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Morgan Stanley

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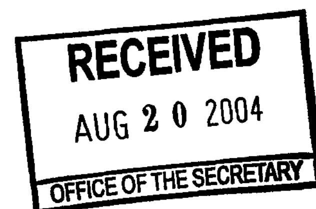

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0609

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

Dear Mr. Katz:

The overarching objective of equity market structure reform should be to create economic incentives to *foster* rigorous competition in all corners of the U.S. equity capital markets. We emphasize "foster" as it should not be the role of government to dictate precise standards whose near-term obsolescence is assured, and whose enforceability by regulatory authorities is impossible. Rather, the SEC should lay out a set of broad principles and guidelines equally applicable to all segments of the equity trading space, and then let *market* forces shape market structure within that framework. What we are principally referring to are core principles that recognize the critical importance of a level playing field and informed investor choice within a framework ultimately designed to advance the SEC's mandate of investor protection and market integrity.

It is clear that a new and modern concept of a "national market system" is needed that not only reflects the evolution of the market structure to where it is today but is also robust enough to carry the markets forward into the future. It is only through broad, nimble standards that such reform can have any meaningful, lasting effect.

Morgan Stanley & Co. Incorporated[1] believes in large part that the SEC's proposed Regulation NMS[2] accomplishes these objectives, with a few important caveats and constructive comments detailed in this submission. Regulation NMS, consistent with investor protection, seeks to set the bar even higher for the duty of best execution by establishing a market-wide trade-through prohibition. Recognizing, however, that quotes accessible only through manual or low-tech means in the listed markets subject to the current ITS trade-through rule have hindered the efficiency and competitiveness of the market for listed stocks, the SEC has rightfully

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[1] Morgan Stanley & Co. Incorporated is an SEC-registered broker-dealer and a member of the NASD and all U.S. stock exchanges.

[2] Securities Exchange Act Release No. 49325 (February 26, 2004) (the "Release"); supplemented by Securities Exchange Act Release No. 49749 (May 20, 2004) (the "Supplemental Release").

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qualified the trade-through prohibition as applying only in the context of quotes that are "automatically" accessible. The SEC exercised appropriate restraint in choosing not to define what is "automated" beyond certain easily ascertainable standards that pertain to methodology of response through technology. Importantly, the SEC declined to define how fast is "fast," which we believe is critical to maintaining a vigorously competitive environment in which order execution facilities ("OEFs") can compete for order flow on a number of levels, including speed.

The SEC also provided for an "opt-out" to enable informed investors and broker-dealers alike to waive trade-through protection to the extent a market with "automated" quotes nonetheless is materially inferior in non-price related execution quality (including, in particular, time of response). A trade-through rule with an opt-out exception represents a carefully considered balance between protecting resting orders on away markets and allowing investors and broker-dealers the freedom to "vote with their feet" if they are dissatisfied with the service they are getting from a particular market center. Ideally, the opt-out would hang like the Sword of Damocles over the collective heads of all market centers that are slow to respond to the demands of the marketplace. The mere existence of the opt-out, we believe, will compel markets to compete and eliminate the complacency that results inevitably from regulatory routing mandates.

It is disheartening, therefore, to read press reports that the SEC is considering eliminating the opt-out provision, as without it Regulation NMS loses much of its appeal in our view and becomes another example of command and control regulation. In particular, we vigorously object to claims made by opponents of the opt-out that it would discourage placement of limit orders. Experience has demonstrated that limit orders will and should find their way to markets with high fill rates. We also take serious issue with the contention that use of the opt-out would violate one's duty of best execution, where the opposite is the case if in the course of chasing a relatively inaccessible price the order executer ultimately executes at a worse price.

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Following are the views of Morgan Stanley & Co. Incorporated on specific aspects of Regulation NMS, all of which are discussed in greater detail below:

- We support a market-wide trade-through prohibition applicable to all national market system securities, with the following qualifications:
    - We agree with proposed Regulation NMS that trade-through protection should only extend to automated quotes;
    - We disagree with proposed Regulation NMS that manual quotes be given *any* trade-through protection, and indeed believe manual quotes should not be included in the consolidated national best bid or offer, reflecting our view that the

incidences of manual quoting should not adversely affect order handling and trade execution;

- We believe that only Nasdaq's top of book should be extended trade-through protection, consistent with the manner in which the exchanges and other market centers would be treated;

- We fully support the concept of an opt-out exception to the trade-through rule as proposed by Regulation NMS, without layering on arbitrary categories of orders and investors for which the opt-out would be available; and

- We do not support the back-end disclosure requirements proposed in connection with the opt-out, as the costs of production would so exceed the benefits that they would effectively eviscerate the opt-out exception altogether.

- We generally support the access standards set forth in proposed Regulation NMS, and in particular agree that the SEC should not dictate response times as they would likely become obsolete quickly and would be impossible to surveil for or enforce. We do, however, believe that market participants' ability to charge access fees should be treated uniformly.

- We support the proposed prohibition of sub-penny quoting.

- We agree with the SEC's attempt to reapportion market data revenues to reward markets that contribute to price discovery and to disincentivize, if not flatly prohibit, market data rebates and other questionable business practices. Nonetheless, we believe the SEC has only "rearranged the deck chairs" and has not addressed the most fundamental problem with market data today – the bloated size of the market data revenue trough.

I. THE TRADE-THROUGH PROPOSAL

A. General Support for Trade-Through Protections

Morgan Stanley believes that the core components of the trade-through rule as proposed in Regulation NMS[3] should be maintained for listed stocks and be extended fully to Nasdaq securities. As a general matter, trade-through protections provide important benefits to the market place. These benefits include the promotion of best execution, integration of competing markets and incentives for competitive displays of liquidity (posting of limit orders). We strongly agree with the Commission, however, that the current trade-through rule in effect for listed markets needs to be drastically modified to reflect the fundamental changes that have taken place in the financial markets since the 1970s. These changes include quantum leaps in computing power, order routing technology, linkages, execution technology and the disintermediation of central communication facilities.

Despite our general support for the trade-through rule, experience demonstrates that trade-through protection may stifle competition across markets and adversely impact market participants' ability to choose the appropriate venue to obtain best execution for their orders. The mere public dissemination of a quote should not result in trade-through protection for that originating market if the quote is inaccessible or represents a quote that no longer exists. A trade-through rule that protects manually accessible quotes seriously distorts competition by protecting less efficient and less innovative markets and providing disincentives to markets to improve their response times, liquidity and functionality. The advent of electronic trading systems has made the current trade-through rule ill-suited to today's marketplace. It forces markets to be held hostage to the slowest, least accessible quotes disseminated by the least efficient markets and drags the overall market down to the capabilities of the lowest common denominator. In the listed market, this has hindered the entry of ECNs as viable competitors and allowed slower, less efficient markets to maintain market share at the expense of all market participants' order routing choices and execution quality. In the Nasdaq market, application of the current version of the trade-through rule would enable slow, inaccessible and ephemeral UTP quotes to undermine an essentially electronic marketplace. Consequently, as discussed further below, we strongly support the automated quote/manual quote distinction in the application of the proposed trade-through rule.

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[3] As proposed, Rule 611 of Regulation NMS would require each exchange, the NASD and any OEF to establish, maintain and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market, with several exceptions set forth in the Rule. The proposed trade-through prohibitions would apply to any orders for the account of a broker-dealer or a customer, as well as any orders that an OEF executes internally within its market, whether or not that market posts its best bid and offer in the consolidated quote system. The trade-through restrictions would not apply, however, to bids or offers that are not disseminated pursuant to an effective NMS Plan.

The proposed trade-through rule requires each exchange, OEF and the NASD to establish, maintain and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market. We believe instead that the Commission should adopt a single, uniform trade-through rule applicable across all markets. This would allow the SEC's goal of establishing uniform trade-through principles applicable across all markets to be more easily achieved.

We note that much of the current debate regarding the trade-through rule centers on "manual" versus "automated" markets or quotes – narrowing the discussion to one of floor-based markets vs. electronic ones. We believe that this is an overly simplistic approach that fails to take into account the changing nature of technology and innovation in the marketplace. Regardless of how a market operates, whether through a floor-based system, a purely electronic system or a hybrid model that incorporates an electronic "trading crowd", what is important is that the quotes disseminated by that market into the public quote stream are "real" – that is, they may be freely accessed in an automated fashion. Markets should remain free to adopt whatever model they choose to execute transactions within their own market. However, when their chosen method of operation slows down and obstructs the rest of the market, preventing market participants from achieving their optimal execution strategies, that market must yield for the overall good of the marketplace.

In implementing the trade-through rule, we believe that no justification exists for distinguishing between exchange-listed and Nasdaq stocks. We believe that uniform regulation across markets should be the norm and applaud the Commission for moving in this direction with respect to both Regulation NMS and Regulation SHO. As the Nasdaq and exchange-listed markets have evolved, the historical justification for disparate treatment between markets no longer exists. At the time of the 1975 Amendments to the Exchange Act establishing a national market system, Nasdaq securities were traded over-the-counter through a large number of dispersed, unlinked dealers. In contrast, listed stocks were traded primarily on a small number of exchanges. Given the state of the markets and then-existing technology and connectivity constraints, it was reasonable for the SEC to focus on linking the listed markets through a trade-through rule (via ITS) and excluding Nasdaq stocks entirely.

Today, however, we believe that the Nasdaq market model represents the more instructive example. Today's Nasdaq demonstrates the power of technology to link markets in a highly efficient manner, with market centers such as the ECNs and SuperMontage competing aggressively for market share. This competition has resulted in dramatic reductions in execution speeds and lower costs. While Nasdaq lacks a central pool of liquidity, it largely functions as a virtual order book by providing nearly instantaneous executions at the publicly disseminated quotes of each quoting market participant. Trade-throughs in listed stocks between the NYSE and a regional exchange should be treated no differently than trade-throughs in Nasdaq stocks between an ECN and a competing exchange or SuperMontage. While exchanges may operate with different trading functionalities than ECNs and dealers, this is merely the manifestation of a

choice of different business models. These different business models should be free to compete for market share in the trading of fungible securities in the same manner, irrespective of the designated "primary" market.

Consequently, we also believe the trade-through rule should apply equally to all NMS stocks, including ETFs. For this reason, there is no need to perpetuate the Commission's current temporary *de minimis* exemption from the trade-through rule for trading in certain ETFs. One of the rationales for this exemption was that the ECNs on which these instruments were traded provided faster, and more certain, executions than manual markets. If the Commission adopts the automated quote and opt-out provisions of the trade-through rule, there will be no need for a continued *de minimis* exemption solely for these products.

B. Automated Quote Exception

Recognizing that certain investors value speed and/or certainty of execution over the possibility of obtaining a slightly better price on another market, and taking into account "the comparative difficulty of accessing market quotes from non-automated markets,"[4] the Commission proposed an exception to the trade-through rule that permitted automated *markets* to trade through quotes displayed by non-automated markets by *de minimis* amounts. One of the sticking points of the original proposal, however, was that certain automated markets might also provide manual quotes in certain instances. Consequently, the Supplemental Release proposed an automated *quote* exception that would exclude quotes that are not immediately accessible in an automated fashion from trade-through protections.[5]

We agree with the suggestion in the Supplemental Release that the distinction should be one of automated versus manual *quotes*, not *markets*. This would enable markets to choose a structure that best suits their and their customers' and members' needs. For instance, one market could be wholly electronic at all times and could choose to meet whatever standard the Commission adopted so that all of its displayed quotations/orders would be considered "automated" for purposes of the trade-through rule. Another market may choose to adopt a hybrid system containing both automated and manual elements. Those quotes subject to automatic execution could be considered "automated" while quotes obtained during a manual auction process would not be. The important aspect of this distinction is that the individual market continues to choose its own structure under the regulatory framework, and, more importantly, the market participant routing the order maintains the power to choose the appropriate venue for its order.

In order to avoid disadvantaging certain market participants or potentially encouraging manipulative activity, the Commission should establish appropriate standards for when and how

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[4] Release at 11140.

[5] Supplemental Release at 30143.

an automated market could convert a quote from automated to manual. These guidelines should also set forth what steps should be taken with respect to those orders already received by the market when it converts from automated to manual quoting. For example, a floor-based market that is considered an automated market by virtue of an automated execution system, may wish to shift to a manual quote mode in order to assemble and execute a block trade. Specific, clear guidelines and enforcement mechanisms are needed to prevent market participants from taking advantage of both existing orders on the market's order book and orders that may be received subsequent to the quote changing to manual. Markets that convert their quotes from automated to manual should be required to reject immediate-or-cancel (IOC) orders received when they are in manual mode. In addition, in order to incentivize markets to limit the amount of time that their quotes are manual, markets should be precluded from receiving any credit for executions in a manual mode – both in calculating market share and for market data revenue purposes.

We suggest that the Commission employ a simple, uniform and non-time-specific standard for designation of an "automated" quote. As long as a quote can be automatically accessed – that is, the market displaying that quote must accept, process (execute, reject or route to an automated quote) and transmit a response for an incoming order in an automated manner – without any manual intervention, it should be deemed an automated quote. The Commission should require markets to identify whether a particular quote is automated or manual, such as with an identifier if the quote is a non-automated quote, at all times the quote is displayed.

Beyond this general "automated quote" formulation, we urge the Commission not to adopt more precise standards, such as a specific speed standard, but rather to let competition drive automated markets to provide the best response time. If the Commission were to adopt a specific time standard, that standard would inevitably become the lowest common denominator. In that case, there would be inadequate incentives for markets (especially floor-based markets) to "build the better mousetrap" to attract orders. Whether every market was responding to every order within the allotted time frame also would be difficult for the SEC to police. Rather, markets that offer automated quotes that are materially slower than other markets' automated quotes should be driven by competitive forces to respond more quickly to incoming commitments. As explained more fully below, the only way to ensure robust competition and continuous improvements across all market centers is for the Commission to enact a workable opt-out provision.

It is important that the Commission establish strong disincentives for manual quotes. Consequently, not only do we support affording trade-through protection *only* to automated quotes, but we believe strongly that manual quotes should be denied *any* standing in the NBBO. Quotes that are slow or difficult to access must not dictate the NBBO because they are not subject to automatic execution (*i.e.*, are effectively inaccessible). Including such inaccessible quotes in the NBBO results in a misleading NBBO to market participants. Indeed, if a quote can be traded through in favor of an automated quote, why should it be deemed the "best" quote and be disseminated as such? Furthermore, because numerous actions and regulatory responsibilities are based on, or at least must take into account, the NBBO (*e.g.*, SRO surveillance of best

execution obligations, Rule 11Ac1-5 reporting, automated execution systems, etc.), the NBBO should not include non-automated quotes.

Given our strong preference for automated quotes and their overwhelmingly positive impact on the market, we recommend that the SEC eliminate the proposed *de minimis* limitation on trade-throughs under the automated quote exception. An automated quote should be able to trade through a manual quote for any amount, subject, of course, to the client's instructions and the broker-dealer's best execution obligation. If a quote does not have standing for trade-through or best execution purposes, and should not be part of the NBBO, it also should not act as an artificial limitation on the price of a transaction that could otherwise immediately take place. Otherwise, inefficient or non-competitive markets with stale or unreliable quotes will continue to act as bottlenecks in the plumbing of the national market system. Ultimately we believe, given the current dynamics of the equity markets and the technology currently available, the SEC should permit market centers to maintain manual quotes only if such quotes are walled off from the national market system, and so long as economic forces and best execution obligations still apply to the operation of such market centers.

C. Nasdaq Market Trade-Through

Under the proposal, trade-through protections will be extended to the best bid and offer of any OEF that is disseminated pursuant to an NMS Plan.[6] With respect to Nasdaq securities, this would include the best quotes of (i) each exchange that trades a Nasdaq security, (ii) each registered Nasdaq market maker or ATS that provides its best quotes to Nasdaq, and (iii) each ADF quoting market participant that provides its best quotes to the NASD. As a result, the best quotes of each individual market maker and ATS in the Nasdaq SuperMontage would be protected by the trade-through rule, but nothing beyond the top of the book in every other market, whether for Nasdaq or listed securities, would be afforded such protection.

To equalize the protections available to all market participants, we believe the Commission should treat SuperMontage as a single market for purposes of the trade-through rule, instead of treating each individual Nasdaq market maker as a separate quoting market participant. As such, the displayed top of the Nasdaq book should be treated as its own automated quote. This not only comports with the treatment of the top of the book of ATSs and exchanges under Regulation NMS as single quotes for purposes of the trade-through rule, but also is necessary to comport with the operation of SuperMontage. Quotes in SuperMontage often contain undisplayed reserve size. An order larger than the displayed size of the best quote will execute against the reserve size before moving on to quotes from other market participants on SuperMontage. The operation of SuperMontage renders the concept of protecting each

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[6] An OEF is defined in proposed Rule 600(b)(50) 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."

market maker's quote illusory.[7] The SEC could remedy this situation by treating Nasdaq's displayed top of book as the sole automated quote for that market for trade-through purposes.

D. The Opt-Out Exception

Morgan Stanley strongly supports the "opt-out" exception to the SEC's proposed prohibition on trade-throughs. Although the opt-out provision has often been miscast in terms of speed versus price, our positions described below will demonstrate that the opt-out can be used to improve the price of executions and enhance market competition and innovation.

As a preliminary matter, we wish to make clear that, *ideally*, the opt-out would be a rarely used tool. In a perfectly automated, synchronized and connected market system we recognize that there would be little or no need for an opt-out. Market participants would be able to see and immediately access the best price. The Commission has properly recognized, however, that such perfect standards do not exist and cannot realistically be imposed or regulated. The Commission has instead wisely sought to establish a framework that encourages market competition and innovation by including an opt-out exception to the general prohibition on trade-throughs. Specifically, the opt-out preserves and respects the informed freedom of choice fundamental to and inherent in our capital markets.[8] As described more fully below, this informed choice can then be exercised by market participants to satisfy their best execution and fiduciary obligations and to stimulate the free market competition necessary to compel excellence and innovation from order execution facilities.

1. The Informed Freedom of Choice Involved in the Opt-Out Encourages Best Execution

The Commission has long recognized and emphasized the multi-faceted nature of a broker-dealer's or fiduciary's best execution obligations. In its release proposing Regulation NMS, the Commission repeated the following factors as important in best execution analysis: (i) price, (ii) speed of execution, (iii) trading characteristics of the specific security, (iv) availability of accurate market data, (v) technology; and (vi) cost and difficulty of executing with a specific venue. The Commission has previously stated that price is not the sole factor in determining best execution:

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[7] For example, suppose the displayed bids in SuperMontage for stock ABC are $20.00 for 1,000 shares and $19.99 for 500 shares. If a firm agrees to commit capital to facilitate a customer's block sale of 20,000 shares at $19.98, it will send a sell order for 1,500 shares to SuperMontage to take out the displayed bids. It will then print the customer's block trade at $19.98. If there happens to be a hidden reserve size in SuperMontage of 1,000 shares at the $20.00 bid, however, the print of the customer's block trade at $19.98 would *still* cause a trade-through. Moreover, the market maker or ECN whose market was displayed at $19.99 would not afforded trade-through protection despite the intent of the rule as proposed.

[8] According to the Commission, "the opt-out exception would provide greater flexibility to informed traders." Release at 11138.

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> A broker must take price (including opportunities for price improvement) into consideration in determining where to route its orders for execution, but price is not the only criteria that a broker may consider. It may also consider factors such as the trading characteristics of the security involved and the cost and difficulty of obtaining an execution in a particular market center, among other factors (emphasis added).[9]

Broker-dealers and fiduciaries are responsible today for evaluating each of these factors in determining where to route orders for best execution. An opt-out from the proposed trade-through rule would enable them to continue to use their professional judgment as they do today in performing this evaluation. Morgan Stanley believes, therefore, that a trade-through prohibition without an opt-out exception would effectively make the displayed price the only factor in a best execution analysis, without regard to significant factors bearing on the accessibility of that price.

There are several flaws with this outcome. First, it does not guarantee that the best overall price will always be obtained, even where the price is from an automated quote within an automated market. The "available" price may be at a market that is difficult to access, that is materially slower than another market, that has little or not liquidity or that is not firm with its quotes. In addition, the price may move away while time is spent accessing this quote so that while the execution does not violate a trade-through prohibition, the overall price is worse than might otherwise have been obtained. Today, a market participant might make a reasoned determination not to trade with the "best price" because to do so would actually be inconsistent with its best execution obligations. Without the opt-out this decision could not be made, and the resultant overall execution quality for the order may suffer as a result. This certainly can not be the result that the Commission was trying to achieve.[10]

Second, relying solely on the best displayed price would effectively change the existing best execution landscape. Market participants have developed and implemented rigorous systems and processes for evaluating all of the factors the Commission has cited as being important in obtaining best execution.[11] It was only a few years ago that the Commission itself

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[9] Securities Exchange Act Release No. 42450 (February 23, 2000).

[10] Other examples include a customer who might choose to sweep through the quotes at different price levels at one market center for a large order rather than chase the top of the book at multiple market centers, or direct access customers who wish to emphasize speed and certainty of execution over price. All these objectives can be satisfied through an opt-out without sacrificing best execution.

[11] For example, Morgan Stanley, like its competitors, has established a best execution committee to ensure it fulfills its duty of best execution with respect to customer orders in equity securities. This committee's evaluations and determinations rely upon execution information provided by market centers, Morgan Stanley systems used to monitor best execution and certain other factors, including responsiveness, level of service and ability to accommodate substantial order volume. The committee is also required to review and consider information disclosed by market centers under SEC Rule 11Ac1-5. In addition, Morgan Stanley has developed a sophisticated

mandated publication of new statistics regarding order execution quality and order routing decisions designed in part to promote competition for order flow among market centers based upon an evaluation of numerous factors.[12] If the trade-through prohibition adopted by the Commission mandated that best price must be obtained without consideration of the other factors historically important to a best execution determination, this would constitute a radical alteration of the regulatory landscape without any justification. Of course, if the SEC thought that market participants were exercising their opt-out rights improperly, or not satisfying their best execution obligations as a result of an opt-out, it could still rely on its existing anti-fraud and other regulatory authority to enforce these principles.

2. The Opt-Out Provision is Essential to Preserving Market Competition and Innovation and Making the Trade-Through Prohibition Workable

We believe an opt-out would provide the necessary incentive for markets displaying technically "automated" quotes to compete vigorously on the bases of accessibility (*e.g.*, speed) and quality (*e.g.*, depth), especially if the Commission follows through on its proposal not to mandate specific standards for speed of response. Without an opt-out exception, the potential for an unequal playing field is great because markets (or quotes) would only need to meet the minimum SEC standards for "automated." In a free market system where technology is constantly improving and many automated markets are developing increasingly faster trade execution systems, more and more investors are finding that a millisecond (or smaller) difference in response time is critical. Those informed customers should be able to choose to go to the fastest quote, even if that quote is not at the best price. Other informed customers might also legitimately value other factors as well, such as the market's fill rates, historical depth in a particular security or a number of other factors.[13] Allowing informed participants to "opt-out" upon evaluation of these factors would reward markets that provide faster and surer executions, and conversely, would penalize those markets that are materially slower or are displaying smaller

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proprietary system designed to perform an automated best execution analysis of customer orders. Finally, Morgan Stanley subscribes to third party vendors for execution quality information and analytics used by the committee.

[12] *See* Securities Exchange Act Release No. 43590 (March 9, 2001), which stated:

> The Commission agrees ...that execution price and speed are not the sole relevant factors in obtaining best execution of investor orders. It repeatedly has noted that other factors may be relevant, such as (1) the size of the order, (2) the trading characteristics of the security involved, (3) 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 (4) the cost and difficulty associated with achieving an execution in a particular market center. Rule 11Ac1-5 does not address, much less alter, the existing legal standards that apply to a broker-dealer's duty of best execution.

[13] In fact, the order routing and execution data disseminated pursuant to Exchange Act Rules 11Ac1-5 and 11Ac1-6 are designed to allow investors to make reasoned judgments as to which execution venues are most appropriate for their own trading strategies, and also enable investors to judge their broker-dealers' order routing practices.

quote sizes by ignoring those markets' quotes. Those customers for whom the difference in speed or depth between various markets is not material obviously will not choose to trade through a slower or thinner market with a better price. However, to the extent that the difference in response speed or liquidity between markets is material, frequent use of the opt-out likely will force the slower market to speed up its response time and the thinner market to take steps to increase depth. Without a workable opt-out, competitive forces, not SEC rules, would be the force driving markets toward providing automated quotes that would not need to be traded through.[14]

The importance of this framework is evident where an OEF "processes" an order by routing it to another OEF. The second OEF may be slower, and perhaps not even automated, or the route may be through an inferior transmission mechanism. For example, if the transmitting system used to route cannot adequately carry the order volume this will delay the route and potentially diminish the quality of the execution. Alternatively, the difference in speed between the two OEFs may be material to the order placer and could influence the execution quality. In the absence of specific standards, the opt-out will serve as the sole recourse in these situations. Without it, an order placer whose order is re-routed through a capacity-challenged transmission pipe, or sent from an automated quote to a slow market, would be forced to continue to send its orders to this OEF's "automated" quotes. The Commission should not implement a system without an opt-out that precludes order placers from evaluating and acting upon material factors that directly impact order execution quality.

To illustrate the practical necessity of an opt-out exception, assume a broker-dealer is in the process of filling a customer's "not-held" order to buy 250,000 shares of XYZ stock. Assume that the then-NBO is $14.95 per share with a displayed size of 500 shares. Assume further that other quoting market centers are displaying "automated" quotes at various higher prices ranging between $14.96 and $15.00, with varying sizes. Given the size of the client's order, the client's desire to minimize market impact as a result of an execution of its order and an agreement on the part of the dealer and the client that the true, "clearing" price of an order of that magnitude would be $15.00 (*i.e.*, given the lack of depth at $14.95, the NBO does not represent the price for a large block), in the current trading environment the dealer might agree to sell all or a significant portion of the order to the client at $15.00. An opt-out exception to proposed Regulation NMS's trade-through prohibition would enable the client in this situation to continue to opt for speed, certainty and stealth in order to achieve its investment objectives. Absent an opt-out exception, the dealer's efforts to execute against each quoting market center's top of book up to $15.00 may provide the market with information about the client's order (and the

[14] An opt-out would let investor choice force all markets desiring their quotes to be deemed "automated" to have truly automated quotes. Consequently, the Commission would not need to establish and police specific response time standards. On the other hand, were the SEC to remove the opt-out exception from the final version of Regulation NMS, it would have to articulate minimum standards for response (including standards for line capacity) and understand that at least some market centers may not feel compelled to satisfy any more than such minimum standards.

dealer's resulting facilitation position) that would have otherwise remained confidential, and raises the potential for higher overall transaction and execution costs (in particular, the client may end up paying a greater premium for the block, *i.e.*, a higher price, to compensate the dealer for taking on more risk).

Notwithstanding the previous example's reference to a block trade, we believe that in order to maximize investor choice in the handling of their orders, the ability to opt-out of the trade-through rule should be available to as wide a range of orders as possible. A minimum order size or customer type should not be used to limit the ability to opt-out. Such criteria will inevitably be arbitrary and consequently under-inclusive. Rather, "know your customer," suitability, and best execution obligations should govern when a broker-dealer will accept an opt-out choice by a particular customer. This reinforces the important principle of freedom of choice.[15] Because existing "know your customer" requirements would apply to a broker's acceptance of a customer's decision to opt out of trade-through protection, we do not anticipate an abuse of the opt-out provision for individual investor accounts. If a single, retail-sized order gets best execution by getting the best price available from automated markets, then it is unlikely that an opt-out would be appropriate or justifiable.

3. The Frequency with which an Opt-Out Might be Used is Irrelevant

Some market participants have argued that, because an opt-out would be infrequently used, it should not be adopted. Morgan Stanley unequivocally disagrees with this assertion. First, we hope market practice would result only in infrequent use of the opt-out as this would likely mean that the automation and connectivity of the markets is operating effectively. Second, simply because something is used infrequently does not mean it is not a necessary tool. In fact, we expect the existence of the opt-out right for market participants to be the primary "stick" that ensures OEFs are automated, efficient and reliable (and thus capable of attracting order flow), and therefore the "stick" may not be needed as often. Even if only a small subset of the market uses the opt-out, this will encourage all order execution facilities to compete aggressively for order flow in terms of price, speed and reliability. Third, and perhaps most importantly, it has been a fundamental tenet of our markets to date that all market participants, including broker-dealers and fiduciaries, are free to exercise their informed judgment in determining how, when and where to execute an order. To disenfranchise such market participants by specifically precluding an opt-out from the trade-through prohibition would fundamentally and negatively alter their ability to satisfy their objectives in transacting in the markets. We are not aware of *any* evidence that would justify a blanket trade-through prohibition without freedom of choice in the appropriate circumstances.

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[15] If the Commission were nonetheless intent on limiting the availability of the opt-out to particular kinds of trades, at a minimum it should apply to block facilitations by dealers, average- or formula-priced trades, client elections of "stops" and bona fide hedging transactions by dealers transacting for their own accounts for the purpose of legitimate risk management.

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4. There is No Evidence an Opt-Out Provision Would Negatively Impact Limit Order Placement

Morgan Stanley agrees that the encouragement and protection of limit orders is an important goal of the national market system. We disagree, however, with those who believe that an opt-out exception from the trade-through prohibition would discourage the placement of limit orders. Not only is there no evidence that would lead one to conclude that this was a likely occurrence, in fact market developments in recent years have demonstrated the exact opposite effect. The more markets become automated, and the faster the automated markets are able to respond to limit orders sent to them, the less likely there would be any adverse consequences for limit orders.[16]

A critical, fundamental fact to consider is that limit orders today are extremely portable. In other words, the placement of a limit order is not a permanent, irrevocable action. Best execution obligations and technological advances (including improved linkages and smart routers that algorithmically send limit orders to market centers for execution) mean that limit orders are constantly moving among execution venues in response to changing market conditions. A limit order that is not quickly filled may be automatically cancelled and sent to another market. This portability is a direct result of market competition and innovation. Execution venues now recognize that if they do not quickly and effectively execute limit orders they will lose the order to competing market centers, often almost instantaneously. Thus, while the opt-out would not discourage the overall placement of limit orders, it is likely it would discourage limit order placement at those venues that could not compete for order flow on the basis of overall execution quality.

As noted above, the actual experience in today's markets also does not support the idea that a prohibition on trade-throughs is necessary to encourage limit order placement. The trading market for Nasdaq stocks strongly demonstrates that an opt-out from the trade-through prohibition does not discourage the placement of limit orders. Although there are no mandated linkages and there is currently no trade-through rule, limit orders represent a substantial portion of the orders for Nasdaq stocks. Indeed, ECNs and SuperMontage are essentially limit order books, holding numerous limit orders in Nasdaq stocks.

Likewise, the placement of limit orders on the NYSE is substantial even in the absence of mandated electronic linkages between the exchanges (other than the ITS's commitment-based system), the fact that the ITS trade-through rule does not apply to upstairs firms and that as a

[16] If markets are truly competing on the basis of speed or depth of top of book, so that there are not material differences in their response times or market depth, the opt-out likely will not be employed often, and there would be few adverse consequences for limit orders. On the other hand, an opt-out is much more likely to be used with some regularity if there are material differences in response time or depth between markets. In that case, limit orders will migrate to the markets that do not get traded through. As a result, the slower markets would be forced to improve their respective response times in order to retain limit orders, which would benefit the markets as a whole.

consequence there can be numerous instances, or at least the appearance, of trade-throughs in the listed markets. In addition, there is no evidence that the execution of listed block transactions in the third market today has adversely affected the placement of limit orders in the listed market. Because Regulation NMS's proposed trade-through rule will decrease the amount of trade-throughs of automated quotes to a degree much less than what occurs today, there seems little reason to believe the ability to opt-out would in an of itself discourage the placement of limit orders in any market center.

Finally, best execution obligations require consideration of the limit order fill rates of each OEF in determining to which market it should send that limit order. Data relating to limit order fill rates of OEFs is publicly available through the requirements of Exchange Act Rule 11Ac1-5. Any OEF trading through limit orders would have this practice evaluated and a broker-dealer could simply choose to route its customer orders to those markets where the likelihood of a fill is greater and the frequency of trade-throughs is less.

5. The Proposed Procedures for Exercising Opt-Out Rights are Unnecessarily Onerous and Should be Simplified

While we support informed use of an opt-out exception, we do not think the Commission's proposal to require NBBO disclosure to those customers who opt out is helpful in ensuring that the opt-out is "informed." The NBBO disclosure proposal is so burdensome that it would eviscerate the potential utility of the opt-out.[17] Because broker-dealers are not required to offer an opt-out opportunity to their customers under the proposal,[18] the detailed nature of the required back-end disclosures for an opt-out and the significant systems changes needed to implement them would make it unlikely that many firms will offer their customers the choice of whether to opt out from trade-through protections. For the reasons described above, this would have a negative effect on execution quality and overall market competition.

Apart from noting the difficulty of producing it, we also question the disclosure's value. If an informed customer chooses to opt out from the trade-through prohibition we fail to see the

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[17] Under the proposal, a broker-dealer whose customer has consented up-front to forego trade-through protection pursuant to the opt-out provision would nevertheless have to disclose to that customer after the trade, as soon as possible but no later than one month from the date of the order's execution, the NBBO, as applicable, at the time of execution for each execution for which the customer opted out. We note that although the Release states that this disclosure could be made in the Rule 10b-10 confirmation, the monthly account statement or some other form of disclosure document, the Commission also states that "the bid or offer that would be required to be disclosed to the customer pursuant to this exception would need to be displayed in close proximity to, and no less prominently than, the execution price for the applicable transaction sent to the customer pursuant to Rule 10b-10." Release at 11140. The latter statement could be read to require the disclosure of the NBBO wherever and whenever the execution price is disclosed, which would include both the confirmation, which is generally generated at or close to the time of the execution of a trade, and the customer's monthly account statement.

[18] *See* Release at 11138.

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use or benefit to such customer of the back-end disclosure. The price that a customer may have been able to obtain is not particularly relevant and could even be misleading. As the Commission knows, the displayed NBBO is not a guaranteed price. Other market participants are simultaneously trying to execute against that best quote. Furthermore, informed customers who choose to opt out will be following the market so closely that they could (and should) evaluate for themselves the execution cost of the opt-out and would not need the back-end disclosure. Indeed, their upfront awareness of the NBBO at the time of exercising their opt-out rights is an essential element of their decision making process. After the fact disclosure of this information will provide little or no incremental information to customers, while imposing serious burdens on broker-dealers.

There also are practical problems with the proposed back-end disclosure. The time clocks utilized by the different markets are not synchronized. The difference of a second or even milliseconds between time clocks could produce misleading back-end disclosure information to customers. The occurrence of flickering quotes similarly can add to the misleading nature of the back-end disclosure. Furthermore, such back-end disclosure would be particularly troublesome in instances in which a single customer order was broken up to achieve execution, such as in the case of average price trades. In that instance, which NBBO would be "disclosed" after the fact – the then-NBBO for each constituent part of the overall print, or the NBBO displayed at the time the final portion of the overall trade was executed? Either of those choices would result in a misleading disclosure. Also, even if the customer's opt-out order was executed in a single transaction in a market not displaying the NBBO, but which was displaying a worse price but with sufficient size, disclosure of the then-NBBO that was not of sufficient size to cover the customer's entire order could be misleading.

If the Commission were to continue to believe that the back-end information should be available to those customers who want it and could derive some productive use from it, we believe there are two better approaches. One would be to require broker-dealers to provide that information only to those customers that request it at the same time they choose to opt out. It should be noted, however, that, many firms might view the costs and burdens of providing the information on even this periodic basis as so prohibitive that they would not offer the opt-out choice to customers that wanted to receive the information. In practice, then, those customers that choose to receive explicit information about the amounts of their trade-throughs would be precluded (potentially to their detriment) from opting out from trade-through protections in the first place.

Another effective but significantly less burdensome method for delivering this disclosure would be to provide a disclosure akin to that required on Rule 10b-10 confirmations in connection with payment for order flow arrangements – a statement to the effect that if the customer chose to opt out from the trade-through rule, details concerning the then-NBBO at the moment the customer's opted-out order was executed would be available upon request.[19] We

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[19] *See* Exchange Act Rule 10b-10(a)(2)(i)(C).

question, however, the benefit to investors of adding more language on an already crowded confirmation.

II. ACCESS PROVISIONS

A. Open Access Standards Should Be Adopted

We agree with the Commission's decision to require markets and market participants that display quotes in the national market system to make those quotes accessible to other market participants on a non-discriminatory basis. Requiring open access to the best quotes across the entirety of the securities markets provides investors and broker-dealers with more choices for order-routing and execution. It also extends the concept of equality across the markets – a person accessing a particular quote through a member of that market center, such as through a sponsored access arrangement, should not be treated differently than if the member itself was accessing that same quote directly. Furthermore, this open and fair access is necessary for the efficient operation of the trade-through rule as proposed.

We agree with the Commission that all markets should be encouraged to provide open and fair access to their quotes and we favor a national market system with linked markets. However, our experience has led us to become highly skeptical of the effectiveness and wisdom of a single, unitary linkage operated by markets that may be motivated in equal parts by anticompetitive sentiments and inertia. The operation of ITS over the past 20 years has reinforced our skepticism of a single linkage and led us and other market participants to conclude that it is a failed model. A single public linkage provides a single point of failure, raises bureaucratic governance, technology and fee-setting issues, and institutionalizes barriers to competition and innovation. We believe that the preferred solution is for markets to establish private, bilateral or multilateral linkages among themselves, with the SEC setting broad standards for required access through these linkages. Private linkages are much easier to establish and operate and can be constructed directly between OEFs or through market intermediaries. The smooth operation of the market for Nasdaq stocks today clearly demonstrates the power of private linkages. Archipelago's utilization of an affiliated broker-dealer (formerly known as WAVE Securities) to route orders, and Nasdaq's intention to acquire BRUT (which would provide Nasdaq with an order-routing capability), demonstrate the practicality of this approach.

A series of private linkages between quoting market centers also would stimulate competition for routing services. Market routers will compete on the speed and scope of their routing services, while marketplaces will compete on the variety of access points to their quotes. Markets that are not accessible to the most efficient routing systems, either for incoming or outbound orders, will lose order flow to those markets that are better connected.

Our suggested approach is consistent with much of the proposed fair access standards of Regulation NMS. The key role for the Commission under this proposed regulatory structure

would be to enforce implementation of the non-discriminatory access requirement for any market that reaches a level of 5% of a security's trading volume. In addition, as noted above, the Commission should implement strict oversight and enforcement of markets' designation as having "automated" quotes. If the Commission adopts a trade-through rule that extends only to automated quotes, and provides an opt-out provision, virtually all market centers eventually will respond to orders automatically in fractions of a second due to competitive pressures. In this type of competitive environment, markets will be driven to provide immediate access to their best quotes to other market centers and market participants.

B. Market Participants' Ability to Charge Access Fees Should be Treated Uniformly

As noted above, the Commission has proposed that access to quotes must be fair and non-discriminatory to all market participants. For such access to be truly fair and non-discriminatory, all market participants should be accorded the same treatment with respect to their ability to impose access fees. The current situation in which ECNs can charge access fees, but market makers cannot, is unfair and anachronistic. We and many other entities consistently have urged the Commission either to permit all market participants to charge quote access fees in the same manner, or to prohibit all such fees. While we believe that access fees distort the true NBBO and unnecessarily complicate order routing programming logic, we support the Commission's compromise attempt to resolve the difficult issue of access fees, provided the playing field is truly level.[20] We caution, however, that adopting an access fee provision that permits all market participants to impose access fees may lead to future disputes over the definition of "access fee" and appropriate fee levels as the market continues to evolve. Despite this caveat, we support the Regulation NMS approach that permits <u>all</u> quoting market participants to charge an access fee in the same manner.

We believe that one element of the Commission's proposal relating to access fees – the provision that access fees may only be charged by those market participants publicly identified with a particular quote – should be changed before adoption. As currently drafted, the proposed

[20] The Commission's proposal would permit all quoting market centers, quoting market participants and broker-dealers that display attributable quotes through SROs to impose *de minimis* fees for executions against their quotes. Specifically, the access fees charged by any individual market participant would be capped at $0.001 per share, and the accumulation of these fees would be limited to no more than $0.002 per share in any transaction. Also, a quoting market center or quoting market participant would be prohibited from charging a non-member, non-subscriber or non-customer a fee for indirect access to it through a member, subscriber or customer, although the member, subscriber or customer could be charged the standard access fee.

fee limitations applicable to different types of entities depend on how the order router accesses those entities' quotes.[21]

In order to ensure even treatment of all quoting market participants, quoting market participants that are not directly identified with their quotes should be permitted to charge access fees. We see no reason why an anonymous quoting participant should be precluded from charging an access fee. For example, a broker-dealer should be able to post a quote under the identifier SIZE on SuperMontage and still charge an access fee for that quote. The identity of a quoting market participant is irrelevant to a market participant desiring to hit that quote if the quote is an automated quote that can be accessed immediately. Moreover, it makes no sense to preclude a market maker whose quote is anonymous from charging an access fee for a quote in an SRO order execution facility but allow that market maker to enter the anonymous quote on an ATS and directly obtain an access fee. This distinction perpetuates the existing access fee bias in favor of ATSs.

C. Intermarket Sweep Orders – Avoiding the "Daisy Chain" Effect

We support the Commission's proposal in the Supplemental Release relating to "intermarket sweep orders." An intermarket sweep order involves the simultaneous routing of an order or orders to interact with the displayed best bids and offers of multiple market centers in the national market system. A likely scenario involves a broker-dealer seeking to execute an order no worse than a few cents below the NBBO by routing parts of the order to multiple markets whose combined size at their respective top of books could fill the order. Under these circumstances, a "daisy chain" effect could be created as the destination markets whose best quote is outside the NBBO might route the orders it receives to the market displaying the best price at that time. That market to which the orders have been rerouted might not have the best price when the orders arrive because the order (or portion thereof) originally sent to that market by the broker-dealer has wiped out the best quote on that market. In that case, the orders would again be routed away to the market with the then-current NBBO. This cycle could repeat itself

[21] First, proposed Rule 610(b) permits an SRO to charge a fee of up to $0.001 per share. If the quote is attributable to a particular broker-dealer, that broker-dealer also may charge a fee of up to $0.001 per share. According to the Commission, "the purpose of the 'attributable' requirement is to enable an order router to know in advance whether an additional broker-dealer fee would be charged when a quotation is accessed through an SRO facility."[21] Second, a quoting market participant (an ATS or market maker whose quotes are displayed in the ADF and are not accessible through any SRO execution facility) may charge an access fee of no more than $0.001 per share. Third, the access fees charged by a broker-dealer whose quotes are accessed directly and which would not be a quoting market participant because its quotes also are accessible through an SRO order execution facility, would only be subject to the $0.002 total fee cap. The Commission admits that this type of direct access to a non-quoting market participant broker-dealer's quotes is not specifically covered by the proposal, and whether access fees could be charged would depend on existing rules, which permit a broker-dealer that is an ATS to charge access fees but preclude market makers from charging similar access fees. New Rule 610(b)(3) would authorize market makers to charge an access fee only in the limited circumstance of when an attributable quote was accessed through an SRO order execution facility.

in a continuous loop. To prevent this from occurring, a market should be able to accept an order that is designated "Intermarket Sweep – Do Not Route." This designation would signal to the receiving market that the broker-dealer has already sent an order to the market displaying the best price so there is no need to route away to that market to fulfill any trade-through obligations. This order type, however, would be limited to the identified types of transactions – it is not intended to operate as a substitute for a workable opt-out exception. The routing broker-dealer would be responsible for maintaining an appropriate audit trail demonstrating the appropriate routing of the remainder of the order to the other markets.

D. Clearly Erroneous Quotes, Orders and Trades

Currently, the markets do not have equivalent standards for determining when a quote or order is clearly erroneous. In connection with its uniform trade-through rule, the Commission should standardize the elements of a clearly erroneous quote that can be ignored for trade-through purposes. A trade-through rule based on automated quotes and fair access to those quotes can be corrupted by the submission of a clearly erroneous quote or order to an automated market. To help prevent such erroneous quotes and orders from negatively impacting the markets and participants' related order handling obligations, the SEC may wish to require markets to adopt a "speed bump" similar to the current Nasdaq procedure. Under this type of procedure, a market participant submitting a quote that is 10% or more away from the previous last sale price of the security would receive a query from the market displaying the quote as to the legitimacy of that quote. The market participant would have to respond affirmatively, and immediately, to the query for the quote to be disseminated. In addition, the Commission should address the disparate policies across markets (including the ECNs) for canceling clearly erroneous trades after the fact. Absent uniform guidelines, these policies will have a similar negative impact on the smooth operation of the trade-through rule.

E. Trading Halts

Another situation that the SEC also will need to address relates to trading halts and the application of the trade-through rule. An automated market should clearly identify when it is halted for a particular security or when it is no longer providing automated quotes for that security. Otherwise, a stale quote could create a logjam as other automated markets would be prevented from trading through that quote.

F. Clock Synchronization

In order to monitor and enforce a trade-through rule, it is essential that the Commission promulgate standards for an intermarket clock. The existing clock synchronization standards, which differ by market, combined with penny trading increments, would render it virtually impossible to effectively monitor compliance with the proposed trade-through rule.

III. SUB-PENNY QUOTING PROPOSAL

Morgan Stanley supports the SEC's proposal to prohibit sub-penny quoting and allow for sub-penny printing of trades that were the result of mid-point or volume-weighted pricing algorithms. As with other Regulation NMS proposals, we support the equal, uniform application of the rule to all securities, including ETFs. We believe the proposal will improve the transparency and effectiveness of market quotations and reduce the potential for stepping ahead of pending orders. This destructive trend – jumping ahead of existing limit orders by infinitely small amounts – would likely increase if sub-penny quoting became more widespread and could significantly undermine market integrity.

IV. MARKET DATA PROPOSALS

A. Commission's Proposal Avoids Many Important Issues

While the Commission's proposals would effect positive change on the manner in which market data revenue is apportioned among the various SROs (which we address later in this section), we believe nonetheless that the Commission has not yet addressed the core problem with market data – the excessive amount of data revenue the SROs are deriving from an antiquated, exclusionary and oligopolistic system. Many years have passed since the SEC's concept release on market data and the filing of the Seligman Committee report, though no meaningful proposals have yet been put forth to stem the windfall of market data revenue to the SROs. While we understand the SEC's hesitancy to engage in rate setting,[22] the SEC nonetheless needs to take an activist role in controlling the costs of market data revenue from a broker-dealer community already overburdened with increasingly higher and duplicative regulatory and transaction fees.[23] The overall "size of the pie" issue becomes ever more critical in an environment where market-wide trade-through restrictions increase the minimum amount of market data that broker-dealers need to provide their customers with best execution. Consequently the Commission must ensure that the top of book information from all markets is available for a nominal charge or the potential benefits of Regulation NMS will come undone. Limiting the "core" consolidated information specified in the SEC's proposal solely to the price, size and market center identification of the NBBO will only exacerbate this problem.

At a minimum, we believe the SEC should require more transparency as to the establishment of market data fees, including a full disclosure of the justification for the fee levels, the costs of providing the market data and the use of fee levels above the cost of running

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[22] We note, however, that the SEC has effectively "set rates" by proposing to cap access fees, so a precedent has been set.

[23] Notwithstanding Nasdaq's taking a bold leadership role in proposing to voluntarily decrease its net retention of market data revenues, it is not our expectation that many, if any, other SROs will follow suit.

the market data system. Such a system should, for example, provide a justifiable explanation for the inordinately high level of Tape B fees relative to Tape A fees, and lacking a reasonable justification, should result in a substantial decrease in Tape B fees. Proposed changes to the market data fees should be published and remain open for a full comment period with adequate opportunity for public input and comment. In addition to these steps, the SEC also should aggregate and simplify the market data Plans and develop core standards for data usage agreements.[24]

In addition, while the SEC recognizes a need to reevaluate the market data governance structure, the proposed public advisory role in Plan governance is unlikely to result in meaningful changes. The SEC should consider requiring the participation of independent voting participants in the market data Plans.

B. Market Data Dissemination and Fee Allocations

We agree with the Commission that the current structure of market data dissemination, fees and revenue allocation is inequitable. Pursuant to the current rules, the data disseminated for each NMS security consists of (i) an NBBO with prices, sizes and market center identifications, (ii) a montage of the best bids and offers from each SRO that includes prices, sizes and market center identifications, and (iii) a consolidated set of trade reports in the security. As the Commission has noted, sales of this information to market participants in 2003 resulted in revenues of $424 million to the three Networks, and of this, $386 million was distributed to the SROs participating in those Networks.[25] The allocation to each SRO of this revenue essentially depends on the number of trades reported by the SRO, without regard to the size of the trade, and none of the Networks currently takes quoting activity into account when allocating market data revenue. The large sums of money involved, together with the focus solely on reported trades, has led to unethical practices such as "tape shredding," wash trades and the proliferation of print facilities.

Consequently, we strongly support the proposed development of a market data revenue allocation system that rewards market centers for their real contribution to price discovery rather than merely incentivizing tape prints. In this regard, the Commission's new proposed allocation formula is intended to better measure the contribution of an SRO's quotes and trades to the consolidated data stream.[26] We agree with the Commission that quotes should be an important

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[24] In this regard, we note that the Plans are not broadly available in their complete current states. Rather, as the Commission noted in n. 270 to the Release, the most recent complete Plan was published in 2001, and all three plans have been amended several times since the last publication of the complete plan. These Plan documents should be made easily available to the public in their complete, up-to-date forms.

[25] *See* Release at 11176.

[26] *See* Release at 11181.

component of the market data revenue stream, and the Commission's formula takes into account both an SRO's proportion of quotes with prices that equal the NBBO and its proportion of quotes with prices that improve the NBBO in each Network security, as well as trading activity. We have no comment on whether the SEC has proposed the optimal formula, but will leave it to the Commission's expertise to devise one that effectively rewards beneficial quoting activity and lessens the incentives for tape-shredding, wash trades and print facilities.

C. Market Data Fee Rebates Should Be Banned

Regardless of the formula the Commission ultimately adopts for market data revenue allocation, we urge the Commission to ban market data fee rebates. These rebates make a mockery of the validity of market data charges. In today's markets, all market participants are essentially required to obtain and provide consolidated trade and quote data if they disseminate any quote or trade information. The expensive fees paid for this consolidated information – a large part of which might not be useful or necessary for all persons using it – result in an excess of revenue to certain SROs, which they, in turn, re-distribute to their members (particularly ATSs and ECNs) in order to attract order flow. The bad practices the Commission identifies – print-buying, tape-shredding and wash trades – are either made possible by or are a direct result of market data fee rebates. If this economic incentive to send orders to markets other than those displaying the best price no longer exists, those practices likely will cease.

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We appreciate the opportunity to present our views on Regulation NMS and sincerely applaud the Commission's tremendous efforts to effect meaningful change to the structure of the U.S. equity markets. In particular, we enthusiastically support all aspects of the proposals where the Commission has restrained from establishing baseline standards, instead relying on competitive dynamics to encourage an ongoing process of improving the quality and efficiency of our national market system.

If you have any questions concerning our views please contact me at (212) 762-8193, Ivan Freeman at (212) 761-4600, Jill Ostergaard at (212) 259-1068, Tom Smallman at (212) 762-4863 or Paul Fitzgerald at (212) 762-6312. We look forward to continuing our dialogue with the Commission and its staff on these critical market structure changes.

Very truly yours,

Thomas N. McManus
Managing Director and Counsel

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The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
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