

MEMO# 17722

July 1, 2004

INSTITUTE COMMENT LETTER ON SEC REGULATION NMS

[17722] July 1, 2004 TO: SEC RULES MEMBERS No. 96-04 EQUITY MARKETS ADVISORY COMMITTEE No. 31-04 RE: INSTITUTE COMMENT LETTER ON SEC REGULATION NMS The Institute has filed a comment letter with the Securities and Exchange Commission on proposed Regulation NMS and the Commission's supplemental request for comment on the proposed rules.¹ Regulation NMS contains four interrelated proposals – the trade-through proposal, the market access proposal, the subpenny quoting proposal and the market data proposal – which, collectively, are designed to modernize the regulatory structure of the U.S. equity markets. The most significant aspects of the comment letter are summarized below and a copy of the letter is attached.

I. Trade-Through Proposal The proposed trade-through rule would require an order execution facility, national securities exchange and national securities association market, with regard to the trading of "NMS Stocks," to establish, maintain, and enforce policies and procedures reasonably designed to prevent the purchase or sale of an NMS Stock at a price that is inferior to a better price displayed on another market. The letter supports the establishment of a uniform trade-through rule for all market centers and states that such a rule would be a significant step forward in providing protection for limit orders. The letter also provides comments on several specific aspects of the proposed rule. Most significantly:

- The letter supports the application of the proposed rule to: (1) all "NMS securities," including Nasdaq securities; (2) the account of a broker-dealer as well as the account of a customer; and (3) the best displayed bid and offer of any order execution facility as well as all other displayed limit orders or quotes that are also priced better than the order being executed and are automatically accessible.

¹Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) ("Proposing Release") and Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release").

- 2 • The letter supports the proposed exception to the trade-through rule that permits an "automated" market to trade through a better displayed bid or offer on a "non-automated" market, but recommends that the Commission amend the proposed definition of an "automated" market to: (1) establish minimum performance standards with respect to what would be considered an "immediate" response to, and update of, a quote and (2) require a market, in order to be considered an "automated" market, to provide automatic execution to its entire limit order book and not only to its best bid and offer.
- The letter supports the Commission examining whether to amend the trade-through proposal to create an exception for "non-automated" or "manual" quotes (instead of "non-automated" markets), as proposed in the Supplemental Release; however, the letter recommends that the Commission delineate a clear definition of what would be considered an "automated" quote, as well as the specific parameters for the operation of a manual quote exception.
- The letter does not support the trade-through proposal's "opt-out" exception, provided that the Commission adopts an

“automated” market or manual quote exception, as amended by the Institute’s recommendations for those exceptions. • The letter recommends that the Commission eliminate the proposed “trade-through limit amount,” and permit an “automated” market (as defined under the Institute’s recommendations) to trade through a “non-automated” market for an unlimited amount, or, if the Commission creates a manual quote exception, permit a market participant to trade through a manual quote for an unlimited amount. II. Market Access Proposal The letter supports the market access proposal, which would establish rules that would modernize the terms of access to quotations and the execution of orders in the national market system. Most significantly: • The letter supports the creation of minimum access standards that would provide market participants with non-discriminatory access to all displayed prices for a security (and not only the best displayed bid and offer for that security) no matter where those prices are displayed and that would reduce the current barriers to intermarket access. • The letter supports limiting to a de minimis amount the fees for the execution of orders that can be imposed by all quoting market centers, quoting market participants, and broker-dealers that display attributable quotes through SROs. • The letter supports the proposals that would require every SRO to establish and enforce rules requiring its members to avoid locking or crossing the quotations of quoting market centers and quoting market participants and to prohibit members from engaging in a pattern or practice of locking or crossing the quotations in any security. 3 III. Subpenny Quoting Proposal The letter strongly supports the subpenny quoting proposal, which would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment less than a penny. The letter states that while the Institute strongly supported the move to decimalization and the trading of securities in minimum increments of one penny, it has strongly opposed the entry of orders and the quoting of securities in subpennies. Specifically, the letter states that permitting the entry of orders and the quoting of securities in subpennies would eliminate much of the benefits brought by decimalization and would exacerbate many of the unintended consequences that have arisen in the securities markets since its implementation, which have proven harmful to mutual funds and their shareholders. IV. Market Data Proposal The market data proposal would amend the rules and joint industry plans for disseminating market information to the public. Most significantly, the proposal would modify the formulas for allocating market data revenues. The letter generally supports revisions to the allocation of market data revenue that would discourage practices that currently exist solely to generate increased revenue. In addition, to the extent that the revenues from market data allocated to the markets do not reflect the true costs of collecting and disseminating that data to the marketplace and operating the markets, the letter recommends that the Commission create an allocation system that better reflects these costs. The letter also supports other changes made to the joint industry plans, specifically: (1) the amendment to the joint industry plans that would broaden participation in their governance; (2) amendments relating to the independent distribution of market information; and (3) the proposed rule to require SROs to act jointly pursuant to one or more national market system plans to disseminate consolidated information for NMS Stocks. Ari Burstein Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 17722, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17722.