NASDAQ OMX[SM]

Joan C. Conley
SENIOR VICE PRESIDENT & CORPORATE SECRETARY
9600 BLACKWELL ROAD
ROCKVILLE, MD 20850

P: (301) 978-8735
F: (301) 978-8472
E: joan.conley@nasdaqomx.com

June 23, 2010

Ms. Elizabeth M. Murphy
Secretary
US Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Proposed Amendments to Rule 610 of Regulation NMS (Release No. 34-61902; File No. S7-02-10)

Dear Ms. Murphy:

The NASDAQ OMX Group, Inc. ("NASDAQ") [1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to "prohibit an exchange from imposing unfairly discriminatory terms that inhibit efficient access to quotations in a listed option on its exchange and establish a limit on access fees that an exchange would be permitted to charge for access to its best bid and offer for listed options on its exchange" ("Fee Proposal").[2] While NASDAQ supports the Commission's work to optimize market structure, NASDAQ sees no basis in theory or in fact to conclude that the Fee Proposal will improve market structure. To the contrary, NASDAQ believes that, if adopted, the Fee Proposal would undermine robust competition, harm investors, and weaken the national market system.

NASDAQ respectfully submits that it is qualified to assist the Commission in assessing the Fee Proposal. We are the world's largest exchange company. We operate 22 markets and ten clearinghouses world-wide. We provide technology to over 70 exchanges, clearing organizations and central securities depositories in over 50 countries. We regulate the trading and clearing of equities, options, commodities, and derivatives across the globe. NASDAQ's two U.S. options markets, NASDAQ OMX PHLX ("PHLX") and The NASDAQ Options Market ("NOM") execute approximately 200,000 options transactions per day. These markets employ the two distinct pricing models currently under review, the traditional "payment for order flow" model applies generally at the PHLX market and the newer "Maker/Taker" model applies on NOM and also to 81 options classes currently trading on PHLX. NASDAQ understands the

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1 NASDAQ OMX Group, Inc. files this comment on behalf of the two options markets it operates in the U.S., The NASDAQ Options Market LLC and NASDAQ OMX PHLX, Inc..

2 *See* Proposed Amendments to Rule 610 of Regulation NMS (Release No. 34-61902; File No. S7-02-10), available at http://www.sec.gov/rules/proposed/2010/34-61902.pdf.

role fair markets play in serving and protecting millions of investors in the United States and around the world that rely on the safety and predictability of our markets to grow their savings and safeguard their futures.

NASDAQ supports and shares the Commission's stated goals for issuing the Fee Proposal: ensuring fair and efficient access to the best displayed prices, promoting inter-market price protection through effective private linkages, and providing fair and useful quotation information to market participants. As we stated recently in response to the Concept Release on Equity Market Structure, fair and open access to trading systems and trading interest, reliable and liquid public reference prices, and effective private linkages are each fundamental to a strong national market system.[3] Open access to the best displayed prices fosters order interaction, price discovery and market efficiency; restricted access creates order isolation, price opacity and inefficiency.

Nevertheless, we see fatal weaknesses in the Fee Proposal.

1. ***The Commission's analysis of competition is flawed in several respects.*** First, the Fee Proposal fails to fully assess the current competitive state of the markets. Competition among and between the existing Options Exchanges is robust. Further, existing competition, ease of entry by new competitors, and transparency in exchange pricing effectively constrain exchange fees. Additionally, the Commission misconstrues the source of the market power attendant to protected quotations: broker dealers, not exchanges, wield market power. Broker dealers control the orders that exchanges display and exchanges must compete to attract those orders.

2. ***The Commission's analysis of price differentiation is incomplete.*** The Commission appears to conclude without meaningful analysis that price differentiation is inherently unfair. This conclusion is contrary to historical Commission practice in allowing price differentiation in a wide variety of contexts, including in options pricing. It is also contrary to the great weight of competition law and relevant academic research.

3. ***Maker/Taker fees do not inhibit access to quotations and, in fact, the Maker/Taker model encourages aggressive quoting by all market participants.*** There is no analysis or evidence to support the Commission's conclusion that fees exceeding $0.30 inhibit fair access. When an options exchange using a Maker/Taker pricing model is alone at the NBBO, its transaction price is the best price for the customer even after adding the full Taker Fee. Provided that total fees do not exceed $0.99, a market participant will always benefit by executing a quotation that is alone at the NBBO on a Maker/Taker exchange.[4] Owing to successful

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[3] *See* Concept Release on Equity Market Structure (Release No. 34-61358; File No. S7-02-10). NASDAQ's comment letter is available at: http://www.sec.gov/comments/s7-02-10/s70210-168.pdf.

[4] Theoretically, the benefits available on Maker/Taker exchanges increase as trading increments increase. For series with higher minimum increment's the level of the access that could be charged while still offering an outright improvement would be higher, $4.99 for options with

Commission policies promoting transparency of exchange pricing, when the Maker/Taker exchange is not alone at the inside, market participants can survey the exchanges and execute at a venue of its choosing based on the most favorable prices, fastest technology, deepest liquidity, or best service.

4. ***The Fee Proposal arbitrarily discriminates against the Maker/Taker competitive model.*** The Commission understates the benefits of the Maker/Taker model, namely increased competition, transparency, and equal availability of fees and rebates. It also overstates the harms of the Maker/Taker model by failing to recognize that the private linkages plan adopted in July of 2009 has virtually eliminated locked markets, a major harm cited by opponents of Maker/Taker pricing.[5] Finally, the Fee Proposal is incomplete, failing to analyze and regulate evenly all competitive practices, including the practice of exchanges offering equity-based incentives to attract order flow.

5. ***The proposed rulemaking does not satisfy the requirements of the Administrative Procedures Act.*** The rulemaking record contains insufficient evidence or analysis to support the conclusion that participants lack fair access to the best displayed prices or that competition does not or would not sufficiently control such practices now and in the future. Assuming *arguendo* that a threat to fair access does currently exist, the record contains insufficient evidence and analysis to conclude that a fee cap would solve that problem. Nor does the record contain meaningful analysis of less intrusive alternatives that would also address the perceived harms. The standard for empirical data and analysis is particularly high where, as here, the government chooses to cap prices, the most intrusive alternative available to any regulator.

In NASDAQ's view, the Fee Proposal is not sound public policy or administrative rulemaking. Before taking the unusual step of fixing prices, the Commission must have a substantial record that a pricing problem exists and that price fixing is the only way to alleviate it. No such record exists here. There is no empirical data supporting an arbitrary cap of $0.30 per contract, as opposed to $0.99 as commenters have suggested, nor is there any justification for why the fee cap should be identical for options of differing minimum increments. Furthermore, there is no sound basis to limit the transparent, publicly-disclosed, equally-available access fees that Maker/Taker exchanges charge (and that support liquidity rebates) while placing no corresponding limits on other fees and practices that have an equal impact on competition.

I. Competition Among and Between the Existing Options Exchanges is Robust, New Competitors Can Enter Easily, and Competition Sufficiently Controls Prices.

Congress charged the Commission with promoting competition in the development and

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$0.05 increments and $9.99 for options with $0.10 increments. Competition has kept access fees low even in options trading in wider increments.

5 *See* Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) ("Plan Approval Order").

operation of the national market system. Yet, the Fee Proposal's entire discussion of current competition conditions in the options markets is set forth in just two sentences:

> Generally, the Commission believes that market forces and the dynamics of competition should determine the level of exchange fees whenever possible. As discussed below, however, the Commission is concerned that because of the requirements for intermarket price protection, competitive forces, by themselves, are not, and will not be, enough to prevent fees from being charged that interfere with fair and efficient access to an option exchange's displayed prices.[6]

The Commission did not analyze whether competitive forces can prevent the charging of excessive fees now or in the future. It simply concluded that they cannot. NASDAQ believes that competition does currently constrain prices and that it will continue to do so in the future.

Rather than analyze competitive forces in the options industry, the Commission simply substituted a regulatory judgment for a market-based one. This can distort prices charged by exchange and other market participants and also impact retard incentives to innovate. That is true because the tools that regulators use to mimic a competitive market will inevitably be imperfect and create perverse incentives for regulated entities to exploit the ratemaking formula to their own private advantage. Similarly, government ratemaking can discourage innovation because it blunts incentives for companies to cut costs. In a free market, increased efficiency in production leads to additional profit. It is difficult for regulators to counteract those perverse incentives because they are poorly placed to second-guess competitors' judgment about the investment needed to provide a service, or about the proper allocation of costs among multiple interrelated services.

1. <u>Competition Between and Among Options Exchanges is Robust.</u>

The Exchange Act makes clear that Congress, in the 1975 Amendments, intended for the Commission to promote a free, competitive market for market data to the maximum extent possible. Congress directed the Commission to facilitate the creation of a national market system for the trading of securities, and allow it to "evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed." *See* H.R. Rep. No. 94-229, at 92 (Conf. Rep.) (emphasis added).

Competition in the options industry is active and robust, and that robust competition already constrains prices effectively. Option trading in the U.S. is intensely competitive. The eight existing options exchanges compete vigorously; none of the eight currently executes more than 30 percent of equity option trades. In the last six months, one new market (The BATS Options Exchange) has been approved and at least one other new entrant have announced definitive plans to launch a new options market this year. As Erik Sirri recently told the U.S. Chamber of Commerce, the Commission's policy towards new market entry has been to "let a thousand flowers bloom." These Commission policies have increased competition and

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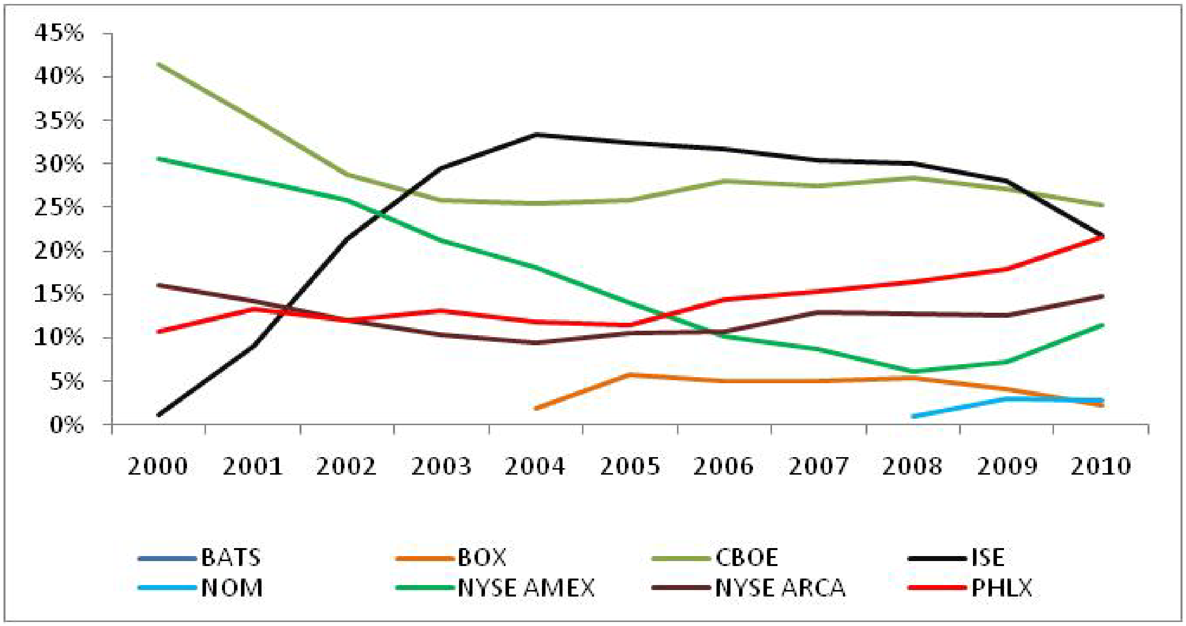
[6] Fee Proposal at 19.

benefitted investors tremendously. Yet, the Commission fails to analyze the benefits to investors, members and non-members of the Commission's current policy on competition.

The graph below depicts the intense and increasing competition in the options markets:



Competition takes many forms. Exchanges compete to attract liquidity and order flow using varied tools, including market structure (affirmative/negative obligations of liquidity providers, linkages, data dissemination, allocation models), technology (speed and reliability of execution systems, routing capability, connectivity, communications networks, data processing , innovative execution functionality), pricing (cost of execution services, market data, connectivity, routing), and customer service (contract administration, new product development, communication, reliability, help-desk support). NASDAQ believes that market structure will serve investors best by ensuring the broadest possible mix of business models rather than attempting to rank or otherwise elevate one competitive model over another.

This increase in competition has benefitted investors by, among others, reducing trading costs and improving market quality. For example, during the last six months, PHLX has been attempting to compete by adopting a Maker/Taker model for actively-traded options classes and by reducing prices. Since the inception of Maker/Taker pricing, PHLX quoted spreads have narrowed substantially, posted size has increased significantly, executed volume has doubled, average execution speed has increased, and PHLX's volume at the inside market has increased for all affected options and for all categories of market participants. These improvements, which benefit investors, are a direct consequence of aggressive quoting behavior encouraged by Maker/Taker pricing. Additionally, several markets, including NYSE Amex, NYSE Arca and the International Securities Exchange, have responded to PHLX price cuts by lowering their pricing. For example, there are five options exchanges with elements of "Maker/Taker" pricing, and three charge a "Take" fee for customers that is less than or equal to the proposed $0.30 access fee cap. Commission policies are designed to create precisely this form of competition.

Before imposing an arbitrary fee cap, the Commission must first conduct a detailed analysis of current competition in the options market. When it does, it will find that competition is robust and that exchange markets compete aggressively on price, speed, liquidity, functionality, and service. The Commission should proceed cautiously before disrupting the positive trends that its own policies have created.

2. Analysis of Market Power.

Government-imposed price controls are well understood to have a negative impact on competition and innovation. Therefore, they are only indicated where they overcome severe market imperfection such as monopoly ownership of a critical resource. In the case of options fee caps, it is the presence of a posted order at the NBBO which causes the Commission to be concerned that no force prevents exchanges from imposing unreasonable fees on traders seeking to access the best price. The Fee Proposal depends on the existence of sustained market power created by the requirement of best execution and the prohibition against trading through.

The Commission makes many assumptions about market power. First, it assumes without evidence or analysis that such market power exists. The Fee Proposal further assumes, also without evidence or analysis, that such market power is controlled by options exchanges. Finally, the Fee Proposal assumes, again without evidence or analysis, that the market power presumably wielded by options exchanges is so great that options exchanges can charge excessive fees now and in the future. None of these assumptions is valid.

In examining the case for fee caps in options markets it is important to understand the source of the market power and the entity controlling it. The Fee Proposal assumes incorrectly that the market power created by the best execution policy and trade through prohibition rests with the exchange displaying the bid or offer. In reality, the market power is controlled by the market participant that chooses the market in which to display bids and offers.

Exchanges compete vigorously to attract these limit orders. They compete using many costly incentives including allocations, rebates, payment for order flow, equity ownership benefits, superior execution systems, and customer service. This vigorous competition is evidence that the market power associated with displayed orders does not reside with exchanges, it resides with broker dealers.

Exchanges also compete for liquidity taking orders. When multiple venues have quotes at the same price, participants route their order to the venue that has the best combination of access fee and other features. A venue with a high access fee that is not justified by high service will be at the bottom of broker routing tables, creating a powerful headwind against the market's ability to attract and maintain market share. It will also reduce execution rates for brokers that route their limit orders to that venue, reducing the success of their trading strategies. Even under the best execution policy and trade through obligation, powerful competitive forces are clearly present that discourage exchanges from exercising pricing power. In such an environment the Commission cannot state without evidence that market power exists.

Even when only one order is at the best price, liquidity takers are unlikely to be disadvantaged by the existence of freely determined access fees. First, as discussed earlier, the liquidity taker is not disadvantaged compared to the next best quote in a penny environment unless the access fee is above the unlikely level of $0.99, higher with higher quote increments.

Second, a broker that route to a high-fee venue chooses to pay a price in terms of execution rate. Commission policies require transparency of exchange fees. Smart routers that are available to all market participants calculate the fees applicable at each exchange and create dynamic routing tables. Participants have complete control over the execution fees they pay or choose not to pay. These routing tables ensure that no order routed to a market with fees that are unacceptable to the order's owner. In other words, no order is charged a higher fee than its owner is willing to pay. The Commission cannot state without evidence that the clear and transparent fee flexibility practiced by exchanges is not justified by the constantly improving execution services provided. It is incumbent on the Commission to offer evidence that this is not the case.

Finally, if market power does exist, government policy is the source of that power. The Commission must consider alternative solutions based on changing those policies. For example, the Commission could require net quoting or allow brokers to consider net prices, rather than gross prices, in meeting their best execution and linkage obligations. There are advantages and disadvantages to net quoting and reasonable minds can differ on their ultimate wisdom. Nonetheless, the Commission is obligated to assess all alternatives rather than select one and assume it is superior.

II. The Fee Proposal Fails to Define the Term "Unfair" in the Phrase "Unfair Discrimination"

The Commission fails to analyze in a holistic manner what it means under the statute and Rule 610(a) for an exchange to impose "unfairly" discriminatory price terms among market participants. The Commission appears to assume that discrimination or differentiation of any amount among any market participants is unfair.[7] The language of the Fee Proposal does not admit the possibility that a differentiation of some level would be considered fair and permitted

[7] *See*, e.g., Fee Proposal at fn. 51 and accompanying text ("any attempt by an options exchange to charge differential fees based solely on the non-member status of a person obtaining indirect access to its quotations would violate Rule 610(a) as proposed to be amended."); Fee Proposal at page 19 ("Thus, options markets would be prohibited from imposing unfairly discriminatory terms that prevent or inhibit efficient access to the entire depth of book of displayed orders."); Fee Proposal at 43 ("Rule 610(a) as proposed to be amended would prohibit an exchange from charging higher "Take" fees in certain options classes to non-directed customers than to directed customers.").

under Rule 610(a). In essence, the Commission's current interpretation of the Fee Proposal would effectively read the word "unfair" completely out of the proposal.

The Commission's apparent interpretation of Proposed Rule 610(a) is at odds with past Commission practice. In fact, the Commission itself has accepted multiple pricing structures that result in differential pricing:

- ***Order Capacity Differentiation:*** The options exchanges have differentiated between customers and professional customers, broker/dealers clearing in the "Firm" range at the Options Clearing Corp, broker/dealers registered as market makers, away market makers, early-adopting market makers, and many others;

- ***Volume tiers:*** equity and options pricing has long included volume tiers that provide discounts to the heaviest liquidity providers, highly capitalized broker/dealers or takers;

- ***Fee caps:*** Many exchanges have fee caps and enterprise licenses that favor heavy users of a system over other users;

- ***Professional vs. Non-professional data recipients.*** Different recipients pay different fees for the same market data based upon their status;

- ***Equity Investors:*** The Commission has accepted the sale and purchase of equity ownership in exchanges predicated upon incentives for continued order flow provision; and

- ***Directed Participants:*** In March 2009, the Commission permitted Amex to begin differentiating between participants that accepted directed orders and those that do not.

- ***Order Handling Methods***: The Commission has permitted price differentiation based on whether an order is processed manually versus electronically.

Before reversing this history of prudent price differentiation, the Commission is obligated to perform an in-depth analysis of the justifications for and impacts of existing price differentiation, as well as whether and to what extent such differentiation can or cannot continue in the future. The Commission cannot summarily conclude and assert that all price discrimination is inherently unfair.

NASDAQ also requests that the Commission provide guidance and a clear rationale for abrogating two PHLX options filings that would have resulted in lower overall fees for market participants. On December 22, 2009, NASDAQ OMX PHLX filed a proposed rule change[8] with

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[8] See Securities Exchange Act Release No. 61337 (January 12, 2010), 75 FR 2905 (January 19, 2010) (SR-Phlx-2009-104).

the Commission to amend its Fee Schedule. Among other changes to the Fee Schedule, NASDAQ OMX PHLX proposed to amend its existing discount program of $0.05 per contract fee in equity options overlying Standard and Poor's Depositary Receipts/SPDRs, directed to specialists, Streaming Quote Traders and Remote Streaming Quote Traders by an order flow provider and executed electronically. The standard fee at the time was $0.21 per contract. That filing proposed to expand that $0.05 per contract fee to all equity options transactions sent to a Directed Participant. This filing was abrogated by the Commission without explanation. At the direction of Commission staff, PHLX replaced that filing with a propose rule change[9] that eliminated the discount for SPY equity options that are directed to specialists, SQTS or RSQTs.[10]

NASDAQ OMX PHLX also filed a proposed rule change[11] adopting, for a two-month pilot period, per contract transaction fees for options overlying SPY. The fees were proposed to apply to: (i) transaction sides that remove liquidity from the Exchange's disseminated market, and (ii) Firm and broker-dealer quotes and orders that are included in the Exchange's disseminated market. The proposed filing sought to assess fees for removing and adding liquidity as well as provide a rebate to various market participants. Thereafter, the Exchange amended its Fee Schedule to add additional symbols to its "make/take" fees.[12] On February 19, 2010, the Commission abrogated these aforementioned filings.[13] NASDAQ OMX PHLX filed a replacement filing that removed the fee reduction for Directed versus Non-Directed Customer. [14]

Additionally, the staff has required PHLX and other exchanges to adhere to specific maximum differentials for fees charged or rebates offered to different market participants. For example, NASDAQ was directed by staff to limit to the effective fee differential it assessed to market participants that provide liquidity in Maker/Taker options classes on PHLX. Additionally, the staff determined that it was improper simultaneously to offer a rebate to one participant and assess a fee to other market participants for the same liquidity-providing

9 *See* Securities Exchange Act Release No. 61665 (March 5, 2010), 75 FR 11967 (March 12, 2010)(SR-Phlx-2010-25).

10 *See* Securities Exchange Release Act No. 61547 (February 19, 2010) ("Abrogation Order").

11 *See* Securities Exchange Act Release No. 61398 (January 22, 2010), 75 FR 4884 (January 29, 2010)(SR-Phlx-2009-116).

12 *See* Securities Exchange Act Release No. 61480 (February 3, 2010), 75 FR 6428 (February 9, 2010) (SR-Phlx-2010-14 (this filing proposed the addition of options overlying the PowerShares QQQ Trust; Ishares Russell 2000 and Citigroup Inc. to the "make/take" fees.)

13 *See* Securities Exchange Release Act No. 61547 (February 19, 2010) ("Abrogation Order") (The Abrogation Order stated that the Commission is "…concerned about whether the proposals are consistent with the statutory requirements applicable to a national securities exchange under the Act…).

14 *See* Securities Exchange Act Release No. 61684 (March 10, 2010), 75 FR 13189 (March 18, 2010) (SR-Phlx-2010-33).

conduct.[15] NASDAQ believes that the Commission should provide specific guidance on price differentiation and how it would apply to the abrogated PHLX filings. This will alleviate burden on staff of dictating the specific fees and fee differentials that exchanges can implement.

Contrary to the Commission's current assumption, price differentiation is not inherently unfair; in fact, price differentiation is widely considered by economists to signal a healthy and mature market for goods or services. Given the emphasis the Commission has placed on effects on competition when applying the statutory and regulatory prohibitions on unfair discrimination, it is appropriate to consider how differential pricing is treated under the antitrust laws, where analysis of competitive effects is also critical. In the antitrust context, the regulation of differential pricing under the Robinson-Patman Act (15 U.S.C. § 13) has been the subject of extensive analysis by the courts and economists, policy-makers, and commentators. Although the fundamental goals of the antitrust laws do not align perfectly with the goals of the securities laws, this analysis provides some useful guideposts for the Commission's analysis of differential pricing in the securities context. Most notably, the concerns expressed by antitrust commentators with respect to over-deterrence of differential pricing apply with full force in the securities context.

In the antitrust context, it is universally recognized that over-deterrence of differential pricing may be harmful to competition and consumers.[16] Price differences among buyers of the same products routinely occur in competitive markets and industries, and indeed are often an essential aspect of properly functioning competitive markets.[17] For this reason, Congress has circumscribed the situations in which differential pricing may be deemed unlawful in the Robinson-Patman Act, and government enforcement actions under the Robinson-Patman Act have been few and far between since the mid-1970s.[18]

For example, in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, the Supreme Court explained that the Robinson-Patman Act "condemns price discrimination only to the extent that it threatens to injure competition," that "Congress did not intend to outlaw price differences that result from or further the forces of competition," and that the statute should be "construed

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15 *See* Securities Exchange Act Release No. 61961 (April 22, 2010), 75 FR 22881 (April 30, 2010) (SR-Phlx-2010-61)).

16 Antitrust Modernization Commission, Report and Recommendations at 318, *at* http://govinfo.library.unt.edu/amc/report_recommendation/chapter4.pdf (last visited on January 27, 2010); R. H. Pate, Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, Letter to D. A. Garza, Chair, Antitrust Modernization Commission, regarding Suggested Topics for Antitrust Modernization Commission Study (Jan. 5, 2005), *at* http://www.justice.gov/atr/public/comments/207122.pdf (last visited on January 28, 2010).

17 *Id.*

18 R. H. Pate, Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, Letter to D. A. Garza, Chair, Antitrust Modernization Commission, regarding Suggested Topics for Antitrust Modernization Commission Study (Jan. 5, 2005), *at* http://www.justice.gov/atr/public/comments/207122.pdf (last visited on January 28, 2010).

consistently with broader policies of the antitrust laws."[19] Similarly, Prof. Herbert Hovenkamp, the co-author of the leading treatise on antitrust law, has stated that overbroad enforcement of the prohibition against differential pricing in the Robinson-Patman Act may discourage pro-competitive price differences. In particular, he explained that differential pricing "resulting from an upstream firm's unilateral pricing decision must enjoy a very strong presumption that [it is] socially beneficial and not 'anticompetitive' in any economically acceptable sense of that term."[20] Thus, a manufacturer should be able to reward more aggressive dealers by giving them price discounts and rebates to increase the competitiveness of its distribution system and volume of sales.[21] Prof. Hovenkamp cautioned that all buyers would suffer from a broad prohibition against selective price cuts, because sellers would likely respond to such a prohibition by not making any price cuts at all to avoid the cost of extending them to all buyers.[22] Such conduct would contribute to price rigidity and effectively establish a price floor,[23] and it would also facilitate or help maintain price coordination.[24]

These concerns were echoed by the Antitrust Modernization Commission ("AMC"), a bipartisan blue-ribbon panel created by Congress in 2004 to study and report to the President and Congress on the state of antitrust enforcement in the United States. The AMC's Report and Recommendations, which were issued in 2007, cautioned strongly against aggressive enforcement against differential pricing, explaining that there were "many legitimate, pro-competitive reasons" for differential pricing.[25] For example, the AMC found that volume discounts can allow sellers to achieve certain scale economies in production[26] and facilitate new entry when the seller can selectively offer its products to large buyers at prices that are lower than those charged by incumbent competitors.[27] In addition, sellers can use volume discounts to

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19 509 U.S. 209, 220 (1993); *see also Great Atl. & Pac. Tea Co. v. FTC*, 440 U.S. 69, 80 n.13 (1979) (same); *Automatic Canteen Co. of Am. v. FTC*, 346 U.S. 61, 74 (1953) (same).

20 H. Hovenkamp, Antitrust Law ¶ 2342b (Aspen Publ., Inc. 2006, Second Edition); H. Hovenkamp, *The Robinson-Patman Act and Competition: Unfinished Business*, 68 Antitrust Law Journal 125, 127 (2000).

21 *Id.*; H. Hovenkamp, Testimony on Robinson-Patman Act, Antitrust Modernization Commission, at 8 (June 2, 2005), *at* http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Hovenkamp.pdf (last visited on January 26, 2010).

22 H. Hovenkamp, Antitrust Law ¶ 2340b.

23 American Bar Association, Comments of the Section of Antitrust Law of the American Bar Association in Response to the Antitrust Modernization Commission's Request for Public Comment Regarding Robinson-Patman Act Study Issues 7-8 (Apr. 2006).

24 H. Hovenkamp, Antitrust Law ¶ 2340b.

25 Antitrust Modernization Commission, Report and Recommendations at 318-319, *at* http://govinfo.library.unt.edu/amc/report_recommendation/chapter4.pdf (last visited on January 27, 2010).

26 *Id.* at 319.

27 *Id.* at 320.

introduce their products to new customers or to reward distributors for high sales and aggressive promotion of their products.[28] Overall, the AMC's Report concluded that a broad prohibition against differential pricing was detrimental to consumers because it would discourage price discounts that midstream buyers can pass on to consumers.[29][30]

In addition to these general cautions against over-deterrence of differential pricing, the framework for addressing differential pricing under the antitrust laws can also provide some useful guideposts for the Commission's consideration of differential pricing in the securities context.

First, a decision by a business to drop its prices is broadly protected by the antitrust laws, as long as that price is above predatory levels (that is, a price above the seller's marginal costs). "Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition. . . . To hold that the antitrust laws protect competitors from the loss of profits due to such price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share. The antitrust laws require no such perverse result."[31]

Second, differential pricing is not subject to an across-the-board prohibition, but rather is prohibited only where it can be shown to threaten the fundamental goal of antitrust—the protection of competition.[32]

Third, even where differential pricing threatens harm to competition in some segment of the marketplace (and therefore could be subject to prohibition), it is permitted under a range of circumstances in which the differential pricing is likely to be a product of efficiency-enhancing conduct or will enhance competition among suppliers. These specific carve-outs include the following situations:

- a different price is offered to one customer (or set of customers) to meet competitive pricing;[33]

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28 *Id.*

29 Antitrust Modernization Commission, Report and Recommendations at 318-319, *at* http://govinfo.library.unt.edu/amc/report_recommendation/chapter4.pdf (last visited on January 27, 2010).

30 Commentators have expressed similar concerns in observing that widespread adoption of "most favored nation" clauses ("MFNs") throughout an industry can act as a disincentive to price-cutting—which benefits consumers and enhances competition—and facilitate price coordination among competing suppliers.[30] A prohibition on differential pricing is in a sense a regulatorily-imposed requirement for MFN pricing.

31 *Brooke Group*, 509 U.S. at 223 (internal quotation marks and citations omitted).

32 *Id.* at 220.

33 15 U.S.C. § 13 (b). The Supreme Court has construed the "meeting competition" defense broadly, for example, making it available even if the seller sets its lower prices to meet the generally

- different prices are justified by different costs, including discounts that are attributable to lower costs of serving certain customers;[34]

- different prices are justified by differences in grade and quality of the products that affect their marketability;[35]

- different prices are instituted in response to "changing conditions affecting the market for or marketability of the goods concerned";[36] and

- different prices are functionally available to all customers.[37]

Simply put, investor protection is furthered by the lowering of prices and the robust competition, not by a regulatory paradigm that (contrary to current economic thought) enforces price rigidity and uniformity while looking askance at attempts to reduce prices. As Congress and the Commission both recognize, nothing is more important to fostering a national market system than competition—and few things are more important to competition than the ability to quickly alter prices or other terms to respond to competition or win a significant new customer. Price rigidity and uniformity are signs of a stagnant market, not a vibrant one; regulation of differential pricing should be reserved to anti-competitive conduct that impedes the objectives of the securities laws.

III. The Maker/Taker Model Should Be Regulated Similarly To Other Models Against Which It Competes.

The Commission's analysis of the Maker/Taker pricing model understates its demonstrated benefits and overstates its potential harms. Maker/Taker pricing has exerted significant competitive pressure on other options exchanges, resulting in better execution prices for investors. Also, Maker/Taker pricing is more transparent and available equally to all

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prevailing market prices rather than to meet competition on a customer-by-customer basis, or where the seller creates price differences by raising rather than lowering prices. *See Falls City Indus., Inc. v. Vanco Beverage, Inc*., 460 U.S. 428, 431 (1983). The Court has also allowed sellers to rely on the meeting competition defense even if they offer low prices to obtain new business rather than retain existing business. *Id.* at 446-47.

34 15 U.S.C. § 13(a). For example, volume discounts are permitted if they are attributable to lower per-unit production costs, shipping costs, or other costs.

35 15 U.S.C. § 13(a).

36 *Id*. Thus, for example, a seller may reduce prices if the demand for its product has decreased due to the seasonal or perishable nature of the product or its technological obsolescence. *See, e.g.*, *Comcoa, Inc. v. NEC Tels., Inc.*, 931 F.2d 655, 665-65 (10th Cir. 1991) (holding that "although the statute speaks of obsolescence of seasonal goods, price differences as a result of technological obsolescence or the introduction of a new product model are circumstances sufficiently similar to the examples named in the statute that they fall within" its general scope).

37 *See FTC v. Morton Salt Co*., 334 U.S. 37, 41 (1948).

participants.

Additionally, the Commission's analysis of fees must be more dynamic and holistic. The Fee Proposal arbitrarily targets execution-based fees such as access fees, regulatory fees, and licensing fees that it claims impact fair and equal access to the best-priced displayed quotes. The Commission rejected limits on other fees or competitive practices that have the same or greater impact on options trading, such as payment for order flow and periodic access fees such as for trading permits or monthly system access fees. The Fee Proposal also ignores entirely aspects of market structure that directly and strongly impact order flow and trading, including mutualized ownership structures that allow broker-dealers to enjoy the financial benefits of exchange ownership.[38]

1. <u>The Maker/Taker Model Benefits Investors</u>

Opponents of the Maker/Taker model generally make two arguments: (1) Make rebates and Take fees distort the market and disadvantage retail customers; and (2) the Maker/Taker exchange creates incentives for market participants to lock other markets. The second argument is easily rebutted because locked markets are now prohibited under the Options Order Protection and Locked/Crossed Markets Plan ("Distributive Linkage Plan") and the rules of each options exchange. The Commission cites no evidence regarding the continued prevalence of locked markets, or whether Maker/Taker exchanges are involvement in locked markets more than other exchanges, or the impact of Maker/Taker pricing on locked markets. There is no support for the conclusion that locked markets are currently a problem, that Maker/Taker exchanges disproportionately cause locked markets, or that the proposed fee cap would address the perceived problem.

If current rules prohibiting locked markets were ineffective, the Commission still would be unjustified in arbitrarily capping fees on the large number of orders that do not involve locked markets simply to address a small number that do. The Commission could address the issue more directly by prohibiting exchanges from charging transaction fees on orders received from an away exchange when the executing exchange has posted a locking quote. If ever there was evidence that Maker/Taker exchanges caused locked markets, which is not the case, there is no evidence in the administrative record of the Fee Proposal that this remains true today.[39]

The claim that access fees "distort" the market and disparately impact retail investors is a red herring. The distortion argument would only have merit where the per-contract execution fees are greater than the per-contract tick equivalent (*i.e.* fees exceeding $1.00 for a contract trading in pennies) because there the customer would be worse off routing their order to the better-priced market and paying the execution fees. Provided the customer benefits overall by

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[38] The conflict of interest created by mutualized ownership of exchanges by broker dealers is being considered by the U.S. House of Representatives and the U.S. Senate in the context of over-the-counter derivatives trading.

[39] It is unnecessary to reach the argument made by some market participants that locked markets benefit investors by offering an opportunity to trade without paying a spread.

getting the better price on a Maker/Taker exchange and paying the access fee (as the customer would with fees of $0.99 or under), the market distortion argument is simply smoke and mirrors.[40]

The argument for capping Take fees only works, if at all, where a Maker/Taker exchange is displaying a better price than a traditional Exchange. In that scenario, the inter-market linkage trade-through rule requires that a customer order be routed to the Maker/Taker market, at which time the access fee will apply. Where the away Maker/Taker market is displaying the same price as another market, the order may trade with it but is not required to because there is no time priority across U.S. options markets. It is a simple mathematical equation: if a customer order is routed to an away Maker/Taker exchange displaying a price that is one penny better than the Broker/Payment exchange, the customer is always better off if the order is routed to the Maker/Taker exchange, provided that the total fee paid is $0.99 cents or less.

Due to long-standing Commission policies requiring transparency of exchange fees and also to the availability of smart routers, market participants have absolute control to direct where their orders are routed. As a result, participants have complete control over the execution fees they pay or choose not to pay. Market participants use widely available independent smart routers as well as routers at broker dealers and exchanges to control their orders. Smart routers calculate the fees applicable at each exchange and create dynamic routing tables. These routing tables ensure that no order routed to a market with fees that are unacceptable to the order's owner. In other words, no order is charged a higher fee than its owner is willing to pay. This capability further undermines the market power, if any, that attaches to an order that an exchange displays as its best bid or offer.

The Fee Proposal states, without evidence or analysis, that a fee cap of $0.30 per contract will increase the usefulness of quotations, implying that market participants lack adequate information about fees to make informed routing decisions:

> An access fee limit also creates more transparency in the cost of accessing quoted prices. Currently, there are so many different fees across options exchanges, across different categories of options participants, and across different product types, that it is not easy to estimate the total cost of executing against a quotation for a particular transaction. An access fee cap would provide clearer information on the maximum cost for accessing quoted prices.[41]

The Fee Proposal later contradicts itself by noting that options exchanges can compete for better placement on firms' routing tables by charging fees lower than the proposed $0.30 cap:

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40 The Commission's rationale for choosing $0.30 as opposed to $0.99 or another amount is over-simplified "For example, having a $0.30 cap would help ensure that an offer of $2 is not inferior to an offer of $2.01 once access and other per-contract fees were added to the price." Fee Proposal at p. 30. This logic would apply equally to any fee of $0.99 or less.

41 Fee Proposal at p. 9.

> Some exchanges might choose to charge lower fees, thereby increasing their ranking in the preferences of order routers; others might charge the full $0.30 per-contract fee and rebate a substantial portion to liquidity providers.[42]

The Commission clearly understands at some level that market participants are sophisticated and that they do already consider total execution fees when developing their routing tables. A $0.30 fee cap will add little if any transparency to order routing decisions.

The benefits of the Maker/Taker model are clear: (1) it encourages aggressive quoting, (2) it encourages narrowing of spreads, (3) it is typically democratic (*i.e.*, available to more market participants), (4) it is transparent, and as a result, (5) it promotes competition. As explained above, Liquidity rebates are financed by Take fees. Therefore, the proposed fee cap is more than just a cap on fees; it is also an implied limit on rebates given to the market participant who posted the quote that was executed. Because Maker Credits are paid by Taker Fees, any limit on Taker Fees would effectively create a cap on Maker Credits. A limit on Make Credits will harm investors by removing an incentive to quote aggressively.

Liquidity rebates encourage aggressive quoting and narrowing of the NBBO because market participants post better prices in order to earn the rebates. When one exchange displays a better price at the NBBO, other exchanges compete to match the better prices. When this occurs, the market benefits. An arbitrary fee cap (*i.e.*, any cap under $0.99 for a penny option) will reduce the incentive to narrow the NBBO and result in wider spreads. For example, there is compelling evidence that the Maker/Taker model narrowed spreads on the NASDAQ OMX PHLX market. The Maker/Taker model also encourages aggressive quoting by being democratic. In the Maker/Taker model, all or many market participants can receive rebates for providing liquidity. In contrast, on traditional exchanges, incentives are focused on narrower sets of market participants.

The Maker/Taker model encourages aggressive quoting by being transparent because Take fees and Make rebates are published and known to the public. Transparency encourages market participants to share the liquidity rebates with their customers. Customers, if they choose, can see exactly how much their broker was charged or rebated for an option order on a Maker/Taker exchange and can see exactly how much of these fees and rebates, if any, were passed to the customer. Well-informed customers can and do compare competing brokers and exchanges and negotiate with their brokers the pass-through of Maker/Taker rebates and fees. As a result, they can also reap the benefits of liquidity rebates by placing aggressive limit orders in the market. Opening the market to more traders and to more diverse interest increases competition, narrows spreads, and adds transparency and liquidity for public customers.

Competition law demands that the Commission move slowly and carefully when one competitor asks the government to limit the prices charged by other competitors. The Commission should consider some simple questions: What motivates those calling for

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[42] Fee Proposal at p. 28 – 29.

artificially limiting competitive quoting behavior? Who would benefit from fee caps and why? What business model is disrupted by the Maker/Taker model?

2. <u>If The Commission Adopts A Fee Cap, It Must Regulate Other Business Models In An Equivalent Manner</u>

If the Commission does decide to impose a cap on access fees, it is important that it impose an economically equivalent cap on competing business models. . Additionally, the Commission should demand greater transparency of all fees and other competitive incentives to enable investors and market participants to compare fees and incentives in the Maker/Taker model against fees and incentives in other models. If a fee cap provides greater transparency of fees (which, as described above, is questionable) and current quotation information is not accurate and useful without additional information about fees (also questionable), why would investors need more information about Maker/Taker fees than about other business models? NASDAQ sees no justification for distinguishing between the two and no evidence or analysis contained in the Fee Proposal establishes otherwise.

The Fee Proposal concedes that Maker/Taker and PFOF exchanges compete directly for members, for order flow, and for executions. They simply use different economic incentives to accomplish those goals. In 2000, the Commission conducted a special study about payment for order flow and internalization in the options markets and found that "Payment for order flow is a method of transferring some of the trading profits from market making to the brokers that route customer orders to specialists for execution[43] and funds generated from payment for order flow and internalization ideally should be passed on to the customer in the form of "reduced cost."[44] The Commission's own study demonstrates the complicated balance of fees and incentives at work in traditional exchanges and how that might compare to the Maker/Taker model. Yet, the Fee Proposal fails adequately to update, analyze, or otherwise leverage the conclusions from the Special Study.

A market participant can readily determine what fees and rebates are in effect on a Maker/Taker exchange; it is important for the Commission to assess whether the same can be said of other market models. For example, when an order flow provider routes an order to a PFOF exchange, the broker is unable to determine with whom that order is interacting (*i.e.*, with a customer resulting in no PFOF rebate, or with a market maker order that pays the PFOF charge). It is difficult to measure the amount of PFOF fees that are included in the disseminated quote. If the Commission is committed to improving participants' ability meaningfully to compare quotes across all exchanges, it should examine all business models equally.

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43 SEC, Special Study, Payment for Order Flow and Internalization m the Options Markets, 4 (Dec. 2000), available at www.sec.gov/news/studies/ordpay.htm.

44 *Id.*

Payment for order flow affects the true cost that investors are paying for options, and these costs must factor in to the Commission's analysis. The Commission observes that disparate access fees render quotations less useful and accurate, in that such fees make it difficult to meaningfully compare quotations across markets. As stated above, this assumption is questionable given that access fees are fully transparent by virtue of the Commission's rigorous filing and publication requirements. NASDAQ believes the Commission should focus on establishing comparability across business models, rather than singling out a single business model and ensuring comparability within that model alone. As such, a cap on Taker Fees is effective and equitable only to the extent that all options exchanges are subject to a comparable limit on fees and incentives.

The Commission owes investors a more detailed analysis and explanation for singling out the Maker/Taker model without addresses other business models against which it competes.

3. Equity Incentives and Mutualization Directly Impact Competition

The Commission's analysis of pricing and competition must be comprehensive. To be so, it must include consideration of equity-based incentives that are offered to market participants in exchange for providing order flow. In August of 2009, NYSE Amex announced that it was selling almost half of its ownership interest in the exchange to a small group of broker dealers that provide order flow to that exchange. Almost immediately, the market share of NYSE Amex reversed a long period of decline and rapidly increased by three percentages points. Additionally, on June 15, 2010, the National Stock Exchange ("NSX") filed a rule proposal to establish an equity rights program that rewards members monetarily for providing order flow to the exchange; the more order flow members provide, the greater their reward.[45] NSX seems to assume, along with NASDAQ, that equity incentives qualify as fees, just like access fees, payment for order flow or marketing fees, options regulatory fees, and other fees that the Commission oversees. To regulate access fees but ignore the NSX equity rights program and similar programs would be arbitrary.

IV. The Proposed Rulemaking Does Not Satisfy the Requirements of the Administrative Procedures Act and Would Not Withstand Judicial Scrutiny

Under the Administrative Procedures Act ("APA"), a Court "shall hold unlawful and set aside" a final agency rule that is "in excess of statutory jurisdiction [or] authority." 5 U.S.C. § 706(2)(C). A Court must also "hold unlawful and set aside" a final agency rule that is "arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with law."[46]

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45 *See* SR-NSX-2010-005 (June 15, 2010) (www.nsx.com/resources/content/5/1/documents/SR-NSX-2010-06.pdf). NSX designated the proposal as a due or fee pursuant to Exchange Act Section 19(b)(3)(A)(ii) and Rule 19b4-(f)(2) thereunder.

46 Under this provision, "an agency rule would be arbitrary and capricious if the agency . . . entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or it is so implausible that it could not be ascribed

Also under the APA, a court "shall hold unlawful and set aside" a final agency rule that is "unsupported by substantial evidence." 5 U.S.C. § 706(2)(E). Pursuant to this standard, a Court would examine whether the Commission has examined the relevant data and articulated a satisfactory explanation for its actions including a rational connection between the facts found and the choice made and consideration of reasonable alternatives to its proposed action.[47] NASDAQ questions whether the Fee Proposal meets these standards.

First, the stated rationale for the Fee Proposal lacks a valid and documented factual basis. There is no evidence in the administrative record supporting the conclusion that existing rules and practices actually harm or threaten to harm investors or the national market system. The Commission hypothesizes that a threat to fair access currently exists or could exist, but it cites no empirical data, no study or analysis, and no academic research of any kind to support that hypothesis. There is no record evidence that participants lack fair access to the best displayed prices; there is no record evidence of a threat to inter-market price protection; and there is no record evidence that the options markets do not currently provide fair and useful quotation information. The Maker/Taker model lends itself to study and analysis because the model was only recently introduced into the trading of listed options and the application of Maker/Taker pricing to new options classes have been well documented and readily identifiable events.

Second, assuming *arguendo* that harmful pricing or trading practices did exist, NASDAQ would support a proposal backed by data and analysis and demonstrated to be the best alternative among many for fixing them. There is, however, no evidence or analysis in the record upon which to conclude that the Commission has adequately considered all available alternatives. Nor is there evidence or analysis demonstrating that the Commission has chosen the best alternative available or why the chosen alternative is superior to other available alternatives. The current record contains no basis to conclude that the Fee Proposal is either necessary or sufficient to address the Commission's stated objectives.

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to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). Where an agency "offers no more than mere speculation to support its conclusion," it fails to provide "adequate grounds upon which to sustain [] agency[] action." *Natural Resources Defense Council, Inc. v. EPA*, 859 F.2d 156, 210 (D.C. Cir. 1988); *see also Horsehead Resource Dev. Co. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994) ("speculation is an inadequate replacement for the agency's duty to undertake an examination of the relevant data and reasoned analysis," and reliance on speculation is "arbitrary and capricious" under the APA).

[47] See *Chamber of Commerce v. SEC*, 412 F.3d 133, 145 (D.C. Cir. 2005). Pursuant to this standard, the court's "paramount objective is to see whether the agency, given an essentially legislative task to perform, has carried it out in a manner calculated to negate the dangers of arbitrariness and irrationality in the formulation of rules for general application in the future." *Industrial Union Dep't v. Hodgson*, 499 F.2d 467, 475 (D.C. Cir. 1974) (citation omitted); *see also Am. Textile Mfrs. Inst. v. OSHA*, 182 F.3d 1261, 1267 (11th Cir. 1999) ("Substantial evidence is 'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.'" (quoting *Am. Textile Mfrs. Inst. v. Donovan*, 452 U.S. 490, 522 (1981)).

Third, the need for detailed and substantiated analysis is particularly compelling where, as here, a government agency charged with promoting competition chooses the extreme and largely discredited approach of interfering in the price setting mechanism. Moreover, there is no evidence or analysis to support the $0.30 level at which the Commission proposes to cap fees as opposed to capping fees at $0.50 or $0.99 as some commenters previously have suggested. Additionally, the Commission has failed to analyze the harmful economic effects of limited governmental price setting on smaller, less capitalized broker-dealers and the potential for members generally to pay more than non-members in exchange membership and technology based fees as a result of the Fee Proposal. In NASDAQ's view, the Commission should not move forward with a price fixing proposal in the absence of compelling evidence of actual harm and detailed analysis supporting the conclusion that less extreme constraints would be ineffective to address that harm.

Fourth, the Commission draws support for the Fee Proposal from the existing $0.003 fee cap on equity pricing currently contained in Rule 610 under Regulation NMS. The Commission assumes without evidence or analysis that the existing equity fee cap successfully protects investors and promotes fair and equal access to displayed quotations. The Commission also assumes without evidence or analysis that imposing on options markets the monetary equivalent of the equity fee cap will work in the same manner and to the same effect as the equity fee cap has in that market. There is evidence that the proposed fee cap represents a smaller percentage of the minimum allowable spread for options than for equities, however the Fee Proposal makes little use of that evidence. There is no evidence or analysis in the record to support the conclusion that the proposed options fee cap is necessary to protect investors in the options markets.

Fifth, the Fee Proposal also draws support from the Petition filed by Citadel Investment Group LLC in 2008 which called for a cap on access fees of $0.20 per contract.[48] The Commission fails to note that comments received on the Petition and the NYSE Arca fee proposal overwhelmingly opposed an arbitrary fee cap such as the Commission is proposing now. Five of the seven comments received on the Petition and the NYSEArca fee proposal opposed the arbitrary fee cap.[49] The only commenters that supported the fee cap were Citadel and TD

48 File No. 4-562 - Petition of Citadel Investment Group L.L.C. for Rulemaking to Address Access Fees in the Options Markets.

49 Letters received in response to SR-NYSEArca-2008-75: See letters from Stephen Schuler and Daniel Tierney, Managing Members, Global Electronic Trading Company to Florence E. Harmon, Acting Secretary, Commission, dated September 2, 2008; and Robert R. Bellick, Managing Director, Wolverine to Nancy M. Morris, Secretary, Commission, dated September 10, 2008; David M. Battan, Executive Vice President, Interactive Brokers Group LLC, to Florence Harmon, Acting Secretary, Commission, dated September 8, 2008; and William Easley, Vice Chairman, Boston Options Exchange to Florence E. Harmon, Acting Secretary, Commission, dated September 11, 2008; Lawrence Leibowitz, Group Executive Vice President and Head of Global Execution and Technology, NYSE Euronext, to Florence E. Harmon, Acting Secretary, Commission, dated September 3, 2008 (available at www.sec.gov/comments/sr-nysearca-2008-75/nysearca200875.shtml or www.sec.gov/comments/4-562/4562.htm).

Ameritrade. The Commission failed to account for how changes in the options markets have occurred during the intervening period, including increased competition from new entrants and the adoption of a new private linkage plan and exchange rules that prohibit locked markets. The Commission failed to update or otherwise verify the validity of statistics cited in the Petition, including statistics such as time at the inside and price improvement.

Sixth, the Fee Proposal appears to contain no analysis from the Commission's Division of Risk, Strategy, and Financial Innovation, particularly its Office of Markets, Office of Data and Data Analytics and Office of the Sell Side.[50] It is unclear whether the Commission has brought to bear on the Fee Proposal the resources necessary and available to craft the best possible proposal. For example, in 2000, the Commission conducted a Special Study on the practice of Payment for Order Flow.[51] Did the Commission update or otherwise revisit that study and, if not, should it have done so in light of the comparisons drawn between the Maker/Taker and other pricing models? Did the Commission undertake a similar study of Maker/Taker pricing practices and, if not, should it have done so prior to proposing to access fees under that model?

This is a lengthy but not exhaustive list of potential weaknesses in the administrative record of the Fee Proposal. The Fee Proposal contains preliminary conclusions and assumptions that also appear to be without evidentiary support. The Fee Proposal also fails to analyze fully how the economics of trading actually operate currently, how investors are harmed by current access fees, and how the Fee Proposal would actually impact fees into the future. NASDAQ believes that these deficiencies, if left uncorrected prior to adoption of all or part of the Fee Proposal, would prove fatal on judicial review.

Conclusion

NASDAQ urges the Commission to reconsider the Fee Proposal. Market forces should determine exchange fees and the Commission should not be drawn in to price fixing. Maker/Taker fees are substantially lower than the value of a standard trading increment (*e.g.* if the price is $0.01 better than the price on another exchange, this $0.01 is equivalent to $1.00 to the customer per contract traded). No data is provided to support the argument that access fees are restricting efficient access to quotations, that they have caused an increase in locked markets, or that a fee cap of $0.30 is the only or even best way to address such perceived problems. Competition is working; there is no evidence or analysis to the contrary.

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50 According to the SEC's website, The Office of Data and Data Analytics is charged with financial data processing and analysis, the Office of Markets is charged with exchanges, clearinghouses, and market structure and the Office of the Sell Side is charged with broker-dealers, prime brokers, rating agencies, and banks. The activities of the Offices as a whole include providing detailed, high-quality economic and other analyses, specific subject-matter expertise, and general guidance to the Commission and other Divisions/Offices developing analytical approaches, methods and models in order to identify trends, risks or potential securities law violations in the capital markets.

51 SEC, Special Study, Payment for Order Flow and Internalization m the Options Markets, 4 (Dec. 2000), available at www.sec.gov/news/studies/ordpay.htm.

If the Commission decides to enact fee caps, a cap on access fees is only justified to the extent it is accompanied by an economically equivalent cap on all business models. The Commission should also conduct a detailed examination of all the economics aspects of options industry competition, including exchange ownership by members and equity-based incentives for order flow providers. If implemented as proposed, a cap on access fees and increased restrictions on differential pricing will have a negative impact on competition and on investors by hamstringing exchanges that offer better prices and lower costs to market participants and investors.

Sincerely,

Joan C. Conley

Joan C. Conley

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
Robert W. Cook, Director, Division of Trading and Markets
James A. Brigagliano, Deputy Director, Division of Trading and Markets