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August 10, 2004

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

Re: File No. S7-10-04.

Dear Mr. Katz:

The Philadelphia Stock Exchange ("Phlx" or "Exchange") welcomes the opportunity to offer our comments on the Securities and Exchange Commission's ("Commission") Regulation NMS proposal.[1] We appreciate the challenge the Commission has undertaken to modernize the regulatory framework for the national market system in a comprehensive manner that addresses the important market structure issues facing the U.S. equity markets. As a general matter, we agree with the Commission's overriding goal to promote faster, more efficient markets through greater market use of automated trading technology. Historically, the Phlx, like other regional exchanges, has been a leader in the development of automated order routing and executions systems. The Phlx, in fact, is actively pursuing ways to expand automation in our equity markets, in a manner that complements our floor auction.

Nevertheless, we would like to raise several issues of concern.

1. Clarification That Proposed Rule 610 Applies To Equities and Not Options

Proposed Rule 610 is intended to promote uniform access to published quotations. It contains three substantive parts that would: (i) require market centers to provide non-members or non-subscribers with access to their quotations on terms that are not unfairly discriminatory; (ii) regulate the access fees that market centers may charge and (iii) require self-regulatory organizations ("SROs") to adopt rules preventing their members from locking and crossing the quotations of other markets. Based on the discussion in the NMS Release, it is our understanding that each of these parts is intended to apply solely to NMS stocks[2] and not to options. As currently drafted, though, Rule 610 could be read

[1] Securities Exchange Act Release No. 49325 (February 26, 2004) 69 FR 11126 (the "NMS Release"); Securities Exchange Act Release No. 49749 (May 26, 2004) 69 FR 30142.

[2] Proposed Rule 600(b)(44) defines NMS stock as "any NMS securities other than an option." Proposed Rule 600(b)(43) defines NMS security as "any security or class of security for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options."

more broadly to apply to listed options as well, because the rule does not identify the types of securities it covers. Thus, we wish to confirm that Rule 610 is limited in application to NMS stocks, and ask the Commission to revise the rule to make this explicit.

2. Non-Discriminatory Access: Proposed Rule 610(a)

Proposed Rule 610(a) would prohibit "quoting market centers" and "quoting market participants" from imposing "unfairly discriminatory terms that prevent or inhibit a non-member, non-customer, or non-subscriber" from accessing their quotations or executing orders through their members, customers or subscribers. As defined, "quoting market center" covers any SRO that provides an order execution facility (i.e., the exchanges and Nasdaq) and "quoting market participant" covers any broker-dealer publishing quotes through an SRO view-only quotation facility (i.e., the NASD ADF) but not through a quoting market center.

We agree that no market center should restrict indirect access to its published quotations through unfairly discriminatory terms. Indeed, that is a standard we already follow and for good reason: we want to attract order flow to our markets, not discourage it. SRO markets should not be required, though, to treat all classifications of non-member users in an identical manner. In particular, our rules, like those of other exchanges, make a number of distinctions between non-member broker-dealers and public customers. We believe that the Commission's proposal would still allow an exchange to treat different classifications of non-member market users in different ways, so long as those differences do not unfairly discriminate against any one class. We wish to confirm that our reading is correct.

We also wish to confirm that the proposed Rule would not be read to prohibit exchanges from maintaining membership or the requirements of membership as a prerequisite to direct access to its facilities. For instance, in order to receive and maintain membership and then as members, to access quotations and execute orders, persons may need to complete certain forms, pass certain examinations, pay certain fees, subject themselves to disciplinary jurisdiction, use approved types of technology to access the market, etc. These requirements are currently the subject of rules filed by the exchanges with the Commission and must meet current statutory requirements of fairness and non-discrimination.

3. Access Fees: Proposed Rule 610(b)

We understand that the issue of ECN access fees has been a prevalent and controversial one in recent years. Nevertheless, we object to the Commission's proposal to cap the access fees that quoting market centers, quoting market participants and other broker-dealers (under specified circumstances) may charge individually or in the aggregate. The Commission should refrain from such ratemaking activity, except as a last resort. Ratemaking is a highly intrusive, and widely discredited, form of government regulation.

The Commission's 1999 Concept Release on Regulation of Market Data Fees and Revenues illustrates in chilling detail the complexities of trying to micro-manage the fees that markets impose.

This current foray into ratemaking is no different. It is likely to lead the Commission into a quagmire of interpretive issues and arbitrary judgments. Regulation NMS, for example, does not define "access fees," leaving open the types of SRO fees that could be covered by the caps. The NMS Release assumes that SRO transaction fees are covered, but what about trade comparison fees or regulatory fees? Exchange fee schedules are varied and complex; the term "access fee" is quite unclear in the exchange context. We also question why the Commission seemingly equates exchange transaction fees with ECN access fees. Unlike ECN fees, exchange transaction fees are subject to the Commission's review under statutory standards of fairness and the Commission's ability to abrogate such fees; unlike ECNs, exchanges have statutory obligations that require an "equitable allocation of reasonable dues, fees, and other charges among its members . . . and other persons using its facilities."[3] The dispute between ECNs, ECN users and certain broker-dealers should be addressed directly and precisely. Casting a wide net to capture exchange fees is overbroad and unfair.

Moreover, government ratemaking, by its very nature, is anti-competitive. Section 23(a)(2) of the Securities Exchange Act of 1934[4], added with the 1975 Amendments, directs the Commission to consider the impact that its rulemaking would have on competition, and prohibits the Commission from adopting a rule that "would impose a burden on competition not necessary or appropriate in furtherance of the purposes" of the Act. The Commission believes that adoption of this rule, creating a cap on fees that exchanges and others may charge, would "encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among marketplaces thereby increasing efficiency and competition."[5] On the contrary, we believe that such ratemaking, if enacted, would denigrate the efficiency of the marketplaces that the Phlx and other exchanges have created with competitive, statutorily consistent fees and distort the current, robust landscape in which marketplaces compete with each other in the area of fees charged to our users. We can find no compelling justification for the Commission to take such intrusive action, nor do we believe the Commission can justify the proposal under the standards of Section 23(a)(2).

4. Market Data Revenues: Proposed Revisions to Market Data Plans

The Commission is proposing to replace the formulas in the CTA[6] and Nasdaq UTP[7] Plans for allocating market data revenues with a much more complicated formula

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[3] 15 U.S.C. § 78f(b)(4).
[4] 15 U.S.C. § 78w(a)(2).
[5] See NMS Release, supra, at p. 137.
[6] See Securities Exchange Act Release No. 10787 (May 10, 1974), 39 FR 17799 (approving a joint plan between the existing national securities exchanges and the National Association of Securities Dealers, which became the Consolidated Tape Association ("CTA") Plan).

designed to encourage aggressive quoting. The new formula will be costly to implement, without any offsetting benefits to justify such expenditures. For example, while the formula is designed to encourage and reward an exchange for aggressively quoting, it is possible that such increased revenue from the formula simply may be transferred to the CTA and Nasdaq UTP Plan processors in the form of increased payments by the exchange to the processors for the requisite increased use of quoting capacity necessary to generate those quotes. In addition, the complicated nature of the formula will likely create "gaming" opportunities that will create market distortions. Further, it is inappropriate for the Commission to seek to influence quoting behavior through financial incentives because it is unfair to reward aggressive quoting, when exchanges, by Government mandate, must commit financial resources, derived in part from market data revenues, to collect and disseminate quotes[8] and to operate their market surveillance programs[9], regardless of how often their quotes establish or join the NBBO, how large the such quote is or how long those quotes represent the inside market. For these reasons, we urge the Commission not to adopt its proposed market data revenue formula.

5. Proprietary Dissemination of Market Data: Proposed Revisions to Display Rule

The Vendor Display Rule (Rule 11Ac1-2, to be redesignated as Rule 603) requires market data vendors and broker-dealers, when providing their customers with trade data from any one market center, to provide them with the consolidated last sale and quotation data from all reporting market centers. This consolidated market data is a critical component of the national market system, without which effective inter-market competition could not exist. The Commission is proposing to limit the consolidated quotation information that vendors and broker-dealers must provide to the prices and sizes of the NBBO quotes along with market identification: vendors and broker-dealers would no longer have to make available the consolidated montage of all best-priced quotations provided by the reporting market centers.

We oppose this change because it would deprive investors of a ready means to compare the depth and liquidity that competing markets, including the Phlx, offer in a security. In today's national market system, where NBBO quotes often lack any meaningful size, it is just as important for investors and their brokers to know which markets are quoting near the NBBO and at what size as it is for them to know which markets are quoting at the NBBO. The Commission should be seeking to promote market transparency, not impair it.

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[7] See Securities Exchange Act Release No. 28146 (June 26, 1990), 55 FR 27917 (July 6, 1990) (approval order of the Reporting Plan for Nasdaq –Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis ("Nasdaq UTP Plan")).

[8] See 17 CFR 240.11Ac1-1.

[9] See 15 U.S.C. § 78f(b)(1) and 15 U.S.C. § 78s(g)(1)(A).

Conclusion

The Exchange supports the Commission's goal to modernize the regulatory framework for the national market system, and in a manner that will encourage market centers to provide faster, automated trade executions. We urge the Commission, though, to reconsider the features of its proposal relating to access fees, allocation of market data revenues and dissemination of consolidated quotations. We also ask the Commission to provide another round of public comment before adopting final rules, as it is critical that interested parties be provided a full opportunity to evaluate and express their views on such an important rulemaking initiative.

We may supplement our comments. We are happy to discuss our comments with the Commission or members of the Commission's staff.

Sincerely,

Edith H Hallahan /SD

Edith H. Hallahan
First Vice President
Deputy General Counsel

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