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June 30, 2004

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Jonathan G. Katz
Secretary
Securities & Exchange Commission
450 Fifth Street
Washington, DC 20549

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Re: File No. S7-10-04.

Dear Mr. Katz:

The Security Traders Association ("STA") appreciates the opportunity to comment on the critical matters discussed in the Commission's recent proposal of Regulation NMS[1]. We commend the Commission for its efforts in addressing these structural issues in a comprehensive manner since there are important interactions between the proposals.

- The Commission has proposed four new rules as well as a number of technical changes to existing rules. The new rules[2] would address the following issues:
- A uniform rule for the prevention of trade-through across all market centers, subject to certain exceptions.
- A uniform rule that would permit all market participants to access other markets on a non-discriminatory basis with a *de minimis* charge for such access.
- A ban on sub-penny quotations.
- A modification of the formula used for allocating market data revenues.

These proposals deal with various facets of a fundamental problem: inadequate access to the best priced quotes of all market centers, on market neutral terms. The STA believes that there are two core elements necessary to overcome market fragmentation and its causes. The first is for all market

[1] Securities Exchange Act Release No. 49325 (February 26, 2004) 69 FR 11126 (the "Proposing Release"); Securities Exchange Act Release No. 49749 (May 26, 2004) 69 FR 30142 (the "Supplemental Release") (posing additional questions and extending the comment period).

[2] Proposed Rule 611 (trade throughs); Rule 610 (access and access fees); Rule 612 (quoting increments) and revisions to the CTA and Nasdaq/UTP Plans (allocation of market data revenues).

centers (i.e., exchanges, Nasdaq, ECNs and market makers) to provide immediate, automated access to their quotes, along with automatic update of quotes as they are traded against. Secondly, the Commission should ban ECNs from imposing access fees when their quotes are accessed through an SRO execution facility.[3]

About STA

The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for our members. We have approximately 6,000 members, all engaged in the buying, selling and trading of securities. Our members participate in STA through 28 national and international affiliate organizations and represent the interests of the trading community and institutional investors. The STA provides a forum for our traders, representing institutions, broker dealers, ECNs and floor brokers to their share their unique perspectives on issues facing the securities markets as they work together to promote their shared interests in efficient, liquid markets as well as investor protection.

Given the aforementioned disciplines represented by the STA, one would expect that they often have differing perspectives on market structure issues. We have diligently worked through the issues presented by the Commission in proposed Regulation NMS, and have in most instances reached consensus on recommendations that we believe are beneficial for the market as a whole, not the individual interests of our constituencies.

The STA's White Paper

In August of 2003, the STA published a monograph entitled "Fulfilling the Promise of the National Market System: STA's Perspective on U.S. Market Structure" (the "White Paper"). The White Paper discussed in detail the STA's views on the current state of the US markets and the issues it felt must be dealt with in order to make those markets stronger and more liquid. While not a one-for-one parallel with the Commission's proposal, our concerns are remarkably similar to those addressed by the Commission in the Proposing Release. Specifically, the White Paper identified certain factors that affect the transparency of available quotation information and the ability of market participants to access those quotes. Four problems were identified: fragmentation; the prevalence of locked and crossed markets and the lack of efficient and economical intermarket linkages; the existence of ECN access fees; and regulatory arbitrage due to inconsistent trading rules between markets. In our view, the combination of these factors makes it more difficult for investors and their brokers to obtain best execution of their orders. Based on its analysis, the STA made three recommendations[4]:

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[3] We are using the term "access fees" broadly, in the same manner as the Commission uses it in the proposed rules and Proposing and Supplemental Releases, to cover fees imposed on members and subscribers in addition to fees imposed on non-members and non-subscribers.

[4] White Paper at 7-9.

- Improve intermarket linkages and adopt rules that would prohibit locked and crossed markets;
- Eliminate ECN access fees;
- Assure that core-trading rules such as the short sale rule are consistent across markets.

Because the White Paper addressed many of the same issues discussed in the Proposing Release, many of our comments will be based on our earlier analysis and the difference between our earlier recommendations and the Commission's proposals.

Access to Published Quotations for Automated Trading

To achieve the objectives of the national market system, it is imperative for market participants to have open and immediate access to the NMS quotations of all market centers, on market neutral terms free from the trading distortions caused by ECN access fees (or regulatory arbitrage). Above all, this means that quotations should be accessible for trading on an automated basis. As an example, our members' experience with trading of Nasdaq stocks on the Amex emphasizes the need for efficient access. The specialists on the Amex often quote very competitive markets; however, due to the inefficiencies of access to that market, it is functionally almost impossible to interact with that liquidity. More generally, the growth of unlisted trading of Nasdaq stocks on the Amex, BSE, CSE, CHX and PCX and the increased use of the ADF highlight the need for measures to ensure open access to the competing markets for all stocks. Moreover, certain ATSs that quote exclusively in the ADF are accessible only through their proprietary networks.

We are pleased that the Commission shares our view on the need for much more efficient access to quotations. Many features of its proposal are intended to encourage predominantly manual markets to incorporate automated trading technology to a far greater degree than they do at present. The Commission asks in the Proposing Release whether it should take even more definitive action by mandating automated trading under the proposed access standards of Rule 610.

We believe that it should. Specifically, the STA recommends that the Commission adopt a rule requiring that ***all*** market centers – exchanges, Nasdaq, ECNs and market makers – provide automated trading access to their publicly displayed quotes for listed and Nasdaq stocks. The Commission should require, at a minimum, system capabilities that provide for an immediate automated execution or response to incoming orders and that automatically refresh quotes once they are traded against. One of the results of decimal pricing is the fact that the BBO of any particular market may reflect only a small portion of the liquidity available there. If a market chooses to provide that information it should be available for automated execution/response as well. This will encourage greater liquidity, market depth and genuine trading rather than quoting. We are not arguing for a CLOB, but for access and execution capability on an immediate basis.

The STA does not advocate any one model for how orders should be routed to reach a market center's quote. In particular, we do not believe it is necessary to mandate formal intermarket linkages under a national market system plan. We do believe, though, that non-SRO market centers such as ECNs must make their quotations available for auto-execution through the facilities of an SRO. In this way, other market participants will only have to maintain access to six or seven markets, not to dozens. Moreover, if the exchanges and Nasdaq decide to retain ITS for listed stocks, they should be required to improve the system to provide for efficient and timely trade executions consistent with prescribed standards (auto-execution and response; automatic refresh).

The Commission should adopt this rule mandating automated execution with a phased implementation schedule. This approach would allow manual markets time to develop and implement plans for providing automated trading access to their published quotations in accordance with the minimum standards prescribed by the rule. Importantly, a phased approach will provide the Commission, the markets and market participants the opportunity to monitor progress and to identify and make appropriate adjustments to address unintended consequences.

The rule should accommodate the plans of some floor based exchanges announced at the April 21 NMS hearing to implement auto-execution facilities as part of a hybrid structure integrating automated trading capabilities with their floor auctions. STA cautiously supports these initiatives, provided that manually executable quotes are excluded from the definition of "national best bid and offer." This means that manual quotes would be excluded from the consolidated NBBO disseminated pursuant to the Quote Rule (Rule 11Ac1-1, to be redesignated as Rule 602) and displayed pursuant to the Display Rule (Rule 11Ac1-2, as proposed to be amended and redesignated as Rule 603). They would also be excluded from the statistical reports on order execution quality prepared under Rule 11Ac1-5 (to be redesignated as Rule 605). We believe, though, that manual-only quotes should be included in the consolidated quotation montage displays, if they are identified as such in those displays. In addition, it is important that the Commission establish standards that limit the circumstances and amount of time a market can switch from automated to manual quotes and establish a monitoring program to assure adherence to those standards.

Trade-Through and Best Execution

The fundamental premise of the Securities Acts Amendments of 1975 is that competition is at the core of the national market system. First and foremost, the Commission's job is to engender competition as a means of protecting investors and strengthening the markets. It is only where competition itself would not bring about the desired result that the Commission is instructed to step in and adopt a regulatory solution.

Before implementing any change to the trade through rule, the Commission should mandate automated trading and eliminate access fees. Once market participants have open and efficient access to trade against the published quotes of all market centers on an automated and market neutral basis, competition should ensure that customers receive the best prices available on their orders. The Commission should not adopt a trade through rule unless it determines based on empirical analysis that such connectivity and automation is insufficient to protect against trade throughs.

Best Execution. The STA is concerned about the interaction between SEC policy and the standard of best execution as applied by SROs and state regulators. Although the SEC has cited a number of factors that may be considered when evaluating best execution, SROs and state regulators focus almost exclusively on price as the only measure of compliance. Thus, for example, when reviewing the quality of execution of a broker or market maker, the NASD has taken the position that any failure to obtain the best price, whether that price is economically or efficiently available, is a violation of the duty of best execution. We take exception to this point of view because we believe that economic and efficient access are essential prerequisites to seeking out a better price.

Thus, the STA recommends that the Commission adopt a safe harbor that recognizes that a broker may, consistent with its duty of best execution, execute a trade for a customer at a price that trades through a quote that is not accessible for automated execution. This safe harbor would be comparable to the exemption proposed in the Commission's draft trade through rule, such that an automated market could trade through a manually executable quotation. The safe harbor would also be necessary if the Commission adopts that exemption in the context of a trade through rule. The safe harbor would protect a broker against best execution liability under state law in situations where the Commission would permit a broker to bypass the quotation of another market.

Trade Through Exemptions

Automated Order Execution Exemption. If the Commission adopts a uniform trade through rule, we support the proposed automated order execution exemption. In the Supplemental Release, the Commission asks whether it should narrow the exemption to distinguish between automated versus manual access to quotes rather than automated versus manual markets. The STA believes this is worth exploring, both in the context of the safe harbor and a trade through exemption, to accommodate exchange plans to establish hybrid markets. However, we believe this approach is only workable if use of manual mode is carefully monitored for abuse and quotes that are only available for manual trading are excluded from consolidated NBBO displays and Rule 11Ac1-5 reports, as explained above.

Flickering Quotes. In the Supplemental Release, the Commission agrees that it would be unreasonable to hold a market center responsible for protecting another market's "rapid-fire quote changes." In fact, the Commission indicates that a market center's trade through policies and procedures should include means to identify apparent trade throughs of such quotes as "false" trade throughs, in essence taking the position that such incidents are not trade throughs. The STA recommends that the Commission formalize this position as a trade through exemption.

Opt-Out Exemption. If the Commission determines to require automated execution through the facilities of a registered SRO on economically neutral access terms, the STA believes that an opt-out provision would be unnecessary, except perhaps for specific types of trades such as large blocks or VWAP trades. Thus, the STA cautiously favors a limited opt-out exemption, subject to restrictions to protect against opt-out becoming a routine market practice. The proposed order-by-order consent requirement or other restrictions could serve this purpose.

Access Fees

The Commission has correctly identified ECN access fees as a critical component of any discussion regarding best execution. Because ECN access fees are not included in the quotations that ECNs display in the consolidated quote stream through an SRO trading facility, they represent hidden costs that distort the true price that the ECN is offering through that SRO facility. As the Commission is well aware, such access fees create market inefficiencies by imposing economic disincentives to seeking out the best price and by creating economic incentives to lock and cross markets.

While we appreciate the thoughtfulness behind the Commission's proposal to permit all markets to charge access fees, we believe that this will exacerbate the problem rather than lessen it. We believe a far more effective approach would be to simply ban ECNs from imposing access fees when their best priced quotes are traded against through an SRO execution facility such as Nasdaq's SuperMontage.

At the same time, the STA believes it is unnecessary for the Commission to ban or restrict the access fees that an ECN may charge its subscribers for providing them with direct trading access to its quotations, including depth of book displays.

Locked and Crossed Markets

Certain ECNs simply refuse to send orders to other markets, forcing other market participants to come to their market and pay their access fees. Eliminating ECN access fees should greatly reduce this problem but will surely not eliminate it unless the Commission requires (as we recommend) that all ECNs make their quotations available through an SRO execution facility. We believe that the Commission should also adopt a rule prohibiting a market from locking or crossing the quotation of any other market. This type of rule has worked within the Nasdaq market for many years but the increase of trading in Nasdaq stocks outside the Nasdaq Stock Market makes it imperative that the Commission adopt a uniform rule across all markets as there is for listed stocks.

Sub-penny Quotes

In the Proposing Release, the Commission identified the problems associated with quoting in sub-pennies. In particular, it noted that sub-penny quoting could: (i) further decrease market depth at the BBO; (ii) facilitate market professionals stepping ahead of public limit orders; and (iii) make it more difficult for broker-dealers to obtain best execution due to flickering quotes. The STA agrees with this analysis and opposes sub-penny quoting.

One of the principal benefits of the transition to decimals was clarity and simplicity in the market information provided to public investors. Further, the international decimal standard provided a reference and comparison standard for investors both in the US and abroad. These goals have been achieved, and the Commission's mandate to switch to decimals has, after some adjustment by participants, been recognized overall as a positive development.

A move to sub-penny quoting will substantially undermine the benefits of decimals, and will not improve markets, but will lead to greater inefficiency and confusion. Clearly a few commercial interests will benefit by sub-penny quoting; however, the advantage of these few will cause greater harm to investors, market participants, and markets as a whole. The STA recognizes that there are circumstances (e.g., VWAP, crosses and other averaging mechanisms to determine price) that may justify a sub-penny transaction. These transactions are distinctly different from the issue of quoting in sub-penny increments.

Market Data

There are substantial problems regarding the allocation of market data revenues that need to be addressed. While we are not in a position to comment on the details of the precise formula proposed for distribution of market data revenues, we believe any change that rewards price discovery in favor of print factories will be a good one. Most importantly, market data revenues should be allocated to reward providing true, quality quotes that are in fact tradable and quotes that better the NBBO.

"Tradable" has two components. First, it means that quotes should receive allocation credit only if they are accessible for automated trading. Based on a preliminary analysis, we are concerned that the proposed quoting share allocation in fact rewards inaccessible quotes of manual markets, resulting in allocations out of line with their trade and share volume. Second, it means that quotes should exist for a long enough period of time to trade or do in fact lead to trades to receive allocation credit. One approach could be to reduce a market's quote-related revenue share if it has a high ratio of quote changes to actual prints.

We ask the Commission to reevaluate its proposed formula for allocating market data revenues in light of the foregoing concerns. The Commission may wish to consider working with an industry working group to develop a new allocation formula.

Conclusion

The one criterion that the Commission has used to hold the capital markets and the securities industry in good stead through the years has been to make its decisions in the interest of investors. For it is the investor who drives the markets and it is the investor whom the industry serves. Our view is that an approach focused on connectivity, in the form of immediate automated trading access to quotations on market neutral terms, will best serve investors and market participants.

The US capital markets, and the economy they fuel, have been successful due, in part, because investors and those who serve as their agents are willing to take risks, to follow the rules, and to operate fair, liquid, and orderly markets. Each day specialists and market makers risk their own capital to make sure the system works on behalf of investors and issuers. The roles of liquidity providers have evolved mostly through market forces, not regulation, and for important reasons. They add liquidty when required and serve to moderate volatility. As we seek to move towards an NMS, the Commission should do so with a view towards improving and enhancing the essential roles played by these key liquidity providers.

After the Commission has analyzed the comment letters it receives and decides whether to make any revisions to its Regulation NMS proposal, the STA recommends that the Commission seek further public comment before adopting final rules. The market issues that the Commission is seeking to address are so significant that its regulatory action in these areas deserves a full vetting by interested stakeholders.

On behalf of our 6,000 members, who represent all segments of the industry, let us say that we understand what is at stake, and appreciate the opportunity to participate in this important conversation. We remain fully committed to achieving the "Promise of the National Market System."

Mary McDermott-Holland	John C. Giesea
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cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
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