The Chicago Stock Exchange

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

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

Dear Mr. Katz:

This letter presents comments from the Chicago Stock Exchange (the "CHX" or the "Exchange") in response to Proposed Regulation NMS. The CHX welcomes the opportunity to share its thoughts on this far-reaching proposal. As described below, the Exchange believes that the Securities and Exchange Commission (the "Commission" or the "SEC") has done an admirable job in proposing changes to the current market structure. Indeed, the Exchange believes that many of the Commission's proposals present sound ideas for ensuring the future of the national market system. The Exchange also believes, however, that some of these proposals go too far in trying to correct perceived problems – in some cases, arguably mandating how markets must operate – causing the Commission to play a role in market structure development that it has, at least so far, avoided. Other proposals, particularly those relating to the distribution of market data revenues, seem to favor markets handling large volumes of institutional orders in blue chip stocks, to the detriment of markets that provide a venue for retail trading of smaller capitalized securities. As further described below, the Exchange believes that the Commission ultimately should adopt many of its Regulation NMS proposals, but also should consider changes to key aspects of these sweeping changes.

A. Introduction

The U.S. national market system is an extraordinary institution. In 2003, nine national securities exchanges and one national securities association processed more than 1.5 billion equity trades (involving more than 926 billion shares) in exchange-listed and Nasdaq-listed securities. Although the markets, and the human beings that operate them, are not immune from controversy, the national market system has provided a sound foundation for capital formation and for individual investment that is unmatched.

At the same time, the national market system is suffering from a variety of tensions. Even as the listed and OTC markets begin to look more alike, their differences are becoming ever more noticeable. Markets that are linked to each other for the trading of listed securities sometimes are completely isolated from one another in the trading of Nasdaq securities. As a result, liquidity in Nasdaq stocks might be available for viewing, but not particularly accessible. Markets also have developed very differently over the past years – some markets are fully automated facilities, matching orders against each other. Other markets combine the somewhat more manual processes of a trading floor with automated systems – providing a hybrid product to serve a wider variety of customers. Because of the many different ways that markets are changing, however, the existing inter-market connections are showing signs of strain.

The Chicago Stock Exchange approaches the challenges presented by these markets – and the proposals set out in Regulation NMS to address them – from a unique perspective. The Exchange's members trade both listed and Nasdaq securities, and have done so for many years. In fact, the Exchange's specialists, floor brokers and market makers currently trade 3,754 listed and Nasdaq securities.[1] Moreover, the Exchange has coupled a largely automated specialist trading system with the somewhat more manual order handling services provided by a robust floor broker community. The Exchange's specialists handle retail orders sent by online and full-service brokerage firms. These orders most often are executed automatically and account for the vast majority of the Exchange's trade volume.[2] The Exchange's floor brokers, on the other hand, service the Exchange's institutional customers. Although these floor broker-handled orders account for only a small percentage of the Exchange's overall trades, they constitute almost half of the shares traded on the Exchange.[3] These orders may be handled manually or sent to the Exchange's specialists for a more automated execution.[4] The multi-faceted evolution of the Exchange's market – combining technology with human expertise and permitting the trading of both listed and Nasdaq stocks – has given the Exchange a front-row seat to many of the challenges that the Commission currently faces.

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[1] In 2003, 22,917,330,313 shares were traded on the Exchange – in securities listed on the New York Stock Exchange ("NYSE") (16,069,468,380 shares), American Stock Exchange ("Amex") (2,960,495,242 shares) and the Nasdaq Stock Market ("Nasdaq")(2,703,399,700 shares).

[2] Retail orders accounted for approximately 96.5% of the Exchange's trades in 2003 (57.1% of its share volume, in the same time period). In February 2004, more than 70% of the post-open executions of retail market and marketable limit orders occurred automatically.

[3] In 2003, for example, institutional orders accounted for only 3% of the Exchange's trades, but 42.9% of its share volume.

[4] It is somewhat inaccurate to portray the work of CHX floor brokers as manual – indeed, these members are using a seemingly ever-increasing amount of technology in their businesses, including an electronic order management system developed by the CHX called Brokerplex®.

As further set out in this letter, the Exchange has the following primary comments on proposed Regulation NMS:

- ***Trade-through.*** The Exchange believes that the Commission should adopt the proposed trade-through rule, along with an automated quote exception, to allow a customer to trade through manual quotes displayed in other markets, but not through quotes that are accessible through immediate and automatic means. This updated trade-through rule, which should apply to both listed and Nasdaq securities, will allow both automated and manual markets to thrive, creating a more robust national market system. If the automated quote exception is adopted, the proposed opt-out provision becomes entirely unnecessary. (See the discussion at pages 4 through 11).

- ***Market Access.*** The Exchange encourages the Commission to adopt a more tailored market access proposal, one which requires only that markets provide one another with access to displayed bids and offers. This intermarket access will encourage the important interaction of orders and displayed interest, without requiring markets to provide nonmembers, who do not pay the dues and fees to support the operation of the market, with an essentially free ride. The Exchange suggests that the Commission limit any access fee caps to non-SRO transactions or, at a minimum, to executions of inbound orders against displayed bids and offers. (See the discussion at pages 12 through 17).

- ***Market Data.*** Although the Commission's proposed formula for distributing market data revenue is well meaning, it creates a substantial opportunity for market participants to try to "game" the system. Additionally, with its repeated emphasis on the dollar value of trades and quotes, the proposed formula effectively creates a two-tiered market system that favors venues that cater to sophisticated, institutional customers over those that handle order flow from retail investors. Accordingly, the Exchange believes that the Commission should either revise the proposal substantially or leave the current formula in place. (See the discussion at pages 17 through 22).

- ***Subpenny Pricing.*** Finally, the Exchange supports the Commission's proposal to end subpenny pricing. (See the discussion at page 23).

The Exchange's primary comments are detailed further below.

B. The Trade-Through Proposal

1. The Trade-Through Rule Plays An Important Role In Unifying Markets and Maintaining Investor Confidence.

As the Commission aptly noted in the Proposing Release, "one of the most important goals of [a national market system] is the encouragement of the display of limit orders and aggressive quotes, which provide the basis for all price discovery in the markets."[5] For approximately 20

[5] Proposing Release at 23. Throughout this comment letter, the CHX will refer to the Commission's proposed rules and amendments to joint industry plans (Release No. 34-49325) as the "Proposing Release." The CHX will refer to the Commission's extension of the comment period and supplemental request for comment as the "Supplemental Request

years, the trade-through rule, by effectively preventing a market from executing an order at a price inferior to another market's displayed bid or offer, has encouraged investors to use limit orders and to quote aggressively, improving the price discovery process and contributing to increased depth and liquidity in the markets for listed securities. The trade-through rule also has made it more likely that market orders will receive the best available price, by requiring that market participants seek any better bids and offers that are displayed in other market centers.

In its simplest form, the trade-through rule ensures that if a customer order to buy stock is the best price in the national market system, it will not remain unexecuted when a customer in another market wants to sell stock at a worse price. It also motivates liquidity providers to quote aggressively because it protects their market-bettering quotes from being traded through. This coordination among markets is valuable for many reasons. First and foremost, it protects the investor whose order is displayed – the investor publicly announced his or her willingness to trade at a specific price and should not be ignored.[6] Additionally, a trade-through rule provides an opportunity for markets to compete on a level, price-based playing field by ensuring that orders will be sent to the markets that display the best prices, or at least to those markets that routinely execute orders in accordance with those prices.[7] Finally, a trade-through rule sustains investor belief in the national market system – if customers' orders routinely are traded through by inferior executions in other market centers, it is inevitable that investors, over time, will come to believe that the markets are fundamentally unfair and change their trading strategies accordingly.

a. The trade-through rule should apply to Nasdaq securities.

Given the considerable benefits associated with the trade-through rule, the CHX urges the Commission to extend the protections of the rule to investors in Nasdaq securities. Although there continue to be differences in the markets for the trading of listed and Nasdaq securities, many of those differences appear to be rapidly diminishing.[8] Markets like the CHX, which trade both

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for Comment."

[6] The harm done to this customer is not specifically addressed by relying on SROs to enforce their best execution rules. Those rules focus on the execution given to the customer whose order *was* executed; they do not address the harm caused to the customer whose order *remained unfilled*. Moreover, SROs often surveil for compliance with these rules by considering a broker-dealer's overall success in seeking quality executions for the orders it receives – there often is no attempt to address the specific harm done to a customer whose order is executed at a price worse than that available in another market. Therefore, even if dogged enforcement of best execution rules could try to force broker-dealers to seek out better prices in other markets, it is not a quick solution to that problem. Finally, enforcement of these types of best execution rules could be open to criticism – not only are the standards usually quite vague and open to interpretation, but also the SROs that review broker-dealer compliance with these standards operate their own markets (or have substantial contractual connections to markets). If nothing else, this oversight creates the perception that an SRO might use its regulatory role to encourage its members to route orders to it, instead of to its competitors.

[7]Markets that have liquidity often are able to attract additional liquidity, sometimes without regard to the quality of the individual executions that they provide.

[8] A notable indication of the increasing similarity between the listed and OTC markets is the fact that Nasdaq identifies itself as a "stock market" and has submitted to the Commission its application for registration as a national securities

Nasdaq and listed securities, long have recognized these similarities, while noting the sharp contrast in the intermarket connections that exist within these markets.[9]

In short, the Exchange believes that there is no reason for maintaining a trade-through rule that protects displayed limit orders in listed securities without extending it to investors trading Nasdaq securities. In fact, some might argue that, given the level of fragmentation in the Nasdaq marketplace, there is an even better case for imposing a trade-through rule for Nasdaq stocks, in order to protect customer expectations regarding execution prices.[10] Critics will argue that given the lack of a mandated linkage between Nasdaq markets, it is not practical to impose a trade-through rule. Such an argument ignores the fact that there already exists a comprehensive network of voluntary linkages between and among most Nasdaq market centers, in many cases providing for fully automated executions. The Commission should require individual trading venues to leverage these connections to establish a more robust national market for the trading of Nasdaq securities.

b. To be effective, a trade-through rule must be uniformly interpreted and enforced.

The Commission's proposed rule requires individual market centers to "establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of trade-throughs in their markets." [11] The Commission has noted that, under this proposal, markets would be required to make systems changes to prevent trading at a price that is inferior to a published quote, unless an exception applies.[12] The CHX believes that these general principles are a good starting point, but notes that markets will be able to more effectively implement a trade-through rule if the Commission establishes objective parameters, applicable to all markets, for determining whether a trade truly constitutes a trade-through.[13] A more uniform definition of a "trade-through" also can

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exchange. Among other existing similarities, the Nasdaq and listed markets list similar (or even the same) securities and require their members to follow similar rules when trading those securities. Specifically, Nasdaq and the NYSE compete with each other for the listing of new securities – indeed, earlier this year, Nasdaq announced a new program that encourages companies to list stock on both Nasdaq and NYSE. Similar listing standards add to the similarities between these markets. Moreover, Nasdaq has recently proposed a rule change to impose, on its market makers, requirements for handling customer market orders that mirror the requirements that have been in place in the listed markets for years. *See* SR-NASD-2004-26. Intramarket price/time priority – long a standard element of a traditional securities exchange – has been a hallmark of Nasdaq's SuperMontage system since its rollout in 2001.

[9] Some markets, like the CHX, have established connections with at least some of the markets that trade Nasdaq securities (the CHX has been an automatic execution participant in Nasdaq's SuperSOES and SuperMontage trading systems since July 2001). Other markets, however, are not accessible to one another, except through indirect linkages.

[10] *See* footnote 36, below.

[11] Proposed Rule 611(a)(1).

[12] Proposing Release at 88.

[13] For example, the Commission could identify the number of seconds that a market participant might have (if any) to complete the execution of an order, when quotes are rapidly changing, without causing a trade-through. Similarly the Commission might develop a requirement that markets experiencing systems problems must quickly identify their

help minimize the substantial harm to competition that can be caused when some markets enforce intermarket rules more stringently than others.[14]

2. An Automated Quote Exception to the Trade-Through Rule Maintains Vital Trade-Through Protections While Modernizing The Rule To Accommodate New Technologies And Trading Models.

While trade-through protection is important, it is also important to recognize that markets have developed using different business models. It can difficult to determine how to integrate the operations of the very different market models that exist – in fact, some people are advocating that the Commission essentially abandon that effort and eliminate the trade-through rule. The CHX believes that there is a better way – specifically, the Exchange believes that the Commission should adopt an exception to the trade-through rule that both recognizes the benefits of new technology and protects the integrity of the national market system. [15]

The Exchange believes that an "automated quote" exception to the trade-through rule provides the required solution. Before the Supplemental Request for Comment was issued, the Exchange intended to recommend that the Commission adopt, but refine, the "automated order execution facility" exception.[16] The Exchange was concerned that the originally proposed exception was too broad in its requirements and would have unnecessarily pressured markets to fall into a specific, fully automated model.[17] For similar reasons, the Exchange was not in favor of the

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quotes in a particular manner so that other markets could know, with certainty, that those quotes could be traded through. Without these types of objective requirements, it becomes more difficult to establish the automated systems that the Commission seeks.

[14] Something as simple as the time taken to report a trade to the tape after execution can raise concerns about regulatory arbitrage. In the Proposing Release, the Commission has defined a trade-through as "the purchase or sale of an NMS stock . . . at a price that is lower than the best bid or higher than the best offer of any order execution facility . . . *at the time the transaction was executed.*" *See* Proposed Rule 600(b)(75). Trades in fully automated markets often will be executed just a split second before they are reported to the tape; trades in more manual markets can be executed many seconds (possibly even minutes) before they are similarly reported. If one market allows its members to report trades to the tape within 90 seconds after execution, but others, even occasionally, allow reports to occur as long as two minutes after execution, it will be difficult to avoid intermarket disputes about whether a trade-through has occurred. Indeed, these sorts of disputes occur today in listed markets under the Intermarket Trading System ("ITS") Plan.

[15] The Commission often is called upon to engage in this kind of balancing. In 1975, Congress identified specific attributes of an effective national market system embodied in Section 11A of the Exchange Act, focusing on a variety of factors, including efficiency, competition and transparency. Over the past 29 years, the Commission has struggled to balance these factors in its rulemaking, trying to allow markets to be innovative, and to become more efficient, while still ensuring that investor interests and the need for intermarket competition are considered. To continue this careful balancing, the Commission will need to ensure, for example, that the focus on efficiency does not always triumph over best price or that the desire for best price does not overwhelm the need to encourage competition.

[16] *See* Proposing Release at 55-59.

[17] If the Exchange were required to automatically execute all incoming orders against its displayed bid or offer – a

"automated execution" alternative discussed in the Proposing Release.[18] The Supplemental Request for Comment, however, seeks public input on an "automated quote" alternative that the Exchange believes is the best option for reconciling the interests of the many different types of investors who route orders to market centers with widely varying business models. Under this alternative, a market would be required to identify any of its quotes that were not automatically and immediately accessible to other markets; other markets then could trade through these quotes, either in the de minimis amounts set out in the Proposing Release or, as some commentators have suggested, in an unlimited amount.[19] Subject to the specific recommendations set forth below, the Exchange believes that the concepts embedded in the automated quote alternative permit the operation of a national market system with many, varied competitors, while preserving the protections of the trade-through rule.

a. The Commission Should Set Specific Performance Standards To Define An Automated Quote.

In implementing an automated quote exception to the trade-through rule, the Exchange strongly encourages the Commission to set specific parameters that identify when a quote is automatically and immediately accessible – it is imperative that there be clear and verifiable standards for determining whether a quotation can be traded through, or the industry risks widespread abuse of the trade-through prohibitions.[20]

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requirement to be considered an "automated market" – its floor brokers would not be able to provide the special, often manual, handling that their institutional customers require for large orders. Although floor brokers are using more technology in their handling and execution of orders, this process requires a floor broker to use his experience and market knowledge to provide the specialized execution sought by his or her customer. Moreover, it is likely that a customer with a 500,000 share order does not want to receive an immediate execution of only 500 shares at the Exchange's displayed bid or offer. The automated market model – with its requirement for executions at displayed prices – also might not have allowed the Exchange's specialists to provide their customers with additional price improvement opportunities.

[18] *See* Proposing Release at 55-59. The Commission typically has avoided the task of dictating market structure, noting that it "has sought to establish, monitor and strengthen a framework that gives the forces of competition sufficient room to flourish and that allows the markets to develop according to their own genius." *See* Market Fragmentation Release, No. 34-42450 (February 23, 2000), 65 FR 10577 (February 28, 2000).

[19] The Exchange concurs with the views generally expressed at the NMS Hearing, and summarized in the Supplemental Request for Comment, that the originally-proposed tiered approach would be extremely difficult to comply with, given the frequent incidence of flickering prices in today's decimalized trading environment. Accordingly, the Exchange believes that a market should be permitted to trade through a manual quote by any amount, subject to a broker-dealer's duty to achieve best execution.

[20] The Exchange notes that whatever difficulties are associated with identifying an automated *quotation*, those difficulties are multiplied when trying to identify an automated *market*, which would be required under the Commission's automated order execution facility proposal. Identification of an automated market – because of its focus on a market's handling of many thousands of orders – would be far more difficult to objectively verify, potentially leading to abuses and disputes between market centers.

The CHX recommends that an "automated quote" be generally defined as a bid or offer displayed pursuant to a national market system plan that is subject to immediate and automated execution against any incoming order seeking that execution, up to the full size of the displayed quote, without any restrictions on execution.[21] To ensure a smoothly-functioning system, the Exchange also recommends that the Commission require markets to update their automated quotes automatically and to send immediate and automated responses in response to orders, either reporting an execution or a cancellation.[22]

This general definition should be augmented by a more objective standard of what constitutes an "immediate" execution/cancellation and response. The CHX concurs with the panelists at the recent NMS Hearings that there must be no manual or human intervention prior to execution or cancellation. Further, the CHX believes that the Commission should establish a performance standard of no greater than one second as the maximum time for a market to respond to an order in an automated manner.[23] Use of a measurable standard will provide an objective basis for verification and should preclude disputes between markets as to whether quotation responses are truly automated.[24] The CHX recommends that the Commission require each market to offer automation that provides the same performance standards to *all* incoming orders that seek an immediate and automated execution against quotes, whether from a customer or another market. A market should not be permitted to offer a one-second execution to an order from another market, but then provide even faster executions to its customers.[25]

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[21] The Exchange believes that orders seeking this immediate and automated execution against displayed quotes should be specifically identified as such, to permit the effective integration of automated and more manual trading systems. For example, the Exchange's specialists could receive orders from customers that are seeking opportunities for price improvement – specialists might manually (or even automatically) handle these orders to ensure that that price improvement is provided. Similarly, the Exchange's floor brokers might receive large orders from customers who are not seeking an immediate execution on the share size displayed in the specialist's quote, but instead are seeking some sort of special handling. A specific order identifier would ensure that orders receive the type of execution that they are seeking.

[22] If the size of the incoming order exceeds the displayed bid or offer of an automated quote, the market should immediately and automatically cancel the balance of the order, with a corresponding notification to the other market.

[23] The Exchange believes that it market should not only publicly disclose when the performance standards are not met, but also should participate in linkages that allow for independent verification of these facts. Today, there are frequent disputes between markets regarding the accuracy of public disclosures regarding order execution quality. As noted below, the Exchange believes that ITS, once updated, could readily perform this function, for both listed and OTC markets.

[24] The Exchange believes that establishing a one-second standard will not reduce the incentive to compete based on speed of execution. As long as there are investors who prioritize speed and certainty of execution, market centers will have a continued incentive to further reduce response times.

[25] This scenario, in which the executing market center essentially treats the other market's investor as a "second class citizen," is a common complaint today regarding the operation of the ITS system. While the time periods under the any of the automated proposals are far shorter than the response time required under the ITS plan, the Exchange nonetheless believes that executing markets should afford the same execution times to all incoming orders that execute against an automated quote.

b. Automated Quotes Should Be Accessible By Other Markets, But Markets Should Not Be Required To Provide Automated Access To Every Individual Broker Or Dealer.

The Commission's proposed definition of an automated market (and, by extension, its likely definition of an automated quote) assumes that a market must execute all incoming market and marketable limit orders in an automated way, whether those orders come from a market's own members, from other markets or from the individual members of other markets. The Exchange believes that this aspect of the proposal goes too far – effective inter-market linkage is best achieved by direct market linkages, not through requirements for more indirect access.[26]

Indeed, although this may be a somewhat unpopular solution, the Exchange believes that the ITS system could be maintained and improved to facilitate direct intermarket linkage. While the existing ITS Plan and its commitment/satisfaction process have been under attack for years,[27] the actual linkage architecture could be modified for accessing automated quotations.[28] Today, the participants in the ITS system execute more than a million commitments to trade each month, totaling more than a billion shares.[29] Although executions currently are manual in most markets, and therefore cumbersome, automated and manual markets often fill an equivalent percentage of the commitments that they receive.[30] Modernization of the ITS system would eliminate the deficiencies in this vital linkage system and render it appealing to even the most technologically advanced national market participants, including Nasdaq market makers.

3. Allowing Customers To "Opt-Out" Of The Trade-Through Rule Unfairly Harms The Individual Investors Whose Displayed, Better-Priced Orders Are Ignored.

As set forth above, the Exchange generally believes that the Commission's proposed trade-through rule, when updated with an automated quote exception, preserves the investor protections inherent in the rule while accommodating various technologies and trading models. The Exchange believes, however, that the Commission's proposal to allow customers to opt-out of the trade-

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[26] As noted below on page 14, the Exchange is concerned that the Commission's access proposal, by requiring markets to provide nonmembers with essentially unfettered, indirect access to their quotes and limit order books, undermines the rights of a market's members or subscribers.

[27] As was stated by numerous participants at the NMS Hearings, ITS can be a valuable price discovery and linkage mechanism, but is plagued by the time latencies permitted under existing ITS rules.

[28] The ITS system could also be used to route an order for execution against manual quotations.

[29] For example, in May 2004, the nine participating ITS markets executed 1,343,215 commitments totaling 1,336,673,800 shares.

[30] In May 2004, the NYSE, CHX and ArcaEx each executed approximately 70-75% of the commitments that they received.

through rule potentially undermines all of those benefits, by allowing sophisticated investors to ride rough-shod over the rights of investors who take the time to display their bids and offers in the national market system. Indeed, although the Exchange believes strongly in the importance of a trade-through rule and its fundamental investor protections, the Exchange believes that the opt out proposal is so flawed that investors would be better off without any trade-through rule, rather than a trade-through rule that offered an opt out option.

a. The opt-out proposal ignores the harm to the investor whose order is not executed.

As an initial matter, the opt-out proposal, which allows a customer to decide whether or not to trade through an order in another market, arguably allows the wrong person to make the decision. In some ways, it is like allowing a speeder to determine whether or not the laws against speeding apply to his conduct. The speeder has decided to accept the risks of his activities, but his decision poses grave danger to everyone else on the road. Similarly, a customer who decides to trade through a better-priced order in another market has accepted the risks of receiving an execution at a worse price; his decision, however, should not be permitted to harm the customer whose order is displayed at a better price. This outcome would discourage investors from placing limit orders in the market, a result squarely at odds with the reasons for adopting a trade-through rule in the first place.[31] Moreover, the opt-out would discourage market makers from quoting aggressively. If a market maker's automated quotation was traded through more than episodically, it is likely that the market maker would be reluctant to post market-bettering quotes. This would dampen quote competition substantially, to the detriment of investors.

b. There is no need for an opt-out proposal if the Commission adopts an automatic quote exception to the trade-through rule.

Moreover, the CHX believes that the goal of the opt-out exception – accommodating customers who value speed of execution – can be achieved through the automated quote alternative discussed above. Specifically, a customer who desires an immediate execution can receive one – by executing automatically against any better-priced automatic quote in another market or by trading through any manual quotes displayed on the tape. This outcome serves the interests of all parties – the customer desiring speed is accommodated, but not at the expense of a customer with a displayed limit order.[32]

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[31] The Exchange does not believe that these concerns would be remedied by limiting availability of the opt-out exception to sophisticated investors, who presumably would be in a better position to prioritize speed of execution over availability of a better price in another market. In fact, the Exchange believes that that limitation could actually be a worse alternative, because it would permit sophisticated investors to disregard the interests of less savvy customers, who rely on the integrity of the national market system to ensure that their order is filled as liquidity becomes available.

[32] Markets can ensure that their customers receive trade-through protections by displaying the orders as automated quotes.

4. The Commission Must Establish a Realistic Implementation Plan.

As described above, the Exchange's members already provide automated execution to many of the retail customer orders that they receive; the Exchange would need to make additional changes, however, to automate the handling of orders from other markets and to make other changes associated with the trade-through proposals. In all, the Exchange estimates that it would take at least twelve months to implement the required technology enhancements.[33] Although total costs, including opportunity costs, are always difficult to project, the Exchange estimates that implementation of the Reg NMS trade-through modifications would cost at least $7,000,000.[34] Because the changes associated with implementing any final version of Regulation NMS will, for all markets, compete with other systems changes – those required by the Commission through adoption of a revised short sale rule or other new regulations, those relating to surveillance enhancements and those that are more strategic – the Exchange asks that the Commission establish a reasonable implementation timetable for any new trade-through provisions.

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[33] This time estimate assumes that the Exchange would not make any other changes to its trading system while it focused on Regulation NMS-related work. Clearly, then, the estimate is the "best case" analysis, as the Exchange must retain a reasonable percentage of its development staff for internal initiatives, as well as additional projects mandated by the Commission. The Exchange, like other markets, is striving to make many changes suggested by the Commission to its surveillance and regulatory systems. Those projects likely would need to be given priority over any of the discretionary changes associated with Regulation NMS. It would be a crushing burden for any market to have to accommodate an implementation of Regulation NMS in a very brief period of time while it is attempting to implement regulatory improvements, as well as additional projects recently mandated by the Commission relating to Reg SHO and collection of Section 31(a) fees. The Exchange thus believes it is urgent for the Commission to set out a reasonable timetable, of 18-24 months, for Regulation NMS's provisions to take effect.

[34] In developing this estimate, the CHX has included the estimated costs associated with several significant systems projects that would be necessitated if Reg NMS were instituted in its current proposed form and in its entirety, *i.e.*, without dividing the final rules into separate releases. Projects included in the Exchange's estimate include (a) development of a system to prevent executions that would otherwise constitute a trade-through; (b) automating the execution of inbound ITS commitments; (c) automating the execution of inbound orders from other OTC markets; (d) developing an opt-out order type (if opt-out is approved); and (e) and marking quotes as "manual" if they are not automatically and immediately accessible. The Exchange's estimate is comprised solely of labor costs, as the Exchange does not anticipate significant associated hardware or software expenditures.

It is important to note that the Exchange's estimate does not include labor estimates for additional or revised surveillance and enforcement activities by the CHX Department of Market Regulation. The Exchange is fully committed to instituting appropriate surveillance and enforcement measures, but would note that such measures will not be without cost.

C. The Market Access Proposal

1. The CHX Welcomes The Commission's Recognition That Markets – Or At Least The Participants In Those Markets – Must Have Access To One Another.

Just four years ago, the Commission sought public comment on various issues raised by the fragmentation of the national market system.[35] At the time, the Commission noted that, while there was not significant fragmentation in the trading of listed securities, there were a significant number of alternative trading systems ("ATSs") handling orders in Nasdaq-listed securities.[36] Although the number of ATSs has decreased over the past few years, today there are several different markets that are responsible for relatively significant volumes of trading in both listed and Nasdaq securities. For example, in December 2003, four markets each were responsible for more than 10% of the trading in Amex-listed securities; Nasdaq securities were traded, in significant amounts, by at least four markets.

This increasing market fragmentation has been accompanied by an increasing lack of order interaction among the markets, particularly in the trading of Nasdaq securities. While most of the venues trading listed securities are connected by the Intermarket Trading System and bound by the ITS Plan's trade-through rule, the markets trading Nasdaq securities are not centrally connected. Although the application of a trade-through rule to Nasdaq securities can address some of the problems caused by unconnected markets, linkages among those markets are also necessary.

The CHX believes that a national market system can only exist – and effectively operate – if the markets within that system are linked together. When participants in one market can see the bids and offers in another market, but cannot effectively or efficiently reach those quotes, investors can be deprived of the opportunity to have their orders executed at the best prices. The Exchange therefore welcomes the Commission's attempts to try to rein in the harm caused by today's fragmented marketplace.

2. Access To The Best Prices Requires Fair Access To The Displayed Bids And Offers Of Other Markets, But Does Not Require Access To The Wide Variety Of Services Provided By A Market And Its Participants.

The Commission's access proposal sets out a relatively broad solution to the problems caused by market fragmentation – the proposal prohibits an SRO market (a "quoting market center" in Regulation NMS parlance) from imposing unfairly discriminatory terms on non-members that

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[35] Release No. 34-42450 (February 23, 2000), 65 FR 10577 (February 28, 2000).

[36] In the Market Fragmentation Release, the Commission reported that, in September 1999, 74.4% of the shares and 83.9% of the trades in NYSE-listed issues were executed on the NYSE; 68.7% of the trades and 70.5% of the shares in Amex-listed securities were executed on Amex; and nine ATSs accounted for 28% of the trades in Nasdaq-listed securities. Market Fragmentation Release at 7.

seek indirect access to both the market's displayed quotes and to its limit order book.[37] While the Exchange appreciates the Commission's focus on providing increased opportunities for orders to interact, the Exchange believes that this proposal goes somewhat too far – indeed, the Exchange believes that the Commission can achieve effective linkages across markets, and provide important opportunities for order interaction, simply by requiring that markets provide one another access to their best bids and offers. This is analogous to the approach that the Commission took in directing an options market linkage. Moreover, the Exchange is troubled by the proposal's focus on indirect access to an SRO's limit order book because it seems to require SRO markets to give extensive rights and privileges to non-members, who do not pay the dues, fees and other charges that support the operation of the market. As further described below, the Exchange therefore urges the Commission to adopt a more limited access proposal.

a. Fair access to a market's best bid or offer meets the Exchange Act's goal of making it practical for a broker-dealer to find (and access) the best available price.

In the Proposing Release, the Commission notes that "ensuring access to diverse marketplaces within a unified national market would foster efficiency, enhance competition and contribute to the 'best execution' of orders for securities."[38] The Exchange agrees that inter-market access is important, but believes that access to a market's displayed best bids and offers achieves this objective; complete access to a market's limit order book or to its other execution services is simply not required.

As an initial matter, a market's displayed best bids and offers identify the best prices available in that market. A broker-dealer seeking best execution for its customer orders often uses those price indicators as a significant factor in making order-routing decisions.[39] As a result, requiring markets to provide access to their displayed best bids and offers – the prices at which broker-dealers in those markets have said that they would buy or sell a security – allows sufficient opportunities for another broker-dealer to get the best execution it is seeking.

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[37] Proposed Rule 610(a)(1) states that an SRO market "shall not impose unfairly discriminatory terms that prevent or inhibit a non-member, non-customer, or non-subscriber . . . from obtaining access to quotations and the execution of orders through a member, customer, or subscriber . . ." In the Supplemental Request for Comment, the Commission makes clear that this provision, which is included in a section of the rule entitled "Access to published bids and offers," actually requires SRO markets to provide non-members with fair access to "both a market's best bid and offer and to quotations included in a market's 'depth of book.'" *See* Supplemental Request at note 34.

[38] Proposing Release at 105.

[39] Broker-dealers may use other factors, as well, in choosing an appropriate market for its orders, including the trading characteristics of the security, the availability of accurate market information and the availability of technological aids to process that information and the cost and difficulty associated with achieving an execution in a particular market. *See* Market Fragmentation Release at 14. For many retail-sized orders, however, the best available price often is the single most important factor used in seeking best execution for an order, particularly where the market displaying the best prices also executes incoming orders automatically.

Moreover, access to a market's top of book will become much more meaningful if it is coupled with the ability to receive an immediate, automated execution at that price. The sort of immediate execution envisioned by the automated quote alternative thus would significantly enhance the efficiency of the markets and provide broker-dealers with a much more effective way of seeking best execution for their customers' orders.

b. SRO markets should not be required to provide non-members with essentially free and unfettered access to SRO order execution facilities.

The CHX, much like other SROs, provides a wide variety of services to its members. It develops and operates order routing and execution systems, and related technological enhancements, that help its on-floor members handle the order flow that they receive. It participates in joint industry plans to disseminate its members' best bids and offers to the public and to report the transactions that take place on its floor. It maintains a set of rules, and regularly makes changes to those rules, to allow the Exchange to operate efficiently. It provides a strong customer service department, to ensure that order-sending firms receive the executions that they are seeking. It oversees the assignment of stocks to specialists and operates a listing service for issuers. It maintains the administrative, finance, legal and executive staff needed to support these business activities. And, most importantly, the Exchange regulates the operation of its market, working to ensure that its members adhere to applicable rules, as well as to the federal securities laws.

The Exchange funds these wide-ranging business operations, in part, by charging its members a variety of fees. These fees include membership dues and registration fees, which are charged to all members; transaction fees, which primarily are charged to off-floor member firms who send fee-eligible orders to the Exchange; and fixed fees, booth space and technology charges, which, for the most part, are assessed against on-floor specialists, floor brokers and market makers. With few exceptions, the Exchange's fees are paid by its members – not by others.[40]

By requiring the Exchange to grant non-members access to the full capabilities of its order execution systems, the Commission's fair access proposal would inappropriately require the Exchange's members to help fund the costs of operating a market that could be routinely used by non-members. It would severely undercut the value of membership and enable non-members to free-ride on the fees paid by members.[41] While the Exchange recognizes that it could seek to impose some sort of non-discriminatory access fee on non-members that would be permitted to place orders in the CHX book, it would be quite difficult to establish an appropriate rate for that fee, to both fairly apportion the overall costs of running the Exchange between members and non-members and to stay within any cap placed on those charges by the Commission's proposal.[42]

[40] Among the few fees paid by non-members are the listing fees paid by the Exchange's listed companies.

[41] The ITS Plan was structured as it is – to only permit markets to access one another's best bids and offers – because of a similar concern.

[42] *See* Supplemental Request for Comment, note 39.

Moreover, the SEC's fee proposal, if adopted, would cap such fee at $.001 per share. In any event, the Exchange's members likely would bear costs that non-members simply would not. The Commission's proposal thus inappropriately devalues the rights given to members or participants in an SRO and should be limited to a scope necessary to achieve Exchange Act objectives.

3. Although The Commission's *De Minimis* Access Fee Proposal Is Designed To Address A Variety Of Problems, The Proposal Falls Short Of Its Goals And Should Be Either Rejected Altogether Or Substantially Modified.

The Commission's *de minimis* fee cap proposal is designed, among other things, to ensure that markets and broker-dealers provide fair access to their quotes, to address concerns that the use of access fees may exacerbate the number of locked markets and to respond to other potential market distortions.[43] While the Exchange agrees that these problems exist, it is concerned that the Commission's proposal goes too far and inappropriately places limits on competition among markets.

a. The Commission should not be involved in ratemaking.

The Commission traditionally has been reluctant to involve itself in designing the ultimate structure of the market. The Commission's proposal to set de minimis access fees, however, delves far too deeply into market design, placing unnecessary limits on a market's ability to develop a business model that makes sense for its participants or members. In addition, ratemaking poses a variety of challenges, legal and otherwise, which could divert time away from other Commission objectives.[44] The Exchange thus urges the Commission not to adopt the current access fee proposal.

b. Markets should be allowed to charge fair, non-discriminatory fees to their members or subscribers.

The Exchange understands, however, the burdens on the effective operation of the national market system that are caused when a market sets unreasonably high fees for access to its quotes. These burdens might increase if the Commission's proposed trade-through rule is implemented – a

[43] Proposing Release at 120-121.

[44] Among other things, the Commission may be caused to address the reasons for choosing a specific fee cap and the types of fees to which that cap applies. Although these choices can seem simple, the task of determining whether to extend the proposed fee cap to other transaction-specific charges – an option suggested in the Supplemental Request for Comment – would require the Commission to determine whether the fee cap applies to all fees that are based on the number of transactions that take place (traditional transaction fees charged for floor broker executions, limit order processing fees, clearing processing fees or transaction-based regulatory fees) or whether it only applies to some sub-group of those charges. Also, because markets incur a variety of costs in developing their trading systems and establishing communications lines into those systems, the Commission might be asked to prove the reasonableness of its choice of $.001/share – is that cap reasonable for all markets? Should a fully automated ECN have one cap while a different cap applies to a floor-based exchange that maintains both an automated trading system and other systems to support the handling of orders by floor brokers? Should there be different fee caps for markets based on their regulatory costs? These and many other questions can arise in the context of a decision to establish a cap on fees.

market might establish a relatively high access fee knowing that other markets could not trade through its bids or offers and thus might need to establish direct or indirect links to that market.

As a potential solution to these concerns, the Commission could choose to require that all markets – not just SROs – submit their proposed access fees to the Commission so that they might be published for public comment. This process could help ensure that SRO markets, as well as quoting market participants, establish fair, non-discriminatory fees for access to their quotes. Quoting market participants could submit their proposals through their SROs, using the current Rule 19b-4 process for the handling of rule changes.

c. If the Commission does impose a de minimis limit on access fees, that fee cap should be significantly limited.

The Exchange recognizes that, even with the challenges posed by ratemaking, the Commission may still find it important to establish a de minimis cap for access fees. If so, the Exchange recommends that the Commission either decline to impose the fee cap on transactions effected on an SRO or limit the fee cap to any transaction-based fees charged by a market for the execution of inbound orders against its displayed bid or offer.

Applying the fee cap only to non-SRO transactions would help ensure that this proposal does not compromise an SRO's ability to both regulate its market and provide innovative trading systems for its members. As noted elsewhere in this comment letter, SROs provide a wide variety of services to their members – they develop and maintain order routing and execution systems; participate in joint industry plans to report quotes and trades to the public; establish and modify trading and office rules for their members; operate listing services for issuers; oversee the assignment of stocks to specialists or market makers; maintain the administrative, finance, legal and executive staff needed to support these business activities; and, most importantly, regulate the operations of their markets. Imposing a limit on the transaction fees that an SRO can charge will necessarily impact its ability to deliver all of these vital services.

As an alternative, if the Commission believes that it is important to apply a cap to all market participants, the Exchange recommends that the fee cap be applied only to transaction-based fees charged by markets for executions against displayed quotes.[45] The Exchange believes that this suggestion helps address several of the Commission's concerns. First, because this fee cap would apply to executions against a market's displayed bids and offers, it would address questions about whether published quotes indicate the true prices that are available to investors.[46] Additionally, because this proposed cap would apply to the execution of inbound orders against a displayed bid or

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[45] This fee cap should not apply, for example, to the execution of limit orders that were placed in a market's limit order book before being executed or to the execution of orders at prices better than a market's displayed bid or offer, whether those executions are provided by a floor broker crossing an order between the market or by specialist providing price improvement to an inbound order.

[46] Proposing Release at 115.

offer, it could be easily applied to all markets, whether they operate only in an automated way or also have a more traditional trading floor. And, finally, because the fee cap would apply only to those fees charged on a transaction-by-transaction basis, it provides some certainty about its scope to both markets and the persons sending orders to them for execution.[47]

D. Market Data Proposal

1. The Commission's Market Data Revenue Distribution Proposal – With Its New Emphasis On Both Trades And Quotes – Tries To Address Perceived Problems In The Current Formula, But Leaves Substantial Room For Market Participants To "Game" The System.

The current plans for collecting and distributing revenue associated with the sale of market data – the OTC/UTP Plan for Nasdaq-listed securities and the CTA/CQ Plans for exchange-listed securities – distribute revenue to individual SROs based on their trading activity in those securities.[48] In its proposal, the Commission seeks to add new aspects to this formula, by also compensating a market for its quoting activity, both at the NBBO and at prices better than the NBBO. According to the Proposing Release, these new features are designed to "address the serious economic and regulatory distortions" associated with the existing calculation – to ensure that markets with the best prices and largest trade sizes are better compensated and that markets do not become "print facilities" or facilitate their members' use of shredded trades to maximize market data revenues.[49]

The CHX agrees with the Commission's overall goals – markets should receive market data revenue for transactions that actually occur within their markets and market participants should not engage in sham transactions just to receive additional market data rebates. The Exchange believes, however, that the Commission's new proposal is just as likely to spur markets and their participants into taking actions that result in the highest possible level of market data revenues. For example, by giving a market the ability to receive market data revenue based on the amount of time that it quotes at the NBBO, the Commission is encouraging markets and their participants to build systems that automatically disseminate quotes at the NBBO, at the highest number of shares possible, for the longest period of time that is possible without actually trading at those prices.[50] Although these

[47] If the Commission were to adopt an automated market proposal that would require markets to specifically identify quotes that are not immediately and automatically accessible, those identifiers could also serve to indicate quotes for which there is no transaction-based access fee cap.

[48] The OTC/UTP Plan bases its formula on both shares and trades; the CTA Plan bases its formulas strictly on the number of trades.

[49] Proposing Release at 204.

[50] Under the proposal, an SRO would earn one Quote Credit for each second of time and dollar value of size that the quote equals the price of the NBBO. *See* Proposed Amendments to CTA Plan, CQA Plan and Nasdaq/UTP Plan, Proposing Release at 276-79. An SRO could earn, for example, 500,000 Quote Credits with the one-second display of a

prices might be automatically accessible to other markets, they would not necessarily reflect true indications of buying or selling interest and would simply clutter the market data stream, decreasing transparency. As described below, the Exchange believes that the proposed calculation could be improved to address some, but not all, of these opportunities for "gaming."

2. The Market Data Proposal Incorporates Several Specific Components That Should Be Refined.

The Exchange proposes that the Commission make several modifications to the proposed calculation. Some of these suggestions target the potential ways that markets and their participants might try to exploit the formula without adding to the value of disseminated market data. Other suggestions are designed to ensure that the Commission does not place undue emphasis on the dollar value of quotes and trades, effectively creating a two-tiered market system that favors markets that cater to sophisticated, institutional customers over those that handle order flow from retail investors.

a. The overall formula places undue emphasis on the dollar value of transactions and quotes.

The proposed revenue allocation formula bases most of its measures on the dollar value of a transaction or quote. This emphasis begins with the Security Income Allocation – the initial determination of the overall value of the trades and quotes in a particular security – which is based on the square root of the total dollar volume in the security. This emphasis is carried forward in the individual calculations of the Trading Share, the Quoting Share and the NBBO Improvement Share.[51] The Exchange believes that this emphasis on dollar value, rather than on the number of trades or the number of shares involved in trades or quotes, inappropriately rewards markets that handle higher-priced stocks, while devaluing the efforts of markets that trade securities that have a lower price.[52]

This proposed system could have several potential, negative impacts on competition. First, markets that trade lower-priced securities pursuant to unlisted trading privileges could decide that it is no longer possible to trade them, limiting competition among markets and leaving investors with

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50,000-share bid at $10.00. Automated systems could be developed to both disseminate a large-value quote when there are many other quotes already existing in the market at that price point, and to remove that quote quickly, limiting the possibility of an execution at that price, but generating substantial Quote Credits. Because of the likelihood that one market (or its participants) might engage in this practice, other markets might feel the need to develop similar automated quoting systems, so that they are not left behind in the race for Quote Credits and the accompanying data revenue.

[51] *Id.*

[52] The Trading Share calculation, for example, would value a 1000-share trade in Berkshire Hathaway Holding Co. A (which traded at a per share price of $88,000 on June 29, 2004) at $88,000, while valuing a 1000-share trade in Nortel Networks Corp. (which traded at a per share price of $4.99) at only $4,990, which would be below the $5,000 threshold and therefore would be excluded from the formula.

the potentially higher costs that result from this decreased competition.[53] Additionally, markets that list these lower-priced securities could determine, at some point, that it is no longer cost-effective to engage in those practices, limiting the opportunities for businesses to seek capital in the securities markets. The Exchange urges the Commission to consider these potential unintended consequences and to reevaluate the appropriate allocation of market data revenue, to take into consideration the undue weight given to higher-priced securities and the lack of sufficient weight given to lower-priced securities.

b. Because of the potential "gaming" associated with the proposed quote-based formulas, the Trading Share should count for more than 50% of the overall allocation formula.

Under the proposal, a market's overall allocation of market data revenue is roughly based on its Trading Share (50%), its Quoting Share (35%) and its NBBO Improvement Share (15%). A market's Trading Share is based, in part, on its Trade Rating, a number representing the market's proportion of the dollar value and qualified trades in a particular security, as compared with the activities of other markets.

Trade data, whether it is calculated on the number of trades or number of shares executed, reflects actual activity in the market. A buyer and a seller agreed to trade at a particular price. Quote data, however, is only an indication of willingness to trade at a particular price and, as noted above, can be fairly easily disseminated in a way that limits the possibility that any particular quote will be executed. For these reasons, the Exchange suggests that the Commission revise its formula so that a market's Trading Share counts for more than 50% of the overall calculation, reflecting the heightened informational value of actual trades, rather than the more ephemeral, and more easily manipulated, information provided by quotes.

c. Trades with a value of less than $5,000 should not be excluded from the Trading Share calculation.

In the proposal, the Commission excludes trades valued at less than $5,000 from the Trading Share calculation, stating that these trades "often have the least price discovery value" and that, if these smaller-value trades are excluded, market participants will be less likely to shred trades to

[53] Most SROs currently both operate and regulate a market. In performing those roles, most markets maintain increasingly sophisticated order delivery and trading systems, as well as systems to surveill the trading that occurs. SRO staff work to ensure connectivity to other markets, to conduct member examinations, to take appropriate enforcement actions and to perform all of the other myriad tasks associated with conducting a highly regulated business. Market data revenue – based on the quotes and trades from each market – help fund the many business activities of SROs. Although these revenues often are not the only source of income to a market – transaction fees, membership dues and listing fees often are also available – most markets rely on them to some extent. The CHX trades most securities pursuant to unlisted trading privileges and thus does not receive significant revenue for acting as a listing market. Market data revenue, therefore, is an important component of the Exchange's budget. (In 2003, market data revenue accounted for approximately 15.1% of the Exchange's overall revenues; this revenue is planned to account for 23.8% of the Exchange's 2004 revenues).

receive higher revenue allocations.[54] While this aspect of the proposal might serve to prevent market participants from shredding trades, it completely and inappropriately devalues the information provided by the execution of small orders, particularly in lower-priced stocks. This aspect of the proposal reflects an improper bias toward large institutional entities, and the markets that serve them, a bias that consistently appears throughout proposed Regulation NMS.[55]

Markets serve a wide variety of customers. Some markets have made a business out of handling larger orders of institutional investors; others, like the CHX, service a mix of institutional and retail order flow. In handling retail orders, the Chicago Stock Exchange's specialists regularly execute trades valued at less than $5,000. Indeed, in March 2004, these trades accounted for approximately 36% of the Exchange's overall trade volume. While a large institutional customer may not find much "price discovery value" in the execution of a 200-share order in a $24 stock, a small retail investor, hoping to sell 200 shares of the same stock, might find that pricing information to be quite important. The Exchange believes that the Commission should provide full value in the Trading Share calculation to orders of all sizes and should seek another way to reduce the number of "shredded" trades.[56]

d. The Trading Share calculation should exclude, or provide a reduced value to, any executions resulting from a decision to opt-out of the requirements of the trade-through rule.

The Commission's trade-through proposal contains a provision that would allow an investor to opt-out of the trade-through rule's requirements and trade at a price worse than the displayed NBBO.[57] This trading activity, if permitted to occur, would ignore existing bids and offers at better prices, fundamentally undermining the operation of an effective national market system. In addition, these opt-out orders, when executed and reported to the tape, would provide potentially confusing information to the market. Because opt-out orders would opt out of the generally applicable requirements of the national market system, trades resulting from the execution of these orders should not receive full value in the Trading Share calculation.

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[54] Proposing Release at 209.

[55] For instance, the opt-out provision is unlikely to be used by retail investors, and in fact likely could harm retail investors. Similarly, access to a market's entire limit order book is important only to institutional investors.

[56] The Exchange understands the Commission's desire to ensure that the Trading Share calculation is not "gamed" by market participants that shred trades to create additional tape revenue. One potential means for addressing this issue would be to use both trades and shares as measurements in the Trading Share calculation.

[57] Proposed Rule 611.

e. Non-automated markets should receive fewer Quote Credits than automated markets for time spent quoting at the NBBO.

The proposed Quoting Share calculation allows an SRO to earn Quote Credits for each second of time and dollar value of size that the market posts a bid or offer equal to the NBBO price.[58] The calculation confirms that a market that is not fully accessible through automatic execution cannot receive a Quote Credit when it is left alone at the NBBO until it re-quotes its bid or offer. The CHX believes that this provision appropriately recognizes that these quotes could be stale, but does not go far enough in limiting the Quote Credits that a non-automated market may receive. Because a non-automated market likely would not have an automated means for updating its quotes, its quotes could be stale throughout the trading day, not only when it is left alone at the NBBO. Moreover, because a market earns Quote Credits based, among other things, on the length of time at the NBBO, the proposed formula creates an incentive for a non-automated market to delay updating its quotes – or at least creates an incentive for a market not to work hard to develop an automated means of immediately updating its bids and offers.

3. The Exchange Encourages The Commission To Consider The Impact On Competition Of Changes To The Market Data Revenue Allocation Formula.

The Commission's proposed changes to the market data revenue allocation formula may have far-reaching consequences for some markets, particularly markets that rely heavily on market data revenue to fund their business activities. Under the Commission's proposal, the Exchange believes that certain markets will gain additional market data fees solely by virtue of their quoting activity. [59] Other markets, including the CHX, generally would have a decreased share of market data revenues under the proposed formula.[60]

The CHX, like most of these regional markets, relies on market data revenues for a relatively substantial portion of its budget – the Exchange has a fairly small listing program and attracts orders by, among other things, providing low-cost services.[61] As a result, any decrease in

[58] *See* Proposed Formula Amendment, paragraph (d).

[59] Market System, Inc. ("MSI"), working on behalf of the CHX and other markets, developed a system that analyzed current market data using the proposed formula. As an example of the impact that quoting activity would have on the allocation of market data, MSI's analysis, based on the quotes and trades in AMEX-listed stocks during the first quarter of 2004, revealed that the NYSE would increase its market data revenue share from 1.7% to 4.9%; that Amex would increase its market data revenue share from 38% to 52%; and that Nasdaq would increase its market data revenue share from 12% to 21%. This analysis assumes that trading and quoting activity would remain the same after a change to the market data revenue allocation formula; although that assumption may ultimately prove false, the CHX and MSI believe that there is not a better way to try to evaluate the impact of these proposed changes on each SRO.

[60] MSI's analysis, again using data from the first quarter of 2004, reveals that ArcaEx might decrease its overall share of Nasdaq market data fees from 24% to 20%%; that BSX might see a decrease in its Tape B market data revenue from 1.13% to .4%; and that the National Stock Exchange might see a decrease in its share of Tape B revenue from .6% to .23%. The CHX itself likely would see a slight decrease in its revenue from all Tapes A, B and O.

[61] The Exchange's 2004 budget forecasts that 23.8% of its gross revenues would come from market data fees. In 2003,

market data revenues to the CHX could have a substantial impact on its financial plan. While the CHX supports the Commission's desire to allocate market data revenues in an appropriate way – and believes that changes should be made to the proposed formula to ensure an appropriate allocation of those revenues among markets – the CHX recognizes that it may become more difficult to operate its market if these fees are substantially reduced. Indeed, when combined with the proposed $.001 cap on transaction fees, the market data proposal could render it infeasible for most markets to compete with listing markets, which have independent, and substantial, sources of revenue.

While the Commission may not be particularly sympathetic to the economic plight of regional markets, the Exchange would note that the Commission consistently has articulated its stance that competition among market centers benefits investors.[62] A drastic reallocation of market data revenue thus may be to the ultimate detriment of the investing public. If the revenue allocation formula proposed by the Commission were immune from "gaming," the Exchange might concede that such a measure was appropriate. As noted above, however, the Exchange believes that the proposal is at least as susceptible to abuse as the existing structure. Accordingly, the Exchange would encourage the Commission to consider seriously the potential detriments of its proposed reallocation formula.

4. The Exchange Urges The Commission To Allow Quarterly Payments Of Market Data Revenue As Currently Permitted Under The CTA, CQA And OTC/UTP Plans.

One unheralded change to the allocation of tape revenue among SROs is included in the text of the proposed amendments to the transaction reporting plans.[63] This change seems to require that revenue from the plans be paid to SROs on an annual basis, modifying the current plan provisions that require quarterly payments of those revenues, subject to a year-end accounting.[64] The CHX believes that it is appropriate, for a variety of reasons, to continue to allow these plans to distribute revenue on a quarterly basis. As an initial matter, SROs have on-going expenses and should be able to use this revenue to offset those expenses – it is a hardship to require SROs to cover their on-going expenses with other funds, while waiting for a once-a-year infusion of cash. Additionally, the Commission has not articulated any reason for changing the timing of these payments – there is no harm to investors or to competition associated with quarterly plan payments. Finally, allowing the securities information processor to retain the funds for twelve months or more is simply wasteful – these resources should be put to an efficient use.

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that percentage was somewhat lower; 15.1% of its gross revenues during that period resulted from market data fees.

[62] Proposing Release at 18-19.

[63] *See* Proposed Formula Amendment, paragraph (a).

[64] *See* OTC/UTP Plan, Exhibit 1, paragraph 4; CTA Plan, Section XII(a)(iv); CQ Plan, Section IX(a)(iv).

E. The Subpenny Quoting Proposal

Rule 612 of proposed Regulation NMS would bar market participants, including exchanges, ATSs, vendors, brokers and dealers, from accepting, displaying or ranking any bid, offer or order in an increment smaller than a penny.[65] The Exchange welcomes the Commission's proposal to end the practice of subpenny pricing. The Exchange agrees that subpennies should have no priority standing in the securities markets and that the current subpenny quoting practice – rounding a subpenny quote to the nearest penny – may be confusing for investors and others who rely on the consolidated tape for market data.

F. Conclusion

Fashioning a model for an effective national market system can be a difficult task. Too few requirements can lead to a fragmented system of inaccessible markets. Too much regulation can unnecessarily force markets to conform to a single business model, removing opportunities for competition and ultimately harming the investors who benefit from that competition. As described above, the Exchange believes that the Commission has set out several good proposals that will enhance the operation of the national market system. The Exchange simply encourages the Commission to consider changes to those proposals that will better balance the needs of all markets.

Very truly yours,

David A. Herron

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[65] *See* Proposed Rule 612(a).