Testimony of John Giesea
Security Traders Association

Before the
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
of the
House Financial Services Committee

Hearing on "Reviewing U.S. Capital Market Structure:
Promoting Competition in a Challenging Trading Environment"

Thursday, October 30, 2003

Good morning, Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee. I am John Giesea, President and Chief Executive Officer of the Security Traders Association ("STA"). I appreciate this opportunity to discuss the structure of the US equities markets on behalf of the STA members.

Prior to my current position at STA, I served as Senior Executive Vice President and Director of Equity Capital Markets for Advest, Inc., based in Hartford, Connecticut. From 1967 to 1990, I held other senior trading positions with Kidder, Peabody and Co., Inc. in New York and San Francisco, including Senior Vice President and Head of Nasdaq Trading. My years of experience in the trading environment have allowed me to witness some dramatic advances in technology and increases in investor participation.

The STA, as the leading trade organization for industry professionals in the securities industry, is a unique association. Our members are the individuals, rather than the firms, who are engaged in the purchase, sale and trading of securities for individuals and institutions. The STA represents the shared interests of its approximately 6,000 member traders, such as the buy-side, sell-side, and representatives from ECNs and exchanges, that belong to one of 29 national and international affiliate organizations, including those in Canada, London and Paris.[1]

Late last year the STA continued upon our previous efforts to systematically examine the structure of the United States securities markets. This examination resulted in the publication in August of a White Paper, entitled "Fulfilling the Promise of the National Market System," in which the STA analyzed the most pressing issues requiring resolution to obtain the objectives of the National Market System. I request that the White Paper be included as part of the record.

[1] **STA Vision Statement: "**By 2005, become recognized as the representative organization of security traders across all Markets and the leading authority and champion of individual practitioners on issues affecting traders and markets; earn the reputation of being a leading advocate of policies that foster investor trust, professional ethics marketplace integrity; and advance an agenda that supports capital formation, jobs creation and marketplace innovation."

The Securities Act Amendments of 1975

Any discussion of market structure must occur in the context of the goals and objectives Congress articulated in the Securities Acts Amendments of 1975. These amendments to the Securities Exchange Act of 1934 charged the Securities and Exchange Commission ("SEC") with the duty to "facilitate the establishment of a national market system for securities" while safeguarding the public interest and ensuring the "protection of investors, and the maintenance of fair and orderly markets".[2] Specifically, the National Market System would provide efficient execution, fair competition, transparency of quotations, the linkage of markets, and an opportunity for transactions without the participation of a dealer. These goals would help to assure that the US securities markets remain the most efficient and liquid in the world.

Unfortunately, many of the goals of the National Market System are not yet a reality. Congress was correct in understanding that advancements in computing power and other technological innovations in the industry, coupled with the dramatic increase of individual investor participation, would in fact transform the US equities markets. Much of the regulatory scheme, however, has lagged behind market developments

The Need for Liquidity in Markets

As we examine the serious, structural problems arising in our capital markets, it is essential to understand the vital importance of fostering efficient, highly liquid and fair markets. Such markets encourage the capital formation necessary for US economic expansion and growth. Noted economist Larry Kudlow recently described capital formation as "the ultimate tonic for maximizing economic growth, job creation, and the wealth of the nation."[3] In other words, an efficient capital formation function encourages economic and job growth. For example, small businesses need capital to make the investments necessary to grow and innovate, which in turn creates more jobs. In fact, they are often referred to as the engine of the US economy because of their importance to the growth of jobs in the economy. Access to the capital such businesses require to grow and develop is enhanced when the markets are efficient, liquid and fair. Therefore, it is of utmost importance to the US economy that the rules governing our markets encourage the capital formation process. Such rules should be fair to all market participants, encourage liquidity at all market levels, and foster efficient markets.

Providers of liquidity, such as market makers and specialists, continue to play a unique and critical role in this capital formation process through the trading of equity securities when there is no natural counter-party to a trade. As the debate over an electronic market versus a floor-based auction market system continues, the STA is increasingly concerned that issues relating to the trading of less active securities (listed and otherwise) and the significant benefits market makers and specialists provide to investors trading in that market are largely being ignored. The number of market makers has been reduced due to structural changes in the marketplace. Due to the important role that market makers play in the efficient operation of the

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[2] Securities Exchange Act of 1934, Section 11A(a)(2); (15 USC 78k-1)
[3] Larry Kudlow, "Capital Code Red," National Review Online, March 20, 2003, http://www.nationalreview.com/kudlow/kudlow032003.asp

markets, we should be mindful that the rules governing the industry do not disadvantage one participant to the benefit of another. I will touch upon some unfair or inconsistent rules later in my testimony. The role of liquidity providers to the efficient functioning of the entire market should not be overlooked.

There would likely be consensus that the stocks of General Electric (GE-NYSE) and Intel (INTC-NASDAQ) do not, under normal market circumstances, require a liquidity provider to facilitate the execution of trades. These stocks are so active, liquid and transparent that, in most instances, efficient trading occurs without the need for intermediaries. Where liquidity providers add significant value is in the trading of less active stocks where natural buyers and sellers are not always immediately available.

Thus, the introduction of the market making function becomes an important asset in providing liquidity that is crucial for the efficient operations of the market.

The function of liquidity providers is in turn a very important aspect of the capital raising process. Young, small, public companies often experience less active trading, and as a result, have less liquid stocks. Investors benefit through market maker and specialist support by being able to access the liquidity they need to buy and sell those stocks. A lack of liquidity for stocks will certainly diminish the ability of some worthy corporations to raise equity capital and issue IPOs, thus causing harm to the economy. In fact, a *USA Today* article on October 19, 2003, points out that small, public companies experience the greatest financial burden in complying with laws, which potentially discourages issuance of public stock.[4] If liquidity is lost and other impediments to the capital raising process are erected, segments of the US economy dependent upon such capital may potentially stall.

Under the 1975 Amendments, one of the principles mentions the opportunity for investors' orders to be executed without an intermediary. Although this is an important goal, we should not overlook the other National Market System principles of efficient execution, fair competition, transparency of quotations, and the linkage of markets. As I mentioned, buyers and sellers are not always immediately available for some stocks, creating the need for liquidity providers to take the other side of certain trades. This means that in some instances, no matter how fast or great the technology may become for the execution of securities, an intermediary such as a market maker or specialist is needed to facilitate trades and provide the liquidity necessary for the efficient operation of the markets.

Current Situation

Advancements in technological innovation as well as the advent of decimalization have served to reduce costs for most investors. However, the US markets are currently facing a number of stresses that negatively effect investors and certain market participants. These structural anomalies impact the ability of investors to see a more accurate view of the depth of

[4] Del Jones, "Sarbanes-Oxley: Dragon or white knight?" *USA Today*, October 19, 2003, http://www.usatoday.com/money/companies/regulation/2003-10-19-sarbanes_x.htm.

the market and to access liquidity, and therefore, ultimately serve to impede the best execution of customers' orders.

Fragmentation

The volume of trading in Nasdaq securities by the Nasdaq Stock Market has significantly decreased over the past two years. Several developments have contributed to this decline in Nasdaq volume, causing fragmentation of the market for trading Nasdaq stocks. While this may not by itself be harmful to the proper functioning of the market, it has created several structural problems.

First, I should explain that one of the factors contributing to fragmentation relates to the recent increase in the number of exchanges granted what is referred to as Unlisted Trading Privileges ("UTPs") for Nasdaq securities. Put simply, if an exchange is granted UTPs for Nasdaq securities, that particular exchange is allowed to trade securities whose primary listing is the Nasdaq Stock Market. Several exchanges have been granted UTPs for Nasdaq stocks, such as the American Stock Exchange ("Amex") and some regional exchanges, including the ARCA Exchange, and the Cincinnati Stock Exchange.

The increased trading of Nasdaq stocks pursuant to UTP result in more competition between markets but also increased fragmentation since there are some inconsistent principles and rules governing these markets. Fragmentation may be a positive force if it encourages aggressive competition and innovation, which then serves to increase competition of price, liquidity and execution capabilities. However, without appropriate linkages to the various market centers and consistent rules across market venues – both issues of which I will address later – fragmentation does not serve to advance these positive characteristics.

These differences create problems in the ability to not only identify the best possible price, but may also limit a broker-dealers ability to efficiently "take" the price in a certain market and fulfill its best execution obligations for the customer. The STA believes that it is in the best interests of investors and the protection of fair and orderly markets that fragmentation be addressed in a way that does not diminish the ability of market centers to innovate, yet encourages consistent rules and efficient and workable linkages between markets.

Lack of Inter-market Linkages and Increase of Locked and Crossed Markets

One example of the impact of fragmentation is the lack of intermarket linkages, particularly for the trading of Nasdaq stocks. For example, let us examine the effects of recently allowing the Amex to begin trading Nasdaq stocks pursuant to UTPs. On August 2, 2002, the SEC approved the Amex's request for unlisted trading privileges of Nasdaq stocks.[5] One of the major problems associated with this situation is that Amex is a floor-based system that does not provide automatic execution of orders. Other markets trading Nasdaq securities provide automatic execution capabilities. The SEC allows a UTP Plan participant, such as Amex, the

[5] Securities and Exchange Commission Release No. 34-46305, File No. SR-AMEX-2001-106, August 2, 2002.

option of having its quotes available through Nasdaq's SuperMontage system.[6] Since the Amex has chosen not to participate in SuperMontage, a UTP market participant must go directly through the Amex floor to access its quote.

Why has this situation created serious problems? Due to the different technological capabilities and inadequate intermarket linkages, it is difficult for a participant to access the quotes on the Amex even if the quote is the national best bid or offer for a Nasdaq security. As a result, market participants face complications when attempting to make order routing and best execution determinations for investors. Best execution is a market participant's fiduciary responsibility to its customer, derived from common law, to seek to obtain the most favorable terms reasonably available under the circumstances.

The listed market (the New York Stock Exchange or the Amex) also has inadequate linkages to other market centers, although a system called the Intermarket Trading System ("ITS") has existed for over 20 years. The ITS was facilitated by the SEC due to the Securities Acts Amendments of 1975 for the purpose of "linking of all markets" to encourage efficiency, increased competition and the best execution of customer orders.[7] The Congress, in 1975, envisioned the power of technology to link market centers for the purpose of promoting a more liquid and efficient market. The ITS, however, has not achieved its full potential since some ITS participants do not provide automatic execution of orders, and a market has up to thirty seconds to respond to a commitment to trade. In today's environment, the market can move considerably in thirty seconds. It could be comparable to the 400-yard dash: if you lose 30 seconds, the race is already over. As a result, the ITS is being used primarily as a messaging center. Another obstacle to updating the ITS is that its rules require unanimous support by its members before anything can be amended, preventing common sense change and advancement of its technology requirements.

Another impact on best execution and the lack of inter-market linkages is the increasing amount of locked and crossed markets. A locked market is one where the bid and ask are the same price. A crossed market occurs when the bid is higher than the ask price. These situations are not normal market conditions but are becoming increasingly common in the Nasdaq and over-the-counter market, especially during the market opening. There is no such intermarket prohibition against locked or crossed markets.[8]

Locked and crossed markets have a significant impact on the execution of investors' trades. Such market occurrences cause delays in getting customer orders filled. They also render automatic execution capabilities useless during these periods, forcing slower execution of transactions. This may actually result in a customer's trade being executed at an unfavorable price due to the market changing within the time period required to unlock or uncross the market.

[6] Nasdaq Head Trader Alert #2002-114, "Amex Will Begin Trading NASDAQ-Listed Issues on August 12, 2002," - August 7, 2002.
[7] Section 11A(a)(1)(D), Securities Exchange Act of 1934 (15 USC 78k-1)
[8] Nasdaq Head Trader Alert #2003-023, "Archipelago to Begin Quoting and Trading NASDAQ Securities as a UTP Participant on February 14, 2003," February 12, 2003.

Rule Inconsistencies

In the market for listed securities, the same rules and standards apply regardless of which market is trading that security. Unfortunately, this same consistency of rules does not extend to the markets trading Nasdaq securities. As mentioned earlier, Nasdaq securities are increasingly being traded by other exchanges such as the Amex and regional exchanges. The result is a system of varying rules and standards for market participants, depending upon which market the transaction occurs.

The problems of trading Nasdaq stocks pursuant to UTPs are not limited to the Amex's technological deficiencies. They also extend to other regional exchanges because of inconsistent rules, surveillance and enforcement of those rules. For example, the ARCA Exchange does not have a short-sale rule, while the Nasdaq and other markets do. Regardless of the merits of a short-sale rule or the lack thereof, one market should not be permitted to compete with others based upon rules designed for the protection of investors. Investors deserve the same protections whether their trade is executed on the Nasdaq's SuperMontage, the Amex, or the ARCA Exchange. It is very encouraging that the SEC will reportedly require a consistent short-sale rule for all markets, ending the disparity that currently exists for that rule. This action will serve as a very positive first step toward rationalizing the rules of the various markets.

ECN Access Fees

Most Electronic Communication Networks ("ECNs") charge fees, called access fees, to non-subscribers wishing to access orders placed on their systems. SEC rules adopted in August 1996,[9] allowed ECNs to charge these fees; however, market makers and other broker-dealers are not allowed to do this. Note that access fees are not included in the quotes of an ECN's system, making it difficult to know the actual cost associated with the transaction.

To understand why access fees do not result in equal treatment of market participants, it is essential to examine the interactions in the marketplace. Market participants have a fiduciary responsibility to seek to obtain the most favorable terms reasonably available for its customers' orders. This responsibility is often referred to as "best execution obligations." This is important to understand, since broker-dealers that are not subscribers to ECNs may sometimes be required to interact with a quote on an ECN's system if it is the national best bid or best offer for a particular stock. If the broker-dealer interacts with the quote, it is charged an access fee, even if it is not aware that such a fee is assessed. If a broker-dealer would refuse to interact with such a quote, it may be in danger of failing to satisfy its best execution responsibilities. This situation results not only in an unfair treatment of certain market participants but, more importantly, hides the true price of the security.

ECN access fees also provide incentives that encourage other behaviors that cause disarray in the markets. For example, access fees contribute to the increased occurrence of locked and crossed markets. Many ECNs now offer "liquidity rebates," which are payments to market participants placing limit orders, or orders that provide liquidity. ECNs use the rebates to attract liquidity in their systems, which in turn attract liquidity takers who are charged an access

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

fee. The access fees are larger than the liquidity rebates they pay out and result in a "spread" for the ECN, even though the actual market for that security is locked, representing a zero spread.

One encouraging development in this area is a request by the NASD, through Nasdaq, to set a maximum level of access fees that ECNs may charge in Nasdaq's SuperMontage system, which is Nasdaq's order display and execution system.[10] Although this is an imperfect solution since a lack of transparency still remains, it is one way of rationalizing the various levels of access fees that are charged, creating more certainty and predictability of the trading costs incurred.

STA Recommendations

The STA recommends several specific actions to advance the National Market System, which will in turn benefit all investors. The Securities and Exchange Commission has the authority to address each of the issues, as the Congress has given it broad authority over the regulation, oversight and "maintenance of fair and orderly markets."[11]

1. Improve Intermarket Linkages and Trading Rules

The ITS is in dire need of improvements that would provide for more efficient and timely executions of trades for listed securities. Therefore, the STA recommends that the SEC undertake efforts to mandate such improvements to the system, making it more useful and efficient. For Nasdaq securities, the STA recommends that the SEC require the establishment of intermarket linkages to provide automatic execution functionality. The resulting increase in technological capabilities should allow linkages to all participating exchanges, market centers, broker-dealers and ECNs. In addition, we recommend that the SEC promulgate intermarket rules that govern locked and crossed markets to ensure that consistent and fair procedures are used for unlocking these markets.

2. Consistent Rules, Enforcement and Surveillance

The STA encourages the SEC to require adoption of consistent trading rules among markets trading like classes of securities. In other words, we strongly support common rules for markets that trade Nasdaq securities and consistent rules for markets that trade exchange-listed securities. The surveillance and enforcement should also be consistent across markets. Eliminating the inconsistencies inherent in the current SRO model would also address "regulatory arbitrage," where the lack of consistent rules may be used to attract order flow, sometimes to the detriment of investors and other market participants.

3. Eliminate ECN Access Fees

I mentioned earlier that one of the goals of the National Market System is, "The availability to brokers, dealers, and investors of information with respect to quotations for and

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[10] Securities Exchange Act Release No. 34-48501, File No. SR-NASD-2003-128, September 17, 2003.
[11] Section 11A(a)(2), Securities Exchange Act of 1934

transactions in securities."[12] ECN access fees do not meet this standard, as they obscure the true price of a security quoted on an ECN's system that charges such a fee. Access fees are not transparent and diminish a broker-dealers ability to provide best execution for its customers. In addition, the fee is patently unfair as some market participants are not permitted to charge a fee to access their liquidity while ECNs are able to do this.

There are several alternatives to dealing with the situation. The SEC could prohibit ECNs from charging access fees, thus creating a level playing field and improving the transparency of prices. A second, although less desirable, alternative could be to require ECNs to incorporate fees into their quotes to reflect the true price of a security. One significant drawback to this is that quoting in sub-pennies would be the likely outcome, complicating the best bid and offer. A third alternative is to prohibit ECN access fees for the limited purpose of unlocking markets, thus decreasing the current incentives for certain market participants to lock or cross the market in order to attract order flow.

Conclusion

Competition, the hallmark of a free market system, drives innovation, creativity and productivity. At the same time, rules that serve to advantage one set of market participants at the expense of others negatively impacts not only the attainment of the goals of the National Market System but also investors of every type and size.

We would do well to heed Commissioner Paul Atkins remarks when he said, "Since competition was the underlying justification for, and the by-product of, the 1975 Amendments, competition should continue to drive our decisions to seek further efficiency in the 21st century."[13] Rules that promote competition and fairness will ultimately benefit investors and the markets in general. A good starting point for solutions to the current market structure problems is to establish more efficient and appropriate connectivity and access between market centers and to institute consistent rules for all market participants trading and quoting the same security. Such rules will help to ensure that US markets remain the most efficient and liquid markets in the world, as envisioned by the goals set forth for the National Market System.

US policymakers and regulators must address the areas that impede the continued advancement of the goals of the National Market System, namely the maintenance of efficient, competitive and fair markets. The Congress, by its oversight of the SEC, plays an important role in ensuring that the SEC focus on market structure issues that harm the integrity of US markets. The SEC has examined market structure issues for several years, so it should be in a position to act. Several Commissioners have correctly commented on the need for the SEC to seriously focus on addressing the market structure problems, and the STA encourages them to act now and address these issues in a systematic manner. Inaction is itself a decision and serves only to exacerbate the existing problems. Failing to act on these matters would only further degrade the capital formation and retention process, negatively impacting the growth of jobs and the US economy.

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[12] Section 11A(a)(1)(C)(iii), Securities Exchange Act of 1934
[13] Commissioner Paul S. Atkins, Remarks before the American Enterprise Institute, Washington, DC, May 7, 2003.

SPECIAL REPORT

Fulfilling the Promise of the National Market System

STA'S Perspective on U.S. Market Structure

August 2003

STA SINCE 1934
Security Traders Association

About STA

STA is the leading trade organization for industry professionals in the securities industry. Its mission is to improve the ethics, business standards and professionalism of its members. With 29 affiliate organizations and more than 7000 individual members, STA is the largest group of its kind in the world.

Our Vision

"By 2005, become recognized as the representative organization of security traders across all markets and the leading authority and champion of individual practitioners on issues affecting traders and markets; earn the reputation of being a leading advocate of policies that foster investor trust, professional ethics, marketplace integrity; and advance an agenda that supports capital formation, jobs creation and marketplace innovation."

STA's Perspective on U.S. Market Structure

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Security Traders Association

STA SINCE 1934

August 1, 2003

To Those Interested in U.S. Market Structure Issues:

In 1975, the Congress mandated that the Securities and Exchange Commission ("SEC" or "Commission") facilitate the development of a National Market System ("NMS"). Its goal was to assure that securities markets in the United States remain the most efficient and liquid in the world. It was expected that the NMS would foster best execution of customer orders and that broker-dealers would place the interests of their customers first. The Security Traders Association ("STA") shares the goal of achieving the objectives of the NMS, and maintaining efficient and liquid U.S. markets. Fulfilling the promise of the NMS will serve to make the securities markets more efficient and the capital formation process more robust, and in turn benefit the nation's economy and investors in this critical time for the United States.

Much has been accomplished. The heart of the NMS is the integrated delivery of consolidated market information on a real-time basis. Both market professionals and individual investors have more transparent information than was thought possible in 1975. Not only is there reporting of last sale prices and bids and offers for both listed and NASDAQ securities, but also various markets have begun to provide "depth of book" quotes showing liquidity away from the inside market.

Much remains to be done, however. New technologies and the explosion in individual investor participation in the markets, both directly and through institutional money managers, call for continuing analysis of the current market structure and appropriate modification of current rules. The STA does not believe in and does not advocate a complete restructuring of the securities markets in the United States. The NMS has been, and will continue to be, dynamic, constantly evolving to meet current market conditions - conditions driven by investors, industry competitive forces, advances in technology and communications, and the valued and essential work of the Commission and the Congress. To that extent the NMS is simultaneously a market reality and a market goal.

As securities traders, STA members are responsible for executing transactions for and providing liquidity to the American investor. Each day STA members drive the economic engine of the capital in the U.S. markets. The STA represents the shared interests of its approximately 7,000 members, all engaged in the purchase, sale and trading of securities, who belong to one of our 29 national and international affiliate organizations. Our members come from the institutional or "buy side" and the broker-dealer or "sell side" of market participants and from trading venues, including exchanges and Electronic Communication Networks ("ECNs"). STA members facilitate the execution of NASDAQ, bulletin board and exchange listed stocks.

It is from this perspective that STA offers our analyses and recommendations to the Congress, SEC, the securities and investment community, and the investing public.

The STA hopes that our analyses and recommendations will assist the regulatory community to identify and address those areas most likely to impede, rather than further, the maintenance of an efficient and liquid market in which trading venues and trading parties compete with each other on a level regulatory playing field on the basis of execution quality.

John P. Hughes
Chairman

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Dictum Meum Pactum

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Background

The 1990s represented a period of significant change in U.S. market structure. New technology and an unprecedented level of and ability to trade demanded an examination of the market structure and the development of new rules to assure both investor protection and fair, liquid, and orderly markets.

In addition to technological changes in what had previously been a paper-based environment, new market models were appearing worldwide such as for-profit, demutualized stock exchanges and remote memberships. In the United States, technology and competitive forces allowed for entirely new types of market participants, specifically ECNs and other Alternative Trading Systems ("ATSs"). These have been followed by yet newer technology delivery systems such as order management systems, systems integrators and smart order routers. The new environment has led to a number of issues, many of which meet at the fulcrum of transparency and access.

As changes occurred, the SEC's Division of Market Regulation and the Congress examined issues from the perspective of market design, and responded by promulgating and instituting new rules. Among other developments, certain new rules addressed transparency requirements, order handling (and the attendant development of fees to access ECN liquidity) and decimalization. The impact of these rules continues to be felt. STA suggests that the continued effectiveness of these rules in terms of moving towards the goals of the NMS needs to be examined.

While the regulatory environment evolved, the industry wrestled with these same issues from a competitive point of view, consistently providing a greater range of technology to execute orders, with various underlying costs and prices. On the positive side, traders and investors now have available a range of choices in order execution, all of which compete against each other in terms of execution quality to attract order flow. At the same time, the effect of these intense competitive developments on markets and investors continues to be debated, even as the markets themselves are under increasing performance strains.

The STA knows from experience that competitive forces drive innovation. At the same time, rules that advantage one set of participants at the expense of others not only impede movement towards attaining the original objectives of the NMS, but also may adversely impact investors.The problem of the seeming tension between competition and regulation can be resolved.

STA believes the solution is straightforward and rooted in protecting competition on the one hand by establishing adequate, efficient and appropriate connectivity between, and access to, all market centers and their platforms, and by establishing consistent rules, equally binding on, and applied to, all market participants trading and quoting the same security. The net effect will be inclusion of, and continued competition between, all who have innovative ideas to bring to the securities markets without favoring some innovators over others at the expense of the investing public.

To move towards this solution there must be a commitment to ensuring the establishment of efficient linkages between markets coupled with consistent rules. Within that context, STA believes an evaluation of current linkages in markets for both listed and NASDAQ stocks is necessary. This evaluation should be comprehensive and cover the Intermarket Trading System ("ITS") and the propriety of ECN access fees. The benchmark for this evaluation should be whether they impede or promote movement to the NMS.

In addition, to assure compliance, self-regulatory organizations ("SROs") need to apply these consistent rules based on asset class, and according to the practices dictated in the primary listing market for each security. And this needs to be backed by adequate surveillance and enforcement.

To understand the basis for STA's perspective, below is an analysis of the current situation, the keys to moving to a newer more robust environment in the future that achieves the objectives of the NMS, and recommendations on specific actions to move rapidly forward.

The Current Situation

The responses to the rapid changes in technology, trading activity levels, and trading practices have led to certain structural anomalies that impede attaining the objectives of the NMS and which negatively impact both the markets and investors on a daily basis. These anomalies effect the ability to get accurate quotations, the ability to access liquidity, and, therefore, best execution of customer orders.

These negative effects can be seen in four specific areas tied to connectivity and regulation, where recent developments have had a negative impact on market efficiency. Specifically, these issues are fragmentation, connectivity and access to other markets, ECN access fees and regulatory arbitrage.

Each is examined in turn below.

I. Fragmentation

Only two years ago, 98% of all volume in NASDAQ securities was reflected by quotations in NASDAQ. At that time, the only market trading NASDAQ securities other than NASDAQ was the Chicago Stock Exchange ("CHX"), which accounted for less than 2% of the volume and was linked to NASDAQ through the SelectNet System. As a result, traders in NASDAQ and the CHX could easily access each other's markets in the same manner. Today's market for NASDAQ securities looks vastly different. This market has five active venues where NASDAQ securities trade:

1. American Stock Exchange, which recently began to trade NASDAQ stocks. The Amex is the only market trading NASDAQ securities that does not provide automated execution of inbound market and marketable limit orders.

2. ARCA Exchange, an outgrowth of a joint venture between the ECN, Archipelago, and the Pacific Stock Exchange ("PSE") whereby Archipelago operates as a facility of the PSE;

3. Cincinnati Stock Exchange ("CSE"), through which the Island ECN quotes all of its NASDAQ quotations. The CSE now accounts for over 10% of the volume in NASDAQ stocks;

4. NASD Alternative Display Facility ("ADF"), in which market makers and ECNs can display their quotations. The ADF began operations late in 2002 and one of the largest ECNs, Instinet, now displays its quotations there. Another ECN, NexTrade, is beginning to migrate to that facility; and

5. NASDAQ's SuperMontage, which within the next few months, it is likely to reflect less than 50% of all NASDAQ trading volume.

To the extent that the availability of alternative trading venues creates an environment of competition based on price, liquidity and execution capabilities, fragmentation is a positive force. But the positive attributes of market fragmentation, such as robust competition and constant innovation, are lost without active contemporaneous efforts to link trading venues with a consistent set of underlying principles and rules governing access to and behavior in those venues. In effect, market fragmentation alone can result in inefficient markets, which may benefit some market professionals but not the investing public. Recent market structure events for NASDAQ stocks have made market fragmentation a real concern that must be addressed.

II. Lack of Intermarket Linkage and Prevalence of Locked & Crossed Markets

The fragmentation described in the prior section has resulted in severe market dysfunction because of the lack of neutral, efficient intermarket linkages and the lack of a common regulatory structure regarding their use. This has created numerous problems for market participants as they face frequent locked and crossed markets in NASDAQ securities and still seek to fulfill their best execution obligations. Certain private vendors do provide linkages to various markets that make access easier, but at least one exchange does not provide automatic execution of incoming orders, a fundamental feature that should be required. It is clear, however, that these private initiatives do not sufficiently address the problems arising from fragmentation. Without linkages that provide consistent, reliable and efficient execution standards and rules requiring their use where appropriate, investors suffer because broker-dealers face impediments to their efforts to make appropriate order routing and best execution determinations on behalf of their customers.

In 2000, the Securities Industry Association (SIA) identified four central characteristics for effective market linkages:

* State of the art technology;
* Automatic or immediate execution capability;
* Governance representation by all qualified market centers, and
* Access to the linkage for all qualified market centers (including direct access for market makers).[1]

The STA concurs that these characteristics provide a solid framework for effective linkages that also enhance competition.

As a result, STA urges the SEC immediately to oversee the development and maintenance of linkages that meet or exceed the underlying principles described above and to adopt, at a minimum, rules that prohibit intermarket locked and crossed markets.

However, linkages in and of themselves do not completely solve the problem. Without rules that prohibit markets from ignoring existing quotations and either posting quotations that lock those markets or simply trading through quotations, the linkages will be ineffectual. While there may indeed be valid reasons why a market would from time to time chose to ignore quotations from other markets, the fee structures adopted by certain ECNs and markets provide economic incentives to do so. The STA believes the convoluted rate structure used by these markets — whereby users receive rebates adding liquidity and are charged fees for absorbing liquidity — have led to negative behaviors in the marketplace. For example, suppose a customer was interested in selling a stock that was currently quoted at 10.00-10.05. Traditionally, the customer would execute its orders by accessing the 10 bid. In today's rebate scheme, the broker would be better off entering a sell order in an ECN at 10, instead of hitting the existing bid, and creating a locked market (10 best bid - 10 best offer), thereby receiving a rebate and, in the process, possibly depriving the customer of an execution.[2]

[1] See Comments on Securities Exchange Act Release No. 34-42450 from the Market Structure Committee of the Securities Industry Association (May 5, 2000).

[2] Simply stated, a "locked market" is one in which both the inside bid and inside ask for a particular security are identical, resulting in no bid-ask spread. This scenario occurs mainly in volatile and high volume trading. This abnormal market condition occurs primarily in NASDAQ and over-the-counter securities both prior to the market opening and throughout the day. NASDAQ rules require a market maker who locks a market to make reasonable attempts to trade with the market maker(s) it is locking prior to entering the locking quotation.

During the many years that NASDAQ had a virtual 100% market share, this activity was impossible due to the NASDAQ prohibition against locked markets. However, now, where volume is spread between many markets and where there is no intermarket prohibition against locked markets, this activity is commonplace.[3] Locked markets cause havoc in the market place. Customer orders represented by published quotations do not get filled when they should and, more importantly, automated execution systems do not function during periods when there are locked markets.

While the least intrusive way of dealing with locked markets would be to eliminate the economic incentives caused by the rebate structure, as a philosophical matter, we are not in favor of regulating rate structures. As a result, a more acceptable way would be to simply prohibit a market from entering a quotation that will lock the market.

For listed stocks, the STA recognizes that there has been an intermarket linkage in place for over two decades. The Intermarket Trading System ("ITS"), implemented in 1978, links all eight exchanges and NASDAQ and is intended to enable market professionals to interact with their counterparts in other markets whenever the Consolidated Quote System CQS shows a better price in another market. The ITS has not, however, realized its potential. Indeed, a very limited level of trading volume goes through ITS. This is in part due to the fact that some participants in ITS do not provide automated execution.[4] As currently structured, ITS often is used simply as a messaging system whereby a market can send a "commitment to trade" to another market that has up to thirty seconds to respond. Thirty seconds is an eternity in today's active, volatile markets. Without an automated or immediate execution facility, ITS is little more than a way of providing inefficient free access to the primary markets.[5]

Congress envisioned that "linking...all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the off-setting of investors' orders, and contribute to best execution of such orders."[6] Congress understood as far back as 1975 that a variety of linked trading venues competing for orders promotes a liquid and efficient market. Congress also had the vision to anticipate the power of technology to achieve such an integration of trading venues.

For ITS to be an effective linkage between markets it must have the capacity to match the technological prowess of market participants. ITS has the potential to do so, once it includes an automatic execution component.

[3] For further discussion of STA's views regarding the issues created by locked and crossed markets, see Letter to Jeffrey Brown, Chairman, NASDAQ Unlisted Trading Privileges Committee (March 6, 2003) - see Appenix A.

[4] STA notes that both the Cincinnati Stock Exchange and NASDAQ on their own initiative provide automated execution of inbound ITS orders.

[5] Another obstacle, at present, to realizing the potential for ITS is that its rules can only be amended with 100% assent by its members.

[6] Section 11A(a)(1)(D) of the Securities Exchange Act.

III. ECN Access Fees

It's simple: Investors deserve accurate, not distorted, prices in securities.

In 1996, the Commission adopted amendments to Rule 11Ac1-1 (the "Quote Rule") to require orders entered into ATSs by market makers and specialists to be publicly displayed[7] and, for the first time, gave ATSs the ability to disseminate those quotations through NASDAQ. Those ATSs that chose to display these quotations were referred to as electronic communication networks, or ECNs.

Requiring the display of these quotations meant nothing unless investors who were not subscribers to the ECNs could access these orders. As a way of securing the cooperation of the ECNs, the SEC included in the adopting release a statement that ECNs must provide non-subscriber broker-dealers with a means of accessing these displayed prices that is equivalent to the means of access provided by the exchanges and NASDAQ.[8] Moreover, the SEC said that ECNs could charge fees for access to their systems that were similar to the communications and systems charges imposed by other markets so long as those access fees were not structured to discourage access by non-subscriber broker-dealers. Subsequently, the SEC granted no-action relief to ECNs based, in part, on representations by the ECNs that they would charge non-subscribers fees no greater than the fees charged their active broker-dealers subscribers, and in no event more than $0.015 per share (the most current SEC mandate has revised this to $0.009 per share).[9] Interestingly, only ECNs have been permitted to levy such access fees. The SEC has expressly precluded market makers from doing the same. This creates a regulatory imbalance that not only fails to provide a true price to investors but which also unfairly provides a revenue source for ECNs unavailable to other market participants.

As STA has stated in previous comments provided to the SEC,[10] STA considers ECN access fees a hidden cost to accessing ECN quotations. Because these fees are not included in the published quotations of ECNs, the quotations do not reflect the true price available at an ECN. This distortion and lack of market transparency is inconsistent with the objectives of the National Market System.

Furthermore, because access fees are not reflected in the quotations of ECNs, they also impact the ability of market makers and order routing firms to obtain best execution, especially when these fees are passed on to customers.[11] In addition, the ECN access fees, when combined with the significant reduction in the minimum trading increment and the average spread since conversion to quotation in decimals have the effect of completely eliminating the dealer spread in many stocks. STA believes that the reduction, and at times elimination, of the dealer spread, though reducing costs for some investors, has contributed to a loss of liquidity in the over-the-counter markets.

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

[8] 61 FR at 48314.

[9] Currently, various ECNs charge anywhere from $0.0025 to $0.009 per share; the resulting amounts paid to ECNs by certain non-subscriber broker-dealers are significant.

[10] Letter to the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, regarding ECN Access Fees, from John C. Giesea, President, Security Traders Association (April 16, 2003); Letter to the Honorable Harvey Pitt, Chairman, Securities and Exchange Commission from Security Traders Association Trading Issues Committee (March 5, 2002) - see Appendix B.

[11] In order to address this concern, NASDAQ added a feature to SuperMontage that permits market makers and order routing firms to elect to execute against ECNs that charge fees last at any given price level. However, given the fact that access fees can exceed the minimum price increment, the net price available through the ECN would still be worse than the price available at the next pricing level.

IV. Regulatory Arbitrage

In the markets for listed securities, the SEC and the SROs have put in place certain minimum standards that apply regardless of the market in which a security is traded. Examples include the short sale rule and the various ITS rules such as unified opening, trade through and block execution rules. These uniform rules reflect the view of the SEC and industry that a market must meet certain minimum standards to participate in the NMS and the fact the market participants cannot seek "lowest common denominator" regulation through regulatory arbitrage. The market for NASDAQ stocks does not have these uniform rules.

Three years ago, when only two markets traded NASDAQ stocks, this disparate regulation was acceptable. Today it is not. New entrants into the NASDAQ trading arena openly advertise the fact that there is no short sale rule in their markets. While STA does not wish to open a debate on the merits of the short sale rule, the SEC has not abrogated the rule for listed stocks and the fact remains that the NASD adopted a similar rule for NASDAQ stocks at a time when it had 100% market share. With NASDAQ market share now approaching 50% this disparate regulation makes no sense and harms the integrity of the markets.

Similarly, the disparity between the enforcement and surveillance policies of different market centers has provided an incentive for some participants to direct order flow to those market centers that may have lax surveillance and enforcement programs.

The existence of this "regulatory arbitrage" harms the integrity of the entire marketplace, impedes best execution, and does not serve to protect investors. As described below, STA believes that consistent trading rules and integrated surveillance systems would further investor protection, improve execution quality, prevent fraud and manipulation, and reinforce principles of fair trade between members and their customers.[12] As envisioned by the framers of the National Market System, such action would allow market centers to compete for order flow on the basis of the quality of execution provided and the provision of other services and systems, not the ability to trade and quote without regulatory and investor protection concern.[13]

[12] Indeed, the SEC, in its Request for Comment on NASDAQ Petition relating to Regulation of NASDAQ-listed Securities, Securities Exchange Act Rel. No. 47849 (May 14, 2003), specifically requested comment on the issue of whether trading rules and market surveillance require greater consistency.

[13] See Letter to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, regarding Commission Request for Comment on NASDAQ Petition relating to Regulation of NASDAQ Listed Securities from the Security Traders Association Trading Issues Committee (June 19, 2003) - see Appendix C.

Recommendations

To address the various problems discussed above and to continue progress towards the goals of the NMS, STA recommends the following:

Recommendation 1: Improve Linkages and Intermarket Trading Rules

As described above, STA concurs that there are four central characteristics for effective market linkages:

* State of the art technology;
* Automatic or immediate execution capability;
* Governance representation by all qualified market centers, and
* Access to the linkage for all qualified market centers (including direct access for market makers).

STA recommends that the SEC mandate that both listed and NASDAQ stocks have linkages that meet or exceed these principles. These linkages should be accompanied by intermarket rules that, at a minimum, prohibit locked and crossed markets.

For Listed Securities

As discussed earlier in this paper, the ITS has been in place for over two decades, but does not, in its current form, provide for efficient executions consistent with the NMS. STA believes that the Commission should mandate improvements to ITS to provide for more efficient and timely executions.

For NASDAQ Securities

STA strongly recommends that the SEC immediately establish and/or oversee the establishment of intermarket linkages and locked and crossed market rules as described above. The linkages must provide automatic execution functionality (assuring the reliability of the market centers' quotations), access to all exchanges and other market centers including broker-dealers and ATSs and technology commensurate with that currently required by the SEC in its approval of other markets.

Recommendation 2: Consistent Rules, Enforcement and Surveillance

Regulatory arbitrage serves to reduce the overall quality of our markets and must be eliminated. STA believes that the SEC must mandate the adoption of consistent, standardized trading rules, such as the short sale rule, among markets trading like classes of securities (i.e. NASDAQ securities and exchange-listed securities). Similarly, surveillance and enforcement functions should be equivalent across markets. Standardization of this type may significantly reduce the need to consider a single SRO by eliminating many, if not most, of the inconsistencies that leave these markets susceptible to manipulation.

All customer-protection related rules applicable to order execution should be uniform to maximize protection of the public investor and to ensure that order flow is not determined by lax, ineffective or nonexistent regulation. In certain cases, markets have imposed rules on their own market maker members that go above and beyond previous standards for providing enhanced guarantees to customer orders. In these cases, rules may rightfully differ and markets should be encouraged to adopt rules to better service the public. Yet, when a disparity surrounding a rule (or lack of a rule) is engineered for the sake of attracting order flow, without any relationship to enhanced customer protection or service consistent with national market principles, it is possible that the SEC should step in to enforce consistency. Within such a framework, marketplaces can compete with each other on the basis of execution quality, allowing such competition to put the public investor in the best possible position.

The regulatory imbalance generally has contributed to a fragmented regulatory framework that increasingly inhibits the ability of the various SROs to surveil for and enforce against intermarket manipulative and fraudulent activity (in addition to their surveillance for and enforcement against such conduct occurring in their respective marketplaces). STA believes that attempts to enhance the current Intermarket Surveillance Group ("ISG") information-sharing agreement, or mandates directing each market center to establish an order audit trail similar to that implemented by NASDAQ, will not improve the regulatory regime.

Instead, STA believes that the SEC should mandate standardized rules across markets trading the same securities (i.e., NASDAQ securities or exchange-listed securities) in each case where a disparity of such rules appears to be for the purpose of gaining a competitive edge without adding any real benefit to the protection of investors.[14]

Recommendation 3: Eliminate ECN Access Fees

STA believes that the changes to the marketplace brought about by the conversion to decimalization and the deleterious effects of access fees on market transparency and best execution strongly suggest that ECN fees should be abolished. The difficulties in monitoring the level of fees and the problems created by including access fees in ECN quotations argue in favor of the SEC taking action and abolishing the charging of such fees.

We note that on June 13, 2003 at the Fourth Annual SIA Conference on Market Structure, Annette Nazareth, Director, SEC Division of Market Regulation, stated:

> The treatment of access fees is another difficult market structure issue that continues to plague the Commission staff. It is remarkable to me that, in such a highly regulated and developed securities market, we find ourselves without a common convention for quoting bids and offers. Without belaboring how we got to this state, let it suffice to say that it is critical we address this unenviable situation in which a price may or may not be a price - it may be a net price, but it may also represent the price with an unstated access fee to be added on top. This disparity - this lack of a uniform convention - causes innumerable difficulties in our national market system, such as a higher incidence of locked and crossed markets, and competitive inequalities between ECNs and market makers. As a result, I believe the Commission will address this issue sooner rather than later.
>
> Obviously, there are a number of potential solutions - from adding the fees to the quote, to permitting fees of a *de minimis* level to, finally, banning access fees outright. The first potential solution, adding the fees to the quote, is the most problematic in my view. For example, the various concerns market participants have raised with the advent of penny spreads would be magnified many times over by the subpenny pricing that would result were access fees simply added to the quote. I take a somewhat simplistic view of subpenny pricing - we don't subscribe to it for virtually any transactions in this country, save for gasoline purchases - but I do believe in this case the burdens would far exceed the benefits. I personally find the other potential solutions to the access fee issue more promising, and I look forward to working with the Commission and the industry to examine them in more depth.[15]

[14] The regulatory community may wish also to consider whether generic surveillance and examination functions should be consolidated into two SROs, one responsible for markets trading NASDAQ securities and the other responsible for markets trading exchange-listed securities. This consolidation might improve examination oversight and policing for manipulative conduct across markets trading and/or quoting specific securities.

[15] STA concurs with Director Nazareth's assessment that quoting in sub-pennies would be deleterious to the markets. See STA letter to the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, regarding Reexamination of Decimalization (May 14, 2003) - see Appendix D; STA comment letter to the Honorable Laura Unger, Acting Chairman, Securities and Exchange Commission, regarding Trading in Increments of Less than One Penny (June 27, 2001) - see Appendix E.

Conclusion

STA recognizes that the NMS will always be a work in progress. Yet as STA looks at the NMS as a benchmark against which to measure market progress and a goal towards which efforts must be directed, STA questions whether all that can be done is being done. As innovations continue, and as new players, practices, and financial instruments enter the markets, markets and market participants must not lose sight of the NMS as a measure and goal. And it is in that light that we see this as an opportune time to take stock, even as we move forward.

The STA believes, based on experience and analysis, that by following basic principles to drive future market structure, the promise of the NMS on behalf of the investors we represent can be fulfilled sooner, rather than later.

Key to achieving this goal is the connecting of and access to all market centers by all market participants on an equal and level basis. At the same time, rules that are binding on and applicable to all participants will assure consistent practices in this environment as well as guarantee investor protection.

The general strength of any market is its ability to inspire investor confidence. Technologically, the tools are available to deliver on automated execution across market centers. What is required is the will to achieve that connectivity. The requirements for best execution demand nothing less.

Such connectivity will assure that innovation and competition will continue to drive the markets. At the same time, setting rules that protect all market participants and advantage none will assure continued confidence in the market on the part of investors and market professionals.

The securities markets in the United States and those responsible for determining the structure of those markets cannot let this opportunity pass. STA urgently recommends careful consideration of the recommendations in this paper and looks forward to a rigorous conversation with regulators, legislators, and our colleagues and our clients.

Appendix A

March 6, 2003

Jeffrey Brown
Chairman
Nasdaq Unlisted Trading Privileges Committee
440 South LaSalle Street, 26th Floor
Chicago, Illinois 60605

RE: Locked and Crossed Markets

Dear Mr. Brown:

The Security Trader's Association ("STA") is writing to the Nasdaq Unlisted Trading Privileges Committee ("UTP Committee") to express its concern about the currently excessive instances and duration of locked and crossed market conditions for a security across different exchanges and markets. As will be discussed in greater detail below, the existence of such market conditions cause significant confusion to the public investor, has a deleterious effect on the speed of execution, and generally disrupts the marketplace. The STA urges the UTP to amend the Unlisted Trading Privileges Plan ("Nasdaq UTP Plan") and promulgate policies that will operate to significantly reduce or eliminate these market conditions.

The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world.

Background

With the creation and implementation of the NASD Alternative Display Facility ("ADF") and the increased trading of Nasdaq securities pursuant to unlisted trading privileges, the STA has recognized a significant increase in locked and/or crossed market conditions between the various exchanges and market participants trading such securities.

Additionally, the extended duration of these conditions exacerbates the harm caused to public investors and other market participants resulting from these deleterious conditions. The increased number of these instances appears to be a direct result of the absence of any rules or policies addressing these conditions,[1] the absence of an electronic linkage and automated execution facility between various exchanges and markets and the apparent desire of some market participants to purposefully lock and/or cross the market in order to attract order flow and, as a result, charge an access fee to the participant that directs a transaction to that party to unlock or uncross the market.[2]

The Effects of Locked and Crossed Marlet Conditions

Locked and/or crossed market conditions cause substantial confusion to the marketplace, public investors and other market participants. The existence of locked and/or crossed markets add significant confusion to the public investor and provide the appearance of an irrational marketplace where it appears that broker-dealers are willing to pay him more for a security than they would be willing to sell it to him for. With this confusion in place, the investor loses the ability to gauge the marketplace for the security and determine if the price of the security is increasing, decreasing or remaining steady, whether he is obtaining a good price and whether it is an appropriate time to purchase or sell. Moreover, such conditions could provide the investor with a false perception of the price volatility of the security.

During a locked and/or crossed market condition many firms shut off their automated execution functionality and attempt to execute orders on a manual basis. This results in slower executions or limited executions until the market unlocks/uncrosses, further confusing the investor as to the operation of the market place, the speed of execution of his order and the appropriateness of his investment decision. Further complicating the execution of the investor's order is the decision as to what price the order should be executed when the inside market is locked and/or crossed. Depending on what prices are reflected when the market unlocks/ uncrosses, if the customer's order is executed at the inside market during a locked/crossed market condition, the customer could receive a very good or very poor execution. A professional market participant is, thus, at a quandary as to how to price the order and such indecision slows down market operations to the detriment of the investor.

The Current Regulatory Environment

Currently, there are no promulgated rules by the Securities and Exchange Commission or the various exchanges and other markets that specifically address this situation. Most markets do, however, maintain rules that operate to deter or eliminate the occurrence of locked and/or crossed markets within its market. For instance, in The Nasdaq Stock Market ("Nasdaq"), NASD Marketplace Rule 4613(e) provides that a market participant shall not, except as provided below, enter or maintain a quotation in Nasdaq during normal market hours if the bid (ask) quotation entered is equal to or greater (less) than the ask (bid) quotation of another market participant entering quotations in the same security. A market participant may lock or cross the market, however, if, prior to entering the quotation that locks or crosses the market, the market participant first makes reasonable efforts to avoid such locked or crossed market by attempting to execute transactions with all market participants whose quotations would be locked or crossed.[3] Additionally, in the event that extraordinary circumstances exist, a market participant may lock or cross the market regardless of whether it has first made reasonable efforts to trade with those market participants whose quotes would be locked or crossed. While the rule does not define "extraordinary circumstances," Nasdaq and NASD Regulation have previously stated that such circumstances generally could exist when there are systemic, market-wide failures in the operation of Nasdaq quotation, execution, or trade reporting and dissemination systems that render Nasdaq quotations virtually inaccessible and/or wholly unrelated to current market activity.

Likewise, NASD Marketplace Rule 5263 requires an ITS/CAES market maker that enters a quote that locks/crosses the market to promptly send a commitment to trade to the other ITS Participant Exchange or ITS/CAES Market Maker it locked/crossed.[4] While these rules provide some effect in controlling the incidents and duration of locked/crossed markets quoted and traded within Nasdaq and for listed securities traded through the ITS, there are currently no rules in effect that operate to prevent such instances between markets quoting Nasdaq securities. In fact, as demonstrated by previous NASD and AMEX pronouncements the quotations of other marketplaces can be ignored for the purposes of locked/crossed market compliance.

STA's Recommendations

The STA believes that the current state of affairs is untenable and needs to be addressed immediately. Further, the STA believes that this issue can be addressed faster and more efficiently by voluntary compliance with policies established by the UTP Operating Committee as opposed to SEC rule promulgation. The STA believes that this issue could be addressed through the following proposals:

1. Prior to entering a quote that would lock/cross another Exchange or Market's quotation, such market participant should be required to first make reasonable efforts to trade with the Exchange and or Market it would lock or cross. The required reasonable effort could be documented by the memorialization of the time of the manual or electronic routing of the order or bid/offer the time the market participant entered the locking/crossing quotation. The STA believes that providing the Exchange or other Market seconds to respond in some manner to its order or bid/offer[5] would demonstrate a reasonable effort to trade.
2. Prohibiting the charge of an access fee by an Exchange or Exchange Member when such Exchange is actively locking/crossing the market.

Conclusion

The STA strongly urges the UTP to take immediate action on this issue to reduce or eliminate these harmful market conditions and increase the efficiency of the marketplace and investor protection and confidence. Please do not hesitate to contact us at 212-867-7002 if you have questions or need further assistance. We would be happy to continue this dialogue with you and help in any way we can to address this unfortunate and troubling situation.

Sincerely,

John C. Giesea
President/CEO

Cc: Richard G. Ketchum
President and Deputy Chairman,
NASDAQ Stock Market, Inc.

Annette L. Nazareth
Director, Securities and Exchange Commission

Robert L. D. Colby
Deputy Director, Securities and Exchange Commission

[1] In fact, as expressed in NASD Head Trader Alert 2002-116 (August 12, 2002), NASDAQ reminded firms that they were permitted to lock-and-cross a non-participating UTP quote and that doing so is not a violation of NASDAQ's locked-and-crossed rule.

[2] See, Gregory Bresiger, SEC Urged to Take Action on Locked Markets, Traders Magazine News Services (January 16, 2003), where it was reported that Nasdaq contended that Island/Instinet is deliberately locking markets to its benefit, earning fees when participants end up in their system.

[3] While the rule does not define what constitutes a reasonable effort to avoid a locked or crossed market, Nasdaq and NASD Regulation staff had, in the past, stated that sending a preferenced SelectNet message for a duration of at least 30 seconds constitutes a reasonable attempt to trade. In determining reasonable efforts to trade between markets and exchanges, the STA believes that a similar minimum time requirement should be imposed

[4] ITS is only used for listed securities. There is no official intermarket linkage system for Nasdaq securities.

[5] In other words, if an Exchange or other market failed to execute the order or bid/offer within seconds, the market participant could enter a locking/crossing quotation.

Appendix B

April 16, 2003

The Honorable William H. Donaldson
Chairman
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington D.C. 20549

RE: ECN Access Fees

Dear Mr. Donaldson:

On behalf of the members of the Security Trader's Association ("STA"),[1] the STA again respectfully requests that the Securities and Exchange Commission ("SEC" or "the Commission") reconsider its position regarding the ability of Electronic Communications Networks ("ECN") to charge non-subscribers access fees and abolish the practice.

The STA has previously provided the SEC with its views on this issue through written correspondence and meetings with former Chairman Harvey L. Pitt, a number of Commissioners and Division of Market Regulation senior staff. It is not the intent of this letter to rehash the obvious deleterious effects this practice has had on the marketplace, market participants and public investors. Based on the STA's previous communications with the SEC, and the continuing dialogue between the STA, other market participants and the SEC, we respectfully believe that the SEC fully understands the significant harmful effects this practice has had on market transparency[2] and best execution[3] of customer orders. We also believe the SEC understands that this practice has created an uneven playing field by allowing ECNs, but not market makers, to charge such fees.

Further, since 1999, the SEC has recognized that allowing the imposition of access fees by ECNs on non-subscribers is a controversial issue that needs to be addressed. For instance Annette Nazareth, Director, Division of Market Regulation, recently stated:

I want to touch briefly on a point that I know is important to you, ECN access fees. It has become clear that changing market conditions, such as the narrowing of the spread and the participation of fee charging ECNs in automatic execution systems, may be adversely effecting the profitability of traders and harming the integrity of the public quotation. Indeed, this organization, along with other market participants, has taken the lead in providing thoughtful and helpful analysis on this issue. We have heard your concerns and they are helping us to frame our continuing examination of this issue in our dynamic and ever-changing capital markets.[4]

The STA also applauds the staff of the Division of Market Regulation for publicly stating that this issue should be the first issue the SEC addresses as a result of the Market Structure hearings it held in late 2002.[5]

In light of the fact that the SEC staff is currently developing a resolution to this issue, the STA reiterates its view that ECN access fees be abolished. There is simply no competitive or market structure reason to allow the practice. In addition to its effects on transparency and best execution, there is no justification for allowing one market participant to charge a fee to another market participant when there is no contractual nexus or other agreement between the two parties for the provision of services or the imposition and payment of fees. Moreover, in today's Nasdaq SuperMontage environment, a market maker is forced to pay an ECN access fee, not only where it has never agreed to do so, but also in a situation where it has made no direct effort to route its order to an ECN or attempt to access the ECN's quote.

The STA respectfully believes that it is time to level the playing field and urges the SEC to act quickly and abolish ECN access fees. An ECN should be limited to charging fees to its subscribers just as a market maker may only charge fees to its customers. Any other solution to this controversial issue will only exacerbate the harms previously addressed above by Ms. Nazareth and the STA and cause further harm to the public investor.

Please do not hesitate to contact me if you, or your staff, if you have any questions, need any assistance or wish to discuss this matter further.

Very truly yours,

John P. Hughes
Chairman

John C. Giesea
President & Chief Executive Officer

cc: Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Hon. Paul S. Atkins
Hon. Roel C. Campos
Annette L. Nazareth
Robert L.D. Colby

[1] The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world. (More information about the STA is available on the Internet at : (http://www.securitytraders.com).

[2] Because these fees are not included in the published quotations of ECNs, these quotations do not reflect the true price available at an ECN. In the case of a security with a penny spread this type of distortion is significant and obscures the actual market for the security. This distortion and lack of market transparency is simply inconsistent with the objectives of the National Market System. This problem is exacerbated by the auto-execution system feature of SuperMontage. Because that system will automatically execute market orders and marketable limit orders against the quotations of any market maker or ECN, a market maker or order routing firm may find itself paying access fees that it affirmatively does not want to pay.

[3] If an ECN quotation is executed against in SuperMontage and that ECN charges an access fee, either the customer or its broker will be penalized for attempting to obtain this price.

[4] Nazareth, Annette L., Remarks at Washington Congressional Conference of the STA (May 9, 2002).

[5] Nazareth, Annette L., Colby, Robert L.D., Remarks at SIA Legal and Compliance Seminar (April 7, 2003).

Appendix C

June 19, 2003

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

Re: Commission Request for Comment on Nasdaq Petition relating to Regulation of Nasdaq-Listed Securities (File No. S7-11-03) (the "Petition")

Dear Mr. Katz:

The Security Traders Association[1] Trading Issues Committee ("STA Trading Issues Committee") welcomes the opportunity to provide its views to the Securities and Exchange Commission ("SEC" or "Commission") regarding the SEC's request for comment on the Petition for rulemaking and whether the concerns raised by Nasdaq in its petition exist also for exchange-listed stocks and options.

On April 11, 2003, Nasdaq filed the Petition requesting that the Commission take action to protect investors trading Nasdaq securities. Nasdaq requested that the Commission:

1. Exercise its authority under Section 19(c) of the Securities Exchange Act of 1934 (the "Act") and Rule 192 of the Commission's Rules of Practice to amend the rules of all markets that trade Nasdaq-listed securities to establish uniform trading rules and to ensure equal surveillance and enforcement of those rules;
2. Exercise its authority under Section 11A(a)(3)(B) of the Act, and Rule 11Aa3-2(b)(2) under the Act to order immediately that the exchanges' costs of regulation, including audit trail collection, surveillance, and enforcement, be aggregated and deducted from the market data revenue collected pursuant to the UTP Plan; and
3. Identify markets that trade Nasdaq-listed securities without approved rules, order audit trails, surveillance, and examination programs that are sufficient to protect investors that buy and sell Nasdaq-listed securities on those markets and, when a market lacks these functions, exercise its authority under Section 12(f)(2) and (f)(3) of the Act to prohibit the launch or continuation of Nasdaq trading by the market to prevent any failure to protect investors as required under the Act.

To address the issues of uniformity of trading rules, equal surveillance and consistent enforcement, Nasdaq specifically asked the Commission, at a minimum, to add to the rules of all SROs that trade Nasdaq-listed securities, rules requiring an electronic audit trail identical to the NASD's OATS Rules and short-sale restrictions similar to NASD Rule 3350.

Nasdaq also asked that, if the Commission's review of other markets' rules, surveillance, or enforcement revealed inequalities that could be addressed through the adoption of uniform rules, the Commission add those rules as well, to reduce regulatory inconsistencies among markets that trade Nasdaq-listed securities.

Nasdaq believes that the fairest way to allocate the costs of supervising the trading of Nasdaq stocks is to aggregate trading venues' costs of regulation, which include costs associated with surveillance and enforcement, and to deduct that amount from the market data revenue collected pursuant to the Nasdaq UTP Plan. Nasdaq believes that this method of funding aggregate regulatory costs would counter the existing economic incentives that lead markets to reduce their regulatory costs to compete for order flow.

The Commission has asked specific questions concerning the above requested relief. The STA Trading Issues Committee believes that while fairness is important between market centers, the overriding principle of investor protection should guide the SEC's response to the Nasdaq Petition. The STA Trading Issues Committee responds to certain of the SEC's questions as follows:

Request for Comment on the Need for Uniform Trading Rules and Surveillance

Q1. Do commenters agree with Nasdaq that there is unequal regulation of trading in Nasdaq securities?

The STA Trading Issues Committee agrees with the premise that regulatory contributions of individual marketplaces are not in balance with the extent to which they share in the benefits of a strong regulatory environment. While this imbalance is seemingly growing in the eyes of the Nasdaq, it also has become a matter of consternation to all market participants including, but not limited to, investors and broker-dealers, as it is those entities that ultimately shoulder the brunt of regulatory costs.

This regulatory imbalance has contributed to a fragmented regulatory framework that increasingly inhibits the various SROs in their ability to surveil for and enforce against intermarket manipulative and fraudulent activity (in addition to their surveillance for and enforcement against such conduct occurring in their respective marketplaces). The STA Trading Issues Committee believes that attempts to enhance the current ISG information-sharing agreement, or mandates directing each market center to establish an order audit trail similar to that implemented by Nasdaq, will not improve the regulatory regime. Instead, the STA Trading Issues Committee believes that the SEC should mandate standardized rules across markets trading the same securities (i.e., Nasdaq securities or exchange-listed securities) in each case where a disparity of such rules appears to be for the purpose of gaining a competitive edge without adding any real benefit to the protection of investors. The SEC should consider whether generic surveillance and examination functions should be consolidated into two SROs, once responsible for markets trading Nasdaq securities and the other responsible for markets trading exchange-listed securities. The STA Trading Issues Committee urges the Commission to consider the potential benefits that consolidation of these functions may have in improving examination oversight and policing for manipulative conduct across markets trading and/or quoting specific securities.

The STA Trading Issues Committee encourages the SEC to request and review empirical data from the various market centers that trade Nasdaq securities to determine the accuracy of Nasdaq's contentions concerning Nasdaq's claims of unequal regulation and the allocation of its costs.

The STA Trading Issues Committee encourages the SEC to redouble its substantial efforts to ensure that the rules of all securities exchanges and national securities associations adhere to the statutory directive that they are designed "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating...processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers brokers, or dealers, ..." Sections 6(b)(5) and 15A(b)(6) of the Act.

Q2. Should all exchanges and associations trading Nasdaq securities have rules requiring detailed audit trail information?

The STA Trading Issues Committee believes that this question can not be answered without an empirical examination of the benefits realized by the NASD in using OATS submitted information compared to the significant costs to member firms to record and report required information to OATS. Moreover, if a determination is made that such an audit trail is needed, the SEC must remain attuned to the costs involved in creating, maintaining and complying with multiple audit trail systems. The SEC might consider expanding OATS to include transactions in Nasdaq securities executed in other markets, rather than requiring separate "OATS-like" systems at other exchanges and associations.

Q3. Should all exchanges and associations trading Nasdaq securities be required to automate their surveillance and examination of Nasdaq trading on their markets?

Fundamentally and practically, the STA Trading Issues Committee believes that each SRO should implement appropriate automation in order to surveil and examine its marketplace for compliance with its rules and the federal securities laws in a thorough and timely manner. That being said, the STA Trading Issues Committee does not believe that a lack of technology should operate as a barrier for any market. If a SRO can demonstrate that its manual systems allow it adequately to surveil and to examine all transactions occurring in its marketplace, the SRO should be allowed to operate. The SEC must make any determination of adequacy of the systems of a specific SRO, however, pursuant to objective standards that focus first and foremost on the protection of investors.

Q4. Should all exchanges and associations trading Nasdaq securities have similar rules to regulate short selling?

The STA Trading Issues Committee believes that the SEC should mandate that all markets trading Nasdaq securities consistently address short selling. Today, short sale activity is regulated differently in different trading venues. SEC Rule 10a-1 generally prohibits short sales in securities listed on an exchange, other than on an uptick. The Nasdaq market short sale rule prohibits, subject to certain exceptions, short selling on a down bid. While these rules operate differently as a result of differing market structure and operation, their effect is the same - both rules prohibit short selling when the market price of a security is falling. The goal of these rules is to prevent manipulative and/or fraudulent activity. The SEC recently issued a Concept Release requesting comment on short sale regulation including, but not limited to, views on whether these rules remain necessary and effective. The SEC has yet to issue its findings in this area. If, however, the SEC concludes that short sale regulation remains warranted for the protection of investors, issuers and the marketplace, the SEC should ensure that such regulation applies in each market center and is consistently enforced.

Presently, within the fragmented market for Nasdaq securities, different market centers address short sale regulation in several different ways, including some market centers that do not regulate short sales of Nasdaq securities. Indeed, some market centers use the absence of a short sale rule to attract Nasdaq order flow. Inconsistent regulation works against protecting investors, however, and provides opportunities for regulatory arbitrage by investors and other market participants.[2]

Q5. What other trading rules should be uniform across all markets?

The STA Trading Issues Committee believes that all customer-protection related rules applicable to order execution must be uniform to maximize protection of the public investor and to ensure that order flow is not determined by lax, ineffective or nonexistent regulation. In certain cases, markets have imposed rules on their own market maker members that go above and beyond previous standards for providing enhanced guarantees to customer orders. In these cases, rules may rightfully differ and markets should be encouraged to adopt rules to better service the public. Yet, when a disparity surrounding a rule (or lack of a rule) is engineered for the sake of attracting order flow without any relationship to enhanced customer protection or service consistent with national market principles, the SEC should step in and impose corrective action. In addition, markets should set out consistent rules prohibiting quotation in increments below a penny to ensure that the positive benefits of trading in decimals are not lost and the negative attributes of trading in decimals are not magnified.[3] Within such a framework, marketplaces can compete with each other on the basis of execution quality allowing such competition to put the public investor in the best possible position.

Q6. How should the Commission address any regulatory gaps that can arise when trading in the same security is fragmented across different SROs?

The STA Trading Issues Committee believes that regulatory gaps can and do arise when the same security is traded across different SROs. Deficiencies in market structure arising from this fragmentation can be addressed, however, by improving the linkages between market places and by implementing consistent trading rules and surveillance mechanisms.

Unlike the markets for listed securities, there is no intermarket linkage system that even theoretically will permit a firm seamlessly to access liquidity in any of the markets in which Nasdaq securities are traded. For instance, in order to access the markets at the four exchanges trading Nasdaq stocks, an order-routing firm must be a member of each exchange or execute through a clearing firm that is a member of each exchange. Thus, an order-routing firm must maintain its own linkages to the four marketplaces and the two ECNs trading in the NASD's Alternative Display Facility (the "ADF"), as well as to Nasdaq. Furthermore, unlike the market for listed securities, the market for Nasdaq securities lacks an intermarket regulatory structure prohibiting locked and crossed markets or trade throughs, and, as described above, lacks consistent short sale regulation.

The STA Trading Issues Committee cannot over-emphasize the critical importance of accessibility in trading Nasdaq securities where there is active competition between markets with very different market models. Yet currently we lack an adequate linkage between markets that trade Nasdaq securities. This has created numerous problems for the market participants as they face frequent locked and crossed markets in Nasdaq securities and still seek to fulfill their best execution obligations. Certain private vendors do provide linkages to various markets that make access easier, but at very steep prices. It is clear, however, that these private initiatives do not address sufficiently the problems arising from the fragmentation. Without linkages that provide consistent, reliable and efficient execution standards, investors suffer because broker-dealers face impediments to their efforts to make appropriate order-routing and best execution determinations on behalf of their customers.

Previously, the SEC mandated creation of the ADF, but did not mandate linkages between markets using the ADF, and the markets have failed to develop linkages on their own. As a result, we urge the SEC immediately to establish or oversee the establishment of such linkages. The SEC must oversee creation of linkages that provides automatic execution functionality (assuring the reliability of the market centers' quotations), access to all exchanges and other market centers including broker-dealers and ATSs and technology commensurate with that currently required by the SEC in its approval of other markets.

The STA Trading Issues Committee notes that the formal mechanism for linkage between trading venues for listed securities is the ITS. The ITS operational and technological protocols have not, however, kept pace with the markets, and now the antiquity of ITS actually inhibits efficient linkage between the eight exchanges and Nasdaq that are the ITS participants because ITS processes information too slowly to be useful to most sophisticated market participants. Therefore, the STA Trading Issues Committee would recommend establishment of effective linkages in both the Nasdaq securities and exchange-listed markets in order to address regulatory issues or gaps caused by the failure of market participants to access each other.

Additionally, as described above, we believe that the SEC should mandate rule consistency across markets and should continue to consider whether surveillance and examinations should be consolidated in two SROs responsible respectively for the markets for exchange-listed and Nasdaq securities.

Q7. To what extent is ISG a useful mechanism for coordinating intermarket regulatory efforts? Does ISG fully address the regulatory gaps Nasdaq contends exist? Does the fact that the Commission does not have direct oversight of ISG limit the sufficiency of the ISG framework in ensuring adequate regulation of violative conduct in the trading of Nasdaq securities that can occur across markets, such as insider trading or certain market manipulations?

No Comment

Q8. Are there models sufficient to address potential concerns raised by fragmentation of regulation by multiple SROs trading Nasdaq securities?

No Comment

Q9. Are there advantages or disadvantages to a single market regulator with regulatory oversight across all markets trading Nasdaq securities?

As stated above, the STA Trading Issues Committee believes that the SEC's first priority should be to oversee adoption of consistent standardized trading rules among markets trading like classes of securities (i.e. Nasdaq securities and exchange listed securities). Standardization of rules may significantly reduce the need to consider introduction of consolidated SROs by eliminating many, if not most, of the inconsistencies that leave these markets susceptible to manipulation.

The SEC, of course, should continue to evaluate whether the "single" SRO model would be the most effective model. However, the SEC should not assume that the "single" SRO model is preferable to the existing SRO structure until markets have had a reasonable opportunity to compete within a framework of consistent marketplace rules.

Q10. Should a competitive bidding process be required to determine which entity will serve as the single regulator?

If the SEC ultimately determines that a single SRO should oversee markets that trade Nasdaq securities and that another SRO should oversee markets that trade exchange-listed securities, the SEC could conduct a competitive bidding process to determine these regulators. The STA Trading Issues Committee believes that the adequacy of surveillance and regulatory systems should be the deciding factor, however, when the choice of regulator is made, as selection of this entity solely on the basis of cost could place investors in peril.

Request for Comments on Allocation of Regulatory Costs

Q1. Should proceeds from the Nasdaq UTP Plan be withheld to pay for regulatory costs?

Q2. Would Nasdaq's proposal to aggregate and deduct regulatory costs from market data revenue result in adequate regulation? If so, what costs would appropriately be considered regulatory costs and therefore, appropriately deducted from the market data revenue?

Q3. Should other methods of fairly allocating regulatory costs be considered?

Q4. Should the NASD be required, as suggested by the CSE, to alter its systems to include more data from intermarket trading to improve inter-market surveillance?23 If so, who should pay for this enhancement?

Q5. Who would determine what are legitimate regulatory costs? On what basis should such a determination be made?

Overall, the STA Trading Issues Committee believes that the actual number of transactions reported on a marketplace should form the basis for determination of how to allocate regulatory costs. Regulatory costs could be derived from SEC Section 31 fees, the Nasdaq UTP Plan or through the imposition of transaction activity fees. The allocation of regulatory costs, however, raises the same issues the STA Trading Issues Committee addressed in response to the creation of the recently approved NASD TAF fee. In particular, broker-dealers and investors potentially could find that they must pay regulatory fees to more than one market center for the same transaction. If, however, such fees are properly allocated based on market participation, and one regulator operates as described above, this issue should be addressed.

Request for Comments on the Application of Nasdaq's Recommendations to Exchange-listed Securities

Q1. Do commenters believe that there is unequal regulation of exchange-listed securities among the markets trading such securities? If so, do commenters believe that the proposals made by Nasdaq with respect to Nasdaq securities would address such unequal regulation in the listed markets? If not, what other approaches do commenters recommend?

The STA Trading Issues Committee believes that the issues raised in the Petition do not presently exist in the exchange-listed environment in the same magnitude as in the Nasdaq Market, because at present the exchange-listed market is less fragmented. As competition increases, and market structure changes, however, fragmentation in the exchange-listed market will continue to increase. As a result, the issues raised in the Petition should be addressed across all markets to reduce the likelihood that they will arise in the exchange-listed market in the future. This will maximize protection of investors, in particular by minimizing the effects of fragmentation on their trading in exchange-listed securities at the same time that such effects are finally reduced for investors in Nasdaq securities.

Q2. Should the Commission require an intermarket consolidated order audit trial system for Nasdaq-listed and exchange-listed securities, other than options?

The STA Trading Issues Committee respectfully refers the Commission to the response to Question 2 in the first set of queries.

The STA Trading Issues Committee appreciates this opportunity to submit its comments pursuant the Commission's Request for Comment. As a membership organization, the Security Traders Association draws members from a wide spectrum of market participants. Therefore, the Trading Issues Committee membership covers a broad scope and these comments reflect the consensus views of the STA Trading Issues Committee.

Please do not hesitate to contact the undersigned at 212-867-7002 if you have any questions.

Very truly yours,

Mary McDermott-Holland
STA Vice Chairman
Co-Chairman-STA Trading Issues Committee

Mark Madoff
Co-Chairman-STA Trading Issues Committee

John C. Giesea
STA President and Chief Executive Officer

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

[1] The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world. (More information about the STA is available on the Internet at: (http://www.securitytraders.com).

[2] The STA Trading Issues Committee recently commented on ECN access fees, which create another unwarranted disparity, this one between marketplaces based on cost of access. Letter to the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, regarding ECN Access Fees (April 16, 2003).

[3] See STA comment letter to the Honorable Laura Unger, Acting Chairman, Securities and Exchange Commission, regarding Trading in Increments of Less than One Penny (June 27, 2001).

Appendix D

May 14, 2003

William H. Donaldson, Chairman
U. S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20546

Re: Re-examination of Decimalization

Dear Chairman Donaldson:

The Security Traders Association (STA) acknowledges your call yesterday (as reported by Reuters) for a complete re-examination of the impact of trading in decimals. We welcome such an examination and urge that it be undertaken promptly.

We believe that the introduction of decimalization, although well intended, has increased investors' costs, reduced transparency, increased volatility and diminished the visibility of liquidity. Indeed, a recent study by two Vanderbilt professors estimates that trading costs have increased by one to two percent of assets annually for active fund managers.

The goals of moving to decimals from fractions were clearly well intended. These included helping investors understand more easily the pricing of securities. They were also intended to narrow spreads, with the expectation that they would generate a significant saving for investors. While STA argued against the move, we understood the compelling logic for the Commission's action.

With the experience of the last two years, however, we are now finding that decimalization has produced a number of unintended consequences. These include increased costs to investors and economic hardship for specialists, market makers and those risking capital in adding valuable liquidity to the markets.

The confluence of a three-year bear market, market structure changes and decimalization is undermining the economics of the trading community and threatening its future.

The loss of liquidity providers and its potential impact on investors is of major concern to STA. While we would agree that the most active NYSE and Nasdaq stocks could literally trade "by themselves," those less active securities (the overwhelming number of publicly traded securities) and their shareholders do in fact benefit by the presence of market makers and specialists.

The raising of equity capital by corporations is the cornerstone of our economy. However, given the recent regulatory events surrounding research and investment banking and market structure changes affecting trading, the raising of capital has become exceedingly more difficult. That, in turn, is impacting the U.S. economy and its ability to create jobs.

Action must be taken soon to remedy what could soon be a capital formation crisis. A re-examination of decimalization is a good place to start.

In that connection, STA is prepared to be of assistance to the SEC in this undertaking in any way the Commission may find helpful.

Sincerely,

John C. Giesea
President & CEO

Cc: Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Hon. Paul S. Atkins
Hon. Roel C. Campos
Annette L. Nazareth
Robert L.D. Colby

Appendix E

June 27, 2001

Ms. Laura Unger
Acting Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington D.C. 20549

RE: Trading in Increments of Less Than One Penny

Dear Ms. Unger:

At the request of the Securities and Exchange Commission (the "Commission"), the Security Traders Association (the "STA") is providing the following comments concerning the potential consequences of allowing Nasdaq and the Exchanges to permit quotations and trades in Minimum Price Variations ("MPVs") of less than one penny ("Sub-Penny Trading").

Brief Summary

One of the principal benefits of switching from fractional to decimal pricing is the clarity and simplicity that the new trading increments provide for many public investors. Penny, nickel and dime increments incorporate both the international decimal standard as well as the currency of the United States, and provide a clear standard of reference and comparison for investors in the U.S. and abroad. Allowing quotations and trade increments in MPVs of less than one penny substantially undermines that benefit, and leads to a more obscure and confusing price structure than ever before. Sub-Penny Trading also exacerbates many of the negative consequences to transparency and liquidity that have accompanied the decimal conversion. The STA therefore urges the Commission and the U.S. Congress to act immediately to prohibit Sub-Penny Trading.

Discussion

The Commission has extended until September 2001 the deadline for Nasdaq and the Exchanges to submit reports detailing the impact of decimal pricing on the capital markets, and make recommendations concerning the suitable MPV for various securities. Currently the New York Stock Exchange requires that both quotes and trades take place in MPVs of one penny, while "Average Price" trades may be reported in up to four decimal places. Nasdaq requires that quotes take place in penny MPVs but does not apply this limit to trades. Therefore, on the Nasdaq Stock Market, trades can take place with no limit to the number of decimal places. The conflicting standards have caused a significant degree of confusion among investors and traders, and created a void that should be addressed by legislative and regulatory action.

Clarity and Simplicity

Since the beginning of the legislative effort almost six years ago to convert the U.S. capital markets from fractions to decimals, one of the primary motivating factors was the desire to simplify pricing for investors, and clarify the amount paid or received for the purchase or sale of a security. To the ordinary investor, fractional increments of 1/8 or 1/16 cannot be easily translated into a monetary equivalent. Nor can they be easily compared-while it may be immediately clear to the professional trader that a security offered on Exchange A at 10 13/16 and on Exchange B at 10 3⁄4 should be purchased on Exchange B, to the average investor who does not deal in fractions in his/her daily life this is not obvious. A price structure that reflects both the U.S. currency of pennies, nickels and dimes as well as the decimal system would, it was rightfully believed, provide a universally acknowledged price reference.

This desire for clarity was repeatedly stated by legislators and regulators alike to be one of the primary reasons for moving away from fractions. The sentiment was reflected in the naming of the "Common Cents Stock Pricing Act of 1997," which was the predecessor House Bill to the one that eventually enacted the decimal conversion. In recent testimony before the Subcommittee on Securities and Investments of the Senate Committee on Banking, Housing and Urban Affairs, most of the comments focused on the clarity that decimal increments have provided.

The STA supports decimal increments insofar as they provide clarity to the United States capital markets, and allow investors to easily compare prices across competing market centers. We urge the Commission to recognize, however, that the primary source of enhanced clarity is the correlation of the new pricing system to the United States currency. Any investor can more easily relate to a purchase price of $10.31 than to one of 10 5/16; or compare puts and calls trading in dime increments on the various options exchanges. The decimal conversion has succeeded in reducing security prices to the same terms used in daily life.

By severing the connection to the U.S. currency, Sub-Penny Trading completely undermines the common sense basis for the decimal conversion, and leads to a more confusing price structure than ever before. Would the average investor be more likely to understand a price of 10 3/8, or one of 10.369759139? We believe that Sub-Penny Trading would reduce security prices to a series of indecipherable numerical sequences extending out several decimal places to the right of the decimal point. This would deter the maintenance of "stable and orderly markets," which is one of the paramount goals of the National Market System (See S.Rep. 94-75, 94th Cong. 1st Sess. 7 (1975)). It would also change the focus of the trading community from providing fast, accurate and dependable prices to the splitting of incremental differences that have little impact on the average investor. This was most definitely not the intention of the Commission and Congress in enacting the decimal conversion.

We submit that if Sub-Penny trading had even been contemplated at the time of the enacting legislation, it most surely would have been rejected as contrary to the intention and spirit of the entire decimal conversion. We urge the Commission to act now to protect the enhanced clarity provided by decimal increments by prohibiting Sub-Penny Trading.

Transparency and Liquidity

While the public has benefited from simplified decimal prices, it is clear to our members that other elements of the conversion have led to some undesirable consequences. Many trading factors related to decimal quotations and trades are causing a growing number of market participants to conclude, for example, that decimal pricing has so thoroughly clouded transparency and reduced liquidity as to hurt rather than help most investors.

In the months leading up to the conversion, many industry commentators predicted that increasing the number of price points per dollar by over 600%, as occurred in the switch from sixteenths to pennies, would result in fewer shares available at any given quote. It was also predicted that the smaller MPVs would lead to shorter lived quotes spread out over more quotations, with increased "tick" changes. These phenomena have occurred to an even greater degree than anticipated, leaving many experienced traders concerned and frustrated.

According to the Commission's Office of Economic Analysis, The New York Stock Exchange has experienced a 60% decrease in display size, while Nasdaq has seen an even greater 68% decrease. The amount of liquidity available at the National Best Bid or Offer ("NBBO") has decreased not only because of the smaller display size, but also because many firms that used to guarantee executions at the NBBO can no longer do so. The new market features smaller quotes spread out over many price points, which frequently flicker in and out of existence and are therefore effectively inaccessible. In this environment the "true" market often remains hidden, making it difficult to provide the public with accurate price estimates. Traders are less likely to display size for fear of being "picked off," or improperly allocating capital.

The number of executions required to fill even small orders has increased dramatically as the number of shares available at any one price has diminished. In the decimal environment it is much less likely that orders will get filled at the NBBO, and traders are increasingly concerned with the percentage of trades executed outside of the inside market (or "override" trades). The NBBO, which is the primary price indicator broadcast around the world, has diminished in meaning and value. It no longer necessarily serves as an indication of the price at which an order can be filled, or the amount of time it will take for an order to be completed.

The industry has also witnessed an increase in the number of trading strategies designed to enhance profits by taking advantage of the smaller MPV. "Stepping ahead" or "pennying" of orders, for example, has reportedly increased significantly on many of the exchanges. Computer trading programs have proliferated that automatically post penny bids or offers in order to profit from limit orders. Such gaming practices do not further the interests of the public investor, and undermine confidence in the markets.

Sub-Penny Trading would exacerbate these problems by further obscuring the market for publicly traded securities. Liquidity would become hidden in even smaller amounts behind hundreds if not thousands of more infinitesimal trading increments that exist for ever shorter times. The role of the quote itself as a means of price discovery may come under question as display size diminished further. We believe that the type of gaming strategies designed to profit from penny MPVs would inevitably increase as the MPV infinitely decreased. It is even possible that many market participants would pull out of certain securities altogether as it became more and more difficult to manage risk.

Transparency and liquidity are the primary engines behind the historical success of the U.S. capital markets. Thousands of market participants willing to commit unlimited capital to two sided quotations of publicly traded securities is a phenomenon almost unique to this country, and its importance cannot be overestimated. It is the foundation behind the successful underwriting of investments that has made our markets the envy of the world. Sub-Penny Trading risks interfering with this critical function for little if any potential benefit to the public investor. The STA believes this is clearly a risk not worth taking.

Conclusion

The STA applauds the Commission for enhancing the clarity of the U.S. markets through the introduction of decimal increments. We urge the Commission to act now to protect those benefits by prohibiting Sub-Penny Trading. We are willing to work with the Commission in any way possible on this and other critical industry initiatives.

Very truly yours,

Lee Korins
President and Chief Executive Officer
Security Traders Association

Michael Bird
Chairman, Trading Issues Committee
Security Traders Association

Geoffrey Cloud
Counsel to the Trading Issues Committee

Glossary

Ask - The stated price at which a broker-dealer will sell a stated amount of a security to another market participant; also known as the "offer" price.

Alternative Display Facility ("ADF") - Operated by the NASD for its members to collect and disseminate published bid and ask quotations, compare trades and collect and disseminate trade reports for NASDAQ securities.

Backing Away - When a market maker fails to honor its published bid or ask quotation by not purchasing or selling the stated amount of shares at or better than its published bid or ask price when presented with an order. Backing away is a violation of SEC and SRO rules and is enforced through disciplinary action.

Best Execution - The obligation of a broker to seek to obtain for its customers' orders the most favorable terms reasonably available under the circumstances. This obligation derives from common law agency principles and fiduciary obligations.

Bid - The price at which a broker-dealer will buy a stated amount of a security.

Buy-Side - Investing institutions like mutual funds, pension funds, and insurance firms that tend to buy significant amounts of securities.

Crossed Market - When the inside bid price of a security exceeds the inside ask price. Contrary to normal markets where the bid-ask spread is positive, in a crossed market the spread is negative. This scenario occurs mainly in volatile and high volume trading. This abnormal market condition occurs mainly in markets for NASDAQ and over-the-counter securities both prior to the market opening and throughout the day. NASDAQ rules require a market maker who crosses a market to make reasonable attempts to trade with the market maker(s) it is crossing prior to entering the crossing quotation.

Electronic Communication Network (ECN) - An electronic system that widely disseminates to third parties orders entered by an exchange market maker or an OTC market maker, and permits such orders to be executed either in whole or in part. An ECN networks major brokerage firms and individual traders so that they can trade directly between themselves.

Inside Market - The highest quoted published bid and the lowest published offer price among competing market makers in a security.

Limit Order - An order placed with a broker-dealer to buy or sell a predetermined amount of shares only at a specified price or better. Limit orders also allow an investor to limit the length of time an order can be outstanding before being cancelled.

Locked Market - When both the inside bid and inside ask are identical, resulting in no bid-ask spread. This scenario occurs mainly in volatile and high volume trading. This abnormal market condition occurs mainly in NASDAQ and over-the-counter securities both prior to the market opening and throughout the day. NASDAQ rules require a market maker who locks a market to make reasonable attempts to trade with the market maker(s) it is locking prior to entering the locking quotation.

National Best Bid and Offer (NBBO) - The highest quoted published bid and the lowest published offer price among competing market makers in a security across different markets trading the same security.

Sell-Side - Traders and the sales and research departments that sell securities and make recommendations to a broker-dealer's customers.

Specialist - A person on the trading floor of certain exchanges who maintains an orderly market for a security by bringing buyers and sellers of the security together and taking a position himself when necessary. There is usually one specialist for each stock traded on the NYSE, except for lower volume stocks.

Spread - The difference between the bid and the ask prices of a security or asset.

SuperMontage - A fully integrated order entry and execution system operated by NASDAQ for its members. The SuperMontage system is designed to be more accurate and efficient than predecessor systems.

Two-Sided Market - A market where both bid and ask prices are quoted.

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