UBS Investment Bank

UBS Securities LLC
677 Washington Boulevard
Stamford, CT 06901

Huw Jenkins
Managing Director
Head of Equities for the Americas

Tel 203 719-8050
Fax 203 719-4331
huw.jenkins@ubs.com

www.ubs.com

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June 30, 2004

Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington D.C. 20549-0609

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

Dear Mr. Katz:

UBS Securities LLC ("UBS") is the U.S. investment-banking arm of UBS AG, one of the largest and most successful financial institutions in the world.[1] Based upon the breadth and depth of its participation in the global financial markets, and the diversity of its clients, UBS possesses a unique perspective on the global equity markets and the important role of the United States within those markets. This perspective allows UBS to provide comments that are unencumbered by an allegiance to any particular market structure or method of trading. Our primary interest in submitting these comments is to promote the development of a superior market structure that provides the most efficient and effective execution capabilities for our clients and the markets as a whole.

UBS respectfully submits this letter in response to the U.S. Securities and Exchange Commission's ("Commission") proposed Regulation NMS[2] ("Proposing Release") as supplemented by the Commission's Supplemental Request for Comments[3] ("Supplemental Release"). We welcome the opportunity to comment on this important and significant proposal, and commend the Commission and its staff for the care,

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[1] UBS AG serves a diverse international client base ranging from individual investors to multinational institutions and corporations. Through its subsidiaries and affiliates, UBS AG is the world's leading private bank and among the world's largest and most influential asset managers, investment banks and U.S. retail brokers. UBS Securities LLC is the U.S. broker-dealer within the UBS Investment Bank, a business group of UBS AG, which provides investment products, research and advice, and comprehensive access to the world's capital markets, for its own corporate and institutional clients and for other parts of the UBS Group. UBS Investment Bank has 81 stock exchange memberships in 31 countries, and is widely acknowledged as a leader in the secondary equity markets and in equity, equity-linked and equity derivative products for the primary markets.

[2] *Regulation NMS*, Securities Exchange Act Rel. No. 49325 (Feb. 26, 2004), 69 FR 11125 (Mar. 9, 2004) ("*Proposing Release*").

[3] *Proposed Regulation NMS: Extension of Comment Period and Supplemental Request for Comment*, Securities Exchange Act Rel. No. 49749 (May 24, 2004) 69 FR 30141 (May 26, 2004) ("*Supplemental Release*").

thought, and effort involved in formulating and issuing this proposal. First and foremost, UBS believes that the U.S. equities markets are among the strongest and deepest in the world. This position can be maintained, however, only through the Commission's continued encouragement of innovation through competition, and the protection of price transparency, execution efficiency and fair access to those market places. Though we oppose those aspects of proposed Regulation NMS which impose a uniform trade-through rule, we believe that Regulation NMS establishes a viable framework with which to achieve the aforementioned goals. We respectfully request that the Commission carefully consider the following comments in formulating its final rules.

I. OBJECTIVES OF MARKET STRUCTURE REFORM

The *Proposing Release* states that the proposals are intended to:

- Establish uniform rules that promote equal regulation of, and free competition among, all types of market centers;
- Update antiquated rules that no longer reflect current market conditions; and
- Promote greater order interaction and displayed depth, particularly for the very large orders of institutional investors.

We agree with these objectives and believe that the primary goal of any market structure reform should be to promote competition among markets and among the various participants within the individual markets. Competition is the instrument that will encourage the continued innovation and renewal of technology and ideas that will allow the U.S. markets to continue to thrive and maintain a leading role in the international trading markets.

To encourage such competition, the Commission should not mandate, directly or indirectly, a particular market structure, but should instead establish minimum standards that would allow differing market participants and execution venues the opportunity to interact in a national market place. Various markets that provide different types of access, execution capabilities and services should be allowed to compete for order flow based on the quality of the executions and services they provide. Competition will enhance and expose the unique benefits and valuable alternatives that are offered by floor-based auction markets, regional exchanges, ECNs, market makers, and SuperMontage.

The goal of promoting competition, however, must be balanced against the disadvantages of market fragmentation. The Commission can best achieve these objectives by establishing broad guidelines that will stimulate competition, while also promoting the efficient interaction of orders in these competing markets and efficient order routing decisions. In particular, transparency through consolidation of quotations, efficient access through electronic linkages and automated execution standards will facilitate the ability of market participants to obtain execution of their transactions in the most economically efficient manner possible. By contrast, a national best bid and offer ("NBBO") that consists of quotations that are not firm, readily accessible, or available for instantaneous execution means that the NBBO is illusory, and will not only distort competition, but will encourage market participants to route order flow to less efficient market centers.

II. SPECIFIC PROPOSALS

A. TRADE-THROUGH PROPOSAL

UBS believes that the proposed application of a uniform trade-through rule upon the equity markets would be an unnecessary action severely limiting the scope of best execution as applied to diverse market participants and public customers. Rather, UBS believes that the critical issue in executing transactions is satisfying the duty of best execution, a duty which the Commission itself has frequently and appropriately noted as not being limited merely to best price.[4] The Commission should instead focus its efforts upon vigorously enforcing the duty of best execution, thereby protecting the investing public without inhibiting the continued evolution of the concept of best execution.

Best Execution

Assertions that price alone is determinative of best execution are fundamentally inconsistent with our experience in the equity trading markets. Different clients, different securities, and different global events can all dictate differences in how best execution is defined and achieved. The Commission itself acknowledged this fact when it commented that "[p]rice is not the sole factor that brokers can consider in fulfilling their duty of best execution. The Commission has stated that a broker also may consider factors such as: (1) the trading characteristics of the security involved; (2) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and (3) the cost and

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[4] This position is affirmed in note 5 of the Proposing Release, which acknowledges that in addition to price, other relevant factors in obtaining best execution may include:

(1) execution speed;
(2) the size of the order;
(3) the trading characteristics of the security involved;
(4) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and
(5) the cost and difficulty associated with achieving an execution in a particular market center.

difficulty associated with achieving an execution in a particular market center."[5] The Commission has also expressed this concept in the context of the options markets, in which it declined to apply a market-wide trade-through rule.[6]

Accordingly, while price is of unquestionable importance in trade execution, it is not, and should not be, a singular measure of best execution for every type of trade. The investor entering a small order may construe best execution as speed, preferring the certainty of an immediate execution in a volatile security to the potential for insignificant price improvement (or disimprovement). A large investor, meanwhile, may define best execution in terms of market impact as it relates to the overall price of an entire order. The codification of a trade-through rule, however, would limit the options available to these investors, placing price above all other considerations and needlessly inhibiting the growth and continued progression of our markets. To use the Commission's own words, "the scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices."[7] Consequently, the Commission should refrain from enacting a trade-through rule that would needlessly impede the evolution of best execution.

Application of the Trade-Through Rule to Nasdaq Securities

Should the Commission determine that a trade-through rule is absolutely necessary, we would strongly oppose the extension of such a rule to the market for Nasdaq securities. To the contrary, the Nasdaq market is an illustration of why such a rule is unnecessary. We are unaware of the existence of any empirical evidence, in our own experience or offered within the Proposing Release, suggesting that retail or institutional customers have been harmed by the absence of a trade-through rule within the Nasdaq market. In fact, in asserting the position that a "trade-through rule would encourage the use of limit orders, aggressive quoting, and order interaction and help preserve investors' expectation that their orders will be executed at the best displayed price", the Proposing Release prudently observes that, despite the lack of a trade-through rule "the Nasdaq market does not appear to lack competitive quotations in the most actively traded securities."[8]

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[5] *Notice of Filing of* Proposed *Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation*, Securities Exchange Act Rel. No. 42450 (Feb. 23, 2000), 65 FR 10577, 10584 (Feb. 28, 2000).

[6] ". . . investors may value speed, size, or liquidity over price." *Firm Quote and Trade-Through Disclosure Rules for Options*, Securities Exchange Act Rel. No. 43591 (Nov. 17, 2000), 65 FR 75439, 75444 (Dec. 1, 2000).

[7] Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48322-48323 (September 12, 1996).

[8] Proposing Release at B.2.c.

Opt-Out Exception

Nevertheless, if the Commission determines that a uniform trade-through rule is necessary across all equity markets, the rule must contain certain minimum exceptions that will allow the market to continue to function in an efficient manner. Foremost among these necessary exceptions is an opt-out provision that would provide sophisticated customers with the ability to define best execution on their own terms. This point was articulated by the representative of a significant institutional investor during the recent Regulation NMS Hearing, who stated that best execution is "best all-in price to us. . . . And so we need to be able to exercise our judgment to go where we want and when we want using our fiduciary responsibility and our understanding of best execution."[9]

As previously stated, best execution is a flexible concept for investors and thus not all investors should be presumed to value price as the foremost element in execution quality. In addition to price, speed, and certainty of execution, an increasing number of clients prefer to use VWAP orders that spread executions out over an entire day. Others seek the commitment of capital by their broker through the use of block executions or price guarantees. Implementation of a trade-through rule without a suitable opt-out exception would unduly impair the ability of sophisticated investors to utilize these effective execution alternatives.

Therefore, in addition to a general opt-out exception, we would propose the use of absolute exceptions for specific types of orders including (i) block orders; (ii) stop orders, (iii) VWAP orders; (iv) portfolio and basket trades; and (v) other not held orders where a broker-dealer commits capital or crosses matching orders to provide liquidity and decrease volatility in the market. Those who enter orders of this type are inherently less concerned with the price of individual executions or the current market price than in ensuring that the entire order is completed at a favorable overall price.[10]

While we fully support an opt-out exception, the proposed version, as drafted, would be burdensome to implement and administer. The requirement of obtaining investor opt-out consent on a trade-by-trade basis, especially with regard to institutional or well-informed individual investors, is impracticable. While such a requirement may be appropriate for most retail investors, it would serve no purpose other than to delay the executions of sophisticated investors. For that reason, an institutional or well-informed individual investor should be permitted to provide standing instructions with a broker-dealer as to whether it would prefer to opt-out of the trade-through rule.

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9 Statement of Scott DeSano, Fidelity Investments, Regulation NMS Hearings, April 21, 2004, New York City ("Regulation NMS Hearings"). Transcript available at http://www.sec.gov/spotlight/regnms/nmstrans042104.txt.

10 UBS would support the use of a trade reporting modifier for such orders to appropriately identify to the market that they have little or no bearing on the current market price.

Of additional importance is the burden of the proposed requirement to disclose the best price when opt-out is elected. While this would impose significant technical, financial and practical burdens to develop systems capable of disseminating this information, the disclosed information would be of negligible value – it would be incapable of accounting for the depth and liquidity of the market or the changes to the NBBO throughout the course of executing the order. A written statement indicating that the NBBO was available at a single price for 100 shares for a fleeting moment would be of insignificant informational value, and may even be misleading when evaluating the execution performance of a large order.

Manual Market/Manual Quote Exception

The rules set forth in the Proposing Release would permit a fast market to trade-through a better price displayed on a slow market up to the "trade-through limit amount." The exception is intended to reflect the comparative difficulty of accessing market quotes from non-automated markets, and to adjust the trade-through requirements accordingly. The Supplemental Release recasts this proposal by suggesting that the distinction should not be between a fast and slow market, but instead between automated and manual quotes. The *Supplemental Release* also requested comment as to whether there should be any limit on the amount by which a market should be allowed to trade through a manual quote.

We believe that the Commission recognized the appropriate distinction in the Supplemental Release as being between automated and manual quotations. The designation of a market as being "fast" or "slow" is of less importance than to simply know that a quote is firm for its full size, is electronically accessible, and immediately executable. Absent these characteristics, no market participant should be required to access the quotation in conformity with the proposed trade-through rule, without regard to *de minimis* levels. Anything less than this standard would hold the markets hostage to the slowest manually operated market.

In addition to being excluded from the trade-through rule, quotations that fail to meet these "automatic" standards should not be included in the NBBO. In today's markets, they are not truly firm quotations. Many executions, both small and large, are based upon the NBBO, even if not executed in the market center displaying the NBBO. One example is the provision by many broker-dealers of automatic execution to small orders based on the NBBO. An NBBO that includes quotations that are not reasonably accessible to members for execution, not only provides a false indication of the best available price in the market, but may also negatively affect the prices at which orders are executed.[11]

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[11] The most obvious example of the fragmentation in the Nasdaq market is the recent decision by the American Stock Exchange ("AMEX") to trade Nasdaq securities. The AMEX specialists began quoting Nasdaq securities without first providing efficient electronic access to or immediacy of

We believe that the concept of automated quotations would be acceptable assuming the existence of a suitable indication that the quote was inaccessible on an automated basis and that any such indication could be quickly accepted and interpreted by electronic systems. Through such an indicator, broker-dealers and automated routing systems would be able to recognize and differentiate among accessible quotations, and appropriately omit inaccessible quotations from automatic routing algorithms.[12]

Defining Accessibility

Should the Commission adopt the uniform trade-through proposal and implement either an automated market or automated quotation standard, the final proposal should define such terms as they relate to immediacy in providing an automated response. In doing so, we believe that the Commission should consider imposing a minimum performance standard with respect to response times.[13] In our view, a market center must be able to provide an immediate and timely response for other market participants to be able to execute trades. If the Commission does not define the term "immediate," then we foresee lengthy and contentious disputes among market centers as to whether a market center is truly an "automated order execution facility," as defined by the proposal. We would further recommend that the Commission clarify that any established time frame is an outer limit, and that market centers must respond as quickly as possible.

Many commentators at the Regulation NMS Hearings questioned the degree to which speed was important in execution as compared to price. We believe that speed is critical to obtaining best price, not merely for the sake of speed, but due to the certainty of pricing afforded by fast executions. For example, if the best quoted market price is at a market providing automated, but slow, response times, a number of market participants

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execution against those quotations. The AMEX quotations were not immediately accessible except by the time-consuming and uncertain method of telephone calls. This development has created a perceived increase in the number of locked and crossed markets, as the AMEX quotations have not moved as quickly as the rest of the market. Although electronic access is now available in the AMEX market, there are continuing and substantial delays caused by this market due to the inability to automatically execute against AMEX quotations.

12 The Commission should ensure, however, that markets are not allowed to become inaccessible as a form of "backing away" from quotations simply to avoid liability in illiquid or volatile market conditions. The continued strict enforcement of specialist trading obligations and market maker firm quote obligations will be necessary.

13 We recognize, however, that there are significant risks with the Commission imposing minimum performance standards. In particular, we are concerned that market centers may not be motivated to compete on speed, with the result that the "floor" could become a "ceiling" (*i.e.*, as long as a market center satisfies the Commission's minimum performance standard, it may have little incentive to provide even more rapid response times). The markets, in effect, could unwittingly fall prey to what is known as the "Fleet Effect" in which "the fleet is said to go only as fast as the slowest ship." Efficiency of execution could be severely limited if the market execution time is slowed to an unreasonable level.

may direct orders to that quote before learning that another participant accessed the quotation first. While the other participants will receive a rejection notice that the quote has already been accessed, a slow responding market may cause the market participants to miss other available execution venues while awaiting the response. The ultimate result for the investor may be an execution at an inferior price. At the very least, the Commission should clarify that a market center or market quotation that does not provide an immediate response will be excluded from the trade-through rule, regardless of whether the market center or market quotation generally provides automatic execution.

Costs of Implementation

Within the Proposing Release, the Commission provides rough estimates concerning the costs of implementing a trade-through rule. The one-time cost upon the industry is estimated to be nearly $250 million, with annual costs exceeding $75 million.[14] These are staggering costs that may, in fact, be significantly undervalued. Not only do we believe that the benefits of this proposed rule do not outweigh the burdens, but we are at a loss to identify any quantifiable benefits that could justify such an enormous expenditure of resources.

In summation, we believe that the trade-through rule is a well-intentioned, but inappropriate proposal that would prove to be ultimately detrimental to the U.S. equities markets. The intended benefits of this proposal would serve only to emulate the protections already afforded by best execution standards, and if adopted would have the detrimental effect of reducing investor choice in execution alternatives. We think that the Commission was wise to alter its focus from automated markets to automated quotes, which for the reasons noted above, leads to the conclusion that a trade-through rule is unnecessary. We urge the Commission to reconsider this proposal, as well as to eliminate the existing trade-through rule, and to emphasize the principal of best execution.

B. INTERMARKET ACCESS

Non-Discriminatory Market Access

Regulation NMS establishes a uniform market access rule that attempts to provide non-discriminatory access to the best prices displayed by market centers, but without mandating inflexible, "hard" linkages such as the Intermarket Trading System ("ITS"). UBS supports this approach, in particular supporting the view that direct access, rather

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[14] Proposing Release; Text surrounding notes 97-108.

than hard linkages is the preferred approach. Required hard linkages between markets raise substantial questions about the maintenance costs and governance of the linkages, in addition to ensuring their continued technological development. These issues can be avoided altogether by mandating and developing standards of direct access instead. Various vendors provide direct access to market centers through smart routing technologies and have been found to be an efficient and effective way of maintaining these linkages.

The Commission must be cautious, however, about the costs imposed on market participants of providing direct access to peripheral market centers that do not trade significantly or actively in particular securities. This issue could be addressed by requiring indirect access through another market center or ECN for small or start-up market centers. The Commission has proposed to lower the trading threshold that triggers the fair access standards of Rule 301(b)(5) of Regulation ATS from 20% to 5% of the average daily volume in a security. We believe that the Commission's proposal strikes an appropriate balance between costs and benefits and, therefore, endorse this proposal.

Access Fees

Regulation NMS also establishes an access fee standard. This standard - designed to promote a common quoting convention - is intended to harmonize quotations and facilitate the ready comparison of quotes across the national market system. The proposal establishes a maximum fee standard for all market centers and broker-dealers that display attributable quotes through self-regulatory organizations ("SROs"). Specifically, access fees would be capped at $0.001 per share, and the aggregation of this fee would be limited to no more than $0.002 per share in any transaction. We support this approach and, in particular, support the ability of all market participants to charge access fees on an equal basis.

Locked and Crossed Markets

The proposed rule requires each SRO to establish and enforce rules requiring its members to avoid locking or crossing the markets and prohibiting them from engaging in a pattern or practice of so doing. UBS supports this approach, as locked and crossed markets impair the efficiency of the markets and the ability of brokers and others to provide best execution for their customers' orders. SROs should be required to take action immediately to unlock/uncross quotations within their markets and to work with other markets to achieve these same objectives. Such an intermarket capability would be possible through the use of automated executions, automated quote updates and immediate response time. The Commission should, however, provide an exception for an automated market that locks or crosses a non-automated order execution facility. Failure to provide such an exception would impede automated markets and once again subject the marketplace to the inefficiencies of the slowest market.

C. SUB-PENNY PRICING

Regulation NMS bans sub-penny quoting in most securities. Specifically, it prohibits market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in pricing increments of less than a penny in national market system stocks, other than those with a share price below one dollar.

While we believe strongly in minimum interference with competitive factors, we generally agree with this approach. Trading increments of less than one penny in all but the most actively traded securities will increase possible execution points and, thereby, negatively affect price discovery, liquidity and depth of market. As a result, order execution, particularly of larger orders, will be more difficult, inefficient, and ultimately more expensive. Sub-penny quotations also would increase the issue of flickering quotations because of the frequency of potential changes to quotations.

In contrast, we believe that sub-penny executions should be allowed to continue. Price improvement, average price trades and midpoint pricing are examples of legitimate trades that should be allowed to continue at sub-penny increments.

D. MARKET DATA

UBS supports the concept that there should be a fair and equitable formula for distribution of revenue that does not result in market distortions. As proposed, allocating between dollar volume of qualified trades, SRO quoting share and NBBO Price Improvement Measures seems to be a fair method of allocation. However, we believe that if the Commission elects to implement this formula, it must ensure that the appropriate resources are available to formulate and periodically review the methodologies for allocating market data revenues. It will be critically important to avoid any approach that may introduce subjective standards that can be "gamed" in the allocation of revenues.

Regardless of methodology, the cost of SRO regulation is an important issue for which the Commission and the SROs share responsibility. Certainly, the SROs will need appropriate resources to discharge their regulatory functions, but, in the absence of market discipline, regulators and SROs must ensure that their collection of revenues and allocations of revenues to different regulatory functions maximize investor protections at a reasonable cost. To ensure the reasonableness of such costs and the use of market data revenues, we would also encourage the Commission to bring transparency to this process to allow market participants to know how and where these fees are being utilized.

III. CONCLUSION

Proposed Regulation NMS is another important step in the Commission's ongoing effort to modernize the securities markets to meet the current challenges resulting from technological and other changes. Subject to the specific comments set forth above, we support the Commission's efforts and welcome the opportunity to respond to any questions that may arise from our views expressed in this letter. Please direct any inquiries to our Legal Department, attention Scott W. Anderson, at 203-719-6974.

Sincerely,

Huw Jenkins
Managing Director
Head of Equities for the Americas

CC:
Hon. William H. Donaldson, Chairman
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation