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June 29, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549-0709

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

Dear Mr. Katz:

I would like to address several comments regarding Proposed Rule: Regulation NMS. Specifically, these comments relate to Section III. C. & D. Trade-Through Proposal and Section VI. C., Allocation of Network Net Income.

TRADE-THROUGH PROPOSAL

The Trade-Through Proposal attempts to address some distortions and inequities in the securities markets. It, however, does not address the source of many of those problems. That source is the notoriously slow response to ITS Commitments by the New York Stock Exchange and the American Stock Exchange. As a result, these markets display bids above legitimate, accessible offers on other venues and offers below bids on those venues. These distorted quotations can last even longer since the participants in other markets know that commitments to trade on these quotations will usually be cancelled. An inquiry into the cancellation will usually be responded to with some version of; "stock traded ahead." Therefore, market participants will usually not even attempt to trade on these quotations since they know that it would most likely be futile, the order would be in limbo for up to 30 seconds until the response is received, and speed is of the essence. This causes both trade-throughs, and locked and crossed quotations. These problems would be solved by prohibiting all Non-Automated Trading Facilities from displaying a bid greater than or equal to an offer on an Automated Facility or from displaying an offer less than or equal to a bid on an Automated Facility. A Non-Automated Facility should be required to immediately route any portion of any order to an Automated Facility which can be immediately executed against a displayed quotation at the Automated Facility, if the specialist or market makers at the Non-Automated Exchange will not immediately execute the order. Trade-Throughs should only be allowed (with consent of the customer) after all automated bids or offers at superior prices to the proposed trade through price have been filled. With the instant executions available at the Automated Facilities, there can be no justification for ever trading through their markets, or locking or crossing their market quotations.

ALLOCATION OF NETWORK NET INCOME PROPOSAL

The present system for Allocating Market Data Revenues, which has been in place since the 1970's, has had many consequences for the securities markets of the United States; some of which were clearly unintended. Nevertheless, they have engendered competition resulting in the deepest, fastest, lowest cost markets in history. There have also been abuses; "print facilities", "wash trades" and "shredded trades." The new proposed formula addresses some of the negative ramifications of the existing system, but the benefits would be outweighed by the dampening of competition and reduction of hedging activities which I believe will be a consequence of this proposal.

Under the present system, many non-primary SRO's have chosen to utilize their Market Data Revenue to compete with the New York and American Stock Exchanges (the primary markets.) They have done this in several ways. They have rebated a portion of this revenue to specialists, market makers and broker-dealer proprietary traders who can in turn use these revenues to compensate the brokerage firms which send them orders. The SRO's also use these revenues to reduce their charges to these order-sending firms. In turn, these order-sending firms reduce the commission charges to their public customers in order to compete with large firms who do business mostly in the primary markets; and to compete with one another. Furthermore, these specialists, market makers and broker-dealer proprietary traders also utilize this revenue to reduce their transaction costs enabling them to enter bids and offers which might otherwise be uneconomic, resulting in deeper, more liquid markets. All of these factors have reinforced one another. Low transaction costs, deep, tight active markets attract customers, begetting more activity, deeper markets and more competition.

There have also been abuses, but these can be corrected without the draconian measures proposed. "Wash Trades" are clearly illegal, and their practitioners have been punished. "Shredded Trades" have little impact on markets. If a 500 share order is broken into five 100 share orders, all 500 shares are represented in the bid or offer, so width and depth of the market are not misrepresented. The only possible misrepresentation is the number of trades at a given price. This is probably of little or no significance to almost all market participants. This technique is probably most prevalent in Nasdaq 100 Tracking Stock (QQQ). Still the average trade size in this issue approximates 900 shares, so the practice is probably not that common.

Finally, there is the problem of the "Print Facility." The proposal to weight revenue allocation based upon dollar volume of trading will significantly disproportionately reward exchanges who can obtain "prints" in large volume crosses on their exchange. In these crosses, the exchange, its specialists and market makers are not putting capital at risk, and are not providing price discovery. They are simply capitalizing on relationships to get the print and its resulting revenue. Thus the proposal would be counter-productive in eliminating "print facilities." Inet ATS (formerly Island) has joined with the National Stock Exchange, and Archipelago with the Pacific Exchange to provide an exchange environment in which to print their trades, but these prints are in no way illegitimate, and these arrangements provide a better regulatory environment.

The Market Data Revenue proposal seeks to both remedy perceived abuses, and to reallocate resources from the heavily traded issues, primarily ETF's, to less active, more thinly traded issues. By shifting Market Data Revenue from ETF's to less active issues, the theory would be that with these revenues allocated to participants in those issues, the markets would become deeper, and therefore more liquid. Unfortunately, this is quite unlikely to occur to any great extent in practice, because the lower cost of trading those issues would not be sufficient to offset the perceived risks and lower opportunities in those issues. By a rough calculation, under the square root of the dollar trading volume proposal, market data revenues allocated to SPY and QQQ would decline about 70%. This would not benefit overall liquidity because it ignores the secondary benefit to liquidity in the underlying issues generated by deep fluid markets in the ETFs and in Stock Index Futures. The deep, active, liquid markets in these issues encourage hedging transactions in the underlying securities by broker-dealers. This results in greatly increased liquidity in the underlying issues. If there were to be a significant reduction in the liquidity of these two issues due in part to the reallocation of these revenues, it would have negative liquidity ramifications for all of the underlying securities.

This proposal in its present form would reduce the listed market data revenues for all but the primary exchanges and reallocate revenues from ETFs to other equities. This would result in substantially reduced competition between market centers and reduced liquidity in our securities markets.

CONCLUSIONS

Trade-Throughs and Locked and Crossed Quotations could be largely eliminated by prohibiting Non-Automated Exchanges from posting the quotations which cause most of these problems, or more importantly, from allowing stale quotations to remain posted, outside of automated market quotations. They would have an affirmative obligation to see that these orders are filled in whole or in part the moment an immediately accessible quotation exists which would satisfy all or part of the order.

Wash Trades are already prohibited.

Print Facilities would cease to be a problem if crossed orders which have been negotiated outside of the exchange environment, and do not involve a substantial proportion of specialist or market maker participation, are excluded from any volume calculations for the purpose of allocating Market Data Revenues.

The present system for allocating Market Data Revenues contains minor flaws, but has produced great benefits for our markets. Abandoning it for a system based upon the square root of total dollar volume, while including crosses, would not accomplish the Commission's objectives, and could seriously impair liquidity and competition in our securities markets. While utilizing the total number of trades as a basis for allocating these revenues may need some modification, the proposed formula as presented could generate serious negative consequences in the form of reduced competition between market centers and reduced liquidity in hedging vehicles.

Sincerely,

Ronald A. Oguss
President
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Member, Chicago Stock Exchange
ETP Holder, Archipelago Exchange