Lava Trading Inc.
95 Morton Street, 7th Floor
New York, NY 10014
T 212.609.0100
F 212.609.0101
www.lavatrading.com

Via Electronic Mail

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

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

Dear Mr. Katz:

Lava Trading Inc. ("Lava") welcomes the opportunity to provide the Securities and Exchange Commission (the "Commission") with its comments on proposed Regulation NMS.[1/] Lava is a technology firm that develops high-performance trading solutions for the financial services industry. Lava licenses its technology to large and medium-sized broker-dealers for use by firms' trading desks and their buy-side customers.

The national market system has evolved rapidly over the last several years due, in large part, to technological advances. Many broker-dealers now have access to consolidated market data feeds and intelligent order routing capabilities, either through proprietary systems or through systems built by third-party vendors (such as Lava). The advanced technology available today enables broker-dealers to make more efficient order routing decisions and helps firms carry out their duty of best execution. We believe that proposed Regulation NMS would modernize the regulatory structure of the U.S. equity markets, while supporting current and future technological advances.

I. Trade-Through Proposal

Lava has extensive experience in building high-performance trading systems that link to multiple market centers in both the listed and over-the-counter equity markets. Our systems offer broker-dealers highly efficient and powerful intelligent order routing capabilities to access liquidity. These capabilities give broker-dealers the tools necessary to comply with the trade-through rule for listed securities as it exists today under the Intermarket Trading System Plan and self-regulatory organization ("SRO") rules.[2/]

1/ *Regulation NMS*, Securities Exchange Act Release No. 49,325 (Feb. 26, 2004), 69 Fed. Reg. 11,126 (Mar. 9, 2004) ("Proposing Release"); and *Regulation NMS Extension of Comment Period and Supplemental Request for Comment*, Securities Exchange Act Release No. 49,749 (May 20, 2004), 69 Fed. Reg. 30,142 (May 26, 2004) ("Supplemental Release").

2/ *See, e.g.*, New York Stock Exchange Rule 15A; American Stock Exchange Rule 236; Chicago Stock Exchange Rule 40; Philadelphia Stock Exchange Rule 1085; and National Association of Securities Dealers Rule 5262.

As a technology firm, Lava is neutral in the current market structure debate and neither supports nor opposes the adoption of a uniform trade-through rule for the U.S. equity markets. Lava agrees with the Commission that, whether or not such a rule is adopted, broker-dealers ultimately are responsible for seeking to obtain best execution for their customers' orders. If the Commission decides to adopt a uniform trade-through rule, however, Lava believes the rule should be crafted in a manner that takes into account execution speed and efficiency, responds to the needs of market participants, and preserves the benefits of competition.

A. Trading in Parallel Exception

Proposed Rule 611 of Regulation NMS would require any order execution facility,[3/] national securities exchange, and national securities association to "establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market," unless one of the exceptions set forth in proposed Rule 611(b) applies. The exception contained in proposed Rule 611(b)(7) would be available to the extent that "at the same time or prior to executing a transaction that constituted a trade-through, the order execution facility sent an order or orders to trade with each bid or offer of another order execution facility that was disseminated pursuant to an effective national market system plan and that was priced better than the price at which such transaction was executed."

The responsibility for complying with this exception would be placed on the order execution facility that receives an order covered by the rule, not the broker-dealer sending the order. As the Supplemental Release notes in its discussion of "intermarket sweep orders," neither proposed Rule 611 nor the SRO rules take into account the current ability of broker-dealers to effect sophisticated trading strategies in which a broker-dealer attempts to take liquidity from multiple market centers simultaneously.[4/] In such circumstances, the broker-dealer is in the better position to ensure compliance with the trade-through rule because the trader is the only one who knows where all of its orders have been routed; an order execution facility only knows it has received an order and whether its facility is showing the best price. As such, Lava believes that the proposed structure creates inherent trading inefficiencies and could considerably reduce the speed of execution, particularly for large orders. These inefficiencies can be demonstrated using the example below.

Example: In the table below, a series of offers from different market centers is displayed as a montage.

3/ An order execution facility is defined to include national securities exchanges, national securities associations, exchange specialists and market makers, alternative trading systems, over-the-counter market makers, block positioners, and any other broker-dealer that executes orders internally by trading as principal or crossing orders as agent that operates a facility that executes orders. *See* Proposed Rule 600(b)(50).

4/ *See* Supplemental Release, 69 FR at 30145.

Market Center	Offer Price	Displayed Quantity
MKTA	10.50	500
MKTB	10.51	1,500
MKTC	10.52	1,500
MKTD	10.52	2,000
MKTE	10.53	3,000

In this example, in seeking to comply with current SRO rules and its duty of best execution, a broker-dealer interested in buying 2,000 shares at the market sends an order to MKTA to buy 500 shares. The trader could wait for MKTA to: (i) fill the order (in whole or in part), (ii) send a report indicating the number of shares that could not be executed, *and* (iii) update its quote in the montage before the trader sends the next order to MKTB, and so on until all shares are executed. This would slow down trading and could give certain market participants an unfair advantage.

Alternatively, if the trader were to immediately send an order for 1,500 shares to MKTB after sending an order for 500 shares to MKTA, one of the following could occur:

- MKTB would reject the order since it is unaware of the order sent to MKTA and it still sees MKTA displaying a better price; or

- Under the exception in proposed Rule 611(b)(7), MKTB could route out to access MKTA for its 500 share displayed size at the same time or prior to executing any shares in its own market at an inferior price, which is very inefficient as the trader has already sent an order to access MKTA.

In the example, MKTB is simply trying to ensure compliance with the trade-through rule, but the structure is unnecessarily complex and could lead to decreased execution efficiency. These issues would be exacerbated with larger sized orders.

To eliminate these market structure inefficiencies, Lava believes that, if proposed Rule 611 is adopted, it should include an exception to accommodate **"Trading in Parallel."** Trading in Parallel occurs when a taker of market liquidity simultaneously attempts to access multiple markets and different prices that fall within the trader's price tolerance. We believe that any trade-through rule should include an exception that would allow a market center that receives one of these orders to execute it immediately without regard for whether a better price is displayed on another market center.

Under the proposed exception, a trader could instantaneously execute an 8,000 share order by simultaneously sending five orders to take out the displayed size in each market. MKTB, MKTC, MKTD and MKTE would be free to ignore the better displayed prices on any other market and execute the order received. Note that, while the market center would be exempt from proposed Rule 611,[5/] the broker-dealer would have to comply with the SRO rules governing trade-throughs and its duty of best execution.

Allowing broker-dealers to quickly and efficiently access multiple markets simultaneously, in accordance with SRO rules and their duty of best execution, would improve execution quality and provide significant incentives to market centers to provide fast access to displayed firm quotes. Trading in Parallel could thereby achieve speed, efficiency and fairness of access among markets in an environment of changing technology.[6/]

B. Identification of Trading in Parallel - Pre-comply Flags

Trading in Parallel can only work if the markets that are not displaying the best price know that they have received an order which is part of a broader trading strategy, and that the broker-dealer effecting the strategy is simultaneously taking out the liquidity at the best price. Thus, the Supplemental Release asks how an order can be identified such that "the receiving market center would be able to execute the order without regard to whether a better price were displayed on another market center."[7/] To facilitate Trading in Parallel, Lava recommends that the Commission allow the use of a **"Pre-comply flag."** A Pre-comply flag would indicate to a receiving market center that the liquidity taker has already sent orders to access any better-priced, displayed liquidity, thereby permitting the market center to immediately execute the incoming order.

Referring back to the 8,000 share example trade above, if all market centers supported Pre-comply flags, a broker-dealer that desired rapid execution could send simultaneous orders to MKTB, MKTC, MKTD and MKTE with the Pre-comply flag attached, as well as sending an order to MKTA. Thus, Pre-comply flags would facilitate rapid executions across multiple market centers, while avoiding trading-through other markets' firm quotes.

C. Uniform de Minimis Trade-Through Amount

If there is a trade-through rule, Lava supports the concept of a de minimis trade-through exemption. Unlike the proposed varying trade-through amounts for automated order execution facilities, set forth in Rule 611(b)(9), Lava believes that a uniform de minimis exemption would be simpler to implement and understand. A single amount also would provide adequate protection of customer orders and motivate execution venues to improve their technology and pricing. In addition, Lava believes that any uniform de minimis trade-through exemption should

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5/ Lava believes, however, that the each market center should still be required to maintain an audit trail that incorporates the use of a Pre-comply flag (see discussion below), so that it can justify immediate execution of an order.

6/ Lava believes that the Commission's opt-out exception in proposed Rule 611(b)(8) would not address the market inefficiencies the proposed Trading in Parallel exception is attempting to correct (although it may serve other purposes). Because the opt-out exception would require a broker-dealer to obtain consent from each customer on an order-by-order basis, the speed and efficiency of executions would be considerably reduced, even with the use of technology that is designed to accommodate the opt-out exception.

7/ *See* Supplemental Release, 69 FR at 30145.

be set at such a level as to accommodate inadvertent trade-throughs caused by "flickering" quotes.

II. Sub-Penny Quoting Proposal

Lava supports proposed Rule 612 to the extent it permits broker-dealers to indicate their willingness to have an execution in subpennies. Broker-dealers and their customers often seek to execute trades at the midpoint of the NBBO, in order to avoid market impact, minimize slippage, and reap the benefits of price improvement. If, however, the bid/ask spread is an odd number of minimum price variations (1-cent, 3-cents, etc.), a true midpoint trade could only be effected at a subpenny price. Thus, whether or not market centers are permitted to accept orders priced in subpennies, we believe that it would be beneficial to allow market centers to accept orders that *indicate a willingness* to be executed at the midpoint of the spread, which may, but not necessarily will, result in a subpenny execution.

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Lava appreciates the opportunity to comment to the Commission on proposed Regulation NMS and would be happy to discuss any of our thoughts with the Commission in further detail.

Very truly yours,

Richard A. Korhammer
Chairman & Chief Executive Officer