INVESTMENT COMPANY INSTITUTE

June 30, 2004

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

Re: Regulation NMS (File No. S7-10-04)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed Regulation NMS[2] and the Commission's supplemental request for comment on the proposed rules.[3] Regulation NMS consists of four substantive proposals – the trade-through proposal, the market access proposal, the subpenny quoting proposal and the market data proposal – which, collectively, are intended to enhance and modernize the regulatory structure of the U.S. equity markets.

The Institute strongly supports the goals of Regulation NMS – to create a market structure that furthers the objectives of the national market system that are so critical for investors (*i.e.*, efficiency, competition, price transparency, and the direct interaction of investor orders). The structure of the securities markets has a significant impact on our members, who are investors of over $7 trillion of assets on behalf of over 86 million individual shareholders and who held 22 percent of the value of publicly traded U.S. equity outstanding in 2003.[4] The Institute and its members, therefore, have a strong interest in ensuring that the securities markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the securities markets encourages, rather than impedes, liquidity, transparency, and price discovery. Consistent with these goals, we have strongly supported past regulatory

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,633 open-end investment companies ("mutual funds"), 622 closed-end investment companies, 126 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.393 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) ("Release").

[3] Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release").

[4] Investment Company Institute, *2004 Mutual Fund Fact Book*, 44th Edition, at 59.

efforts to improve the quality of the U.S. markets.[5] We commend the Commission for these efforts, of which Regulation NMS is the latest example, and for providing the public with the opportunity to comment through this proposal on some of the most significant issues facing the securities markets.

I. Summary of Institute Recommendations

While the Institute's comment letter will address each of the four Regulation NMS proposals separately, it is important to note that the issues raised by these proposals are closely linked and that the decisions made by the Commission on each proposal will impact, in one way or another, the workings of the other three proposals. For example, a uniform trade-through rule adopted under the trade-through proposal will be largely ineffective unless strong access standards are created under the market access proposal. Similarly, decisions made regarding subpenny quoting will influence how securities are traded and therefore will impact elements of the trade-through, market access and market data proposals. Where appropriate, we will discuss the impact of each proposal on the other Regulation NMS proposals.

In addition, while our comment letter reflects the initial views of Institute members on the Regulation NMS proposals, it is clear that the debate over the issues raised by Regulation NMS will be lengthy and that the current comment letter process is only the beginning of deliberations on the topics raised by the proposals. Indeed, as evidenced by the decision to issue a supplemental request for comment based on developments at the Commission's recent Regulation NMS hearing,[6] there will undoubtedly be an extensive debate on these issues. We therefore offer our assistance to the Commission as it continues to examine the issues raised by Regulation NMS and its impact on the securities markets.

Following is a summary of the Institute's recommendations:

Trade-Through Proposal

- We support the establishment of a uniform trade-through rule for all market centers. We also support the application of the rule to: (1) all NMS securities, including Nasdaq securities; (2) the account of a broker-dealer as well as the account of a customer; and (3) the best displayed bid and offer of any order execution facility as well as all other displayed

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[5] *See*, *e.g.*, Letter from Craig S. Tyle, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 16, 1996 (File No. S7-30-95) (Order Execution Obligations); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 28, 1998 (File No. S7-12-98) (Regulation of Exchanges and Alternative Trading Systems); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 12, 2000 (Market Fragmentation Concept Release); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 20, 2001 (Subpenny Concept Release).

[6] SEC Regulation NMS Hearing, April 21, 2004, New York, New York.

limit orders or quotes that are also priced better than the order being executed and are automatically accessible.

- We support the exception to the trade-through rule that permits an "automated" market to trade through a better displayed bid or offer on a "non-automated" market. However, we recommend that the Commission amend the proposed definition of an "automated" market in two ways: (1) the Commission should establish minimum performance standards with respect to what would be considered an "immediate" response to, and update of, a quote and (2) in order to be considered an "automated" market, a market should be required to provide automatic execution to its entire limit order book and not only to its best bid and offer.

- We believe that an exception for "non-automated" or "manual" quotes (instead of "non-automated" markets), as proposed in the Supplemental Release, is an idea worthy of serious consideration and may be preferable to an "automated" market exception. We therefore would support the Commission examining whether to amend the trade-through proposal to create such an exception. We recommend, however, that the Commission delineate a clear definition of what would be considered an "automated" quote, as well as the specific parameters for the operation of a manual quote exception.

- We do not support the trade-through proposal's "opt-out" exception, provided that the Commission adopts an "automated" market or manual quote exception, as amended by our recommendations for those exceptions.

- We recommend that the Commission eliminate the proposed "trade-through limit amount," and permit an "automated" market (as defined under our recommendations) to trade through a "non-automated" market for an unlimited amount, or, if the Commission creates a manual quote exception, permit a market participant to trade through a manual quote for an unlimited amount.

Market Access Proposal

- We support the creation of minimum access standards that would provide market participants with non-discriminatory access to all displayed prices for a security (and not only the best displayed bid and offer for that security) no matter where those prices are displayed and that would reduce the current barriers to intermarket access. We also support the flexible approach proposed by the Commission that seeks to ensure proper access through linkages established by the markets and not through government imposed linkages.

- We support limiting to a *de minimis* amount the fees for the execution of orders that can be imposed by all quoting market centers, quoting market participants, and broker-dealers that display attributable quotes through self-regulatory organizations ("SROs").

- We support the proposals that would require every SRO to establish and enforce rules requiring its members to avoid locking or crossing the quotations of quoting market centers and quoting market participants and to prohibit members from engaging in a pattern or practice of locking or crossing the quotations in any security.

- We support lowering the Regulation ATS "fair access" threshold from twenty percent to five percent.

Subpenny Quoting Proposal

- We strongly support the subpenny quoting proposal, which would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment less than a penny.

- We support permitting the reporting or "printing" of a trade that was the result of a mid-point or volume-weighted pricing algorithm, as long as the proposed subpenny quoting rule is not violated with respect to the trading interest that resulted in the execution.

Market Data Proposal

- We support revisions to the allocation of market data revenue that would better reflect the costs of collecting and disseminating that data to the marketplace and that would eliminate incentives for "print facilities," "wash" trades and "shredded" trades that exist solely to generate increased revenue.

- We support other proposed changes to the joint industry plans, specifically: (1) the amendment to joint industry plans that would broaden participation in their governance; (2) amendments relating to the independent distribution of market information; and (3) the proposed rule to require SROs to act jointly pursuant to one or more national market system plans to disseminate consolidated information for "NMS Stocks."

Our recommendations and specific comments on proposed Regulation NMS are discussed more fully below.

II. Introduction

The Release notes that the Regulation NMS proposals are designed to address a variety of problems facing the U.S. securities markets that generally fall within three categories: (1) the need for uniform rules that promote the equal regulation of, and free competition among, all types of market centers; (2) the need to update antiquated rules that no longer reflect current market conditions; and (3) the need to promote greater order interaction and displayed depth, particularly for the very large orders of institutional investors. It is this third category with

which our members are most concerned. As the Release states, "perhaps the most serious weakness of the NMS is the relative inability of all investor buying and selling interest in a particular security to interact directly in a highly efficient manner. Little incentive is offered for the public display of customer orders – particularly the large orders of institutional investors. If orders are not displayed, it is difficult for buying and selling interest to meet efficiently. In addition, the lack of displayed depth diminishes the quality of public price discovery."[7]

Problems surrounding the lack of order interaction, its causes, and its impact on the securities markets are not new. The Institute and its members have, for many years, been recommending changes that would facilitate greater order interaction and, in turn, more efficient trading. For example, in our comment letter on the Commission's market fragmentation concept release in May 2000, the Institute raised concerns over the lack of priority rules for limit orders, inadequate market linkages, internalization, and the markets' lack of transparency and depth of book.[8] The Institute also expressed concerns over the lack of protection for limit orders and the inability to interact with those orders in a March 2001 letter to the New York Stock Exchange and made several recommendations in order to facilitate trading by institutional investors on that market.[9]

A consistent theme throughout all of the Institute's recommendations was that in order to promote greater order interaction and displayed depth in the markets, a market structure should be created that contains several key components.

First, there should be price and time priority for all displayed limit orders across all markets. Providing protection and priority for all displayed limit orders would ensure that investors will realize the benefits of displaying those orders and thereby encourage further use of limit orders. As a result, the entire securities market would benefit from improved price discovery, liquidity, and tighter spreads. Our members report that without adequate protections for limit orders, they often are reluctant to place these orders for fear that they will go unexecuted while at the same time they are used as a basis for other market participants to trade against.

Second, there should be strong linkages between markets that permit easy access to limit orders. Providing protection and priority for limit orders is not enough. An efficient market structure also must make these orders easily accessible to investors. In addition, market linkages should not only be strong but should permit competition between markets and include systems that allow market participants to efficiently route orders to different markets on a price and time priority basis.

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[7] Release at 11129.

[8] *See* Market Fragmentation Concept Release Letter, *supra* note 5.

[9] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Richard A. Grasso, Chairman, New York Stock Exchange, dated March 1, 2001.

Finally, there should be standards relating to the execution of orders. In order for markets to function effectively, markets should provide the opportunity for automated executions at the best available prices. Minimum standards relating to the execution of orders would ensure that inefficient markets do not inhibit more technologically advanced markets in the execution of investor orders.

Although the Regulation NMS proposals would not implement all of the components we believe necessary for a fully efficient market structure (most significantly, the trade-through proposal would not establish price *and* time priority for displayed limit orders across all markets), the proposals would be the most significant step towards the creation of a truly national market system in almost thirty years. We therefore encourage the Commission to take advantage of the opportunity that is presented through Regulation NMS to make the fundamental changes necessary to improve the structure of the securities markets.

We recognize that trying to develop a market structure that promotes the fundamental principles of a national market system while at the same time balancing the competing interests of all market participants is no easy task. Nevertheless, we are hopeful that the Commission can achieve the goals set forth in Regulation NMS while taking into account the interests of the markets' most important participant - the investor.

III. Trade-Through Proposal

The current debate over trade-through prohibitions is often framed as a dispute over what is more important for an investor when executing an order – obtaining the best price *or* executing an order with speed and certainty of execution. The Institute believes that investors should not have to make this choice. Instead, they deserve to have their orders executed under a market structure that provides immediate and certain execution at the best available price.

Regulation NMS' trade-through proposal attempts to resolve this debate. Specifically, the proposed trade-through rule would require an order execution facility,[10] national securities exchange and national securities association market, with regard to the trading of NMS Stocks,[11] to establish, maintain, and enforce policies and procedures reasonably designed to prevent the purchase or sale of an NMS Stock at a price that is inferior to a better price displayed on another market.

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[10] An order execution facility would be defined under Regulation NMS as "any exchange market maker; OTC market maker; any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent; alternative trading system; or national securities exchange or national securities association that operates a facility that executes orders."

[11] "NMS Stock" would be defined under Regulation NMS as "any NMS Security other than an option." "NMS Security" would be defined as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan."

As a preliminary matter, judging by the amount of debate and interest already generated by the trade-through proposal, it is clear that this proposal will be controversial, and arguably could have the greatest impact on the structure of the U.S. securities markets going forward. Nevertheless, it is important to note that the entire debate over whether to implement a trade-through rule for the securities markets becomes irrelevant and a formal trade-through rule would be unnecessary, if a market structure is created containing the key elements discussed above (*i.e.,* price *and* time priority for all displayed limit orders across all markets, strong linkages between those markets, and standards relating to the execution of orders).

Until such a market structure is created, however, we support the establishment of a uniform trade-through rule for all market centers and believe such a rule would be a significant step forward in providing protection for limit orders. A uniform trade-through rule, by affirming the principle of price priority, should encourage the display of limit orders, which in turn would improve the price discovery process and contribute to increased market liquidity and depth. A uniform trade-through rule also would increase investor confidence in the securities markets by helping to eliminate an impression of unfairness when an investor's order executes at a price worse than the displayed quote. Finally, a uniform trade-through rule would facilitate a broker-dealer's ability to achieve best execution for their customers' orders.[12]

Our specific comments on the trade-through proposal follow.

A. Scope of Proposed Rule

1. Covered Securities

The proposed trade-through rule would apply to all NMS Stocks. Currently, only exchange-listed securities (and not those listed on Nasdaq) are subject to a trade-through rule. The Institute supports the application of a uniform trade-through rule to all NMS Stocks. Critics of establishing a uniform trade-through rule argue that it is unnecessary to apply such a rule to Nasdaq securities as those securities have, for the most part, functioned efficiently without one and that a broker-dealer's obligation to seek to obtain best execution for their customers' orders obviates the need for a strict trade-through rule across all market centers. We believe, however, that there is value in protecting a displayed price from trades occurring at inferior prices in other markets and that a uniform trade-through rule is necessary to affirm the principle of price priority across all markets. We also believe that it is impractical to rely *solely* on a broker's best execution obligation as a means to provide price protection to limit orders entered in the markets. Best execution is inherently an imprecise and subjective standard and

[12] The Institute believes that in order for a uniform trade-through rule to operate effectively, strong linkages and minimum access standards must first be in place. Otherwise, we are concerned that it will be an exercise in futility to require that a market send an order to another market to execute against a better priced order on that market if that better priced order cannot be accessed easily and with certainty. We therefore recommend that prior to implementing the proposed trade-through rule, the Commission should ensure that effective linkages and minimum access standards between markets are in place to support such a rule.

can be difficult to apply on a trade-by-trade basis. A uniform trade-through rule, therefore, would provide an additional layer of protection for investors in the execution of their orders.

2. Broker-Dealer Orders

The proposed trade-through rule would apply to orders for the account of a broker-dealer as well as for the account of a customer. The Commission requests comment on whether broker-dealer orders should be included within the scope of the rule. The Institute believes that the trade-through rule should apply to such orders. As noted in the Release, excluding orders for the account of a broker-dealer would undermine the purpose of the proposed rule -- to provide price protection to better-priced displayed limit orders and quotes -- as the broker-dealers' orders would be able to trade-through the better displayed prices placed by investors. We see no practical reason why orders for the account of a broker-dealer should be provided with the ability to ignore better priced orders placed by an investor.

3. Limitation to Best Bid and Offer

The proposed trade-through rule would apply only to the best displayed bid and offer of any order execution facility and would not apply to other limit orders or quotes that are also priced better than the order being executed but are not disseminated pursuant to an effective national market system plan. The Release states that to expand price protection beyond the best displayed bid and offer for each market would entail the Commission requiring quoting market centers to make available, and provide access to, their entire depth of book to other markets and, although "the Commission believes that from a policy viewpoint it would make sense to provide protection to any better-priced quote or order displayed in another quoting order execution facility, not just the top-of-book of each quoting order execution facility,"[13] it questions whether protecting all displayed limit orders and quotes at this time would be feasible.

The Institute recognizes that without adequate access to a market's entire limit order book, protecting all displayed limit orders and quotes may not be feasible at this time. However, we believe that in order to truly promote order interaction in the securities markets, *all* limit orders should be protected (and not just those at the best bid and offer). We therefore urge the Commission to continue to examine the feasibility of requiring market centers to provide the necessary access to all their displayed limit orders and, when such access has been established, to expand the scope of the trade-through rule to include trade-through protection beyond the best displayed bid and offer. Such an expansion would undoubtedly further encourage the placement of limit orders into the securities markets and, in turn, significantly increase market liquidity and depth.[14]

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[13] Release at 11136.

[14] The Release requests comment on whether the scope of the proposed rule should include protection beyond the best displayed bid and offer in the circumstance where a market center voluntarily provides depth-of-book information through the facilities of an effective national market system plan. If the Commission determines not to

B. Policies and Procedures

The proposed rule would require each order execution facility, national securities exchange, and national securities association to develop policies and procedures reasonably designed to prevent the execution of a trade-through in its market. The proposed rule does not specify the nature and extent of the policies and procedures that would have to be adopted.

The Commission requests comment on whether a policies and procedures requirement is sufficient to effectively deter and prevent trade-throughs or whether the Commission should instead, or in addition, explicitly prohibit trade-throughs absent an exception. While we recognize that explicitly prohibiting trade-throughs may raise concerns regarding holding a market responsible for a trade-through it could not have reasonably avoided (*e.g.*, a "false positive" trade-through), we are concerned that relying solely on a market establishing its own policies and procedures may not be sufficient to prevent trade-throughs from occurring. Regardless of whether the Commission adopts an explicit trade-through prohibition or merely requires SROs to adopt policies and procedures, we recommend that the Commission, through its oversight and examination authority, vigorously monitor SRO efforts to prevent trade-throughs. The Institute also believes it would be helpful to enforcement of the trade-through rule if the Commission were to require markets to disclose the amount of trade-throughs that occurred in that market over a designated period of time, and how often that particular market trades through another market in the course of executing transactions.[15]

The Institute believes that an effective trade-through rule not only should prevent trade-throughs from occurring but also should require methods to "satisfy" the order that was traded through. Currently, SRO trade-through rules include extensive procedures for seeking restitution on an order that is traded through.[16] However, our members report that although the trade-through rule is routinely violated, the procedures for restitution are largely ineffectual and, because of the time required and difficulties in obtaining restitution, more often than not, they are likely not to complain about a trade-through that occurs. We therefore recommend that markets be required to establish policies and procedures to ensure that an investor whose order was traded through can obtain restitution with certainty and on a timely basis.

C. Exceptions to the Trade-Through Rule

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expand the scope of the proposed rule as recommended above, at the very least, we recommend that it expand the scope of the proposed rule in this manner.

[15] Specifically, "automated" markets could be required to disclose how often they trade through other "automated" markets and manual markets could be required to disclose how often they trade through any other market. Such disclosure could be modeled on the Commission's current disclosure requirements under Rule 11Ac1-5 of the Securities Exchange Act of 1934.

[16] *See* Release, note 40.

The proposed trade-through rule includes two major exceptions that are designed to address issues that have been raised regarding the current Intermarket Trading System ("ITS") trade-through rule. One exception would permit an "automated order execution facility" to execute orders within its market without regard to a better price displayed on a "non-automated order execution facility," within certain price parameters. The other exception would permit customers and broker-dealers trading for their own accounts to "opt-out" of the protections of the trade-through rule by providing informed consent to the execution of their orders in one market without regard to the possibility of obtaining a better price in another market. In addition, the Commission, in the Supplemental Release, requests comment on whether to replace the "automated" market exception with an exception that would instead focus on whether a quote (as opposed to a market) is "automated" or "non-automated."

1. "Automated" Market Exception

The Commission is proposing to permit an "automated order execution facility" to execute orders within its market without regard to a better price displayed on a "non-automated order execution facility," within certain price parameters. The Commission proposes to define an "automated order execution facility" as "an order execution facility that provides for an immediate automated response to all incoming subject orders for up to the full size of its best bid and offer disseminated pursuant to an effective national market system plan without any restriction on execution."[17]

The Institute strongly supports the "automated" market exception. Our members report that the inefficiencies of the current trade-through rule in the listed market, which in many instances forces orders to be routed to a "non-automated" market, makes it very difficult to execute large orders in listed stocks. The Institute therefore believes it is extremely important that the execution of orders entered into an "automated" market not be delayed by mandating that those orders be routed to a "non-automated" market where there is no guarantee that those orders will ever be executed.[18]

Nevertheless, while the Institute supports the distinction between an "automated" and "non-automated" market, we believe that the Commission should provide a stronger definition of what constitutes an "automated" market and recommend that the Commission amend the proposed definition in two ways. First, we believe that the Commission should establish

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[17] An "automated order execution facility" would not be allowed to trade through the best displayed bids and offers of other "automated order execution facilities." In addition, a "non-automated order execution facility" would not be allowed to trade through any other market, whether or not it is automated.

[18] One of the most significant reasons the current trade-through rule is ineffective are the parameters set by the ITS Plan and SRO trade-through rules for the execution of orders. Specifically, under the ITS Plan and SRO rules, an "ITS Participant" can send a "commitment to trade" to another ITS Participant to trade with a better price displayed in that market. The receiving ITS Participant, however, has up to thirty seconds to respond to the commitment to trade and is not required to accept the commitment. If the commitment to trade is not accepted by the receiving ITS Participant within the thirty second time frame, the commitment is automatically cancelled.

minimum performance standards with respect to what would constitute an "immediate" automated response and an "immediate" update of a quote. In addition, we believe that in order to be considered an "automated" market, a market should be required to provide automatic execution to its entire limit order book and not only to its best bid and offer. Taken together, these two changes would help ensure the efficient workings of the trade-through rule and would provide increased protection to all limit orders, thereby providing greater order interaction and market liquidity and depth.

a. Minimum Performance Standards

In order to truly distinguish between "automated" and "non-automated" markets, the Institute recommends that the Commission better delineate what "immediate" means in terms of providing an automated response. In addition, we recommend that the Commission require an "automated" market to provide an "immediate" update of their quote. We believe that the best method to achieve this is to impose minimum performance standards. By establishing such standards, the Commission can ensure that a market that provides an "immediate" response under Regulation NMS is truly "automated" and will not unduly delay the execution of orders under the rule.[19] If large disparities in the ability to immediately respond to an order or update a quote are permitted to exist, the inefficiencies experienced under the current trade-through rule could remain, *i.e.*, investors may be forced to send their orders to a "slow" market.

We understand that it will be difficult for the Commission to adopt a specific timeframe for what constitutes an "immediate" response and, given the enormous advances in technology that have occurred and will undoubtedly occur in the future, it may be unwise to set forth an explicit definition of "immediate." After all, what constitutes a "fast" response today may prove to be a "slow" response in years to come. Nevertheless, we recommend that the Commission require that an "automated" market provide prompt automatic execution to incoming orders (or provide automatic cancellations of those orders) without any manual intervention, as well as a prompt automatic update of their quote.[20]

The Supplemental Release requests comment on methods to surveil for and enforce compliance with a performance standard and, in particular, on requiring that each market

[19] For example, as the Commission notes in the Supplemental Release, not updating a quote to immediately reflect the status of a quote inhibits full transparency and could lead to uncertainty as to whether the market center's quotes are actually immediately accessible through an automatic execution facility.

[20] The Supplemental Release requests comment on whether investors would benefit significantly, or at all, and how they would benefit, from sub-second response times. Our members report that they are less concerned with the specific amount of time required to obtain an "immediate" response than with ensuring that an "immediate" response consists of an automatic execution and does not involve any manual intervention. The Release also requests comment on whether a performance standard should require that a certain percentage (*e.g.,* 98 percent) of all incoming orders receive an execution within a very short time frame (*e.g.*, one second), and allow a longer time period for the remaining percentage. The Institute would oppose a specified percentage test, as it could be viewed by markets as a form of safe harbor under which it could "shut off" its automatic execution facility at times that would benefit that particular market and still comply with the rule's performance standards.

center publicly disclose the percentage of time, or each actual instance, that it did not provide a response in compliance with the standards required by the rule. The Institute would support such a disclosure requirement. We believe that such a requirement could provide incentive to market centers to adhere to the required minimum performance standards and could provide important information to market participants and the Commission in determining which market centers are truly providing automatic executions.

b. Automatic Execution of Entire Limit Order Book

The Institute recommends that, in order to be considered an "automated" market for purposes of the proposed trade-through rule, a market should provide automatic execution to its entire limit order book and not only its best bid and offer. As discussed above, we believe that trade-through protection should be extended beyond the best displayed bid and offer to all displayed and immediately accessible liquidity that is priced better than orders in another market. In order to facilitate trade-through protection for those better priced orders, the capability should exist to execute those orders automatically. In addition, requiring that an "automated" market provide the capability to automatically execute against orders on its entire limit order book would further provide incentive for investors to place limit orders onto that market and, in turn, promote greater order interaction.

c. Trade-Through Limit Amount

The automated market exception only would permit an "automated" market to trade through a "non-automated" market up to a "trade-through limit amount." Depending on the bid or offer of a stock, the allowable trade-through amount varies from one cent to five cents. The Institute recommends that the Commission eliminate the proposed trade-through limit amount and permit an "automated" market, as defined under our recommendations discussed above, to trade through a "non-automated" market for an unlimited amount. We are concerned that instituting a trade-through limit amount would only reduce incentive for "non-automated" markets to enhance their trading systems. In addition, eliminating a trade-through limit amount would resolve potential difficulties associated with enforcing this limit in practice. For example, given how quickly stock prices fluctuate, it is unclear how a market participant would determine what the allowable trade-through amount would be if a stock trades in between two levels of allowable trade-through limits.

2. *Manual Quote Exception*

The Supplemental Release notes that many panelists at the Regulation NMS hearing agreed that the distinction between an "automated" and "non-automated" market is important and that market participants should be able to trade through a "non-automated" market. Those panelists noted, however, that a distinction could, and perhaps should, instead be made between "automated" and "non-automated" *quotes*. The Supplemental Release therefore requests comment whether an exception from the proposed trade-through rule should be created that would apply to quotes that are not immediately accessible through an automatic

execution facility (a "non-automated" or "manual" quote), rather than providing an exception for a "non-automated" market.

The Institute believes that creating an exception from the proposed trade-through rule for "non-automated" quotes is an idea worthy of serious consideration and we would support the Commission examining whether to amend the trade-through proposal to include such an exception. A manual quote exception would correctly focus the exception from the trade-through rule on providing protection only to those quotes that are truly firm and immediately accessible and not quotes that require manual execution and are, in effect, only "maybe" quotes or difficult or slow to access. In addition, such an exception would address several of the concerns discussed above relating to defining what would constitute an "automated" market for purposes of the trade-through rule and would eliminate the need to determine which markets, as a whole, should be considered "automated." Finally, a manual quote exception would provide flexibility for a market, such as the New York Stock Exchange, which has expressed interest in becoming a "hybrid" market, containing features of both an "automated" and "non-automated" market.

Nevertheless, while the Institute believes a manual quote exception may be preferable to an "automated" market exception, there are many open questions that remain relating to what would constitute an "automated" quote. The Institute therefore recommends that the Commission set forth an explicit definition of what would constitute an "automated" quote and, as discussed above in connection with the "automated" market exception, institute minimum performance standards relating to what would constitute an "immediate" response to an "automated" quote. At the very least, we believe the Commission should require that such a quote be firm and automatically executable and that no manual intervention would be involved in responding to an order seeking to interact with that quote. The Commission also should require an "immediate" update of an "automated" quote.

Open questions also remain relating to the specific parameters for the operation of a manual quote exception. For example, it is unclear under such an exception if a market can, at any time, "shut off" the automation feature of a quote. We are concerned that if it is left completely up to an individual market's discretion when a quote is "automated" or manual, that market could base its decision on what is in the best interests of that market and its members, as opposed to the best interests of investors and other market participants. We therefore recommend that the Commission set forth specific guidelines when a market may "shut off" the automation feature of a quote and make such instances extremely limited in nature.[21] Even if the Commission determines that a market may "shut off" the automation feature of a quote in a particular situation, we recommend that the Commission also establish guidelines on how often a market would be permitted to "turn back on" the automation feature of that security's quote.

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[21] For example, we believe that if a particular problem arises in the trading of an individual stock, a temporary suspension of trading in that stock would be more appropriate than "shutting off" the automation feature of that stock's quote to resolve the problem.

Finally, although panelists at the Regulation NMS hearing stated that it would be possible to attach an identifier to manual quotes in order to distinguish between "automated" and "non-automated" quotes, it is unclear how such an identifier would work in practice and if it is truly technologically feasible to distinguish between these two types of quotes.[22]

3. "Opt-Out" Exception

The trade-through rule's second exception, the "opt-out" exception, would permit a person for whose account an order is entered (*e.g.,* a customer for the customer's account or a broker-dealer for its own account) to "opt-out" of the protections of the trade-through rule by providing informed consent to the execution of their orders, on an order-by-order basis, in one market without regard to the possibility of obtaining a better price in another market.

The Institute believes that if the Commission adopts an "automated" market or manual quote exception, as amended by our recommendations for those exceptions discussed above, and creates strong access standards between markets, then the "opt-out" exception is unnecessary and we would not support such an exception to the trade-through rule. We see no practical reason why a market participant would ignore better priced orders in the market, especially if a market participant can access and execute against those orders, automatically and with certainty. In addition, an opt-out exception is inconsistent with the principle of price protection for limit orders. We believe that the exception, therefore, would undermine the ability of the Commission's proposals to achieve their stated objectives of encouraging the display of limit orders and enhancing investor confidence in the markets. We also believe that an opt-out exception is unnecessary, as some have argued, to compel non-automated markets to automate their trading systems. A trade-through rule with an "automated" market exception or a manual quote exception should provide the requisite competitive pressure to compel non-automated markets to automate their systems, if they so choose.

Finally, while there is no doubt that, at times, investors may determine that speed and/or certainty is more important than price in executing an order, and while our members may be best served on a particular trade by "opting out" from executing against the best price placed in another market, we believe that in the long term, *all* investors will benefit by having a market structure where all limit orders are protected and investors are provided with an incentive to place those orders into the markets.[23]

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[22] If the Commission determines to create a manual quote exception, we recommend, for the reasons discussed above in connection with the "automated" market exception, that the Commission not establish any trade-through limit amount and permit a market participant to trade through a manual quote by an unlimited amount.

[23] The Institute also is concerned about potential difficulties in the operation of, and the costs associated with, the opt-out exception. Most significantly, if a broker or dealer were to provide investors with the ability to opt out, the proposed rule would require the broker-dealer to, among other things, obtain informed consent from each investor on an order-by-order basis. The Institute believes that such a process could significantly, and unnecessarily, slow down the order handling and execution processes of each broker-dealer, and, as a result, the execution of investor orders. The Institute therefore recommends that, if the Commission adopts an opt-out exception to the trade-through

4. Other Exceptions

One of the current exceptions to the ITS trade-through rule permits a member to trade through a better displayed price on another market in the course of executing a "block trade" or a "block transaction" if the member simultaneously sends a commitment to execute the better priced displayed order at the block price. The proposed trade-through rule, however, would not treat large "block-sized" trades any differently than non-block trades. Therefore, an order execution facility could not execute a block trade at a price inferior to the best bid or offer displayed on any other order execution facility unless the order execution facility sent an order to trade at the price of the better-priced order. While our members, as institutional investors, do make use of block transactions, we believe it is important that there be consistent rules in the market and that orders of any size and dollar amount be required to interact with one another. We therefore do not support a block trade exception.

Nevertheless, if the Commission adopts the definition of an "automated" market as proposed (*i.e.*, with no minimum standards for the execution of orders and update of quotes and requiring automation only at the best bid and offer), or if the Commission does not adopt a manual quote exception (as amended by our recommendations), then the Institute believes a block trade exception may be necessary in order for our members and other institutional investors to efficiently trade large amounts of stocks. In any case, we believe that a block trade exception would be preferable to an opt-out exception to facilitate these types of transactions. Most significantly, a block trade exception would be more limited in nature than an opt-out exception and would be more feasible to employ.[24]

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rule, it permit investors to provide global consent, at least for those investors, such as institutional investors, that may be better qualified to determine and understand the implications of opting out of the trade-through rule's protections.

In addition, if the Commission determines to adopt an opt-out exception, we believe that the ability to opt-out should be extremely limited in scope. In particular, the Institute recommends that the Commission narrow the scope of the opt-out exception to include only those orders entered by a customer for the customer's account. We see no logical reason why a broker-dealer trading for its own account should be able to avoid a better priced order entered by an investor. We believe permitting such an opt-out would provide further disincentive for investors to enter limit orders and would be counter to the reasoning behind implementing a trade-through rule.

[24] Although included in the current ITS trade-through rule, the Commission also is proposing not to include an exception from the trade-through prohibition in cases where the bid or offer that is traded through has caused a locked market. As the Release notes in connection with the market access proposal, locked markets may raise concerns about the orderliness and efficiency of the markets. The Institute therefore supports not including such an exception in the proposed rule, as this could result in the reduction of locked markets. In addition, the provisions in the proposed access standards that are designed to deter market participants from locking and crossing markets may lead to fewer instances of these types of markets, thereby diminishing the need for the exception. The Release also notes that the proposed trade-through rule, unlike the current rule, does not include an exception for trading through a 100-share bid or offer. The Release states that the Commission is concerned that a *de minimis* exception, such as the 100-share exception, would provide an opportunity for market participants to circumvent the requirements of the proposed rule. The Institute agrees. We therefore support the elimination of the *de minimis* exemption to the trade-through rule.

IV. Market Access Proposal

The market access proposal would establish rules that would modernize the terms of access to quotations and the execution of orders in the national market system. Specifically, the proposal would require market centers to permit all market participants access to their limit order books, at least indirectly, on a non-discriminatory basis; would limit any fees charged by market centers and broker-dealers for access to their quotations to a *de minimis* amount; and would require SROs to establish rules to reduce the incidence of intermarket locked and crossed quotations.

A. Proposed Access Standards

Under the proposed rule, "quoting market centers"[25] and "quoting market participants"[26] would not be permitted to impose unfairly discriminatory terms that inhibit non-members, non-subscribers, or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers, or customers. The proposed access standards are intended to ensure that all market participants have effective indirect access to quotations displayed by quoting market centers and quoting market participants, thereby eliminating the need for direct, intermarket linkages between market centers such as the ITS.[27] Currently, there are few regulatory standards governing the manner of access among competing market centers. As the Release notes, markets historically have attempted to maintain effective control over the terms of inbound order access by seeking to erect barriers in the form of fees, execution priorities, membership requirements, direct bans, and other restrictions.

The Institute supports the creation of minimum access standards that would provide market participants with non-discriminatory access to *all* displayed prices for a security (and not only the best displayed bid and offer for that security), no matter where those prices are displayed, and that would reduce the current barriers to intermarket access. The Institute believes that fair and efficient access to all displayed prices is critical to the efficient execution of

[25] A "quoting market center" would be defined as an order execution facility of any exchange or association that is required to make available to a quotation vendor its best bid or best offer in a security pursuant to the Quote Rule.

[26] A "quoting market participant" would be defined as any broker-dealer that provides its best bid or best offer in a security to an exchange or association pursuant to the Quote Rule or Regulation ATS, and whose best bid or best offer is not otherwise available through a quoting market center.

[27] As the Release discusses, there are currently several methods of access to the markets - with respect to exchange-listed equity securities, there is the "hard linkage" of the ITS (with terms of access governed by the ITS Plan) and with respect to Nasdaq stocks, the "soft linkages" established by the terms as set forth in the "Nasdaq UTP Plan." The Nasdaq UTP Plan requires only that each participant in the plan provide direct telephone access to each market maker or specialist in its market. The registered national exchanges, market makers, ECNs, and other broker-dealers may access Nasdaq's SuperMontage through a Nasdaq member to reach quotations displayed in SuperMontage. The NASD's ADF (the alternative to SuperMontage) does not operate a linkage or execution system like SuperMontage and market participants must obtain their own access to ADF participants under the ADF's rules governing access.

orders. In addition, as discussed above, strong access standards also will be essential to an effective trade-through rule. Clearly, being able to identify the market with the best displayed prices will be irrelevant unless an investor can gain fair and efficient access to that market and be able to execute against those prices. Effective market access standards also would help address issues resulting from fragmentation in the securities markets, which may adversely affect the ability of customer orders to interact with one another as broadly as possible.

The Institute also supports the flexible approach proposed by the Commission that would seek to ensure effective access through linkages established by the markets and not through government-imposed linkages. As we have seen, the inflexible "hard" linkage established by the ITS has not proven to be the most effective manner of providing access to the markets (although it is unclear whether the ITS linkage itself, from a technological standpoint, is a concern or whether the rules governing the linkage, *e.g.*, the time period permitted to respond to a commitment to trade, creates inefficiencies). We also are concerned about the effect of a single industry utility to link markets and to route orders to them. Among other things, this could discourage innovation and create a single point of failure that could shut down the securities markets. Nevertheless, while reliance on linkages established by the markets to provide intermarket access is the ideal situation, if market participants cannot agree to and establish such linkages, we believe the Commission then must step in and mandate that such linkages be established.

B. Access Fees

As the Release notes, published quotes today may not reliably indicate the true prices that are actually available to investors due to the disparities that exist in the fees charged by market participants. Most significantly, ECNs that display their quotes in the public quotation system typically charge per share "access fees" to non-subscriber market participants that trade with the orders that the ECNs display. As the volume of orders that ECNs execute has increased, the absence of a uniform quoting standard has arguably made it more difficult for market participants to readily compare quotations across all markets. In addition, although ECNs may impose access fees on other market participants for access to their quotes, currently other market participants must trade at their displayed quotes without imposing such fees.

In order to address the difficulties that access fees have raised, the Commission has proposed an access fee standard that would promote a common quoting convention and facilitate the ready comparison of quotes across the national market system. Under the proposed rule, all quoting market centers, quoting market participants, and broker-dealers that display attributable quotes through SROs would be permitted to impose fees for the execution of orders that would be limited to a *de minimis* amount.[28] Specifically, the proposed rule would

[28] The Release notes that the proposed rule would not address the price or other contractual terms that a member, subscriber, or customer of a particular quoting market center or quoting market participant may establish with third parties seeking access. The proposed rule also would not restrict SROs or broker-dealers from rebating all or a portion of the permissible access fees to their members, subscribers, or customers.

allow an SRO's order interaction facility to charge a maximum fee of $0.001 per share for access to its market. Market makers, specialists, ATSs, and other broker-dealers that display attributable quotes through SROs also would be permitted to charge a maximum fee of $0.001 per share for access to their quotes, and would be permitted to charge this access fee in addition to any access fee that the SRO also imposes on the transaction, with the accumulation of fees limited to no more than $0.002 per share in any transaction.

The Institute believes that a *de minimis* fee standard is a logical approach to addressing concerns regarding access fees. The Release states that the Commission considered various alternative regulatory responses to the problems associated with access fees including: reflecting access fees in the displayed quote; rounding access fees to full-penny trading increments in the displayed quote; banning access fees outright; and establishing the *de minimis* fee standard. The Institute does not believe that access fees should be reflected in the displayed quote because, as the Release notes, this would lead to subpenny pricing, which we strongly oppose (for the reasons set forth below). The Institute also agrees with the Commission's analysis of the "quote normalization" approach that would round access fees to full penny trading increments in the displayed quote. Specifically, such a measure could impair price transparency and distort the accuracy of market information as it would lead to orders being displayed at prices better or worse than the actual price. Finally, the Institute is sensitive to arguments that banning access fees altogether could prove unfair to markets which charge various fees for accessing liquidity in their markets.

C. Locked and Crossed Markets

In order to address concerns regarding locked and crossed markets, the proposed rule would require every SRO to establish and enforce rules requiring its members to avoid locking or crossing the quotations of quoting market centers and quoting market participants.[29] In addition, SRO rules would be required to prohibit members from engaging in a pattern or practice of locking or crossing the quotations in any security.

The Institute supports proposals that would reduce the incidence of locked and crossed markets. Locked and crossed markets can have a negative impact on the securities markets and can be a sign of an inefficient market structure. As the Release notes, many incidences of locked and crossed markets can be attributed to the proliferation of access fees and "liquidity rebates" offered to customers that post limit orders on a market as well as to the problem of market fragmentation, as the locked bids and offers on separate markets cannot meet because the two markets are not linked. In addition, locked and crossed markets may create confusion for investors, as it is unclear under such circumstances what is the true trading interest in a stock. Thus, by helping to reduce the frequency of locked and crossed markets, the proposal could

[29] In order to address accidental locked and crossed markets between competing market centers, the proposed rule would require each SRO to promulgate rules that would discourage market participants from engaging in locking and crossing but that would tolerate some minimal incidents of locked and crossed markets.

improve market quality overall and enhance the production of fair and informative quotations.[30]

D. Amendments to Regulation ATS Fair Access Standard

Currently, under Regulation ATS, an ATS with at least five percent of the trading volume in a security is required to provide its best bids and offers to a national securities exchange or a national securities association. In addition, an ATS with at least twenty percent of the trading volume in a security must maintain standards ensuring that they will not unfairly discriminate or unreasonably deny access to their systems. The Commission is proposing to lower the "fair access" threshold in Regulation ATS from twenty percent to five percent in order to ensure that the quotes of all significant market participants are accessible throughout the national market system. The Institute supports lowering the “fair access” threshold to five percent.

V. Subpenny Quoting Proposal

The subpenny quoting proposal would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment less than a penny (except for securities with a share price of below $1.00). The Institute strongly supports the subpenny quoting proposal.

The proposal is intended to address concerns that have been raised regarding quoting securities in subpenny increments. While the Institute strongly supported the move to decimalization and the trading of securities in minimum increments of one penny, we have strongly opposed the entry of orders and the quoting of securities in subpennies. As we noted in our comment letter in response to the SEC’s concept release regarding the impact of trading and potentially quoting securities in subpennies,[31] permitting the entry of orders and the quoting of securities in subpennies would eliminate much of the benefits brought by decimalization and would exacerbate many of the unintended consequences that have arisen in the securities markets since its implementation, which have proven harmful to mutual funds and their shareholders.

For example, while the move to pricing in whole pennies has enhanced the ability of investors to more fully understand the prices at which securities are quoted, quoting securities in subpennies would make it *more* difficult for investors (as well as market participants executing orders for investors) to understand these prices. In addition, as the Release notes, the increase in “flickering” quotes that could result from widespread subpenny pricing could make

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[30] We also are confident that the other components of the market access proposal, *i.e.*, establishing minimum access standards and a *de minimis* fee standard, will help reduce the economic incentives to create locks and crosses and thereby reduce the incidence of locked and crossed markets.

[31] *See* Subpenny Concept Release Letter, *supra* note 5.

it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities as it will be extremely difficult for brokers to determine with reasonable certainty whether displayed prices are likely to be available.

The Institute also is concerned about the effect of quoting securities in subpennies on market transparency and depth. The reduction in quoted market depth as the result of quoting in penny increments has adversely affected institutional investors' ability to execute large orders. The Institute believes that displaying consolidated quotes in subpenny increments would further reduce the displayed quote size and overall depth of the markets.

Finally, many of the difficulties that institutional investors have faced trading large orders since the implementation of decimalization has been caused by increased instances of stepping-ahead of limit orders. Permitting the entry of orders and the quoting of securities in subpennies would allow a trader to gain priority over another trader by bidding as little as $0.001 more for the same security with almost no risk of loss. This potential for the increased stepping-ahead of limit orders would create a significant disincentive for market participants to enter any sizeable volume into the markets and would reduce further the value of displaying limit orders.[32]

The Institute also supports the aspect of the proposed rule that would not per se prohibit an exchange or association from printing a trade that was the result of a mid-point or volume-weighted pricing algorithm, as long as the exchange or association or its members did not otherwise violate the proposed rule with respect to the trading interest that resulted in the execution. The Institute believes that it would not be problematic for executions to take place in subpenny increments where the prices for these executions are determined through the application of a passive algorithm, as is the case where a trade is executed on a crossing network at the mid-point of a bid and offer.[33]

VI. Market Data Proposal

The market data proposal would amend the rules and joint industry plans for disseminating market information to the public. Most significantly, the proposal would modify the formulas for allocating market data revenues.

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[32] The Release notes that recent economic research conducted by Commission staff and by Nasdaq confirms that market participants may use subpenny quoting "more as a means to 'step ahead' of competing limit orders for an economically insignificant amount to gain execution priority, than as an extrinsic expression of trading interest" and that subpenny pricing, therefore, could discourage market participants from using limit orders, which could deprive the markets of an important source of liquidity. Release at 11164.

[33] The Release requests comment whether there are other types of securities that should be excluded from the proposed rule, such as ETFs, which are derivatively priced and whether those securities raise the same concerns that have been expressed with respect to subpenny pricing generally. We believe that all types of securities, including ETFs, should be subject to the proposed rule and that subpenny quoting raises the same types of concerns for ETFs as for other types of securities.

Currently, the formulas for allocating market data revenues are based solely on the number of trades or share volume reported by an SRO. As the Release notes, these formulas therefore do not directly reward those market centers that generate the highest quality quotes, *i.e.*, those quotes that have the best prices and the largest sizes, which contribute the most to price discovery. In addition, the Release notes that the exclusive focus on trade reporting has distorted SRO competition and created incentives for "print facilities," "wash" trades and "shredded" trades solely to report a large number of trades and maximize market data revenues.

While the Institute does not have any comments on the details of the proposed formula (*i.e.*, the specific components of, or the calculations required under, the formula), we generally support revisions to the allocation of market data revenue that would discourage the practices noted above that exist solely to generate increased revenue. In addition, to the extent that the revenues from market data allocated to the markets do not reflect the true costs of collecting and disseminating that data to the marketplace and operating the markets,[34] the Commission should create an allocation system that better reflects these costs. Such an allocation system may, in turn, create cost savings for investors, who are the ones who place the quotes into the marketplace that allows the markets to generate this revenue.[35]

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The Institute appreciates the opportunity to comment on Regulation NMS. Any questions regarding our comments may be directed to the undersigned at 202-371-5408 or to Elizabeth Krentzman, General Counsel, at 202-326-5815.

Sincerely,

Ari Burstein
Associate Counsel

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[34] The Release notes that in 2003, $424 million in revenues were collected from market data fees and, after deduction of expenses to the "networks" disseminating consolidated market information for NMS Stocks, $386 million was distributed to the individual SROs.

[35] The Institute also supports other changes made to the joint industry plans under the market data proposal. Specifically, we support: (1) the amendment to the joint industry plans that would broaden participation in their governance and that would help assure that the views of interested parties other than SROs have an opportunity to be heard on plan matters; (2) amendments relating to the independent distribution of market information that would permit individual market centers to have the freedom to distribute their own market data independently; and (3) the proposed rule to require SROs to act jointly pursuant to one or more national market system plans to disseminate consolidated information for NMS Stocks.

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

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