BRUT

July 29, 2004

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

Re: File No. S7-10-04

Ladies and Gentlemen:

Brut, LLC ("Brut")[1] appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with its views regarding Exchange Act Release No. 49325 (the "Proposing Release"),[2] in which the Commission published for comment a series of proposals designed to modify equities market structure collectively know as "Regulation NMS", as supplemented by Exchange Act Release No. 49749 (the "Supplemental Release").[3] The Commission and the staff should be commended for their efforts to modernize market structure regulation. No matter what the outcome of these proposals, the dialogue triggered by them is already serving to improve securities markets for the benefit of investors and intermediaries alike.

Since our acquisition by SunGard Data Systems in August 2002, Brut's volume and market share of Nasdaq-listed trading has tripled.[4] Brut believes itself to be a fine example of how, in a market structure environment of fair and efficient competition, firms that provide value to their customers can garner increased order flow over time. While U.S. securities markets are currently the most competitive and liquid in the world, they are not perfect. Regulation NMS is perhaps a unique opportunity to set markets on a path to even greater efficiency and quality.

Introduction – The Role of Regulation Within Market Structure

The Commission plays a vital role in the process of market structure evolution, despite the statutory deference to competition. Regulation and competition are not antithetical. Reforms that remove impediments to competition, and that attempt to solve the challenges of competition in ways that do not diminish it, should be aggressively pursued. Portions of the subject matter of Regulation NMS deals with instances where the regulatory environment currently prevents competitive forces from producing the optimal market outcomes. Brut welcomes prompt action to remedy such inefficiencies.

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[1] Brut operates The BRUT ECN System, a significant electronic communications network ("ECN"). Brut is owned by SunGard Data Systems, which has agreed to sell Brut to The Nasdaq Stock Market, Inc. ("Nasdaq").
[2] February 26, 2004, 69 Fed. Reg. 11126 (March 9, 2004).
[3] May 20, 2004. 69 Fed. Reg. 30141 (May 26, 2004).
[4] Brut's Nasdaq market share has risen from 4.2% in July 2002 to 12.7% in June 2004. *See* http://www.ebrut.com.

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In taking such action, two principles should guide the Commission to improve our markets while preserving the positive attributes of competition and innovation:

Market Structure Mandates: A Last Resort

First, the Commission should be involved solely to the extent that market forces and the self-regulatory structure are inadequate remedies. Problems with market quality typically create demand for improvements that are satisfied through the competitive dynamic. The emergence of ECNs in the 1990s is a classic example – investors were frustrated by the lack of transparency and high cost of trading in Nasdaq-listed stocks, so firms emerged to offer an alternative model. This form of market structure evolution fulfills the congressional directive to have "the National Market System evolve through the interplay of competitive forces."[5]

Where commercial pressures and SRO initiatives are working to alleviate market structure issues, they should be given the chance to do so. The New York Stock Exchange's purported desire to improve their DirectPlus trading system,[6] Nasdaq efforts to curtail access fees charged by ECN participants in SuperMontage,[7] and ECN initiatives to curtail the use of sub-penny trading increments[8] all evidence the innate positive momentum of the current environment. In the Supplemental Release, the Commission acknowledges that competitive developments and SRO initiatives may cause some market structure issues to "largely disappear in the near future."[9] Absent a clear inability of the market or SROs to resolve a regulatory problem, or other compelling need for immediate action, this current burst of progress should be allowed to reach fruition.

Tactical Reform: Intervention Without Interruption

Where Commission involvement is needed to assist the competitive and SRO discipline of market structure, new regulations should be narrowly targeted to focus on the particular aspect of market operation that is inconsistent with national market system principles. Broad initiatives with uncertain outcomes should be rejected where narrowly-tailored methods are available. Complexity should be avoided where simplicity will achieve the objective. To do otherwise risks unintended consequences that may create several new problems in the attempt to remedy one concern. To the extent a particular trading behavior (or pattern of behavior) is deemed to be problematic, direct prohibition should be the Commission's approach, rather than attempts to attack the perceived underlying motivation for such behavior. Any other methodology risks reduced effectiveness and unintended consequences.

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[5] House Conf. Report No. 94-229, Joint Explanatory Statement of the Committee of Commerce (May 19, 1975).
[6] *See* NYSE's Automatic Transition, Wall Street Journal, June 22, 2004, at C1
[7] *See* NASD Rule 4623(b)(6).
[8] *See* "SunGard's BRUT ECN Changes MPV and Extends Trading Hours" *available at* http://www.ebrut.com/infoCenter/2003pr.shtm (November 17, 2003).
[9] Supplemental Release, *supra* n.3, at 30143.

Certain core principles should also guide the implementation of any tactical reform. First, the Commission should preserve as much trader choice as possible, so that innovative trading techniques can continue to be deployed in the marketplace. Second, a level competitive playing field must be maintained, so that similarly-situated firms can compete based on the value of their product and service offerings, rather than on regulatory advantage. Finally, industry participants should be given ample time to prepare their technology and compliance infrastructure for the new changes.[10] Targeted Commission action designed and deployed in this manner will give regulatory reform the greatest chance to be a constructive force in advancing overall market quality.

Perhaps the Commission itself stated best the optimal approach to market structure reform a decade ago in its Market 2000 study, stating that no "approach should be imposed on the markets by regulatory fiat. Instead, the Commission should pursue discrete, incremental market improvements within the ambit of its historical regulatory role: protecting investors, facilitating fair market competition, and promoting full disclosure."[11] Continual adherence to that philosophy, allowing the market to evolve with the gentle hand of Commission oversight to guide it, will serve the interests of investors and their intermediaries alike.

Analysis of Proposed Regulation NMS

When viewed in light of the principles of minimalist, focused government involvement discussed above, Regulation NMS as proposed is at best only a partial success: a mix of simple, flexible solutions and overly complex, unnecessarily intrusive and needlessly rigid new regulation. This vacillation between promoting fair market competition and imposing a mandated method of market operation needs to be remedied by revising these proposals before their adoption. In the Supplemental Release the Commission appears at times to struggle with these contradictions, but often all that is suggested is additional complexity.

Brut will discuss its comments on the four proposals outlined in Regulation NMS by: (i) summarizing its position; (ii) offering its general comments, which it has previously made through its written submissions and testimony at the April 21, 2004 hearing; (iii) speaking specifically to the concepts and questions raised in the Supplemental Release; and (iv) providing more practical suggestions stating how the proposals could be more effectively implemented if adopted, regardless of Brut's underlying point of view with respect to the relevant proposal.

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[10] *See* http://www.sec.gov/news/press/2004-87.htm (stating that industry participants will be given a compliance date of January 3, 2005 "to permit firms to make programming and procedural adjustments" in preparation for the implementation of Regulation SHO).

[11] Division of Market Regulation, Commission, Market 2000: An Examination of Current Equity Market Developments, at III-7 (January 1994).

Trade-Through Proposal

Summary

Overall, Brut believes the conceptual approach to trade-through reform in the Proposing and Supplemental Releases strike an appropriate balance between competing national market system principles. For exchange-listed securities, it effectively would transition the existing Intermarket Trading System rule to a more effective enforcement regime while allowing for trader flexibility and maintaining minimum limit-order protection standards. With respect to Nasdaq-listed stocks, however, the high degree of automation and inter-market connectivity appear to make application of the rule irrelevant, imposing significant initial implementation costs and ongoing compliance burdens with no real incremental benefit. Moreover, the Commission need be mindful of the practical aspects of trade-through reform, so the benefits of this initiative are not overwhelmed by technicalities and bureaucracy.

General Comments

The Commission should be praised for taking action to reform the trade-through rule, which has long been warranted. The recent history of the trade-through rule is, simply put, an example of market structure regulation at its worst. The operation of the current rule has combined to produce obsolete technology, inadequate enforcement and poor governance that has diminished the ability of electronic markets to compete for customer order flow in exchange-listed securities. More importantly, it has denied investors the flexibility among trade-execution alternatives in NYSE stocks – the choice between potentially better prices and consistently certain prices – they demand and deserve. Whatever the Commission decides to implement, bringing the rule within the purview of the Exchange Act will provide for stricter enforcement against serial violators that is currently lacking, leveling the competitive playing field for markets that comply with the rule on an automated basis.

Brut acknowledges the delicate balance the Commission must seek when attempting to advance both customer choice and investor protection simultaneously. Any competition among market centers brings with it the risk that an investor, when placing an order in one market center, may miss an execution they would have received had they placed said order elsewhere. This risk is unavoidable and, absent the creation of a central limit order book ("CLOB") for the execution of all transactions in equity securities, incurable. Yet, over the past three decades, the Commission has considered and rightfully rejected the notion of a CLOB time and time again, mindful that order interaction is not an absolute truth to which all other market structure principles should be subject. Those who now raise up 'price protection' as a sacred market-structure tenet perhaps do so more out of self-interest rather than concern for the public interest, fearing that few will do business in their market absent a Commission mandate.

This notwithstanding, Brut acknowledges the need to have a certain baseline of order interaction to achieve necessary minimums of price discovery and transparency. The question remains, then – where should the balance between healthy competition and risky fragmentation be struck?

Brut believes a solution is within reach, combining competition-driven market technologies with a safety net of current and proposed Commission regulation. Today, the risk of reduced order interaction is significantly mediated by the wide availability and functionality of quote-aggregation and access technologies. SunGard Trading Systems, Lava Trading, Royal Blue Financial and several others offer software that combine order price information from all major market centers and allows users to access all liquidity at the touch of a button or "hot key". Such applications virtually eliminate the risk of missed executions due to the lack of complete market information. From a display and access perspective, quote fragmentation simply no longer exists.

While direct-access software provides the means to trade with limit orders wherever they reside, a broker-dealer's common-law agency obligations and duty of best execution provides them with the regulatory, economic and moral motivations for doing so. When holding a customer market order, broker-dealers will utilize available technologies to route that order to the market center currently displaying the best, accessible price. At that point in time, the interests of both the market order and limit order customer are aligned, and the broker acts as a true intermediary, bringing natural counter parties together. This happens millions of times a day in the trading of Nasdaq securities, without an explicit trade-through rule. It simply isn't needed.

There are times however, when a firm, trading strictly for its own account, may wish to execute trades in a manner different than if it were handling a customer order. Complex algorithmic trading strategies, lower implicit or explicit costs and differences in reliability, capacity or throughput may lead a firm to favor one market center over others when executing proprietary order flow. When not bound by the duty of best execution to a customer, there should be a compelling justification before dictating under law where a firm must trade. This is consistent with Congressional mandates for order interaction under the Securities Act Amendments of 1975, which only dictate that "*investor* orders" be executed "in the best market"[12] and "without the participation of a dealer."[13] This does not mandate that <u>all</u> orders, regardless of source, interact with one another, as that would require a CLOB. Some national market system principles -- such as price transparency -- require the compliance of all market participants to be meaningfully implemented, thus reforms like the Limit Order Display Rule[14] to ensure comprehensive display of priced order interest. With the level of price discovery such rules guarantee, however, there is no compelling rationale for requiring universal interaction or priority rules of all orders in all circumstances to further market efficiency.

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[12] Exchange Act §11A(a)(1)(C)(iv) (emphasis added).
[13] Exchange Act §11A(a)(1)(C)(v).
[14] Exchange Act Rule 11Ac1-4.

Accordingly, the debate over the trade-through rule should not be focused, as some would proffer, over the desirability of "exceptions," but rather how best to craft a rule that restricts trader conduct as narrowly as possible, in order to achieve the necessary objectives through precise regulation. Where there may have been a need for a broad-based trade-through rule in 1978 when ITS was created, given the lack of broker-dealer order-routing technology and price transparency, this is not true today. The Proposing Release acknowledges this metamorphosis:

> 'At the time when the existing rules were put in place, order routing and execution facilities were slower, there was less vigorous intermarket competition in NYSE, Amex, and Nasdaq securities, and the minimum trading increment was 1/8th of a dollar. By contrast, in today's market, rapid advances in technology have provided a variety of means to efficiently route orders to multiple markets.'[15]

A consequence of this transformation is that investors and traders are now sufficiently equipped to "price protect" their own orders, without undue involvement by the Commission in market micro-structure. Market-order customers and their agents see all available prices, with direct access to those prices in various forms, and should generally be free to choose the market center in which they trade. Brokers that take their best-execution and other customer obligations seriously will generally seek to handle orders in the most favorable manner available. Limit-order customers and their agents will choose the market center they perceive to provide the best execution quality over time as the venue for display of their orders. The natural economic incentives of customers, and the regulatory obligations of their agents, are aligned so market orders and limit order meet naturally. Thus, the sole Commission interference in this dynamic should be to provide a back-stop of execution quality to ensure that investor orders do not go unexecuted indefinitely.

Comments on Supplemental Release

Brut will address each of the five areas of the trade-through proposal discussed in the Supplemental Release in turn: (i) how to implement a "manual" exception, and how to define what is not manual or "automated"; (ii) to what extent should trade-throughs of manually-accessible markets and orders be allowed; (iii) the desirability of permitting firms the flexibility to "opt out" of the requirement to trade with a certain market center where they or their customers see fit; (iv) the need for other exceptions to the rule; and (v) the wisdom of implementing an explicit trade-through rule for the first time in Nasdaq-listed stocks. Brut's comments are consistent with our general philosophy that Commission-directed micro-market structure reform should be a last resort and as narrow as possible, to preserve the competition that serves to keep markets moving forward consistent with investor needs and interests.

[15] Proposing Release, *supra* n.2, at 11133.

Fast vs. Slow

By distinguishing between automated and non-automated execution opportunities, the proposed trade-through rule would gives market centers needed latitude to minimize undesired interaction with those markets that operate in whole or in part on a manual basis, and subject said markets to the discipline of counter party preferences. It would act as an important complement to an opt-out exception should one exist, and the last bulwark of accountability should it not. While an opt-out exception would allow traders and investors to choose how they execute their orders, a dichotomy between fast and slow markets would provide markets themselves with the flexibility to choose how they do business with one another. Both are essential for an efficient market structure to perpetuate itself.

To successfully implement this aspect of trade-through reform, the Commission needs to balance the inherent order-based nature of the rule itself and the technologies by which market participants could avail themselves of the exception without undue implementation costs or delays. At its core, any trade-through rule should properly focus on the execution of orders and ideally criteria under the rule should be order-specific. This performance metric gives investors, intermediaries and markets alike the maximum amount of flexibility. This leads Brut to support in principle the concept discussed in the Supplemental Release where manual quotes would lose the trade-through rule's protection, rather than attempting to make a more general classification with respect to an entire market center. Such an approach would heighten choice for both market center operators and their users.

For a quote-specific rule to be implemented quickly and effectively, the authenticity and identity of automated quotes should be clearly established. With regards to the former, the Commission needs to establish strict, yet supple, standards for market centers to comply with regarding the performance of their automated quotation-display and response systems. For a quote to be truly "fast," a market must perform the following functions on an automated basis without any human intervention or exception:

- display of best-priced orders in their quotation upon receipt;
- acknowledgement of orders routed to execute against quotation upon receipt;
- execution of said orders against the displayed quotation, and any reserve size associated with that quotation;
- report of execution outcome (executed in whole, in part, or 'nothing done') for said order;
- refresh of quotation to display new best-priced order upon execution of previous quotation; and
- confirmation of cancellation upon request.

Without performing all these tasks on a universal automated basis, a quote can not be considered "fast" by modern market standards.

Regarding the identification of automated quotes, it is pivotal that order-execution facilities ("OEFs") consistently separate their "fast" and "slow" quotes for dissemination to broker-dealers and market data vendors. Brut's routing technologies typically analyze quotation information through evaluation of each data stream, or "feed" disseminated by each market center. Nasdaq's NQDS and "TotalView" feeds, the UQDF and CQS feeds distributed by securities information processors ("SIPs") and the various "book" feeds distributed by ECNs are the building blocks on which intelligent order-routing decisions are made. Once a feed is incorporated into an order router, said router typically will treat the quotations transmitted in that feed universally throughout the trading day. Prior attempts to distinguish between or take differential action regarding quotations included in the same data feed resulted in an implementation failure.[16] The Commission can ill afford to allow this to happen again.

Accordingly, the prospect of a market switching a quotation feed to "manual mode" intra-day (potentially multiple times in a day) without warning to other market participants would raise serious concerns about the feasibility of a revised trade-through rule being successfully enacted in the near future. Brut thus recommends that, under a quote-based rule, market centers wishing to operate hybrid market places disseminate their best-priced "fast" and "slow" quotations via separate data feeds, priced at cost to the end user.[17] While markets should be allowed to discontinue distribution of their "fast" feed at their discretion, they should not be permitted to change the status of quotes within a given feed from an automated to manual state intra-day. Such an approach would balance flexibility for order-execution facility operators with the needs of market participants to have consistent, reliable market information.

De Minims or De Maximis?

Brut sympathizes with those who question the need for creating any restriction on the ability to trade through a certain market's quote. Any rule that forces an automated order-execution facility to trade with a manual competitor before executing customer orders inevitably drags competition towards the lowest common denominator. Recent improvements in execution quality disclosure, market information and multi-destination trading technologies arguably make such a requirement unnecessary. So long as order execution facilities openly disclose their practices regarding their level of interaction with non-automated markets (and their orders), the ability to exert competitive pressure would give investors and their agents the power to adequately protect their interests.

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[16] *See* Exchange Act Release No. 37619A (September 6, 1996) 61 Fed. Reg. 48290 (September 12, 1996) at 48315, n.283 and related text (requesting that SROs, in implementing the aspects of the Order Handling Rules that would require the display of quotations on a rounded basis, to "modify the public quotation system to ensure that specialists, market makers and ECNs… have the ability to distinguish those rounded quotes."). This aspect of the rule was never implemented, and while the introduction of decimalization dulled the impact, the Commission should not rely on extraneous factors to remedy such failings in the future.

[17] This should be accompanied by complimentary rules prohibiting "intra-feed" locked and crossed markets, as well as market data reform where the incremental cost of multiple feeds are borne by the market center pursuing a hybrid model, rather than investors.

This said, the legacy structure and lagging technology of the markets that dominate trading in exchange-listed stocks, may necessitate the creation of trade-through thresholds as a transitional matter, to protect investor limit orders from the risk of indefinitely missed executions. Brut offers that no market participant is qualified to offer what the "right" amount of a maximum trade-through should be,[18] and suggests the Commission should explore a pilot period for sample sets of securities, with varying permissible trade-through amounts, to study if variances produce meaningful differences in execution quality. Expanding the $.03 approach currently used for exchange-traded funds could be one form of trade-through protection tested during such a pilot.

Opt-Out Exception

The proposed availability of an "opt out" exception, and the conditions for utilizing it, provide a fair framework for allowing market participants to trade as they feel best serves their commercial interests, and their duty of best execution when applicable. The constructive pressure that competition exerts on market centers can not be replicated in any way, shape or form by the action of a regulator. In the Supplemental Release the Commission inquires whether the creation of response-time standards would produce "less of a need for the opt-out as a mechanism for market discipline."[19] This would be true only if response times were the sole competitive variable by which market centers competed for order flow, and the Commission were to aggressively set and update those standards on a regular basis. Because the latter is untenable and the former is untrue, allowing traders to have control over where they execute orders is essential to keep the operators of market centers responsive to their needs.

Legal mandates to satisfy a market's quotation give that market a micro-monopoly – a trader must do business in that market at that point in time. Unfortunately, the current trade-through rule perpetuated a macro-monopoly in the trading of NYSE stocks, creating a market permeated with questionable trading practices and an exaggerated cost structure.[20] With no opt-out exception, market structure would be bereft of the accountability to the trader that is critical to sustained innovation. The suggestion that the principle of 'price protection' would be inexorably harmed by an opt-out exception should be vigorously resisted. As previously stated, nationwide time-price priority of limit orders is not an objective of the Exchange Act, "fair competition among markets, exchange markets, and markets other than exchange markets"[21] is. While the Congress sought to promote investor order interaction, this was not meant to be required by law in situations where investors willingly select to do business elsewhere.

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[18] Brut does note, however, that the current $.03 trade-through exemption for certain exchange-traded funds appears to have facilitated trading activity and improved the market quality of the relevant securities.
[19] Supplemental Release, *supra* n.3, at 30145.
[20] The recent scandals involving "trading ahead" by NYSE specialists and the compensation practices of NYSE officials is well known, and Brut takes no pleasure in citing them. It does so only to make a point: no market, no matter how well-intended its purpose and people are, will serve investors well over the long term unless it is continually under the scrutiny only meaningful competition can provide.
[21] Exchange Act §11A(a)(1)(C)(ii).

Intermarket Sweep Orders

The Supplemental Release is prescient in asking for comment on whether trade-through reform should take into account "intermarket sweep orders," that seek to execute against multiple pools of liquidity at different price points simultaneously.[22] Given direct-access order-routing capabilities now available to broker-dealers and their customers, any trade-through rule that would require a firm to wait for an execution response from the market displaying the best price before routing to other marketable orders would be a large step backwards in terms of speed and other metrics of best execution. In an era of milli-second fluctuations in order and price information, it also would place order-execution facilities in a precarious position of trying to comply with a trade-through rule even though their customer has taken such obligations upon themselves. Any new trade-through rule should have an exception where a order-execution facility customer has indicated that they have taken affirmative steps to trade with all priced interest through which the recipient OEF may be trading through when executing that order.

Analogous regimes already exist to ease implementation of such an example. For example, NASD Rule 3370 allows for broker-dealers to rely on order-by-order customer representations that they have satisfied the relevant affirmative determination requirements when executing a short sale, allowing the recipient to handle such orders without taking its own steps to comply. A like standard could be created in this area, where users could inform an OEF of its own routing to other market centers (through a "tag" in the FIX protocol or an independently developed and recorded identifier), thus relieving the OEF of its trade-through obligations when executing the order. This would fulfill the intent of the rule without degrading current market operation.

The Need re Nasdaq[23]

Application of a trade-through rule to Nasdaq securities seems unnecessary given the vibrant order interaction between market centers trading these stocks. In an atmosphere of vigorous competition and transparent information, the Commission does not need to mandate inter-market order-routing, as this occurrs naturally. As all good stewards should, the Commission should "first do no harm"[24] to this area of market structure. No matter how the final amount is quantified, applying a trade-through rule to Nasdaq stocks will impose new costs on and tap the resources of markets and brokers that trade Nasdaq stocks, both large and small. Before asking the industry (and ultimately investors) to bear these costs, the Commission should thoroughly consider what objective is served by doing so.

[22] Supplemental Release, *supra* n.3, at 30145.
[23] For purposes of full disclosure, Brut once again wishes to note its pending acquisition by Nasdaq. For more information, *see* http://www.nasdaq.com/newsroom/news/pr2004/ne_section04_054..html.
[24] HIPPOCRATES, EPIDEMICS, Book I, Section XI.

In the Proposing Release the Commission alludes Section 11A(c)(1)(F) of the Exchange Act, which authorizes the Commission to "assure equal regulation of all markets for NMS securities," as an important guiding principle of Regulation NMS.[25] Brut respectfully suggests that the Commission should not confuse 'equal' with 'identical'. The creation of equal regulation should not be viewed as a desired end in and of itself, but as a means to: (i) protect investors; and (ii) further the Congressional directives. Within this context, the need for equivalent regulation appears necessary only where market participants are trading the same class of securities. Inconsistencies among market centers trading different classes of securities – such as exchange-listed and Nasdaq-listed stocks – don't appear to affect the areas that Congress contemplated. Given the certain costs, questionable benefits and tenuous basis for expanding the scope of the trade-through rule to Nasdaq stocks, Brut respectfully suggests that the Commission reconsider the merits of expanding the rule to where it simply is not needed.

Practical Suggestions

Should the Commission ultimately decide to implement a trade-through rule that prohibits certain trade-throughs of automated market quotes, Brut believes that as a practical matter the Commission should avoid explicit involvement in the setting of objective technological standards for what qualifies as "fast," because effective management of such an approach is likely to be unsustainable. While the Commission should be aggressive in detailing the elements of a market center's operation that need to be automated to qualify as such (*see* above), the evaluation of the adequacy by which a market center performs those functions over time should be on a more subjective basis. Meaningful objective standards are likely to be quickly overwhelmed by advances in technology and other market developments.

Brut believes the approach when approving ECNs under the Order Handing Rules provides a positive example of how to move forward in this regard. Under the rules, ECNs seeking to qualify under the ECN Display Alternative to the Quote Rule sought no-action relief on behalf of their users, should they choose to satisfy their compliance obligations through the ECN. With respect to performance of their systems, ECNs have generally agreed to respond to non-subscriber orders "as promptly as it responds to subscriber orders, and in any event no more than a few seconds," and periodically review the capacity of their systems.[26] OEFs could apply for analogous relief,[27] making representations as to how their systems operate and will be maintained.

[25] Proposing Release, *supra* n.2, at 11128.
[26] *See* letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission, to William O'Brien, Chief Operating Officer, Brut, at 2 (July 3, 2003).
[27] The technical result of a request letter would likely be a denial of no-action relief (*i.e.,* if an OEF's quotes would be satisfactorily "fast," the Commission would be unable to give no-action relief to those seeking to trade through said OEF's quotes under the rule absent an opt-out or other exemption.).

The Commission also needs to consider a better disclosure regime in the context of trade-through reform. The "informed consent" framework discussed in the Proposing Release would impose significant costs on broker-dealers, notwithstanding that disclosure of a "trade through" amount would create an inaccurate impression of poor execution quality. The current framework of Exchange Act Rules 11Ac1-5 and 11Ac1-6 appear better suited for brokers to provide customers information regarding the trade-offs when trading through prices as well as the statistical consequences of doing so. For example, Rule 11Ac1-5 could be revised so that reporting firms would have to explicitly report the percentage of orders in each reportable category which represent non-exempt trade-throughs, as well as the per-trade average trade-through amount for each category. Rule 11Ac1-6 could require broader disclosure about a firm's policies regarding interaction with non-automated quotes. This would give investors common-sense information on an accessible basis regarding their execution choices, and let the best enforcement regime – competition – decide which practices are worthy of reward through increased order flow.

Market Access Proposals

Summary

Brut strongly opposes the market access proposal as originally drafted in the Proposing Release. While the Supplemental Release contains some productive clarifications and suggestions, much work on the proposal remains before access can be improved without having a net negative impact on market quality. Because the proposed access standards alone would not guarantee brokers means of efficient access to all displayed orders, Brut supports the concepts in the Supplemental Release that would foster reasonable participation in and economically sensible access to the public quote. Brut strongly objects to the proposal to fix the maximum prices a market center could charge for access. The proposal would needlessly implement a rate-fixing scheme that would overcompensate for certain trading behaviors and corporate structures that could easily be remedied through less intrusive means, create an un-level playing field, and risk significant reductions in market liquidity and depth. While the Supplemental Release offers clarifications that alleviate some concerns regarding competitive implications, it makes clear how the rule could encourage even further fragmentation. In the end, no remedy can heal a proposal that is flawed at its core. Brut believes the Commission should abandon any effort to set prices, and instead quickly adopt the proposed limitations on locked and crossed markets and provide greater guidance to broker-dealers as to how access fees can factor into their best-execution analysis.

General Comments – Access Standards

Brut supports the more rigorous fair access standards embodied in paragraph (a) of Proposed Rule 610 and corresponding proposed amendments to Regulation ATS. When a firm displays its order prices in the public quotation system, either as a quoting market center ("QMC") or as a quoting market participant ("QMP"), it should be subject to greater regulation regarding who it denies access to its systems. Given that public display triggers best-execution and other regulatory obligations for broker-dealers and market centers (including potential new trade-through rule obligations), meaningful assurances need to be in place so that fulfillment of these duties will not be prevented by discriminatory denials of access. As such, lowering the "fair access" threshold of Reg ATS to 5% is inherently reasonable, given that volume threshold also mandates public quote participation. Similarly, requiring QMPs to give "most favored nation" status to other QMPs and QMCs is also appropriate, given the non-SRO status of such firms could create a gap that tempts some to thwart attempts at access by competitors.

While these reforms are admirable, they would not address the most pressing access issue facing the market today – the emergence of SRO quote-display facilities without commensurate execution capability. With the adoption of the Alternative Display Facility ("ADF") in 2002, for the first time the possibility arose of orders in the public quote without access to those quotes via an SRO. While some large ECNs used the ADF to end an unhealthy dependence on Nasdaq, successfully migrating with little commotion, it also gave much smaller firms the ability to strike out on their own. This requires vast industry investments to establish private connectivity (or utilize vendors) to access these markets – no matter how small or potentially how fleeting – to satisfy best-execution obligations and avoid market disruption. The effort and investment to establish such connectivity is disproportionate to the liquidity on such a market.

Let Brut provide an example. In June 2004 Brut's router shipped approximately 600 million shares to other market centers for execution. The smallest such destination was Track ECN ("Track"), with approximately 1.5 million shares executed for the month. Thankfully, Track's quotes are accessible through Nasdaq's SuperMontage system. Were they not, Brut would have needed to establish redundant direct connectivity at a cost of approximately $3,000 per month.[28] Based on the volume routed to Track, that would equate to a cost of $.002 per share, roughly four times the gross margin (net of rebates or market center charges) Brut currently recognizes on the trades it executes.[29]

One can only cringe at the cost-benefit analysis faced by the majority of firms that typically route far less volume per day than Brut. These economics have in the past led Brut to consciously avoid *de minims* market centers that are not accessible through an automated SRO order-execution facility (*e.g.*, NexTrade, the American Stock Exchange's Nasdaq UTP pilot). Some firms struggle with the concern that such "routing away" leave them vulnerable when SRO examine their best-execution compliance, which is typically based off the NBBO at time of execution. With trade-through reform on the horizon, firms may not have the luxury of even this difficult choice much longer.

[28] This estimate is based on Brut's current rates with "extranet" connectivity providers such as Radianz, TNS and Savvis. Brut's business model is such that it could not reasonably utilize a vendor to provide such services. As a market center offering smart order-routing functionality, independent access is required.
[29] This analysis does not even consider that small quoting market participants, unbound by the need or desire to maintain or achieve significant volumes or market share, may attempt to extort rates for access to their quotation beyond what is seen by most firms to be realistic or competitive.

General Comments – Access Fees

The price controls of paragraph (b) of proposed Rule 610 raise two fundamental economic questions: when and why should the government override the free market and set prices?

> "Governments have been trying to set maximum or minimum prices since ancient times. The appeal of price controls is easy to divine. Even though they fail to protect many consumers and hurt others, controls hold out the promise of protecting groups of consumers who are particularly hard pressed to meet price increases…
>
> But despite the frequent use of price controls, and despite the superficial logic of their appeal, economists are generally opposed to them, except perhaps for very brief periods during emergencies. The reason is that controls on prices distort the allocation of resources…
>
> With all of the problems generated by controls, we can well ask why are they ever imposed, and why are they sometimes maintained for so long. The answer, in part, is that the public does not always see the links between controls and the problems they create…
>
> But price controls almost always benefit some subset of consumers, who may have a particular claim to public sympathy and who, in any case, have a strong interest in lobbying for controls…
>
> The study of price controls teaches important lessons about free competitive markets. By examining cases in which controls have prevented the price mechanism from working, we gain a better appreciation of its usual elegance and efficiency. This does not mean that there are no circumstances in which temporary controls may be effective. But a fair reading of economic history shows just how rare those circumstances are."[30]

How a product or service is priced is a fundamental right of commercial participation in a market economy. This right should be taken away by regulators only as a last resort, when no other alternatives are available to address a clearly identifiable and significant breakdown in the fabric of the marketplace. No such compelling justification exists for the government rate-setting this proposal represents. The rationales given for the proposal are either outdated, inaccurate, or could be remedied through far-less invasive means than this significant displacement of market and competitive forces. Brut will speak to the concerns raised by the Commission in the Proposing Release that led to the suggestion of this scheme individually.

[30] Excerpted from Hugh Rockoff, Professor of Economics, Rutgers University, PRICE CONTROLS, The Concise Encyclopedia of Economics. *Available at* http://www.econlib.org/library/Enc/PriceControls.html.

Denying Distortion

Brut strongly disagrees with contentions in the Proposing Release that current market-center fee structures "cause distortion" by "rewarding market participants for submitting resting limit orders that give depth to the trading book," and having those paying fees to remove liquidity "act as a subsidy to the subscribers that place standing limit orders."[31] Rebates for limit orders and fees for market orders reflect the market's natural determination of the value of such orders. In debating Regulation NMS, the Commission and market participants have consistently spoken to the value of limit orders, and the need to encourage their placement, complaining that "little incentive is offered for the public display of [limit] orders."[32] ECNs were the first execution providers to recognize the intrinsic value of limit orders and began to help clients monetize their economic worth, "reward[ing] market participants for submitting resting limit orders that give depth."[33] As a result, ECNs became deeper pools of liquidity, and Nasdaq followed their example.[34]

This evolution has kept access fees reasonable. The Proposing Release notes these fees "have decreased steadily in recent years."[35] The average "fee capture" for market centers has declined 90-95% percent from only a few years ago,[36] due to intense rate competition for customers armed with smart order-routing technology that can easily change the markets they use. Brut led the way in this regard, reducing prices in September 2003 for the vast majority of our volume to $.0027 per share, and was rewarded with significant growth.[37] Conversely, market centers attempting to charge exorbitant rates have either failed (MarketXT) or been crippled in their attempts to grow (NexTrade, ATTAIN, Track ECN). Although ECN no-action relief and Nasdaq rules work to legally limit the access fees charged by ECNs, competitive forces are currently the primary mechanism for keeping fees in check. This is as it should be.

Competition, low prices, and liquidity are hallmarks of a properly-functioning market. The market values liquidity to the point of rewarding the participant who is willing to "show their hand" and display a limit order. Those who choose not to must pay for that privilege. Competition keeps these fees reasonable in relation to the value provided, and Commission and SRO regulation serves as a last line of defense against firms that eschew competitive discipline and act irrationally. This is a sound interplay between commercial and regulatory forces, not a "distortion" in need of correction.

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[31] Proposing Release, *supra* n.2, at 11157.
[32] Id., at 11129.
[33] *Id.,* at 11157.
[34] Brut suggests that this will be the natural outcome for other SRO-operated market centers once opportunities to trade ahead of standing limit orders are permanently eliminated.
[35] Proposing Release, *supra* n.2, at 11157.
[36] "Fee capture" defined as the access fee charged net of any rebate paid to a contra-side customer.
[37] *See* "BRUT Announces Dramatic Price Reduction," *available at* http://www.ebrut.com/infoCenter/2003pr/0812.htm (August 12, 2004). *See also supra* n.4. Brut's growth occurred in part from firms configuring their order-routing technology to give Brut preferential routing status due to Brut's superior fee structure, where execution price was equal.

The Fallacy of Non-Transparency

Some have criticized access fees as imposing "hidden" charges on an unsuspecting trading public, leading to Commission concern that it has become "difficult for market participants to compare quotations readily across all marketplaces."[38] Nothing could be further from the truth. Brut urges the Commission to once and for all reject the idea that access fees should be aggregated with an order price for transparency purposes.

Brut challenges attempts to link transaction charges to the price of the relevant underlying security. These rates are <u>not</u> related in any way, shape or form of the price of the stock an investor or agent is seeking to buy or sell, but rather a bill for services rendered in connection with processing an order. They are similar to transaction-oriented charges levied by exchanges, SROs, settlement facilities, and executing and clearing brokers. No one contends that the per-share assessment of the Trading Activity Fee by the NASD distorts the NBBO because, like access fees, it is simply a cost of doing business.[39] Brut contends no trader or investor confuses these fees with the price of the stocks they are seeking to trade.

Moreover, ECN and SRO-equivalent transaction charges are often the most transparent costs of their kind, given the hyper-competition among market centers. Major market centers make these charges publicly available on their web site.[40] Brut is constantly enlightening customers about the advantages of its rate structure, and responding to likewise initiatives from our competitors. Just as important, market-center customers can act on this information, configuring order routing technologies to preference lower-cost destinations and penalize those that seek to raise prices.[41] Everyone from the novice investor to the most sophisticated trader can learn and keep abreast of these charges with minimal effort.

Thus, the Commission should fear not that the nation's investors are disadvantaged by secret charges that fool them into higher execution costs. Market center transaction charges are not directly borne by average individual investors and do not explicitly effect their execution costs. Broker-dealers are highly aware of these charges and adept at managing them, both on a day-to-day basis and through "voting with their order flow" and driving a dynamic of constant rate competition. At most, mandated public disclosure of access-fee rate structures, which could perhaps be satisfied through a quarterly publication akin to Exchange Act Rule 11Ac1-6, would provide a complement to market forces and easily resolve any valid transparency complaints.

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[38] Proposing Release, *supra* n.2, at 11156.
[39] *See* NASD By-Laws, Schedule A, Section 1(a). While the current fee is low ($.0001), Brut's experience is that customers find this amount to be meaningful.
[40] *See, e.g.*, http://www.tradearca.com/exchange/fees.asp (listing Archipelago's fees). *See also* http://www.inetats.com/prodserv/bd/fee/fee.asp (listing INET ATS's fees).
[41] *See supra* n.36. Nasdaq has also introduced an "auto-ex" order type that allows broker-dealers to avoid trading with ECNs that charge an access fee within SuperMontage altogether. *See* NASD Rule 4710(b)(1)(B)(ii)(d).

Charges and Competition

The claim that access fees place non-ECN broker-dealers at an unwarranted competitive disadvantage is a myth perpetuated to mask the desire of some firms to lower their transaction costs through regulatory intervention.[42] Market-making firms trading as principal operate under a business model entirely different from that of a market center executing transactions purely on an agency basis. Moreover, said firms currently charge access fees displayed through Nasdaq's SuperMontage system, with an advantage distinct to that of ECNs and ATSs – having their SRO serve as collection agent for these fees. The Proposing Release notes that "many believe that prohibiting non-ECN broker-dealers from charging access fees…puts the non-ECN broker-dealers at an unwarranted competitive disadvantage."[43] In addition to there being no credible evidence that non-ECN firms have suffered from the burden of a non-fee business model, if they did there would be a remedy – start an ECN. Firms continuing to conduct market-making activities do so pursuant to a conscious choice, not a competitive constraint.

Even should an unfair competitive disparity exist, a remedy far less intrusive and disruptive than wanton rate fixing is available. The Commission should eliminate any prohibition under the Quote Rule on said firms charging for direct access to their quotations, once and for all removing any perceived disadvantages. The access fee proposal does this in part, allowing market makers to charge for access to their attributed quotations in the public quotation system. The Commission refrains from attempting to create total equilibrium, noting that "market makers are not subject to the additional access requirements imposed by Regulation ATS."[44] Brut agrees with this approach, for while identical regulation need not be imposed on all brokers, the assessment of quotation access charges should bring with it a responsibility to provide non-discriminatory access.

Locked and Crossed Markets: A Better Way

Any concern that access fees exacerbate the occurrence of locked markets are alleviated by the proposal to require SROs to develop policies and procedures to prevent such practices from occurring. Brut endorses this proposal as a measured approach to eliminate specific trading behaviors that threaten market quality, as opposed to broad efforts such as those represented by the rate-fixing elements of the proposal. While debate is plausible regarding the positive or negative values of locking and crossing, if the Commission concludes it has a net detrimental impact, it should focus on explicit limits on that activity, consistent with Brut's belief in targeted, tactical Commission intervention in market micro-structure as discussed above.

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[42] Market-making firms that use their own MMID for display of customer limit orders are most inclined to see ECNs only as a source of reduced profitability and higher transaction costs (*i.e.*, ECN order prices narrow the spread and thus the profitability of internalization, and said firms only interact with ECNs to remove liquidity and thus pay fees to do so). Any regulation that would lower ECN fees and jeopardize their economic viability would be seen as a positive from the perspective of such firms.
[43] Proposing Release, *supra* n.2, at 11158.
[44] Supplemental Release, *supra* n.3, at 30147.

Phantom Problems, Real Risks

While the need for the Commission to fix order-execution facility pricing is dubious, the potential peril of doing so is genuine. Commission intervention regarding market-center pricing carries with it the possibility of a variety of unintended negative consequences:

- Lower market liquidity as those who trade in reliance on current market pricing models reduce or refrain from trading in light of the related market disruption. These traders provide valued liquidity, scale and efficiency to the marketplace, ultimately benefiting the retail investor, and should not be discounted.

- Potentially wider spreads and less depth as this loss of liquidity translates to less aggressive market-wide quoting.

- Higher transaction costs for the industry as lower trading volumes reduce scale and increase non-access fee execution costs. These costs could likely be more obscure to the trader and thus less disciplined by market competition.

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

Comments on Supplemental Release

The Supplemental Release evidenced a thoughtful attempt to move beyond the rhetoric surrounding market-structure access issues to the reality of what can be done to practically improve inter-market connectivity without counterproductive restraints on trade.

On Access

Brut generally believes that private initiatives are the optimal way to establish access between markets. A review of the evolution of the market structure for Nasdaq and exchange-listed securities provides a compelling example of how a regulation-mandated public connectivity between markets stunts industry growth through poor governance and lack of incentives to improve or maintain systems. By contrast, where private market forces are allowed to operate, connectivity providers have competed to meet the changing needs of market participants, producing better results at lower cost. Thus, Brut urges the Commission to reject the temptation to repeat history and impose a requirement to create a central "hub" of connectivity on quoting market centers. Over the long run, this approach will not work.

An approach reliant on private linkages does bring with it certain pitfalls that can be alleviated through targeted Commission regulation. As discussed, *de minims* QMPs that voluntarily choose to submit their order prices to the public quotation system can create connectivity inefficiencies. Thus, Brut strongly supports the concept that a market center "should be required to publish its quotations in an SRO order execution facility… until its share of trading reached a point where the cost of direct connections with multiple market participants would not be out of proportion to the entity's level of trading."[45] A structure for implementing this solution exists to this problem within the confines of Regulation ATS. ATSs that fall under the 5% Reg ATS threshold that choose to supply quotations to the public-quotation system should be required to do so through a SRO order-execution facility that will provide ample access to said quotation. This would give emerging market centers a fair and reasonable means to participate in the national market system without the ability to impair the operation of fair and orderly markets by their mere existence.

Reform of this nature should also provide some regulatory assistance to private market forces in keeping market center charges at non-usurious levels. Newly-formed market centers are in some ways those least disciplined by competition. With no existing customer base to satisfy, revenue streams to preserve, or market share to protect, the allure of the "get-rich quick" scheme could tempt a small market-center operator to try gimmick-laden fee structures out of touch with market realities. Access to display their orders in the NBBO give such markets instant distribution and, in the minds of some with best-execution responsibilities, rights of extortion. Mandating public-quote participation through an SRO would serve to rationalize the fees charged by such markets. SROs are collectively-governed organizations that take the interests of their member constituency into account. They have a responsibility under the Exchange Act to "provide for the equitable allocation of reasonable dues, fees and other charges among its members."[46]. Recent Nasdaq action to cap for access fees for SuperMontage participants shows SROs take this responsibility seriously. While this will not guarantee that all will find market center fees to their liking (a nirvana unlikely no matter what the Commission does), a self-regulatory complement to market forces would help keep rates fair and reasonable.

On Fees

The Supplemental Release did well to resolve some questions regarding the rate-fixing proposal that would have compounded the damage of this regulation by not only setting prices, but by doing so on an uneven playing field. Clarifying that ECNs could charge up to $.002 per share for direct access under Proposed Rule 610 squashed the threat of undoing the past five years of regulatory market structure initiatives, which under Reg ATS allowed market centers to compete under both SRO and broker-dealer classifications.[47]

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[45] Supplemental Release, *supra* n.3, at 30146.
[46] Exchange Act §§6(b)(4) and 15A(b)(4).
[47] Brut notes, however, that this could discourage ECNs from quoting in SRO facilities that are widely accessible. Under the proposed rules, ECNs will likely seek to minimize transactions through SRO

These clarifications aside, Brut still strongly objects to the access fee proposal. These rules would represent counterproductive, overbearing government intervention in the setting of prices, a concept flawed at its core, that no amount of suggestions, clarifications or improvements could improve. Despite good intentions, no regulator can effectively manage transaction costs in this manner with any degree of success over the long term. Central planning of this nature would be harmful from the moment of its enactment and only become more toxic to market structure over time. This proposal should not be approved in any form.

What the Commission should do in lieu of setting rates is to once and for all state that firms can take transaction charges into account when fulfilling their duty of best execution, and instruct SROs to be mindful of the same when surveilling for compliance with this obligation. Much broker-dealer frustration regarding access fees arises from a perception that they are "forced" to trade with any firm that is quoting at the NBBO, for fear of an exception appearing on an SRO's best-execution compliance report. This removes the perceived market power these firms have in keeping execution costs at reasonable levels, and emboldens some to raise fees to take advantage of fears, rather than deliver value. With the proposed trade-through reforms, the Commission is explicitly acknowledging more than ever that factors other than quoted price may lead a broker to choose where they execute order flow. A clear statement that the cost of accessing a quotation may also be taken into account will return authority to where it should be in a competitive marketplace – the customer. Rather than subsidizing intermediaries, such guidance will remove the risk of rogue transaction costs that will help keep costs low to the investors that brokers are competing to serve.

Practical Suggestions

To summarize its views on how best to implement access reform, Brut suggests:

- Amending Regulation ATS to require ATS operators under the 5% volume threshold participate in the public quote through an SRO-operated OEF;

- Supplementing Exchange Act Rule 11Ac1-6 to require QMCs and QMPs to describe their fee structures for non-subscriber access to their quotation, to remove any lingering concern over the transparency of these costs;

- Clarify that a broker's duty of best execution can take the costs of accessing a market center into account when deciding how best to execute a customer market and marketable limit order. General advice to this effect, rather than explicit attempts to set a materiality threshold for this variable, is likely to be most valuable to the financial community on a sustainable basis; and

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facilities, for which they can only charge $.001, and maximize "direct access" transactions, for which they could charge $.002. This could lead some ECNs to withdraw from widely-available SRO quote and execution facilities, such as SuperMontage, in favor of other SRO facilities that offer automated, but less commonly-utilized access. This could further perpetuate quote fragmentation and exacerbate access issues.

- Consider locked and crossed market reform hand-in-hand with access issues. The logic for locking or crossing a quote is similar to that of trading through a quote. While locked and crossed quotes have the negative consequence of blurring price information, the interest of the limit order customer that would trade with a quote were it accessible should be considered. Guidance regarding the non-display of such orders may be the appropriate solution, akin to recent market developments regarding exchange-traded funds.[48]

Collectively, these efforts would give incremental enhancement to competitive market conditions, and provide a fair, reasoned framework for market access going forward.

Market Data Proposals

Summary

The current state of how market data is priced and distributed shows how regulation-imposed management and a lack of competition can raise costs for investors. The current method of disseminating market data to the public has not operated efficiently for quite some time. To reverse the damage, the Commission should seek to reduce the amount of data that is centrally distributed, minimize the amount of data investors are required to buy, and rationalize the distribution methods and costs of what they are required to buy. Accordingly, Brut supports proposed amendments to Exchange Act Rules 11Aa3-1 (the "Vendor Display Rule") and 11Ac1-2 that would allow market centers and data vendors more control and freedom over how they buy and sell data products. Brut opposes, however, the proposed changes to the current revenue-allocation methods of the current market-data plan formulas, as they needlessly focus on fee distribution where the real attention should be on plan governance and fee assessment.

General Comments

The almost universal view of significant consumers of market data is that the explicit and administrative costs of these products are far too high.[49] The current plans for how the NBBO and last-sale information for stocks listed on the NYSE (Tape A), American Stock Exchange (Tape B) and Nasdaq (Tape C) have produced inefficient

[48] In June 2004, Brut understands that the Commission explicitly instructed Archipelago and INET ATS to cease displaying order prices that lock or cross the quotations of other markets in the exchange-traded funds for the Nasdaq 100 ("QQQ"), S&P 500 ("SPDR") and Dow Jones Industrial Average ("DIA") indices. Both market centers complied by handling such orders on a non-displayed, or "hidden" basis. *See, e.g.,* "Changes in INET ETF Business," *available at* http://www.inetats.com/prodserv/developers/resources/emailarchive/20040610_a.asp (June 14, 2004). Absent Commission action, an analogous approach would not be practical for Nasdaq securities, given both markets' (and Brut's) status as limit-order display alternatives under Exchange Act Rule 11Ac1-4.

[49] *See, e.g.*, Letter from Carrie Dwyer, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, June 30, 2004 ("Schwab Letter"); Letter from Ellen L.S. Koplow, Esq., Executive Vice President & General Counsel, Ameritrade, Inc., to Jonathan G. Katz, Secretary, Commission, June 30, 2004 ("Ameritrade Letter")(both concerning proposed Regulation NMS).

economic outcomes due to a lack of SRO competition, fueled by non-productive rules of governance and a lack of accountability. Despite much discussion of this subject over the last five years, the system still is not working.

Given the Commission's stated frustrations in setting prices for market data,[50] the optimal means to lower industry costs is to allow SROs to compete for the right to collect such data. This economic competition lowers costs for the brokers generating the data, both directly and indirectly. Only recently has some competition begun to creep into this market, as SROs have begun to compete for the quotation and trade activity of non-SRO market centers. The revenue-sharing programs of the Boston Stock Exchange, National Stock Exchange, and Nasdaq[51] have finally led to the "leakage" of money out of the system, which ultimately flows back to traders and investors in the form of lower transaction costs. Brut's price cut of September 2003 was made in part through increased revenue from its market data due to changes in its trade-reporting practices.

Changing the formulas for how market-data revenue is distributed risks disrupting the competition that is beginning to lower the industry's net cost of market data down to reasonable levels. Current market data revenue allocation formulas allow SROs to value market data and compete for it with relative ease. The complexity of the proposed formulas may dull competition, as SROs find it practically difficult to value in real-time the market data generated by any one participant with relative comfort. As one become less certain regarding the value of an asset, the marketplace for the asset breaks down. Even if this dislocation is temporary, the harm would be significant, given the urgent need for progress in this area of market structure. Any incentives in these formulas that encourage unnatural trading behavior can be eliminated through outright prohibition, continued uncompromising enforcement and/or minor modifications to current formulas. The enforcement example set by the Commission in light of alleged "tape shredding" in the trading of Tape B stocks leaves little doubt that such practices will not be tolerated. Modifying the Tape A and Tape B formulas to mimic that of Tape C (*i.e.*, to be both volume and trade based) should remove the incentive altogether.

Conversely, the proposed formulas appear to be designed to encourage certain trading behaviors, potentially to an unhealthy extent. No experimental economist can foresee all the incentives and opportunities created by gerrymanding how a $424 million pool of revenue is distributed. The more technical and theoretical a revenue-distribution structure becomes, the more likely that loopholes and the potential for unintended consequences exists. Not only would this increase the potential unnatural trading and quoting behavior, it signifies a desire to use market structure regulation to micro-manage market participant behavior, a departure from previous Commission policy and potentially inconsistent with the mandate from Congress under the Securities Act Amendments of 1975.

[50] *See* Proposing Release, *supra* n.2, at 11178.
[51] *See, e.g.,* National Stock Exchange Rule 11.10(A)(j).

The proposed changes to redesignated Rules 601 and 603 offer a much brighter path to greater competition and lower costs. Giving SROs greater rights to distribute their trade reports and other non-core data independently breaks the monopoly of the SIP and will undoubtedly lead to lower prices.[52] Revising the definition of "consolidated display"[53] to market center BBO information, and narrowing the instances where one must be provided,[54] gives vendors the flexibility to choose what data they display within non-trading applications, which will lead to increased clout with the sellers of non-core data. Complementary reforms that ensure investors will get the data they need with making a trading decision, and SROs will not discriminate when selling their own data, provide the right combination of market competition and investor protection.

Comments on Supplemental Release

Focus on the amount and allocation of costs for core-data is still needed, despite the reforms proposed to date. The Supplemental Release rightly asks for comment "addressing the reasonable of market data fees and the Commission's approach to reviewing such fees."[55] While not a significant consumer of market data, Brut believes that to the extent the nature of "core" market data is limited through these proposals, that data should be available to the public through a cost-based approach. Special heed should also be paid to complaints about current market data administrative practices, so the process of getting information to investors is not overwhelmed by autocratic and bureaucratic tendencies of central consolidators.[56]

Brut also cautions the Commission against minimizing the concerns of multiple commenters about the complexity of the proposed market data revenue-allocation formulas as "overstated."[57] The reality is that these formulas will be analyzed and tracked in real-time by SROs (and their members should revenue-sharing program continue) in order to get an accurate sense of their revenues as quickly as possible, to comply with their financial-reporting requirements, SRO governance policies, and Sarbanes-Oxley regulatory responsibilities. There will be significant costs imposed, which the Commission should be convinced are worth bearing given the unique incremental value such a regime would provide.

Practical Suggestions

Should the Commission decide to move forward with the proposed revenue-allocation changes, Brut would recommend significant simplification and foresight regarding implementation. Removal of the "NBBO Improvement Share" portion of the

[52] *See, e.g.,* Exchange Act Rule 11Aa3-1(c)(2-3) (proposed to be rescinded from redesignated Rule 601).
[53] *See* Proposed Rule 600(b)(12).
[54] *See* Proposed Rule 603(c)(1).
[55] Supplemental Release, *supra* n.3, at 30148.
[56] *See* Schwab Letter and Ameritrade Letter, *supra* n.49.
[57] Supplemental Release, *supra* n.3, at 30148.

formula, as discussed in the Supplemental Release, would be a good start.[58] The Commission should also endeavor to perform the function or specifically assign the task of calculating and distributing the results of the formula on a timely basis, to ameliorate the administrative costs to the industry discussed above.

With respect to the cost and process of distributing core market data going forward, Brut offers two suggestions. First, the unanimous vote requirement for material changes to market data plans must be eliminated.[59] This is a *de jure* barrier to any progress that threatens the real or perceived interest of any plan participant. Second, the Commission should consider applying SRO governance standards to SIPs going forward, subjecting their operations to the same standards of transparency and accountability. This will increase the likelihood of fair exercise of the limited monopoly power that SIPs will retain.

Sub-Penny Quoting Proposal

Summary

The need for Commission action to constrain the proliferation of sub-penny quotations appears unnecessary, given that market forces have led to their significant decline in recent months. Customers with strong beliefs regarding the appropriate minimum price variation have exerted pressure on market centers, which have responded and seen order flow increases partially as a result. In the Proposing Release, the Commission notes that "in the absence of a compelling public policy interest, market forces rather than the government should determine the manner in which securities are priced."[60] Given that market forces appear to be directing change in a direction the Commission deems favorable, interference would seem redundant.

General Comments

Brut was the first ECN to take steps to actively restrict sub-penny quoting, disallowing it for orders priced $10 and higher, on a pilot basis beginning August 4, 2003. Brut made this pilot permanent, and further disallowed sub-penny trading for orders priced $5 and above beginning November 17, 2003. Other market centers followed suit in the wake of Brut's market leadership.[61] Brut can not claim any altruistic purpose for this action, for our motives were purely commercial. Brut did what any good business does: it listened to the desires of its customers, and modified its product to meet their changing needs and desires. While competitors clung to 'religion' regarding sub-

[58] *See* Id.
[59] *See* Proposing Release, *supra* n.2, at 11183 n.295.
[60] Proposing Release, *supra* n.2, at 11170.
[61] *See* "Important Notice Regarding Change to Minimum Trading Increments on INET" *available at* http://www.inetats.com/prodserv/developers/resources/emailarchive/20040303.asp (March 3, 2003).

pennies,[62] Brut's agnosticism was rewarded with increased business. In the year since Brut began restricting the use of sub-pennies, our Nasdaq market share has increased over fifty percent.[63]

Accordingly, the sub-penny quoting proposal may be unnecessary, as the market appears to be self-correcting. Any major market center risks the wrath of their customer base should they allow sub-pennies beyond what is deemed necessary. Commission involvement in the allowable minimum increment would most likely to thwart the capability of market competition to keep this aspect of market structure in check as the appropriateness of sub-pennies ebbs and flows with changing market conditions. Even at the outset there appear to be certain instances where sub-penny quoting makes sense for certain stocks over the Commission's proposed limit of $1.00, such as actively-traded exchange-traded funds like the QQQ, and certain low-priced heavily-traded stocks. Commission regulation of the minimum quoting increment is unlikely to be as fluid as market needs demand. Market centers should be allowed to innovate as customer demands dictate, for that will ultimately produce the best long-term outcome.[64]

Comments on Supplemental Release

The sub-penny quoting proposal was not discussed in the Supplemental Release, likely because comments at the Regulation NMS Hearings were universally in favor of the proposal. Brut notes this absence of controversy only because it begs a question – if a desire to limit sub-penny quoting is so universal, is Commission intervention really required to make it happen? Food for though as the Commission ponders where it needs to exert its authority to manage market-structure and where market forces, which Congress believed should be the guiding evolutionary force, can handle the job.

Practical Suggestions

Having had experience at curtailing sub-pennies orders, Brut offers two suggestion should this proposal be implemented. First, any restriction should be solely based on the price of an <u>order</u>, rather than the price of a <u>stock</u> (*i.e.*, sub-penny orders could not be accepted at prices of $1.00 or higher, regardless of the recent trading price of the relevant stock). This is a more manageable approach that does not require countless re-classifications of stocks as "sub-penny eligible" based on fluctuations in their valuation, stock splits, or other price movements.

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[62] *See* <u>Id</u>. (stating "we have determined that trading in penny increments generally provides greater price discovery, market transparency, and better overall execution quality on INET."). *See also* remarks of Ed Nicoll, Chief Executive Officer, Instinet Group Inc., before the Securities Industry Association Market Structure Conference (June 13, 2003) (citing sub-penny trading as a hallmark of an efficient market).

[63] Brut's Nasdaq market share has risen from 7.5% in July 2003 to 12.7% in June 2004. *See* http://www.ebrut.com.

[64] This should be applied with respect to both SRO and non-SRO market centers. To the extent SROs feel commercially disadvantaged by their current minimum increment, they should be allowed to change it without prior public notice and comment as a system change allowable under Exchange Act Rule 19(b)(3)(A).

Second, the proscription on the "acceptance" of sub-penny orders[65] should be clarified so that acceptance is permissible, as long as the recipient market center consistently re-prices such orders to an acceptable increment, and gives such orders no special priority for execution purposes. Brut has found that customers can submit sub-penny orders in error, and a policy of re-pricing such orders is preferred by customers to rejecting them, with the consequence of possibly missing a trading opportunity as a result. Market centers should continue to have this flexibility.

Thoughts On Implementation

If adopted in anywhere near their current form, the securities industry would have a substantial amount of work to prepare for Regulation NMS. The following are mere examples of projects that would need to be completed before "Regulation NMS +1":

- SROs would need to revise execution systems and member connectivity.

- ATSs and ECNs would need to alter routing algorithms, quoting conventions, billing systems, customer communications and inter-market networking.

- All broker-dealers would need to draft comprehensive, tailored procedures and create compliance regimen to ensure adherence to the new rule set.

- Vendors would need to re-configure systems to account for new market data display requirements and execution priority rules, updating their time granularity to the microsecond to comply with trade-through and lock/cross rules .

The industry efforts needed for Year 2000 and decimalization compliance are fair comparables as to the scope of the anticipated industry efforts. In adopting Regulation SHO, the Commission provided a six-month lead time for the effective date of the proposals.[66] For Regulation NMS, there are more rule proposals affecting a wider group of market participants.

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

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[65] *See* Proposed Rule 612(a).
[66] *See supra* n.10.

Conclusion

Comments and criticisms aside, it can not be stated often enough that the Commission and its staff should be praised for the effort that Proposed Regulation NMS represents. The hard work put into the Proposing Release, Supplemental Release, the Regulation NMS Hearings, and management of the comment process is already producing results on issues of market structure that have lingered far too long. These proposals have already had a positive impact on market structure.

To realize their full benefit, however, the Commission need remain true to the principles by which it has governed market structure since 1975. Self-regulation and competition need to be given the breathing room to produce evolutionary change before federal intervention is entertained. When it does get involved, the Commission needs to tread softly, knowing that broad, rigid approaches will only lead to a cycle of continuous, corrective, counter-productive micro-management of market structure. Elements of the Regulation NMS proposals contain the promise of the correct approach to Commission regulation, but other portions hint of a potential deviation down a path of untenable obstructionism. With the interests of the nation's investors hanging in the balance, the Commission should carefully and cautiously move forward at this crossroads in the history of our markets.

Brut is happy to discuss these comments with the Commission and its staff in any manner it would find helpful. Please do not hesitate to contact me at (917) 637-2560 should you have any questions.

Sincerely yours,

William O'Brien
Chief Operating Officer
Brut, LLC

cc: The Hon. William Donaldson, Chairman
The Hon. Cynthia Glassman, Commissioner
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
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