. Finally, the Amex's participation in ITS and the national market system prevents it from creating a comparable service that would compete with Island's speed.

As you would expect, we are eager to have this issue addressed expeditiously. Aside from the revenue implications to the Amex, our own business and technology planning efforts hinge on the Commission's response to these substantial issues. The Amex strongly supports the principles of the national market system and encourages the Commission to allow competition to proceed under equal regulation among the various market centers.

Please feel free to contact me directly if you have any further questions or concerns.

Respectfully submitted,

/s/ Salvatore F. Sodano

Salvatore F. Sodano
Chairman & Chief Executive Officer

AMERICAN STOCK EXCHANGE
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November 19, 2002

Chairman Harvey L. Pitt
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Commissioner Cynthia A. Glassman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Commissioner Harvey J. Goldschmid
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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Commissioner Paul S. Atkins
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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Commissioner Roel C. Campos
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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Dear Chairman Pitt and Commissioners Glassman, Atkins, Goldschmid and Campos:

Introduction

As the Securities and Exchange Commission ("Commission") is aware, for nearly 18 months The Island ECN operated in open and notorious violation of the federal securities laws by failing to comply with the clear provisions of Regulation ATS. Related to this illegal activity, fraudulent and misleading trade reporting became commonplace for much of this year. Still, significant components of the federal securities laws designed specifically to ensure the best execution of customer orders continue to be frustrated and ignored. This letter outlines the background of this problem, including a history of Regulation ATS, Island's illegal activities and the American Stock Exchange's many attempts to address these very serious problems.

In summary, the situation remains intolerable – both in terms of remedying the past illegal activity and addressing the continuing and material violations of the core principles of the National Market System; that is, best execution, transparency, equal regulatory oversight and fair competition. As set forth below, we ask the Commission to take immediate and decisive action to:

- Effective as of January 1, 2002, adjust the revenue sharing formula to exclude trades from any market participant not fully integrated into the National Market System.
- Effective immediately, remove temporarily QQQ, SPY and DIA from the CQ and CTA market data revenue sharing formulas.
- Approve the American Stock Exchange's proposed amendment of the CQ and CTA Plans to modify the market data revenue distribution formula (expected to be filed with the Commission within the next month).
- Repeal Regulation ATS and take appropriate steps to modernize exchange regulation to reflect the realities of today's markets.

Background of the American Stock Exchange

The American Stock Exchange has a long history of innovation and is unique among the U.S. securities markets in that we are the only market that actively lists and trades securities across three diverse business lines – equities, options and exchange traded funds, commonly referred to as ETFs. In equities, we focus principally on providing a well-regulated auction market for small and mid-cap companies. Our options market is the second largest in the United States and, for the first time since entering this business more than 25 years ago, we have recently had weeks where we are the most active equity options market.

What really sets the Amex apart from all other U.S. markets, however, are ETFs. ETFs are probably the fastest growing, most innovative financial products offered by any financial institution over the last decade. After more than four years of working with the Commission and millions of dollars of R&D expense, the Amex pioneered ETFs in 1993 with the introduction of an ETF based on the Standard & Poor's 500® Depositary Receipts, known as Spiders (Amex: SPY). Since then, we have spent tens of millions more developing new products and educating the marketplace about the benefits of ETFs. Nine years later, the Amex remains the clear leader in ETFs, listing 124 of the 132 ETFs listed in the U.S. today, including in addition to Spiders, the Nasdaq 100® ETF (Amex: QQQ) and the Dow Jones Industrial Average® ETF, known as Diamonds® (Amex: DIA). Outside the American market, we have been able to leverage our reputation in ETFs to create a global presence for the Amex, reaching agreements to trade Amex-listed ETFs in Europe and Asia.

Not content to rest on our laurels, however, we are busy creating the next generation of ETF products – innovative products that will provide investors even greater flexibility and new investment opportunities. For example, we recently launched fixed income ETFs and are getting ready to introduce leveraged ETFs, inverse ETFs and, most significantly, actively managed ETFs.

In short, the American Stock Exchange has emerged as a strong, innovative international competitor. Significantly, these accomplishments have been achieved without the Commission bending or waiving the fundamental regulatory scheme that has shaped and fostered the National Market System over the last 25 years. Rather, the American Stock Exchange has spent countless hours and millions of dollars either conforming these new products to the existing regulatory structure or laboriously working with Commission staff and market participants to change rules where appropriate.

Notwithstanding the time, work and money spent developing these products in an environment where our competitors, because of unlisted trading privileges, can begin trading them virtually as soon as we do, the very accomplishments of the American Stock Exchange over the last ten years are now seriously threatened by Regulation ATS. This relatively new rule provides ECNs significant regulatory waivers from the burdens of exchange regulation, undermining the integrity of the Congressionally mandated National Market System – best execution, transparency, equal regulation and fair competition.

Background of the National Market System

In 1975 Congress adopted substantial amendments to the Securities Exchange Act of 1934 ("Act") designed to enhance the integrity and efficiency of our national securities markets. Specifically, Congress mandated the development of a National Market System to ensure, most importantly, the best execution of customer orders. The Commission, in turn, adopted rules under this mandate to require the industry to develop mechanisms and procedures designed, among other things, to enhance transparency of market data (e.g., timely and consolidated display of trading interest and trade executions) and foster interaction of investor trading interest (that is, minimize fragmentation and intermediation).

Central to meeting these requirements, all the exchanges and the NASD/Nasdaq adopted three critical National Market Systems plans for listed equity securities: the Consolidated Quote ("CQ") Plan, the Intermarket Trading System ("ITS") Plan and the Consolidated Tape Association ("CTA") Plan (collectively referred to as "Plans"). To put it in simple terms, CQ lets market participants see trading interest as soon at it arises (i.e., real time transparency of consolidated order and quotation information), ITS provides the mechanism for market participants to access this trading interest across markets (i.e., the exchanges and Nasdaq) and CTA provides the mechanism to learn about trades that occur almost immediately after they are executed.

Collectively, these Plans enhance real-time consolidated transparency of market data (i.e., the CQ Plan for quotes and CTA Plan for trades) and foster interaction of investor trading interest (i.e., ITS). Each of the Plans was submitted to and approved by the Commission. The objective was, and presumably continues to be, to provide the investing public with a consolidated National Market System which provides, *inter alia*, best bid and offer information that can be viewed and accessed by any investor, regardless of the market to which its order is routed.

The CQ and CTA Plans provide that the market data generated from these Plans be sold to market participants on a real-time basis. The revenue generated is then shared among the exchanges and NASD/Nasdaq ratably based on the number of trades executed by each market, but without reference to the number or quality of quotes displayed or if any quotes are displayed at all.

Since the adoption of these Plans, the Commission has on many occasions refined the rules relating to the National Market System (including adopting the Quote Rule, the Vendor Display Rule and Regulation ATS), reinforced the importance of the National Market System and underscored the central role these Plans play in meeting the mandate set forth in the 1975 Act Amendments. The Commission has done this by approving amendments to these Plans, approving rule changes submitted by all the exchanges and the NASD/Nasdaq in connection with the implementation of these Plans and in adopting Commission rules governing the operation of the exchanges, the NASD/Nasdaq and broker-dealers.

In the early 1990s, spurred by a desire to encourage innovation of new markets and "to avoid the strait jacket of exchange regulation" (to use the Commission's own words),[1] Commission staff began to give operators of trading systems that did not enhance liquidity in traditional ways through specialists, market makers or a single price auction structure, "no-action" relief if those systems operated without registering as exchanges so long as they abided by conditions set forth in the no-action letters. By the mid-1990s, however, the Commission became increasingly concerned with its "no-action" approach in light of technological advances and the corresponding growth of alternative trading systems. In part due to these concerns, on May 23, 1997, the Commission issued a concept release concerning the oversight of alternative trading systems, national securities exchanges and related issues.[2] Subsequently, on April 17, 1998 the Commission issued its Regulations ATS proposing release[3] and on December 8, 1998 adopted Regulation ATS.[4]

The Commission also adopted Regulation ATS in reaction to its well-founded concerns, documented in the Commission's Section 21(A) Report concerning the NASD,[5] that alternative trading systems were leading to market fragmentation and harming market transparency by operating as private "hidden markets."[6] Specifically, the operation of these alternative trading systems was – and, unfortunately, still is – leading to a two-tiered market, an unofficial one only accessible by the alternative trading system's customers and the official market being created by the National Market System and used by public investors. The Commission also took this step in

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[1] *See*, Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1980 (Jan. 19, 1990) ("Delta Release"), at page 23; see also Regulation ATS Adopting Release, Securities Exchange Act Release No. 34-40760 (December 8, 1998), at page 181.

[2] *See*, Securities Exchange Act Release No. 34-38627 (May 23, 1997).

[3] *See*, Securities Exchange Act Release No. 34-39884 (April 17, 1998).

[4] *See*, Securities Exchange Act Release No. 34-40760 (December 8, 1998).

[5] Report Pursuant to Section 21(A) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (1996).

[6] See Securities Exchange Act Release No. 34-40760 (December 8, 1998). In adopting Regulation ATS, the Commission, in particular, noted its prior findings in the "NASD 21A Report" that "widespread use of Instinet by market makers as a private market had a significant impact on public investors and the operation of the Nasdaq market" by allowing market makers to quote better prices than those made available to public investors. *Id*. at 8.

an attempt to address the growing regulatory disparity between ATS's and other markets, disparities the Commission found negatively affected other securities markets and, most importantly, public investors.[7]

Regulation ATS was supposed to integrate significant alternative trading system activity into the National Market System. Thus, in adopting Regulation ATS, the Commission stated:

> At present, alternative trading systems are not fully integrated into the National Market System, leaving gaps in market access and fairness, systems capacity, transparency, and surveillance. These concerns, together with the increasing significance of the alternative trading systems, call into question the fairness of current regulatory requirements, the effectiveness of existing National Market System mechanisms, and the quality of public secondary markets. Under the rules the Commission is adopting today, alternative trading systems that have the most significant effect on our markets will be required to integrate their trading into National Market System mechanisms.[8]

In adopting Regulation ATS, the Commission sought to establish a better balance between the regulatory needs of the Congressionally mandated National Market System and the desire to encourage the development of innovative new markets. The Commission sought to accomplish its goal by allowing, on the one hand, an ATS that operated below a threshold of 5% of the average daily trading volume in a security largely to escape the regulatory constraints placed upon registered exchanges. On the other hand, in an effort to bring ATSs into the National Market System, Regulation ATS was supposed to subject an ATS that exceeded the 5% threshold to an order display and equivalent access requirement, thus requiring that quotes in such security in that ATS be consolidated with all other markets' quotes and requiring the ATS to provide access to these quotes equivalent to access to other orders displayed by the exchange or association through which the ATS is quoting. Regulation ATS was also supposed to further subject an ATS that exceeded a 20% threshold to a fair access obligation and to certain other requirements, including capacity estimates and providing evidence of the automated system's stability.

<u>Problems with Regulation ATS and Exchange Regulation</u>

It has become increasingly clear that Regulation ATS has not resulted in the better balance between regulation and innovation sought by the Commission. For example, while a single *de minimis* ATS (an ATS with less than 5% market share) may not have a significant impact on the U.S. securities markets, the Commission failed to anticipate that the trading of multiple ATSs operating under the *de minimis* exemption can, in the aggregate, have a very negative overall impact on the National Market System's guiding principles of transparency, best execution, equal regulation and fair competition. Indeed, we believe the Commission should conduct an immediate analysis on a security-by-security basis of the most actively traded securities by ATSs to determine the consolidated volume in these securities being executed outside the National Market System. No doubt this analysis will show that significant trading

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[7] *Id*. at 8.

[8] Release No. 34-40760a, note 116 and accompanying text.

volume occurs through systems that do not consolidate their trading interest with all other markets and do not provide intermarket access to this trading interest, demonstrating that Regulation ATS has failed to achieve the Commission's stated objectives.

In contrast to the minimal regulatory regimen applicable to ATSs, exchanges are subject to a raft of burdensome requirements. For example, exchanges are obligated to enforce compliance by their members with their rules and the federal securities laws.[9] Pursuant to this obligation, the exchanges spend heavily on technology and incur significant data storage costs in connection with the fulfillment of their obligation to surveil trading in their markets. Not only are these systems very expensive to create, maintain and revise, as is frequently needed, but given their necessary limitations, they also require the exchanges employ large staffs to review the various reports created by them.

The Commission, moreover, recently brought several enforcement actions against SROs when it believed that they were not fulfilling their SRO responsibilities. In contrast to the Commission's willingness to take enforcement action against SROs, the Commission staff earlier this year directed the NASD in writing to desist from taking disciplinary action against any alternative trading system operating in violation of Regulation ATS. With this backdrop, we therefore were surprised to recently receive a letter from Chairman Pitt concerning trade-throughs in ITS that stated:

> SROs must enforce their own rules and the rules of the Commission. **The ITS trade-through provisions were designed to achieve important policy goals that remain vital today – to help achieve best execution of customer orders in exchange-listed securities and promote order interaction**. The Commission recognizes that these rules and the ITS itself were designed at a time when the order routing and execution facilities of the markets were much slower, intermarket competition less keen, and the minimum quote increment of exchange-listed securities was 1/8 of a dollar ($.0125). **However, if changes in the securities markets are believed to necessitate changes to the rules, ITS participants are obligated to work within the ITS Plan and with the Commission to address those issues, rather than failing to comply with the existing rules.**[10]

In addition to the exchanges' wide-ranging regulatory responsibilities, they also are subject to a number of additional burdensome and costly requirements that are not applicable to ATSs, even though ATSs and exchanges both meet the Rule 3b-16 definition of "exchange." Among these additional requirements are obligations to file and obtain Commission approval of rule and system changes; to file rules adopting, changing and even eliminating fees; to provide for fair representation of members in the management of exchange affairs; to have outside directors on the governing board; and, to comply with dual siting and system redundancy policies and fair membership access rules. The numerous requirements applicable to exchanges

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[9] Security Exchange Act Section 19(g)(1).

[10] Letter from Chairman Harvey L. Pitt to Amex Chairman and CEO Salvatore F. Sodano dated October 1, 2002 (emphasis added) (presumably, all other markets received a similar letter).

stifle innovation and impede their ability to compete with the less regulated and, therefore, more nimble ATSs. As noted above, the Commission itself has characterized the pattern of exchange regulation as a "strait jacket." In today's regulatory environment – which includes an exemption from the definition of exchange for some market participants that has swallowed the definition and the use of market data revenues by markets as a source of payment for order flow – there no longer is any meaningful reason to take on the burdens of being an exchange; indeed, from all indications, Island has abandoned its efforts to become an exchange.

The Commission's policy bias in favor of alternative trading systems not only conflicts with the National Market System goals of equally regulated, linked markets making their best prices publicly known and accessible, it also damages the interests of investors by favoring markets that do not employ liquidity providers such as specialists and market makers with affirmative obligations to the market.[11] We thus question the public policy basis for more burdensome regulation on markets that feature specialists and market makers with affirmative obligations as opposed to markets that lack such liquidity providers, particularly when there is no demonstration that markets that feature liquidity providers with affirmative obligations are more susceptible to trading practice abuses than other markets. Ironically, the most fraudulent and abusive trading practice of 2002 occurred as a direct result of the practices of an ATS – trade shredding and wash sales. To layer another level of irony on to this, this ATS used the revenues from the National Market System to support and promote this fraudulent and abusive trading.

While we appreciate – indeed, support – the Commission's desire to foster innovation in the development of our markets by removing the burdens of exchange regulation, we take exception with the unarticulated assumption that alternative trading systems are more innovative than markets registered as exchanges. We believe the American Stock Exchange's innovative leadership over the past 25 years belies this assumption, particularly while wearing the exchange "strait jacket." Indeed, the Amex continues to be a leader in innovation,[12] even in a regulatory environment where participants such as Island operate in unabated and protected free riding of our innovation, to the direct detriment of the very reason we exist – the public investor.

Finally, we believe the National Market System and, more importantly, public investors would be far better served by ending the Commission's policy bias towards new, so-called innovative markets by the development of a more evenhanded, contemporary approach to exchange regulation. The Commission should level the playing field between registered exchanges and alternative trading systems by repealing Regulation ATS and requiring the affected markets to register as exchanges. Further, we believe the Commission should give serious consideration to freeing exchanges from their outdated regulatory burdens and apply a regulatory regime more relevant to today's capital markets.[13] In view of the development of

[11] Congress and the Commission have long recognized that the presence of market makers with affirmative obligations is in the public interest and interest of investors. See, for example, Exchange Act Section 11(a)(1)(A) and Commission Rule 11a-1(b)(1).

[12] For example, for more than four years the American Stock Exchange has sought to innovate and advance trading by providing integrated market making, only to be frustrated each step of the way.

[13] For example, the Commission should publish the Amex's 2001 proposal to modernize the stabilization rules we adopted in 1965.

ATSs in recent years and their acceptance in the U.S. markets, we see no reason to maintain two wildly dissimilar regulatory structures for organizations that perform the historical function of an exchange in providing a forum for trading and fit the Commission's definition of an exchange.

Specific Problems with Island

For nearly 18 months The Island ECN operated in open and notorious violation of the federal securities laws. Without any justification, Island flagrantly violated Regulation ATS by refusing to disseminate into the National Market System its quotations in securities in which it exceeded the 5% volume threshold or to allow access to its orders in such securities to members of other markets. Island also engaged in and fostered other abusive and fraudulent trading practices. Throughout this period, the American Stock Exchange as well as many other market participants and regulators brought these activities to the attention of the Commission and pleaded with the Commission to take the appropriate action to bring it to an end (See Exhibit A).

Each time, however, the Commission either ignored these pleas for action or, worse, summarily rejected every alternative put forth to address the problem. These alternatives ranged from allowing all other market participants to adopt the same trading model as Island to ending the practice of giving Nasdaq credit under the CQ/CTA revenue sharing formula for Island's trades (which revenues Nasdaq in turn kicks back to Island). The basis for seeking to end Nasdaq's kick-back program is that it defies any notion of logic or fairness that Nasdaq or Island should receive direct financial benefit from the National Market System when Island steadfastly refuses to participate in the most fundamental of National Market Systems functions – consolidating quotations with all other markets and providing intermarket access to those quotations.

Ironically, if the Commission had not insisted that a majority of the CQ/CTA participants withdraw their resolution passed in February 2002 which would have excluded trades that violated Regulation ATS from the CQ/CTA revenue sharing formula, much if not all of this problem would have long been resolved. Further, this interpretation would have absolutely prevented Island's trade shredding and wash sale scheme that proliferated during much of 2002. In yet another attempt to address these problems, we sought to amend the CQ and CTA Plans so as to exclude from the CQ/CTA revenue sharing formula trades from a market not participating in the National Market System; amendments, however, require unanimous approval of all plan participants (i.e., all the exchanges and the NASD/Nasdaq). As we were unable to achieve unanimity (not a surprising result given the financial benefits some of the Plans' participants are realizing because of Island's illegal activity), we submitted a petition in May 2002 seeking to have the Commission amend the CQ and CTA Plans.[14] To date, however, the Commission has been unwilling even to publish the proposal for public comment.

To exacerbate matters, Island recently began reporting (i.e., selling) trades in ETFs (including SPY, QQQ and DIA) to the Cincinnati Stock Exchange ("CSE") in a manner that will neither display Island's quotes nor make them accessible. Under this scheme, CSE will pay

14 See letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, to Jonathan G. Katz, Secretary, SEC, dated May 13, 2002, Petition to Amend Section XII(a)(i) of the CTA Plan relating to Calculation of "Annual Share" ("Petition"). The Exchange also submitted to the Commission a Memorandum in Support of Petition to Amend the CTA Plan, dated May 13, 2002.

Island 50% of CSE's market data revenue that it receives under the CTA Plan. In this regard, we note that CSE's arrangement with Island is completely inconsistent with the principles of the National Market System and the express purposes of Regulation ATS. Indeed, Island will **not** be displaying its best priced orders through CSE and **none** of Island's best priced orders will be accessible to other markets through ITS. In fact, orders matched at a price outside the national best bid and offer ("NBBO") – that is, that trade through a better price in the National Market System – will continue to be reported to Nasdaq and be compensated for under Nasdaq's Pilot Payment for Order Flow Program.

Our understanding[15] is that Island, in conjunction with CSE, has developed a creative scheme to carry out this arrangement that works as follows: The Island ECN has an affiliate know as Island Execution Services. Island Execution Services is a member of CSE and acts as a dealer on CSE; that is, they display continuous two sided quotations on CSE. By doing this, technically they are part of the consolidated quotation and accessible through ITS. Since this scheme was developed, however, experience has shown that the CSE quotations in SPY, QQQ and DIA, for example, consistently are exceptionally wide and, thus, are rarely accessed by other markets because they are never the best bid or best offer.[16] When Island ECN receives orders from its customers, and there is a match of a buy and a sell order that is at or between the NBBO,[17] rather than execute the order in The Island ECN, the matched orders are shipped to Island Execution Services which, in its CSE dealer capacity, passes these two orders through the CSE limit order book. The purpose of this exercise is that within each exchange market, all orders are given price-time priority; therefore, if there happens to be an equally priced (or better priced) limit order on the CSE limit order book, it would have priority and would have to be executed before the order being shipped in from The Island ECN.

If neither of the shipped orders is matched with a limit order in the CSE book – and they never are because there are never any limit orders residing on the CSE book – the shipped orders are executed against each other on the CSE. Because all of this processing and shipping is done electronically, this entire arrangement from receipt of the orders by The Island ECN to execution

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15 Our understanding is based on conversations we have had with market participants. In an effort to confirm our understanding, on November 18, 2002 I emailed an outline of our understanding to Cameron Smith, General Counsel of The Island ECN, and Jeffrey Brown, General Counsel for the CSE and placed a follow-up telephone call to both Mr. Smith and Mr. Brown, leaving a message for each. As of the sending of this letter I have not heard from either of them; if we determine that our understanding is not accurate, I will update this letter.

This highlights another classic example of the problems and inequities created by Regulation ATS. That is, through the rule filing process, exchanges are forced to expose to all market participants – including their ATS competitors – the details of their business plans, thus eliminating the opportunity to obtain meaningful first-mover advantage or the ability to maintain trade secrets. ATSs, on the other hand, are never required to expose their business operations. Indeed, attempts by our outside counsel under FOIA to obtain background information concerning Island's lack of compliance with Regulation ATS have been rejected to date by the Commission.

16 Indeed, our data shows that for November 1 - 18, 2002 the CSE average spread for DIA, QQQ and SPY was in excess of $13.00, $25.00 and $27.00, respectively; to provide context, the Amex average spread in these securities during this period was $0.09, $0.03 and $0.08, respectively. Further, for October 2002 CSE's percent of time at the NBBO for DIA, QQQ and SPY was 0.15%, 0.99% and 0.00%, respectively.

17 For purposes of this scheme, the NBBO for SPY, QQQ and DIA is -.03 cents for the best bid and +.03 cents for the best offer to take advantage of the .03 cent trade-through exemption approved by the Commission in August.

on the CSE is carried out virtually instantaneously. All this explains CSE's recent sudden increase in market share in SPY, QQQ and DIA.

In summary, for matched orders outside the NBBO, The Island ECN executes the match and reports it to Nasdaq's third market, which pays The Island ECN under Nasdaq's market data revenue payment for order flow scheme. For matched orders at or between the NBBO, on the other hand, The Island ECN ships the order to Island Execution Services which executes the match on the CSE, which pays Island Execution Services under CSE's market data revenue payment for order flow scheme.

Thus, Island continues to perpetuate a two-tiered market where orders entered in Island never become part of the consolidated quote and are not accessible through ITS. This is precisely the problem the Commission was attempting to address in adopting the Limit Order Display Rule and Regulation ATS. Aside from violating Regulation ATS for nearly 18 months, Island's business model seriously undermines these rules by reducing the transparency of our markets and by impeding access among market participants, all to the detriment of the investing public.

Against this backdrop, it was with utter amazement and frustration that we witnessed this past August the Commission's unilateral amendment of the ITS plan for SPY, QQQ and DIA in a manner obviously designed to accommodate Island and permit its extra-legal conduct to continue.[18] What was most troubling about the Commission's action is that it came with virtually no warning and without any discussion with any of the interested parties except Island. Nevertheless, it is clear to the American Stock Exchange that the Commission – especially the newly appointed Commissioners – took this step without receiving a full briefing of the background and all the problems associated with Regulation ATS and Island's activities. In fact, we believe it is the lack of more extensive consideration and analysis that led to the Commission's miscalculation that Island would actually respect the spirit of Regulation ATS and the ITS exemption.

Further, throughout this year-and-a-half period the Amex has honored every request by the Commission to refrain from taking any action based on promises that the issues would be addressed expeditiously. While we have complied with the Commission's requests, Island has cavalierly ignored the Commission's efforts to have it join the National Market System. This moxie by Island reached its pinnacle in September when, with respect to the same three ETFs that were the subject of the Commission's ITS Plan exemption, it chose to "go dark" (i.e., to no longer even display its subscribers' orders to other subscribers), a tactic it adopted notwithstanding the Commission's grant of an unprecedented exemption to a core National Market System principle designed specifically to accommodate Island.

By "going dark," Island can contend that it has achieved technical compliance with Regulation ATS. However, Island has in fact achieved precisely the result that the Commission sought to avoid with the adoption of Regulation ATS, namely the presence of a two-tired market – an unofficial one only accessible by the alternative trading system's customers and the official market existing within the National Market System that is available to public investors. Island's

[18] Securities Exchange Act Release No. 34-46428, August 28, 2002.

actions have led to the truly perverse result seen today of an alternative trading system (Island) and a facility of a national securities association (Nasdaq) sharing in revenue generated by two National Market System plans (the CQ and CTA Plans) while the ATS is invisible and inaccessible to the intended beneficiaries of the National Market System – the investing public. It should go without saying that allowing significant ATSs to opt out of the National Market System because the Commission is reluctant to allow Regulation ATS to be enforced or because of the exception that allows markets, like Island, to "go dark" undermines the core National Market System principles of transparency, best execution, equal regulation and fair competition.

To make matters worse, Island spends a great deal of time and resources attempting to convince the marketplace that they are the faster, low-cost trading alternative – a disingenuous and misleading claim that is absurd to anyone truly familiar with their practices. The principal reason Island is faster is because it ignores the investor protection rules followed by the other markets that ensure investors receive the best available price in the market – that is, it refuses to participate in the Congressionally mandated National Market System. Worse still, Island is free to use the CQ and CTA Plan revenues kicked back to it to garner more trading volume, which is similarly walled off from the National Market System – and the vicious cycle continues. In other words, the American Stock Exchange and other markets that comply with federal securities laws by fully participating in the National Market System and creating the real value of CQ and CTA, are actually providing direct financial support to a competitor that is knowingly violating mandates of the federal securities laws and undermining the National Market System.

Conclusion and Recommendations

While the American Stock Exchange appreciates the seemingly endless challenges facing today's Commission and the efforts taken to address the myriad of market structure issues – especially the recently held market structure hearings – our frustration with this situation has reached its limits. Accompanying this letter is an outline that details the history of Island's flaunting of the rules and the Commission's acquiescence in that behavior, including the steps we have taken to address this problem (see Exhibit A).

With this background, the Commission should take immediate and decisive action to adopt the following:

- Effective as of January 1, 2002, amend the CQ/CTA revenue sharing formula to exclude trades from any market participant not fully integrated into the National Market System; as noted above, a petition to amend the CQ and CTA Plans to accomplish this was submitted by the American Stock Exchange in May but has not been acted upon.
- Effective immediately, remove QQQ, SPY and DIA from the CQ and CTA market data revenue sharing formulas until such time as: (a) the ITS trade-through issues are resolved and implemented; and (b) the CQ and CTA market data revenue sharing formulas are amended and implemented; a copy of a petition being concurrently submitted by the American Stock Exchange to the Commission is enclosed herewith (See Exhibit B).
- Approve the American Stock Exchange's proposed amendment of the CQ and CTA Plans to modify the market data revenue distribution formula; I expect that a formal petition

will be filed by the American Stock Exchange within the next month, following submission of the matter to the CQ and CTA Plan Participants.

- Take appropriate steps (1) to repeal Regulation ATS in recognition of its failure (thus requiring all markets that meet the definition of exchange to register as an exchange) and (2) to modernize exchange regulation to reflect the realities of today's markets.

Clearly, there is an immediate and continuing crisis undermining the National Market System and leading to fraudulent and misleading trading. Worse still, the National Market System is funding all this. Until an ideal solution is crafted, the Commission should immediately take the actions outlined above.

Respectfully Submitted

/s/ Michael J. Ryan, Jr.

Michael J. Ryan, Jr.
Executive Vice President and
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Exhibit A

<u>History of Regulation ATS, Island's Illegal Activities and Amex's Response</u>

- May 23, 1997 – Commission issues Concept Release concerning Market Fragmentation. (Securities Exchange Act Release No. 38672, May 23, 1997). In response, the Commission receives numerous comment letters from a variety of market participants.
- April 17, 1998 – Commission issues Regulation ATS proposing release in which the Commission proposes, among other things, that an ATS that achieves 10% or more market share must participate in the national market system. Securities Exchange Act Release No. 39884, April 17, 1998). The Commission receives 70 comment letters on the proposal.
- December 8, 1998 – Commission adopts Regulation ATS, but lowers threshold for having to join the national market system from 10% to 5%.
- October 2000 – *Island achieves 2% market share in DIA.*
- December 2000 – *Island achieves 3% market share in DIA.*
- December 2000 – *Island achieves 4% market share in QQQ.*
- January 2001 – *Island achieves 5% market share in QQQ.*
- January 2001 – *Island achieves 6% market share in DIA.*
- February 2001 – *Island achieves 6% market share in QQQ.*
- March 2001 – *Island achieves 9% market share in QQQ.*
- March 2001 – *Island achieves 1% market share in SPY.*
- March 2001 – *Island achieves 7% market share in DIA.*
- April 2001 – *Island achieves 10% market share in QQQ.*
- April 2001 – *Island achieves 4% market share in SPY.*
- **May 2001 – *Island triggers Regulation ATS for QQQ by achieving 5% market share in four of the prior six consecutive months.***
- June 2001 – *Island achieves 15% market share in QQQ.*
- Summer 2001 – Conversations with the Commission proposing making Island a facility of the Amex, which over time would have brought Island into compliance with Regulation ATS – the Commission rejected this idea.
- September 6, 2001 – Michael Ryan letter to Annette Nazareth requesting enforcing Regulation ATS (no response, verbal or written, ever received).
- **September 2001 – *Island triggers Regulation ATS for SPY by achieving 5% market share in four of the prior six consecutive months.***
- October 30, 2001 – meeting with Chairman Pitt, Annette Nazareth, Bob Colby, Sal Sodano, Peter Quick and Michael Ryan concerning, among other things, Island's illegal trading.
- October 2001 –*Island achieves 20% market share in QQQ.*

- October 2001 – *Island achieves 5% market share in SPY.*
- November 14, 2001 – Sal Sodano letter to Chairman Pitt re: impact of Island's activity.
- November 2001 – *Island achieves 6% market share in SPY.*
- *December 4, 2001 – letter from Wick Simmons to Harvey Pitt supporting Island.*
- December 10, 2001 – Michael Ryan letter opposing Nasdaq's PFOF (focused on QQQ).
- December 19, 2001 – Michael Ryan letter opposing Nasdaq's PFOF (focused on DIA).
- December 19, 2001 – Michael Ryan letter to Mark Radke re Island issue.
- *December 20, 2001 – letter from Ed Knight to Annette Nazareth responding to Michael Ryan December 10th and 19th letters (not received until December 27th).*
- December 26, 2001 – Michael Ryan letter to Jonathan Katz re: Nasdaq's PFOF Program.
- December 2001 – *Island achieves 25% market share in QQQ.*
- January 1, 2002 – Island begins paying its customers for order flow. This created the direct incentives for Island customers to shred trades and execute "wash sales."
- January 2002 – Commission issues no-action letter to NASD re: enforcement of Regulation ATS.
- February 11, 2002
  - 11:00 am – CTA meeting (conference call, including Commission representatives) where Michael Ryan outlined proposal Amex to make at February 15th CTA meeting.
  - 12:00 noon – Meeting Annette Nazareth, Bob Colby and Michael Ryan where Michael outlines to Annette and Bob the proposal Amex to make at February 15th CTA meeting.
  - 2:00 pm – Meeting Chairman Pitt, Mark Radke, Annette Nazareth, Bob Colby, Sal Sodano, Peter Quick and Michael Ryan where Amex outlines the proposal it intends to make at February 15th CTA meeting.
- February 15, 2002 – Regular quarterly CTA Meeting (including Commission representatives). A vote on Amex's motion to adopt Resolution interpreting CTA and CQ Plans so as to exclude from plans' revenue sharing formula trades in a security from a market participant not providing quotations in the security as required by Rule 11Ac1-1 or Regulation ATS was taken with Amex, CHX, NYSE, PCX and PHLX in favor, BSE, CBOE and NASD against and CSE abstaining.
- February 16-18, 2002 – Communications from the SEC demanding that the Amex withdraw the February 15th CTA vote.
- February 19, 2002 – CTA Meeting (special conference call, including Commission representatives) Amex advised that in conversations over the weekend, the SEC made clear that it would strike down the interpretations of the Plans covered in the Resolution and that Plan amendments would be required for CTA to adopt those interpretations. Amex advised that while it believed that the interpretation was appropriate, it made a motion to reverse and

nullify the Resolutions. The motion to reverse and nullify the Resolutions was seconded and approved by Amex, BSE, CBOE, CHX, NASD, NYSE, PCX and PHLX. CSE abstained.

- February 2002 – *Island achieves 20% market share in QQQ for the prior four consecutive months.*

- February 2002 – *Island achieves 10% market share in SPY.*

- March 13, 2002 – CTA Meeting (special conference call, including Commission representatives) Amex introduced a proposal to amend the Plans to exclude from the revenue sharing calculation any trades from a Participant's member when the Participant does not furnish quotations from that member to CQ or when the quotations from a member are not accessible through ITS. Amex agreed to modify the proposed Plan amendments to incorporate suggestions made during the discussion and to present new language at a later meeting.

- March 20, 2002 – CTA Meeting (special conference call, including Commission representatives) Amex then proposed a resolution that CTA adopt and approve the amendments to the Plans circulated March 19,2002 as substantially submitted. During the ensuing discussion, the Participants discussed Plan amendments language, obligations of the firm quote rule, trade reporting and ITS, different rules that Participants operate under and various trade reporting scenarios that may or may not be eligible for revenue sharing. Following discussion, Amex withdrew its motion and advised they would incorporate the changes discussed in revised Plan amendments that would be circulated.

- March 22, 2002 - CTA Meeting (special conference call, including Commission representatives) Amex advised the Participants that the objective was to finalize language in the amendments to limit the revenue sharing allocation formula to trade prints of members of Participants that quote through CQ and that makes their quotes accessible through ITS. During the ensuing discussion the Participants reviewed differences in the various markets' trade reporting rules, the value of quotes as part of the price discovery process, the Primex system and how it operates, and the difficulty of crafting language that will address tomorrow's innovations as well as today's technology. At the end of the discussion, Amex advised that it would revise the language along the lines discussed and send copies to the Participant for review.

- March 28, 2002 - CTA Meeting (special conference call, including Commission representatives) Amex advised that, in accordance with comments made at March 13 meeting and at additional special meetings on March 20 and March 22, it had revised the language in the Plan amendment; substance of proposed amendment is to exclude fromCTA/CQ revenue sharing formula trades executed on a marketplace not fully participating in the national market system with respect to the security involved.. Participants voted to approve the Resolution by a vote of 6 in favor: Amex, BSE, CBOE, CHX, NYSE and PHLX; 2 against: CSE and PCX: and 1 abstention: NASD. However, because the Resolution involves amendments to the Plans, the absence of unanimity means that the amendments were not adopted.

- March 2002 – *Island achieves 30% market share in QQQ.*

- March 2002 – *Island achieves 10% market share in DIA.*
- March 2002 – *Island achieves 15% market share in SPY.*
- **March 2002 – *Island triggers Regulation ATS for DIA by achieving 5% market share in four of the prior six consecutive months.***
- May 1, 2002 – Michael Ryan email to Commission (Market Regulation & Chairman's Office) and NASDR informing them of trade shredding occurring on the Island ECN.
- May 8, 2002 - Regular quarterly CTA Meeting (including Commission representatives). In connection with Other Business, Amex distributed copies of a draft resolution covering revenue distribution to a Participant in the case where a member of the Participant or its customers are unjustifiably breaking up trades. Amex referred to Island's Market Data Distribution Plan taken from Island's web site, which motivates customers to break up trades in order to get more market data revenue. Amex showed detail from Island's website that displayed the decrease in average trade size and the increase in total number of trades. Amex distributed the Network B first quarter financials and advised that they reserved the right to revise payments based upon approval of his resolution. Amex advised that they are considering all legal actions and reviewing all rights in connection with the first quarter distribution.
- May 8, 2002 – Michael Ryan letter to all CQ/CTA Participants (with cc to Commission) reserving all rights with respect to first quarter 2002 market data revenue distribution.
- May 20, 2002 – Nasdaq's average trade size in Tape B securities drops from approximately 1300 shares to 750 shares due to trade shredding on Island.
- May 25, 2002 – Nasdaq's average trade size jumps back up to approximately 1500 to 1600 shares in apparent response to email to Commission and NASDR.
- May 13, 2002 – Amex petitions Commission to amend CQ and CTA Plans to excludes trades from market participants that do not fully participate in the NMS (i.e., CQ, ITS & CTA).
- June 10, 2002 – Nasdaq's average trade size returns to approximately 750 shares.
- June 27, 2002 – Amex arranges a meeting for July 30, 2002 between Chairman Pitt and Sal Sodano (to be accompanied by Amex Board members) – Meeting cancelled on July 29, 2002 by Chairman Pitt's office.
- June 2002 – NASD announces enforcement action for "wash sales" against Swift Securities, an Island customer.
- June 2002 – *Island achieves 35% market share in QQQ.*
- June 2002 – *Island achieves 15% market share in DIA.*
- July 3, 2002 – Commission abrogates Nasdaq Stock Market and Cincinnati Stock Exchanges payment for order flow programs (i.e., market data revenue sharing programs).
- July 8, 2002 – Amex's outside counsel submits FOIA request to Commission concerning Island and Regulation ATS; to date no responsive documents have been provided by the Commission.

- July 5, 2002 – Nasdaq’s average trade size jumps back up to approximately 1500 to 1600 shares.
- July 15, 2002 – Commission staff reverses terms and conditions set forth in July 3rd abrogation order.
- July 2002 – Island establishes relationship with Cincinnati Stock Exchange whereby trades at or between the NBBO are shipped from Island ECN to Island Execution Services, a nominal specialists on the Cincinnati Stock Exchange, for trade reporting on Cincinnati.
- July 2002 – *Island achieves 25% market share in DIA.*
- July 2002 – *Island achieves 20% market share in SPY*
- August 9, 2002 – Michael Ryan letter to all CQ/CTA Participants (with cc to Commission) reserving all rights with respect to second quarter 2002 market data revenue distribution.
- August 2002 – *Island achieves 35% market share in DIA.*
- September 18, 2002 – Meeting between Chairman Pitt and Sal Sodano (accompanied by Amex Board members).

AMERICAN STOCK EXCHANGE®
Equities Options ETFs

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January 31, 2003

Chairman Harvey L. Pitt
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Commissioner Cynthia A. Glassman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Commissioner Harvey J. Goldschmid
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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Commissioner Paul S. Atkins
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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Commissioner Roel C. Campos
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Dear Chairman Pitt and Commissioners Glassman, Atkins, Goldschmid and Campos:

I am writing this letter as a follow-up to my November 19, 2002 letter to you. As you will recall, in that letter I outlined for you a serious and continuing problem concerning the operation of our securities markets. Specifically, my letter described the problems with Regulation ATS, Nasdaq's Payment for Order Flow ("PFOF") program and the Cincinnati Stock Exchange's PFOF program and the fraudulent and misleading trading and trade reporting these have spawned through The Island ECN and Island Execution Services. For more than eighteen months The Island ECN operated in open and notorious violation of the federal securities laws through its failure to comply with the clear provisions of Regulation ATS and then its subsequent decision to "go dark", notwithstanding the Commission's grant of an unprecedented exemption to a core National Market System principle designed specifically to accommodate Island.

As I mentioned in my November 19th letter (pages 8 through 10), Island's most recent scheme is with the Cincinnati Stock Exchange. Island has traded in its payment for order flow program that led to trade shredding and wash sales for an equally reprehensible scheme – selling trade reports to the Cincinnati Stock Exchange. This "print selling" scheme involving Island and the Cincinnati Stock Exchange began last summer and continues through today. To give you a sense of the poor quality of the market that is coming from Island and the Cincinnati Stock Exchange here is the average spread and market share for each market for December 2002 in SPY, DIA and QQQ:

Market	SPY		DIA		QQQ	
	Average Spread	Market Share	Average Spread	Market Share	Average Spread	Market Share
American S.E.	$0.07	28.7%	$0.08	24.1%	$0.03	16.1%
Boston S.E.	$0.37	8.1%	$0.04	7.9%	$0.09	8.5%
Cincinnati S.E.	$999.98	15.6%	$13.83	18.5%	$22.88	28.2%
Chicago S.E.	$0.33	3.8%	$0.29	5.1%	$0.14	7.0%
New York S.E.	$0.06	8.1%	$0.07	7.9%	$0.04	6.1%
Pacific S.E.	$0.03	18.0%	$0.04	16.6%	$0.02	12.8%
Nasdaq S.M.	$0.04	17.6%	$0.05	19.9%	$0.02	17.3%
CBOE	$0.09	0.1%	N/A	N/A	$0.14	0.0%
Philadelphia S.E.	N/A	N/A	N/A	N/A	$0.06	4.0%
		100.0%		100.0%		100.0%

I will let the data speak for itself.

Ironically, last week Chairman Pitt wrote a letter to the American Stock Exchange stating that he is "seriously concerned that economic inducements to order-flow providers and internalization by member firms create serious conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution of its customers' orders."[1] We could not agree more and in fact for many, many years the American Stock Exchange has publicly opposed all forms of payment for order flow. Once again, we are calling on the Commission to bring an immediate end to this abhorrent practice. At a minimum, the Commission must stop all SROs from engaging in any form of payment for order flow. Chairman Pitt's letter suggests that the options SROs should consider having the NASD take over enforcement of best execution in the options industry. This is not the right answer. As an initial point, I would remind the Commission that NASD/Nasdaq are engaged in payment for order flow. Indeed, it is this SRO-sponsored payment for order flow program that was at the core of the trade shredding and wash sale problems of 2002. To be fair to the NASD/Nasdaq, the Commission approved this program and went as far as instructing the NASD not to enforce Regulation ATS, which was also a critical part of all these problems.

[1] Letter dated January 24, 2003 from Harvey L. Pitt, Chairman, Commission, to Salvatore F. Sodano, Chairman, American Stock Exchange. Our understanding is that similar letters were sent to all the options exchanges.

If ever there has been an easy answer to any of the multitude of problems and challenges facing the Commission, it is in connection with SRO-sponsored payment for order flow in both the equities and options markets – END ALL OF IT! This practice creates an overwhelming and obvious perception of a conflict of interest. Further, it is making a complete mockery of and, indeed, is destroying the national market system – a system the Commission was directed by Congress in 1975 to develop and maintain because our national securities market were recognized as being an "important national asset."

As I stated in my November 19th letter, there is a clear, immediate and continuing crisis undermining the National Market System and leading to fraudulent and misleading trading and trade reporting. Worst of all, it is all being funded by the National Market System through Commission-approved and SRO-sponsored payment for order flow programs. We recognize that these issues are complex and there are many competing interests, but there is a crisis that worsens with each passing day and there are some very obvious and easy answers.

Respectfully Submitted

/s/ Michael J. Ryan, Jr.

Michael J. Ryan, Jr.
Executive Vice President and General Counsel

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October 28, 2002

Mr. Jonathan G. Katz
Secretary
U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. 4-466 (Hearings on Market Structure Issues)

Dear Mr. Katz:

The American Stock Exchange ("Amex") would like to thank the Securities and Exchange Commission ("Commission") for the opportunity to present our views on the current structure of the U.S. securities markets. We also would like to commend the Commission for undertaking a necessary review of the market structure that has developed since the promulgation of Regulation ATS.

It is almost four years since the adoption of Regulation ATS and we have all had ample time to observe its effects. Simply put, we believe that Regulation ATS has proved to be a mistake, undermining the core principals enshrined in the Congressionally mandated national market system that the Commission has worked to develop for more than a quarter century – best execution, transparency, equal regulatory oversight and fair competition. We, therefore, urge the Commission to return to the fundamental values of the national market system and require all markets, no matter what name they go by, to satisfy and uphold the core principals.

<u>Background of the American Stock Exchange</u>

The American Stock Exchange has a long history of innovation and is unique among the U.S. securities markets in that we are the only market that actively lists and trades securities across three diverse business lines – equities, options and exchange traded funds, commonly referred to as ETFs. In equities, we focus principally on providing a well regulated auction market for small and mid-cap companies. Our options market is the second largest in the United States. Indeed, for the first time since beginning this business more than 25 years ago, we have recently had weeks where we are the most active equity options market.

What really sets the Amex apart from all other U.S. markets, however, are ETFs, probably the fastest growing, most innovative financial products offered by any financial institution over the last decade. After more than four years of working with the Commission and millions of dollars of R&D expense, the Amex pioneered ETFs in 1993 with the introduction of an ETF based on the S&P 500® index, known as Spiders (Amex: SPY). Since then, we have spent tens of millions more developing new products and educating the marketplace about the benefits of ETFs. Nine years later, the Amex remains the clear leader in ETFs, listing 121 of the 123 listed in the U.S. market today, including in addition to Spiders, the Nasdaq 100® ETF (Amex: QQQ) and the Dow Jones Industrial Average® ETF, known as Diamonds® (Amex: DIA). Outside the American market, we have been able to leverage our reputation in ETFs to create a global presence for the Amex, reaching agreements to trade Amex-listed ETFs in Europe and Asia.

Not content to rest on our laurels, we are busy creating the next generation of ETF products – innovative products that will provide investors even greater flexibility and new investment opportunities. For example, we recently launched fixed income ETFs and are getting ready to introduce leveraged ETFs, inverse ETFs and, most significantly, actively managed ETFs.

In short, the American Stock Exchange has emerged as a strong, innovative international competitor, precisely the type of market that the Commission hoped to foster by its promulgation of Regulation ATS. Significantly, these accomplishments have come without the need for the Commission to bend or waive the fundamental regulatory scheme that has shaped and fostered the national market system over the last 25 years. Rather, the American Stock Exchange has spent countless hours and millions of dollars either conforming these new products to the existing regulatory structure or laboriously working with Commission staff to change rules where appropriate. Notwithstanding the time, work and money spent developing these products in an environment where our competitors, because of unlisted trading privileges, can begin trading them virtually as soon as we do, the very accomplishments of the American Stock Exchange over the last ten years are now seriously threatened by Regulation ATS, which provides ECNs significant regulatory waivers from the burdens of exchange regulation, all at the expense of the integrity of the national market system, a system mandated by Congress to ensure public investors receive best execution of their investment decisions, or simply said, investor protection.

Topics for Market Structure Hearings

1. Market Data

The linchpin of the national market system has been the availability to all investors and market participants of real-time **consolidated** quotation and trade information from each market and each markets' members. True market transparency requires that every market's quote be reflected in the NBBO and that all members of each market provide quotation information for inclusion in the NBBO. The Commission asks if consolidated trade reports matter to retail investors. The answer is "Absolutely yes" and so do consolidated quotations. Retail investors may seldom look at last sale data, but, just as investors may seldom examine footnotes to corporate financial statements, the transparency and openness of market information provided by consolidated trade reports, or, financial footnotes, can be vital to protecting investors and promoting sound investment decisions. Real-time consolidated trade information provides a basis for comparing the execution price with prices available in other markets and is a by-product of the national market system for measuring best execution.

The movement by some markets towards display of supplemental market information such as display of "depth of book" improves market transparency. While the Commission should allow the dissemination of this information, the decision whether to make this information available and the nature and extent of that availability should be left to competitive forces in the marketplace.

Rather, Commission regulation and enforcement should be focused first and foremost on ensuring that real-time dissemination of the best bid and offer accurately reflects all quotation and limit order information. Over roughly the past 18 months, significant trading activity has occurred outside, and in flagrant violation of, the most important mechanisms of the national market system. These deviations from the rules are materially undermining the system. Yet, despite repeated objections and many proposals to address this problem by the Amex and other market participants, the abuses continue to this day. Further, through a variety of schemes, the revenues generated from CQ and CTA directly support the operations of those markets that steadfastly refuse to participate in most significant components of our national market system. As if this were not enough, this revenue is also being used to facilitate and, indeed, encourage fraudulent and misleading trade reporting. Even if the Commission determines to allow these markets to operate as they do – a concept that we find incomprehensible, the Commission must put an immediate end to having the national market system provide direct financial support to their operations.

Consistent with our position during meetings of the Market Data Advisory Committee, Amex sees no advantage in having multiple, competing consolidators of market data, as advocated by some Advisory Committee participants. The consolidation function is best performed by an exclusive consolidator under the CQ and CTA Plans. We are concerned that increasing the number of consolidators would simply introduce complexity and inefficiencies, such as the need for multiple disaster recovery sites and plans, without producing any real, offsetting benefits. Moreover, we believe that the competing consolidator model would create the possibility of differing data streams and thus is fundamentally at odds with the notion of a national market system.

As the exclusive information processor under the CQ and CTA Plans, SIAC has continually demonstrated the efficiency of its operations by its long record of providing reliable, real-time market data to the industry without significant disruptions. This record is all the more impressive if one takes into account the exponential growth in the amount of data that SIAC has had to collect, consolidate and make available for re-dissemination, especially the in area of options market data. We are not opposed, however, to explore opening the exclusive processing function to competitive bidding.

Market data rates are set by the CQ/CTA Operating Committee under the provisions of the CQ/CTA Plans. These Plans include significant procedural checks and balances. Fee changes must be approved the Operating Committee. Generally, however, before the Operating Committee votes, the proposals are presented to the boards of the market centers represented on the Operating Committee for consideration by the broader range of interests serving on those boards. After the Operating Committee approves fee changes, they are submitted to the

Commission for public comment and approval, providing a further opportunity for broader industry input. We believe this is a sound procedure for setting rates based on consensus of the markets.

Revenues under the CQ and CTA Plans are allocated among market centers on the basis of the respective number of trades they each report, without regard to share volume or the quality of those markets. This approach disadvantages the market centers that provide greater liquidity by treating a single trade for 100 shares of stock the same as a single trade for 100,000 shares of the same stock in a different market. By the same token, the quality of quotation information is completely ignored in the allocation formula.

Though the current methodology has the virtue of being procedurally simple, its simplicity comes at the great expense of substance. Indeed, its reliance solely on counting the number of trades (a practice dating back to the mid-1970s) causes it to be overly simplistic and, unfortunately, subject to gaming and manipulation solely for the purposes of collecting market data revenue, not improving the quality of the market. The time has come to recognize that the current methodology has utterly failed to achieve what should be the major goals of the Commission and the CQ/CTA participants – to encourage the provision of maximum liquidity to, and the tightest possible spreads in, national market system securities.

This past Friday, the American Stock Exchange submitted to the other markets a proposal for a more sophisticated and substantive method for allocating market data revenues among the CQ/CTA Plan participants. Under this new approach, markets would be encouraged through the policies of the revenue sharing formula to improve market quality by increasing liquidity, tightening spreads and enhancing price discovery.

Two obvious and important objectives, especially in today's increasingly fragmented and volatile markets can be achieved by changing the current methodology. First, if the CQ/CTA Plans were to include a volume measure, in addition to a trade count, when calculating the revenue distribution related to executions, all marketplaces would be encouraged to trade in the maximum depth, providing the greatest liquidity possible.

Second, if the CQ/CTA Plans were to include as part of the revenue distribution mechanism an incentive to provide the National Best Bid ("NBB") or National Best Offer ("NBO"), weighted by volume and time, but limited in its impact to the volume traded in that security relative to all Network A or Network B securities (to prevent attempts to manipulate the revenue distribution methodology by putting up meaningless quotes), the CQ/CTA revenue pool would reward those Plan participants that are actively providing quotations that are meaningful (that is, quoting in size), contain the tightest bid/offer spreads and have the greatest liquidity, rather than those marketplaces (or their participants) that have learned how to manipulate the system solely with the aim of divesting tape revenue.

Under the Amex proposal, the distribution of CQ/CTA market data revenues would generally be 25% based on each of the following: number of trades; share volume traded; bids that are the NBB; and offers that are the NBO. We look forward to discussing this important issue with the other market participants and the Commission in the coming weeks.

Whatever the revenue allocation formula, however, the core national market system facilities for exchange-listed equities – CQ, ITS and CTA – are designed, among other things, to protect investors by providing mechanisms to ensure best execution. Market participants by whatever name that choose not to undertake these obligations should not share in the revenues derived from them. In addition, no market should have financial incentives under the CQ/CTA Plans to reward members, by means of cash payment for order flow, that operate outside the national market system with revenues directly resulting from the operation of national market system facilities.

Indeed, this past February a majority of the CQ/CTA Participants voted in favor of not giving a Participant credit for its members' trades if that member is not a full participant in the national market system (i.e., quoting in CQ, accessible through ITS and reporting to CTA). Unfortunately, the Commission determined that this action needed unanimous approval of the Participants and, therefore, we were forced to reverse the action. After a number of unsuccessful attempts to achieve unanimity, the Amex submitted to the Commission in May 2002 a petition to amend the revenue sharing formula to provide that CQ/CTA Participants will not be given credit for their members' trades if that member is not a full participant in the national market system. To date, however, the Commission has been unwilling to publish this proposal for public comment.

Market data revenue is an important revenue source for funding SRO operations, including regulation and technology development and operation. The value and integrity of the quotation and last sale information is the product of the markets' regulatory and technological efforts as a whole and not merely the cost of processing market data. However, market data revenue rebate programs adversely impact the national market system and self-regulation by encouraging the regulatory abuses, noted above, by members printing trades solely to accrue market data revenue. Indeed, such programs conflict with the national market system because they reward members merely for reporting trades in a particular SRO's market, regardless of whether a member has met its best execution obligations.

Ironically, if the Commission had not forced the reversal of the interpretation approved this past February, many if not all of the recent problems would have long been resolved. In particular, Island would have had no incentive to develop the scheme that has led to the proliferation of trade shredding and wash sales.[1]

2. Best Execution/Agency Issues

Proponents of alternative trading systems and Nasdaq recently have been advocating "speed of execution" as the primary consideration in best execution.[2] The Commission,

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[1] The NASD recently reached a settlement with Swift Trade Securities USA, Inc. and its president, Peter Beck, for engaging in a deceptive trading scheme involving fictitious wash trades in the QQQ ETF in a effort to obtain market data revenue generated from such transactions.

[2] In a recent rule filing to prohibit UTP exchanges from using SelectNet unless they also used SuperSOES, Nasdaq wrote:

> The volume and speed at which trading occurs in Nasdaq have increased dramatically from when SuperSOES was first proposed nearly two and a half years ago. Consequently, market participants demand and require the ability to access liquidity at the best prices instantaneously. Release No. 34-45319 (January 18, 2002), page 17.

however, has clearly stated, "price is the predominant element of the duty of best execution."[3] The Commission, moreover, has stated that a delay in order execution to achieve the best price is a precept of the national market system:

> Our national market system, as it has evolved since 1975, has sought the benefits of both market centralization – deep, liquid markets – and competition. To achieve these benefits, the national market system has maintained equally regulated, individual markets, which are linked together to make their best prices publicly known and accessible.[4]

The Commission's view of a national market system consisting of "equally regulated, individual markets, which are linked together to make their best prices publicly known and accessible," presupposes that price is the most important factor in best execution and that speed of execution, like many other considerations, is a secondary factor. Linking markets to make their prices publicly known and accessible requires the transmission of orders between markets, which necessarily causes delay as orders are transmitted from one market to another. The Commission remains firmly committed to this policy, recently ordering the options exchanges to put in place an intermarket linkage system.

In our view, the agency auction market structure of the Amex provides the optimal combination of speed with price improvement opportunities, particularly for orders larger than 500 shares. Attached is a Rule 11Ac1-5 comparison for the month of August 2002 in the QQQ ETF – the Amex's most heavily traded security (see Exhibit A). The data compares the Amex to the other major market centers in both market and marketable limit orders. The data shows that the Amex provides the best effective spread in 3 of the 4 order size categories and in the 4th, we have the second best effective spread. In contrast, despite their speed, Island is last in 3 of the 4 order sizes and in the 4th, it is second to last. The data also demonstrates that the Amex's execution speed remains relatively constant among all order sizes, while Knight and CHX drastically slow down as they handle larger orders. These trends are consistent month-after-month in QQQ.

We believe that intermarket linkages such as ITS provide a useful mechanism for linking markets. We also believe that *de minimis* trade throughs in traditional common stocks should not trigger the application of the ITS trade through rule if the benefits of a speedy execution in one market center truly outweigh the possible harm of an investor missing an execution in another market center. Absent a showing of harm to investors, however, we do not believe that a market with automatic execution should be excused from such linkages merely because complying with linkages would slow its order processing.

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[3] Report on the Practice of Preferencing Pursuant to Section 510(c) of the National Securities Markets Improvement Act of 1996, United States Securities and Exchange Commission, April 11, 1997, page 89. In addition to stating that price is the predominant element of the duty of best execution, the Commission identified the following factors to be considered by a broker-dealer in satisfying its best execution obligations: the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of technological aids to process such data, the availability of economic access to the various market centers, and the cost and difficulty associated with achieving an execution in a particular market center.

[4] ATS Adopting Release, page 8.

For example, handling orders transmitted to the Amex from other market centers also may slow trading on the Amex, but that does not mean that we should be inaccessible to the national market system. That said, we agree that ITS requires revisions for securities such as ETFs to account for the rapid quote changes associated with derivatively priced securities. The case for modifying the trade through rule for common stocks, however, is less compelling than for ETFs. In our view, the national market system should collectively function as the price discovery market for common stocks and produce an efficient market price for the securities traded in it. In contrast, there are several possible price discovery markets for ETFs: e.g., stock baskets, index futures, or the ETFs. Thus, trade throughs in ETFs do not have the same impact on price discovery as they have on common stocks.

While we agree that some modifications should be made to ITS to better accommodate derivatively priced securities, we are disturbed by indications that the Commission is ignoring its longstanding lodestar that price is the most important element of best execution. We are particularly troubled by the Commission's recent approval, on an accelerated basis, of a Nasdaq pilot program to allow SuperSOES orders to trade through a UTP Exchange's quote without any consideration of the impact of such a rule on a broker-dealer's best execution obligation.[5] The Commission staff has granted similar no action relief to the Chicago Stock Exchange to allow CHX specialists to trade through the Amex's quote in a Nasdaq stock (although the staff apparently stated that the no-action position did not affect the best execution obligations of CHX specialists).[6]

The relief given to the Nasdaq market and CHX is premised on the supposed inaccessibility of UTP exchanges' quotes. In the case of the Amex, this supposed inaccessibility is simply not true. For years the Amex has had electronic order routing and execution systems that, while not as fast as the fastest ATSs for small orders, are as fast or faster than other market centers for larger orders. We thus question whether the markets that seek to exclude the Amex's quotes are doing so to preserve their market share in Nasdaq stocks rather than to protect their systems. We observe no small amount of hypocrisy, moreover, in the Nasdaq's complaints of the Amex's inaccessibility, when Nasdaq shares millions of dollars with an invisible and inaccessible market (Island) through it market data revenue sharing arrangements. As noted in the Market Data section above, these cash payments for order flow by certain participants in the CQ and CTA Plans have led to widespread concerns over tape shredding and wash trades. We believe that the Commission should simply prohibit these schemes

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5 See, Release No. 34-45047 (November 8, 2001), 66 FR 57496 (November 15, 2001). The Commission has twice extended the pilot program without any discussion of its impact on a broker-dealer's obligation of best execution. See Release No. 34-45496 (March 1, 2002), 67 FR 10785 (March 8, 2002), and Release No. 34-46016 (May 1, 2002). Nasdaq made a similar rule filing for alternative trading systems that did not participate in SuperSOES, but we are advised that it withdrew this filing. (See SR-NASD-2002-23, Release No. 34-45957 (May 17, 2002).

6 See, SEC No-Action Letter Week, October 7, 2002, CCH Washington Service Bureau, "SEC Permits CHX to Exclude Certain Quotations from Price Calculations."

3. Exchanges and the Self-Regulatory System

In the early 1990s, spurred by a desire to encourage innovation of new markets and to "avoid the strait jacket of exchange regulation,"[7] Commission staff began to give operators of trading systems that did not enhance liquidity in traditional ways through specialists, market makers or a single price auction structure, "no-action" relief if those systems operated without registering as exchanges so long as they abided by conditions set forth in the no-action letters.

In 1998, reacting in part to its well-founded concerns documented in the Commission's 21(A) Report against the NASD[8] that alternative trading system were leading to market fragmentation and harming market transparency by operating as private "hidden markets," the Commission adopted Regulation ATS.[9] Specifically, the operation of these alternative trading systems was – and, unfortunately, still is – leading to a two-tiered market, an unofficial one only viewable and accessible by the alternative trading system's members and the official market being created by the national market system and used by public investors. The Commission also took this step to address the growing regulatory disparity between ATS's and other markets, disparities the Commission found negatively affected other securities markets and, most importantly, public investors.[10]

In adopting Regulation ATS, the Commission sought to establish a better balance between the regulatory needs of the Congressionally mandated national market system and the need to encourage the development of innovative new markets. The Commission sought to accomplish its goal by allowing, on the one hand, an ATS that operated below a threshold of 5% of the average daily trading volume in a security largely to escape the regulatory constraints placed upon registered exchanges. On the other hand, in an effort to bring ATSs into the national market system, Regulation ATS attempted to subject an ATS that exceeded the 5% threshold to an order display and equivalent access requirement and an ATS that exceeded a 20% threshold to a fair access and certain requirements relating to its operational system.

Since its adoption, it has become increasing clear that Regulation ATS has not resulted in the better balance between regulation and innovation sought by the Commission. While a single *de minimis* ATS (an ATS with less than 5% market share) may not have a significant impact on the U.S. securities markets, the Commission failed to anticipate that the trading of multiple ATSs operating under the *de minimis* exemption can, in the aggregate, have a very negative overall impact on the national market system's guiding principals of transparency, best execution, equal regulation and fair competition.

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[7] *See,* Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1980 (Jan. 19, 1990) ("Delta Release"), at page 23; see also Regulation ATS Adopting Release, Securities Exchange Act Release No. 34-40760 (December 8, 1998), at page 181.

[8] Report Pursuant to Section 21(A) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (1996).

[9] See Securities Exchange Act Release No. 34-40760 (December 8, 1998). In adopting Regulation ATS, the Commission, in particular, noted its prior findings in the "NASD 21A Report" that "widespread use of Instinet by market makers as a private market had a significant impact on public investors and the operation of the Nasdaq market" by allowing market makers to quote better prices than those made available to public investors. Id. at 8.

[10] Id. at 89.

Indeed, the ability of an ATS to frustrate the Regulation ATS requirements designed to integrate ATSs into the national market system has recently been vividly demonstrated by The Island ECN's choice to "go dark", a tactic it adopted notwithstanding the Commission's grant of an unprecedented exemption to a core national market system principle designed specifically to accommodate Island. Thus, a market, like Island, that matches customer orders with other customer orders, does not display its customers' orders and reports its trades through the CT Plan avoids the most substantive provisions of Regulation ATS, including: (1) the order display and equivalent access requirement, (2) the limitation on fees that are inconsistent with the equivalent access requirement, (3) the fair access requirement, and (4) the requirements with respect to the capacity, integrity, and security of the ATS's automated systems.

By going dark, Island achieved precisely the result that the Commission sought to avoid with the adoption of Regulation ATS, namely the presence of a two-tired market – an unofficial one only viewable and accessible by the alternative trading system's members and the official market existing within the national market system that is available to investors. Island's actions have lead to the truly perverse result seen today of an alternative trading system (Island) and a facility of a national securities association (Nasdaq) sharing in revenue generated by two national market system plans (the CQ and CTA Plans) while the ATS is invisible and inaccessible to the intended beneficiaries of the national market system – the investing public. It should go without saying that allowing significant ATSs to opt out of the national market system because the Commission is reluctant to allow Regulation ATS to be enforced or because of the exception that allows markets, like Island, to go dark, undermines the core national market principles of transparency, best execution, equal regulation and fair competition.

In contrast to the "regulation lite" regimen applicable to ATSs, exchanges are subject to a raft of burdensome requirements. Exchanges are obligated to enforce compliance by their members with their rules and the federal securities laws.[11] Pursuant to this obligation, the exchanges have spent heavily on technology and incur significant data storage costs in connection with the fulfillment of their obligation to surveil trading in their markets. Not only are these systems very expensive to create, maintain and revise as is frequently needed, but given their necessary limitations, they also require the exchanges employ large staffs to review the various reports created by them. The Commission, moreover, recently brought several enforcement actions against SROs when it believed that they were not fulfilling their SRO responsibilities. In contrast to the Commission's willingness to take enforcement action against SROs, we understand that the Commission staff recently directed an SRO in writing to desist from taking disciplinary action against an alternative trading system when the SRO was preparing an enforcement action for clear and open violations of the requirements of Regulation ATS.

In addition to the exchanges' wide-ranging regulatory responsibilities, they also are subject to a number of additional burdensome and costly requirements that are inapplicable to ATSs (even though ATSs and exchanges both meet the Rule 3b-16 definition of "exchange"). Among these additional requirements are obligations to file and obtain Commission approval of rule and system changes, file to adopt, change and even eliminate fees (which must be fair),

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[11] Exchange Act Section 19(g)(1).

provide for fair representation of members in the management of exchange affairs, have outside directors on the governing board, dual siting and system redundancy requirements and fair membership access rules. The numerous requirements applicable to exchanges stifle innovation and impede their ability to compete with the less regulated and, therefore, more nimble ATSs. As noted above, the Commission itself has characterized the pattern of exchange regulation as a "strait jacket." In fact, in today's regulatory environment – ranging from an exemption from the definition of exchange for some market participants that is so significant that it has swallowed the definition to the use of market data revenues by markets as a source of payment for order flow – there no longer is any meaningful reason to put on the exchange strait jacket.

The Commission's policy bias towards alternative trading systems not only conflicts with the national market system goals of equally regulated, linked markets making their best prices publicly known and accessible, it also damages the interests of investors by favoring markets that do not employ liquidity providers such as specialists and market makers with affirmative obligations to the market.[12] We thus question the public policy basis for more burdensome regulation on markets that feature specialists and market makers with affirmative obligations as opposed to markets that lack such liquidity providers, particularly when there is no demonstration that markets that feature liquidity providers with affirmative obligations are more susceptible to trading practice abuses than markets that lack affirmative market making requirements.

While we appreciate – indeed, support – the Commission's desire to foster innovation in the development of our markets by removing the "strait jacket" of exchange regulation, we take exception with the unarticulated assumption that alternative trading systems are more innovative than markets registered as exchanges. We believe the American Stock Exchange's innovative leadership over the past 25 years belies this assumption, particularly while wearing the strait jacket. Indeed, the Amex continues to be a leader in innovation, even in a regulatory environment where participants such as Island operate in unabated and protected free riding of our innovation, to the direct detriment of the very reason we exist – the public investor.

To make matters worse, Island markets itself as faster and less costly than exchanges – an absurd claim to anyone truly familiar with their practices. The principal reason Island is faster is because it ignores the investor protection rules followed by the other markets that ensure investors receive the best available price in the market – that is, it refuses to participate in the Congressionally mandated national market system. Worse still, although it defies new Commission rules explicitly requiring them to join the national market system, they actually receive revenue generated from the national market system. In other words, we – the markets that comply with federal securities laws by fully participating in the national market system – are actually providing direct financial support to a competitor that is knowingly violating mandates of the federal securities laws.

Finally, we believe the national market system and, more importantly, public investors, would be far better served by ending the Commission's policy bias towards new, so-called

[12] Congress and the Commission have long recognized that the presence of market makers with affirmative obligations is in the public interest and interest of investors. See, for example, Exchange Act Section 11(a)(1)(A) and Commission Rule 11a-1(b)(1).

innovative markets and developing a more evenhanded, contemporary approach to exchange regulation. The Commission should level the playing field between registered exchanges and alternative trading systems by repealing Regulation ATS and requiring the affected markets to register as exchanges. Further, we believe the Commission should give serious consideration to freeing exchanges from their strait jackets and apply a regulatory regime more relevant to the today's capital markets. In view of the development of ATSs in recent years and their acceptance in the U.S. markets, we see no reason to maintain two wildly dissimilar regulatory structures for organizations that perform the historical function of an exchange in providing a forum for trading and fit the Commission's definition of an exchange.

Conclusion

The Commission concluded in the NASD 21(A) Report that invisible and inaccessible markets damaged investors by degrading best execution and transparency. We hope that this lesson is not forgotten. In addition, we wish to assure the Commission that unequal regulation not only damages markets registered as exchanges, it also harms investors by stifling innovation at the registered exchanges and weakening market centers that provide investors with assured liquidity and price discovery. We therefore urge the Commission to recall the lessons of the past and restore the national market principles of best execution, transparency, equal regulation and fair competition by repealing Regulation ATS and modernizing exchange regulation.

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We appreciate the Commission reviewing market structure issues at this time and would be pleased to further discuss our views with the Commission or staff.

Very truly yours,

/s/ Michael J. Ryan, Jr.

cc: Chairman Harvey L. Pitt
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Lawrence E. Harris, Chief Economist
Annette L. Nazareth, Esq.
Robert L.D. Colby, Esq.
Alden Adkins, Esq.
Christopher B. Stone, Esq.

Rule 11Ac1-5 Data for August 2002 for QQQ Exchange Traded Funds

100-499 Shares

Market Center	Eligible Volume	Effective Spread	Net Price Improvement	Execution Speed
CHX	3,229,539	0.68 ¢	0.16 ¢	3.9
AMEX	**3,948,883**	**0.88 ¢**	**-0.03 ¢**	**19.0**
Knight	3,041,191	1.23 ¢	0.19 ¢	1.4
NYSE	2,406,596	1.82 ¢	-0.52 ¢	8.0
ISLD	12,920,703	3.6 ¢	-1.43 ¢	2.8

500-1,999 Shares

Market Center	Eligible Volume	Effective Spread	Net Price Improvement	Execution Speed
AMEX	**22,921,503**	**1.16 ¢**	**-0.18 ¢**	**22.2**
CHX	10,051,576	1.82 ¢	-0.43 ¢	13.6
NYSE	9,415,695	2.31 ¢	-0.75 ¢	10.3
Knight	7,743,060	2.87 ¢	-0.61 ¢	50.8
ISLD	133,721,905	3.88 ¢	-1.56 ¢	2.3

2,000-4,999 Shares

Market Center	Eligible Volume	Effective Spread	Net Price Improvement	Execution Speed
AMEX	**28,492,811**	**1.7 ¢**	**-0.44 ¢**	**22.4**
NYSE	9,447,765	2.84 ¢	-1.00 ¢	15.5
Knight	10,805,893	3.55 ¢	-0.95 ¢	64.3
ISLD	185,897,453	3.88 ¢	-1.56 ¢	2.2
CHX	9,348,145	3.91 ¢	-1.48 ¢	42.4

5,000 -9,999 Shares

Market Center	Eligible Volume	Effective Spread	Net Price Improvement	Execution Speed
AMEX	**30,213,743**	**2.04 ¢**	**-0.6 ¢**	**25.9**
NYSE	10,144,856	3.15 ¢	-1.16 ¢	15.0
Knight	7,731,440	3.75 ¢	-1.03 ¢	73.9
CHX	5,636,663	3.95 ¢	-1.52 ¢	54.4
ISLD	124,275,195	4.12 ¢	-1.67 ¢	3.3

SEC Market Structure Hearings
October 29, 2002

Statement of Salvatore F. Sodano
Chairman
American Stock Exchange

I too want to thank the Commission for holding these very important hearings. The American Stock Exchange looks forward to working with the Commission and other market participants to address these and other very challenging issues in the weeks and months ahead. Please note that I use the time frame week/months as most of these issues cannot wait very long as they require timely focus.

The American Stock Exchange has a long history of innovation and is unique among the U.S. securities markets in that we are the only market that actively lists and trades securities across three diverse business lines – equities, options and exchange traded funds, commonly referred to as ETFs. We invent investment concepts. We, therefore, would like to clarify that the term “entrepreneurial entrants” as used in the outline for these hearings could equally apply to exchanges, especially the American Stock Exchange. Indeed, it is in this context that we make the following general recommendations: (I will make only two macro recommendations due to time limitations)

- First, as we move forward, it is important that the Commission ensure that the core principals enshrined in the Congressionally mandated national market system be restored – best execution, transparency, equal regulatory oversight and fair competition.

- To achieve this, we believe the last year and a half – especially the recent weeks with Island "going dark" – demonstrated that Regulation ATS did not and is not serving its intended purpose. Therefore, we believe the first step should be to abolish Regulation ATS and require all markets meeting the definition of an exchange to register as such. Further, we believe the Commission should take very concrete steps to modernize exchange regulation, the disparity between markets is simply too vast.

- Finally, the Commission should bring an immediate end to an obvious conflict of interest that has led to nothing but regulatory abuse, reduced liquidity and, therefore, investor harm – market sponsored payment for order flow must be eliminated.

Thank you.