



October 31, 2003

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

Re: SR-NASD-2003-128: Establishment of Maximum ECN Access
Fees in SuperMontage and Elimination of SuperMontage's
Price/Time with Fee Consideration and Price/Size Execution
Algorithms

Dear Mr. Katz:

The Securities Industry Association ("SIA")¹ appreciates the opportunity to comment on the proposed rule change submitted by the National Association of Securities Dealers, Inc. ("NASD") through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), that would establish the maximum fee that electronic communications networks ("ECNs")² participating in Nasdaq's National Market Execution System ("NNMS" or "SuperMontage") can charge non-subscribing members for accessing orders/quotes in their systems.³ The proposed rule change also would eliminate SuperMontage's Price/Time with access fee consideration execution algorithm and the Price/Size execution algorithm.

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

² An ECN is a type of Alternative Trading System ("ATS"), which is defined as "any organization, association, person, group of persons, or system . . . [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange. . ." 17 CFR 240.300(a)(1).

³ Securities Exchange Act Release No. 48501 (September 17, 2003), 68 FR 56358 ("Proposing Release").

At the outset, we would like to acknowledge that, since the advent of ECNs, the issue of access fees has been contentious and various SIA constituencies have held strong views both opposing and supporting access fees. Perhaps the only point of agreement in the access fee debate is that prompt resolution of the issue is needed. Therefore, there is support, albeit not unanimous support, for the proposal. Some firms view this fee cap as a fair compromise, while others consider it a good interim measure. Most firms, however, believe that the Securities and Exchange Commission (“SEC” or “Commission”) should aggressively pursue a solution that addresses in a comprehensive manner competitive fees charged by all market centers, whether exchanges, self-regulatory organizations (“SROs”), or broker-dealers (both ECNs and otherwise).

I. Background and Description of Proposal

Broker-dealers have a duty of best execution in handling customer orders that generally obligates the broker-dealer to seek the best prices for those orders. At times, the best price for a security may be displayed in an ECN, which typically charges a separate fee to market participants that access the ECN’s quote/order.⁴ In 1996, because of SEC concerns that significant pools of liquidity were hidden from the market, the SEC adopted the so-called Order Handling Rules, which expanded the class of market centers required to make their quotes and orders publicly accessible by imposing a compulsory display requirement on ECNs.⁵

In the adopting release, the SEC stated that an ECN must provide non-subscriber broker-dealers with a means of access to the displayed prices that is equivalent to the access that would have been available for the relevant security if these prices had been published in the market makers’ or specialists’ quotation.⁶ Recognizing that, for the first time, non-subscribers to an ECN would be accessing an ECN’s quotes, the SEC stated that an ECN may impose charges for access to its system, similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers.⁷ At this time, unlike in today’s environment, ECN quotes were disseminated solely through Nasdaq systems.

⁴ According to the Proposing Release, there is a substantial disparity in the level of fees among ECNs participating in SuperMontage, with some ECNs charging access fees three times as high as other participating ECNs.

⁵ Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (the “Order Handling Rules”).

⁶ 61 FR at 48314.

⁷ Id. at note 272.

To prevent fees from being used to bar access to non-subscribers, the SEC in a series of no-action letters since 1997 permitted ECNs to charge non-subscribers no more than the fee they charge a “substantial proportion” of their existing broker-dealer subscribers. The SEC also prescribed caps in the no action letters for the fees to be charged by ECNs, ranging from \$.015 to \$.009.⁸

In 1998, in adopting Regulation ATS, the SEC again addressed ECN access fees.⁹ Under Regulation ATS, ECNs are required to provide access to non-subscribers to the quotes they place in the public quote stream. The access they provide must be consistent with the access provided to subscribers. While Regulation ATS does not prohibit ECNs from charging access fees, the adopting release states that, because reasonable fees are a component of equal access, ECNs cannot set fees that are inconsistent with equivalent access, such that the fees have the effect of creating barriers to access for non-subscribers.

The Commission further stated that an SRO could regulate fees of its ECN members to ensure that any fees are charged in a manner consistent with the SRO’s market. For example, subject to Commission review and approval, an exchange or association could establish a standard for what constitutes a fair and reasonable fee for non-subscriber access to an alternative trading system, consistent with effective operation of the SRO’s market and the Commission’s equivalent access requirement. The exchange or association may also require alternative trading system fees to be charged in a manner consistent with the exchange’s or association’s market, such as requiring the fee to be incorporated in the displayed quote.¹⁰

Although ECNs may charge access fees, market makers are not allowed to charge similar fees. In a 1998 letter, the Deputy Director of the SEC’s Division of Market Regulation stated that SEC Rule 11Ac1-1 (“Firm Quote Rule”) does not permit a market

⁸ See, e.g., Letter to Charles R. Hood, Senior Vice President and General Counsel, Instinet Corp., from Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated January 17, 1997 establishing an outer limit of \$.015 per share and Letter to Jon Kroeper, First Vice President, Instinet Corp., from Alden Adkins, Associate Director, Division of Market Regulation, SEC, dated November 1, 2002 establishing a cap at \$.009 per share.

⁹ Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70843.

¹⁰ Regulation ATS Rule 301(b)(4) provides in relevant part “. . .if the national securities exchange or national securities association to which an alternative trading system provides the prices and sizes of orders . . .establishes rules designed to ensure consistency with standards for access to the quotations displayed on such national securities exchange, or the market operated by such national securities association, the alternative trading system shall not charge any fee to members that is contrary to, that is not disclosed in the manner required by, or that is inconsistent with any standard of equivalent access established by such rules.” 17 CFR 242.301(b)(4).

maker to impose such a fee.¹¹ Indeed, the NASD proposed a rule that would allow a market maker to publish an agency quote in addition to its proprietary quote and charge an access fee to anyone accessing that quote, but no action has been taken on the proposed rule to date.¹²

The SEC sanctioned ECN access fees at a time when ECNs had a single venue in which to display their quotes. Today, there is no requirement that ECNs participate in SuperMontage. Rather, ECNs can choose to participate in Nasdaq's SuperMontage or an exchange, or to display their quotations in the NASD's Alternative Display Facility ("ADF"), where they can charge whatever the market will bear or the NASD will allow.

While the SEC has indicated on numerous occasions over the last several years its intention to revisit the issue of ECN access fees, no action has been taken.¹³ Consequently, Nasdaq is now proposing to amend its rules to establish standards for what constitutes a fair and reasonable fee for non-subscriber access to an ECN system through SuperMontage. Specifically, the proposed rule change would amend NASD rules governing Alternative Trading Systems to establish a maximum level of quote/order access fees for ECNs that elect to participate in SuperMontage and to eliminate the Price/Time with access fee consideration and Price/Size execution algorithms in SuperMontage. Under the proposed rule change, ECNs could charge broker-dealers that access the ECN through SuperMontage no more than \$0.003 per share. ECNs that charge more than \$0.003 per share for access to their quotes/orders can continue to participate in SuperMontage as NNMS Order Entry Firms only and, as such, will not be allowed to impose any fee on a broker-dealer that accesses them through the SuperMontage system.¹⁴

¹¹ Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to Joseph G. Messina, Vice President, M. H. Meyerson & Co., Inc., dated June 12, 1998.

¹² Securities Exchange Act Release No. 41343 (April 28, 1999), 64 FR 24430 (File No. SR-NASD-99-16).

¹³ Most recently, the Director of the SEC's Division of Market Regulation, in a speech stated, "In short, many are concerned that pricing disparities caused by access fees may impede access between competing markets, raise trading costs, and create confusion about quoted prices. There are a number of potential solutions that the Commission may adopt, such as requiring that all fees be added to the displayed quotations of market centers, permitting fees of only a *de minimis* amount, or banning access fees outright. Be assured that whichever solution the Commission pursues, the ultimate goal will be to assure that access fees do not distort trading activity." Remarks before The Security Traders Association by Annette L. Nazareth, Director, Division of Market Regulation, SEC, October 17, 2003. *See also*, Testimony before the Subcommittee on Securities and Investment of the U. S. Senate Committee on Banking, Housing, and Urban Affairs by William H. Donaldson, Chairman, SEC, October 15, 2003 and Remarks before the Fourth Annual SIA Conference on Market Structure by Annette L. Nazareth, Director, Division of Market Regulation, SEC, June 13, 2003.

¹⁴ *See* proposed Rule 4701(w).

II. SIA Views on Proposal

As noted above, it is difficult to achieve consensus on the appropriateness of ECN access fees given the diverse membership of the SIA. Certain members representing the dealer community believe it is unfair to be charged a fee to access a bid or offer on an ECN when they are required to access that quote to fulfill their best execution obligations, or because they are automatically routed to the ECN. These firms contend that ECNs have the option of posting their quotes/orders in the ADF, but that SuperMontage participants are being asked to pay ECNs for their decision to participate in SuperMontage. On the other hand, SIA member firms representing ECNs argue that, because they do not trade proprietarily, their sole source of revenue is the charges they impose to access their best bids and offers. Moreover, the only reason that non-subscribers can access the ECN's quote/order is because the ECN is required by regulation to make the quotes/orders accessible. Firms also acknowledge that not only ECNs but also other market centers charge fees for "access," although they are not called access fees. The majority of SIA member firms, however, regardless of their position on the issue, believe that it is important to comment on the Nasdaq proposal to express the industry's strong desire for a resolution of the issue.

Generally, SIA member firms are supportive of Nasdaq's efforts to address the access fee issue. Members agree that fee disparities are a concern in a system like SuperMontage that automates the matching of buy and sell interest using neutral execution algorithms that limit the ability of users to select or anticipate exactly who their counter-party or counter-parties to a particular trade will be. The result is that the member may pay a market center fee to Nasdaq, then have its order matched off against an order that may or may not impose an additional and substantial fee. Many firms believe that market center fees are appropriate and that an ECN may charge such a fee when acting as a market center, but not when it is being accessed through another market center; otherwise, the dealer pays a known market center fee and then possibly an additional, unknown access fee.¹⁵ The cap proposed by Nasdaq is generally in keeping with the level of access fees imposed by most ECNs today and is equivalent to the execution fee Nasdaq imposes on parties automatically executing against quotes/orders through SuperMontage. However, it is unclear what additional fees, if any, Nasdaq may choose to impose in addition to the ECN access fee.

Many firms applaud Nasdaq for taking steps to impose a more reasonable fee structure. Many also believe, however, that Nasdaq should continue to evaluate the cost/fee structure and to work toward bringing access fees down further. Other firms that have advocated the elimination of access fees fear that support for the instant proposal will undermine their position; therefore, they support the proposal only if it is a first step toward total elimination of access fees. These firms believe there is no economic

¹⁵ Some firms believe that a hidden fee – particularly in a system in which participants cannot choose their counter-party – means that you are not getting the advertised price, which distorts overall market transparency.

difference between market makers and ECNs and a level playing field will only be achieved with the elimination of all access fees by ECNs.¹⁶

Certain ECNs support the proposal as a fair compromise and believe the total elimination of access fees is both unfair and unrealistic. Access fees, they contend, are no different than the transaction charges imposed by Nasdaq, and no one would suggest that Nasdaq forfeit its transaction fees. Additionally, ECNs are charging no more than what a substantial portion of their subscribers pay, as authorized by SEC rules.

Both constituencies acknowledge that access fees have been an issue that has been vexing the industry for years. Many SIA member firms continue to believe that the SEC must take affirmative action to propose a market-wide solution that levels the playing field for all market participants.

III. Elimination of Execution Algorithms

In addition to establishing an ECN access fee cap, Nasdaq also proposes to eliminate the Price/Time with access fee consideration execution algorithm and the Price/Size execution algorithm. Again, SIA member firms have varying views. Some firms support elimination of the execution algorithms, noting that once ECN access fees are the same as Nasdaq's own access fee of \$0.003, differentiating ECNs no longer makes sense and would be unfairly discriminatory.

On the other hand, even with the reduction in the maximum permissible access fee to \$0.003 per share, some firms believe there is no reason to do away with the Price/Time with access fee consideration execution algorithm. These firms believe that all market participants should compete on fees or that ECNs that charge a fee should still be reflected in SuperMontage at the bottom of a given price point relative to non-fee charging participants, as firms should be able to access/identify the lowest cost provider. These firms also believe that the above view ignores any additional fees that Nasdaq may choose to impose. Additionally, these firms believe that non-AutoEx eligible quotes from ECNs should not have equal standing with AutoEx quotes. Similar to the Price/Time with access fee consideration execution algorithm, these firms believe that Nasdaq should modify any other execution algorithm, including the Price/Size execution algorithm, to account for which participants are AutoEx and which participants are not. This would allow SuperMontage users to drop the non-AutoEx participants to the bottom at a given price point. These firms maintain that their viewpoint contributes to a level playing field.

¹⁶ Indeed, some firms note that this is simply a Nasdaq proposal and, if adopted, would only restrict ECNs to the extent they participate in SuperMontage. If they do not participate in SuperMontage, they could still charge more to those accessing them outside the SuperMontage system.

Jonathan G. Katz
Secretary
October 31, 2003
Page 7

IV. Conclusion

The SIA appreciates this opportunity to address the difficult issue of ECN access fees. As our letter reflects, there is a wide divergence of opinion within the industry on this subject. Although firms applaud Nasdaq for taking action on this issue, SIA members believe the SEC must act without delay to develop a market-wide solution that levels the playing field for all market participants.

If you have any questions concerning these comments, or would like to discuss our views further, please contact me at 202-216-2000.

Sincerely,

Ann L. Vlcek
Vice President and Associate
General Counsel

CC: Annette Nazareth, Director, Division of Market Regulation, SEC
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