



November 8, 2012

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: File No. SR-EDGX-2012-33 – Response to Comments and Rationale for Withdrawal

Dear Ms. Murphy:

EDGX Exchange, Inc. (“EDGX” or the “Exchange”)¹ appreciates the opportunity to respond to comment letters submitted by The NASDAQ OMX Group, Inc. (“NASDAQ OMX”)² and the New York Stock Exchange LLC (the “NYSE”)³ (together, the “Listing Markets”) with respect to EDGX’s rule filing (the “Filing”) to amend EDGX Rule 11.5(c) to add a new order type, the Edge Market CloseSM (“EMC”) Order. While EDGX does not believe that the Listing Markets raise legitimate legal issues regarding the Filing’s consistency with the Securities Exchange Act of 1934 (the “Exchange Act”), EDGX is nonetheless withdrawing the Filing for the reasons described below.

Response to Comments

The Listing Markets each make a variety of arguments in their criticism of the Filing. EDGX offers its summary responses to each of the Listing Markets’ principal arguments, as follows:

I. Exchange Executions Based on Quote Data and Trade Data

The Listing Markets assert that it is inappropriate for an exchange to price buy and sell orders at a reference price. Specifically, NASDAQ OMX claims that “EDGX is seeking to perform a function traditionally associated with a broker-dealer; executing buy and sell orders at a reference price determined through the interaction of orders occurring elsewhere – in this case on exchanges other than EDGX itself. . .”⁴ The NYSE claims that “the proposed process for execution of EMC Orders more closely resembles a broker-dealer internalizing trades at prices set by reference to the national best bid or best offer price available at a third-party market.”⁵

¹ Direct Edge Holdings LLC (“Direct Edge”), which operates EDGX, is one of the leading stock exchange operators in the United States and globally. More information about Direct Edge is available at <http://www.directedge.com>.

² See Letter from Alex Kogan, Vice President & Deputy General Counsel, NASDAQ OMX, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated September 5, 2012 (the “NASDAQ OMX Letter”).

³ See Letter from Janet McGinness, EVP & Corporate Secretary, General Counsel, NYSE Markets, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated September 11, 2012 (the “NYSE Letter”).

⁴ NASDAQ OMX Letter, *supra* note 2, at 1.

⁵ NYSE Letter, *supra* note 3, at 2.

These comments ignore that it is a well-established principle that exchanges can price and execute orders based upon reference data, even where the price is based on quote or trade data not originating on that exchange itself. For example, EDGX, NASDAQ OMX's exchanges, NYSE Arca, Inc. ("NYSE Arca"), BATS Exchange, Inc. ("BATS") and other exchanges allow orders to execute at the mid-point of the national best bid and offer (the "NBBO"), regardless of whether the current national best bid (the "NBB") or national best offer (the "NBO") exists on that particular exchange.⁶ In addition, several pegged order types on various exchanges, including EDGX, NYSE Arca, BATS and several NASDAQ OMX exchanges, are set in some relationship to the NBBO, regardless of which exchange established or currently has liquidity at the NBB or NBO.⁷

It should be noted as well that NASDAQ OMX itself is proposing to execute orders using trade-based reference data (e.g., the Volume Weighted Average Price) in its "Benchmark Orders" rule filing⁸ with the Securities and Exchange Commission (the "Commission"), which if approved would effectively compete with broker-dealers' algorithmic offerings. Such orders would derive their prices from matching the performance of a selected benchmark over a pre-determined period of time, which includes executions that occur on non-NASDAQ OMX exchanges. In NASDAQ OMX's own words:

NASDAQ does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the [Exchange] Act, as amended. To the contrary, the establishment of Benchmark Orders on NASDAQ will enhance NASDAQ's ability to compete with *similar functionality that already is widely dispersed in the industry both among members and trading venues*. The Benchmark Order is a voluntary offering; voluntary on the part of the Exchange which is not required to offer it and voluntary on the part of members that are not required to use it. If the predicted enhancements and improvements of the Benchmark Order do not materialize, members will simply choose to ignore it. NASDAQ's decision to offer the Benchmark Order is a further indication of the competitiveness of the market for trading platforms. Continued improvements and enhancements such as the Benchmark Order are necessary in order to attract order flow and execute transactions. This need is heightened because the functionality underlying the Benchmark Order has for some time been made available by alternative trading systems that perform functions similar to NASDAQ but that

⁶ See BATS Rule 11.9(c)(9) ("Mid-Point Peg Order"); see also, NASDAQ OMX Rule 4751(f)(4) ("Midpoint Peg" orders); NYSE Arca Equities Rule 7.31(h)(5) ("Mid-Point Passive Liquidity Orders"); EDGX Rule 11.5(c)(7) ("Mid-Point Match Orders"). What these order types have in common is that their execution prices are derived from the top of book prices of all "Protected Quotations", as such term is defined in Rule 600(b)(58) of Regulation NMS under the Exchange Act.

⁷ See EDGX Rule 11.5(c)(6) ("Pegged Order"); EDGA Rule 11.5(c)(6) ("Pegged Order"); NASDAQ OMX Rule 4751(f)(4) ("Pegged Orders"); NYSE Arca Rule 7.31(cc) ("Pegged Order"); and ISE Rule 2104(i) ("Pegged Orders"). A User entering a Pegged Order can specify that its price will equal the NBBO on the same side of the market ("Primary Peg") or the opposite side of the market ("Market Peg"). See NASDAQ OMX Rule 4751(f)(4).

⁸ See Securities Exchange Act Release No. 66972 (May 11, 2012), 77 FR 29435 (May 17, 2012) (SR-NASDAQ-2012-059) ("Benchmark Order Proposing Release").

have been exempted from the requirements of filing proposed rule changes, among others.⁹

Thus, NASDAQ OMX itself proposes to execute orders based on a price that would be set, in part, by executions on other exchanges, just as the EMC Order would.

II. A Balanced Approach to Market Transparency

The claims by the Listing Markets that the EMC Order should be disapproved because it would not contribute to transparency misconstrue the requirements of Sections 6(b),¹⁰ including Section 6(b)(5), of the Exchange Act,¹¹ as they relate to proposed rule changes filed pursuant to Section 19(b)(1) of the Exchange Act¹² and Rule 19b-4¹³ thereunder. In particular, NASDAQ OMX claims that “EDGX is not only failing to contribute to market transparency, but is also threatening the ability of other national securities exchanges to do so.”¹⁴ The NYSE claims that “EDGX’s proposal to execute EMC Orders would denigrate the role of an exchange” and “[t]he activity is antithetical to the concept of a national securities exchange, which should participate in discovering prices for the public – not simply ‘free ride’ on the price discovery performed on other exchanges.” The NYSE also states that “[a]lthough EMC Orders may not constitute quotations or transactions, it nonetheless seems to be at odds with the transparency objectives of the Exchange Act for a registered national securities exchange to hold orders wholly in secret until the end of trading.”¹⁵

In order to comply with Section 6(b) and Section 6(b)(5) of the Exchange Act, a proposed rule change must be 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 facilitating transactions in securities and to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest. Market transparency is an important tenet of market structure, but the Exchange Act does not mandate that a proposed rule change must contribute to market transparency, nor is transparency highlighted as a primary or exclusive Exchange Act objective. Many exchange orders types and other exchange execution practices balance the notion of transparency with other, competing objectives, such as ensuring the efficient execution of securities transactions. For example, depending on the level of the order imbalance at the “cut-off time”¹⁶ for the entry of Market-on-Close (“MOC”)

⁹ Id. at 29435 (emphasis added).

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

¹² 15 U.S.C. 78s(b)(1).

¹³ 17 CFR 240.19b-4.

¹⁴ NASDAQ OMX Letter, supra note 2, at 1.

¹⁵ NYSE Letter, supra note 3, at 2.

¹⁶ NASDAQ OMX designates this “cut-off time” as the “end of the order entry period”.

Orders on NASDAQ OMX (i.e., 3:50 p.m.) and Market-at-the-Close Orders on the NYSE (i.e., 3:45 p.m.), NASDAQ OMX and the NYSE only disclose the existence of an order imbalance, but do not disclose the details concerning which order types comprise the paired or imbalanced shares. This balancing of transparency and other factors bearing on execution quality exist throughout our market structure.

In addition, the Exchange Act does not prohibit non-displayed orders. In fact, numerous order types on EDGX, the NYSE, NYSE Arca, NYSE MKT LLC (“NYSE MKT”) and NASDAQ OMX exchanges are non-displayed or have non-displayed components and, therefore, neither contribute to market transparency nor are transparent on the order books to members of those exchanges. Yet they are legitimate order types and approved by the Commission.¹⁷ Indeed, non-displayed liquidity confers substantial benefits to the marketplace by facilitating greater depth of liquidity and providing price support, among other things.

III. The Distinction Between MOC and Limit-on-Close Orders (“LOC Orders”)

NASDAQ OMX claims that “[t]he EMC may lead to a reduction in the number of limit-on-close orders being submitted to NASDAQ and NYSE because rational market participants would have to weigh anew in each instance the economic desirability of placing such an order against the extra expense, when compared with the fee-free EMC order.”¹⁸ This claim blurs the distinctions between MOC and LOC Orders. EMC Orders are a distinctly different alternative to LOC Orders. Whereas a market participant that uses MOC Orders desires to buy or sell a security at whatever the official closing price happens to be, market participants that use LOC Orders only wish to have an execution if the price is at or better than a specific limit price. In other words, LOC and MOC Orders represent fundamentally different strategies – the former offers certainty of execution, and the latter offers price protection. These order types, therefore, are not interchangeable. Further, broker-dealers that handle so-called “held” orders (i.e., market orders and limit orders) have an agency duty to represent them as they are provided by their customers and not to alter their terms in order to reap the benefits of a fee-free execution. The risk of a higher-than-desired execution price makes it highly unlikely that an investor who wants the price protection offered by a LOC Order would convert it to an EMC Order for the benefit of saving \$0.0010 per share or less.¹⁹

IV. EDGX’s Regulatory Responsibilities under the Exchange Act

NASDAQ OMX argues that the functionality of the EMC Order “must be incidental to, and not at the expense of, the exchange’s core functions, and it certainly must not interfere with the core responsibilities of

¹⁷ For example, Reserve Orders on the Exchange and NASDAQ OMX have non-displayed components. See EDGX Rule 11.5(c)(1) and NASDAQ OMX Rule 4751(f)(2). See also EDGX Rule 11.5(c)(7) (“Mid-Point Match Order”); EDGX Rule 11.5(c)(8) (“Non-Displayed Order”); EDGX Rule 11.5(c)(13) (“Discretionary Order”); NASDAQ OMX Rule 4751(f)(1) (“Discretionary Orders”); NASDAQ OMX Rule 4751(e)(3) (“Non-Displayed Orders”); NYSE Rule 13 (defining non-displayed order types); NYSE Arca Rule 7.31(f) (“Tracking Order”); NYSE Arca Rule 7.31 (defining non-displayed order types); NYSE MKT Rule 13 (defining non-displayed order types).

¹⁸ NASDAQ OMX Letter, *supra* note 2, at 2.

¹⁹ NASDAQ OMX’s standard rate for LOC Orders in its closing cross is \$0.0010 per share. Internalized shares only of MPIDs meeting certain qualifications receive a discounted rate of \$0.0001 per share. See NASDAQ OMX, Price List – Trading and Connectivity, <http://www.nasdaqtrader.com/Trader.aspx?id=PriceListTrading2>.

other national securities exchanges. Under Section 6 of the Act, the Commission should not and would not register a firm as a national securities exchange if the firm's proposed market structure envisioned merely matching orders at last sale prices reported by other exchanges. If so, then a rule change by an existing exchange to implement such a scheme would likewise be contrary to the Act."²⁰ EDGX strongly disagrees with the notion that the EMC Order would somehow interfere with its regulatory responsibilities under the Exchange Act, or with the obligations of other exchanges.²¹ The EMC Order responds to demand from market participants for a product offering and in no way compromises its regulatory obligations. NASDAQ OMX overlooks the steps that EDGX would have taken to ensure the integrity of the closing auction prices, including by passing to its Members closing prices from the applicable listing market for all matched EMC Orders.

NASDAQ OMX's argument also overlooks the fact that the EMC Order is a supplemental offering to various other order types and routing strategies on EDGX rather than the sole element of the Exchange's product offerings, and should have no bearing on EDGX's exchange status. EDGX believes that its filing to offer EMC Orders as an additional exchange offering to satisfy its Members' demand would not violate the Exchange Act or interfere with the Exchange's core responsibilities under the Exchange Act. The notion that an exchange execution product is inconsistent with the Exchange Act because it, by itself, may not satisfy all Exchange Act requirements for Commission approval of an exchange application, is without merit.

V. Burden to Demonstrate Consistency with the Exchange Act

NASDAQ OMX asserts that the "burden to provide to the Commission credible economic evidence to support the proposed rule change lies with EDGX," and "that a credible independent study would be essential for any further consideration of the EMC proposal."²² EDGX demonstrated in the Filing that the EMC Order would promote competition by offering a comparison of pricing for MOC Orders on NASDAQ OMX and Market-at-the-Close Orders on the NYSE from August 2006 through the present,²³ and thereby met its burden under the Exchange Act. EDGX stated in the Filing that "the existence of an alternative venue to obtain closing price executions introduces competition, and, consequently, a potential decrease in fees charged to market participants for such executions."²⁴ In its comments, NASDAQ OMX suggests a new standard of economic analysis that rule filings by self-regulatory organizations must meet in order to satisfy the Exchange Act. However, EDGX notes that the Commission has never applied an independent study/economic analysis threshold to rule filings, as NASDAQ OMX suggests. Indeed, NASDAQ OMX in its own filings to establish a closing cross in NASDAQ OMX-listed securities or securities listed on NYSE and NYSE MKT²⁵ and to offer Benchmark Orders,²⁶ justified its proposals with arguments similar to those asserted by EDGX in the Filing. It

²⁰ NASDAQ OMX Letter, supra note 2, at 2.

²¹ See, infra, at Section VII.

²² NASDAQ OMX Letter, supra note 2, at 4.

²³ See Securities Exchange Act Release No. 67598 (August 6, 2012), 77 FR 47899 (August 10, 2012) (SR-EDGX-2012-33).

²⁴ Id. at 47901.

²⁵ See Securities Exchange Act Release No. 55721 (May 7, 2007), 72 FR 27344 (May 15, 2007) (SR-NASDAQ-2007-047).

²⁶ See Securities Exchange Act Release No. 67655 (August 14, 2012), 77 FR 50191 (August 20, 2012) (SR-NASDAQ-2012-

is therefore curious that NASDAQ OMX is now suggesting that the Exchange satisfy a higher standard in this case.

VI. Competition in the Closing Auction

NASDAQ OMX asserts that “[t]he product in this case is the closing price that is generated by NASDAQ and NYSE in their respective closing processes. For example, NASDAQ offers a meaningfully competitive alternative to the NYSE and NYSE-Amex closing auctions.”²⁷ Similarly, the NYSE states that “EDGX seeks to *unfairly* compete by free riding on costs borne by the Listing Market in running their closing processes. In doing so, EDGX promotes its own self interest at the expense of competition among orders and price discovery.”²⁸

EDGX disagrees with the Listing Markets’ assertions that there is already competition in the closing auction with respect to their listed securities, given what the relevant product and market is. In EDGX’s view, the product is not *any* execution of a security at the close of the market, but an execution at the close of the market at the price generally accepted as the official closing price. This is why NASDAQ OMX’s attempt to offer a Closing Cross in NYSE and NYSE MKT securities does not provide any meaningful market competition for those exchanges,²⁹ because NASDAQ OMX is not offering the same product (and accordingly, not the product that investors and their intermediaries want). In order to truly introduce competition for the Listing Markets’ offerings, any closing execution must be at the price generally accepted by investors as the closing market price.

EDGX believes that its EMC Order would help to introduce competition into the market and thereby lower execution costs for investors in the closing auction, just as NASDAQ OMX argues with respect to its Benchmark Order.³⁰ By introducing the ability to provide executions at the generally-accepted closing price through multiple exchanges, EDGX believes that exchange competition will be introduced in this market for the first time.

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²⁷ NASDAQ OMX Letter, supra note 2, at 4.

²⁸ NYSE Letter, supra note 3, at 4 (emphasis in original).

²⁹ For example, on September 25, 2012, NASDAQ executed the following amounts in its Closing Cross in certain NYSE and NYSE Arca listed stocks: Bank of America (BAC) – 600 shares, Alcoa Corporation (AA) - 0 shares, International Business Machines (IBM) – 0 shares, General Electric (GE) – 1,200 shares, Nokia Corporation (NOK) – 0 shares, Ford Motor Company (F) – 0 shares, SPDR S&P 500 Index (SPY) – 1,240 shares. See <http://www.nasdaqtrader.com/files/crosses/CrossStats20120925.txt>.

³⁰ See Benchmark Order Proposing Release, supra note 6 (“Benchmark Order will achieve new efficiency and cost savings for members.”).

VII. Interference with Listing Markets' Closing Processes

NASDAQ OMX asserts that “[i]f the volume of orders participating in the closing auction is reduced, the value of the auction to market participants in correspondingly diminished.”³¹ In addition, the NYSE states that “[b]ecause the volume of paired off shares entered as EMC Orders at EDGX will be withheld from public view until executed after closing, the volume of paired off shares that the NYSE disseminates in its Order Imbalance Information will be skewed. This will impact both trades entered as part of the NYSE’s closing process as well as trading during the final 15 minutes of the session.”³²

Although the Listing Markets claim that a reduction in the volume of shares submitted to the Listing Markets’ closing processes would negatively impact those processes, EDGX believes that the value of the closing auction does not depend on the volume of matched MOC Orders on NASDAQ OMX and Market-at-the-Close Orders on the NYSE provided by market participants because paired buy and sell MOC Orders and Market-at-the-Close Orders do not contribute to price discovery. Paired MOC Orders and Market-at-the-Close Orders are recipients of a listing market’s closing auction price and do not influence or establish the closing price no matter how much other volume is present for the closing auction.

EDGX acknowledges that certain enhancements to the EMC Order mechanism would address concerns about the market-wide operational impact of the EMC Order. EDGX considered submitting an amendment to the Filing, outlining: (i) how trading halts and order rejects would be treated; (ii) what would occur if there was a delay in executing the closing cross on the relevant Listing Market, or if no cross occurred; and (iii) how EMC Orders on the EDGX Book³³ would be delivered to the Listing Markets upon receipt by EDGX or as soon as practicable thereafter, with one round lot pair of EMC Orders always left to execute in the relevant closing cross, if available. Given EDGX’s decision to withdraw the Filing as explained below, such an amendment is unnecessary.

Rationale for Withdrawal

Notwithstanding EDGX’s responses to the comments discussed above, EDGX is withdrawing the Filing after a careful examination of the benefits the EMC Order would provide relative to the additional operational and technological complexities that would be incurred by its Members and the industry as a whole.

In addition to fulfilling its requirements under the Exchange Act, EDGX has an obligation to be a responsive, constructive participant in the debate over the evolution of market structure. This is an obligation we take very seriously. Over the last several months there has been a rising call for a holistic review of how our current market and self-regulatory structure came to be and how to move it forward. There is also a heightened awareness of the risks that come with operating our markets, and the need for improving risk-management frameworks at the market participant and market-wide level. EDGX applauds these trends and echoes their underlying constructive sentiments. At the same time, EDGX sees several important market structure initiatives on the horizon that will add additional market structure complexity – such as the move to “Limit Up/Limit

³¹ NASDAQ OMX Letter, supra note 2, at 3.

³² NYSE Letter, supra note 3, at 3.

Down” and the creation of exchange-operated “kill switches” – and require significant implementation and testing efforts to introduce successfully. Over the near-term, a delicate balance will need to be struck throughout the industry to ensure that these initiatives are completed, while at the same time maintaining fair and orderly markets.

It is in this spirit of prudence and respect for the operational impact on our Members that EDGX is withdrawing the Filing. While EDGX continues to believe that the market for executions at the official closing price is sorely in need of competition, it is an effort we believe is appropriate to defer in light of more compelling industry needs.

Conclusion

As stated herein, the Exchange believes that the Listing Markets failed to raise legitimate legal issues regarding the Exchange’s EMC Order’s consistency with the Exchange Act. Notwithstanding the foregoing, EDGX is withdrawing the Filing for the reasons stated above.

EDGX would like to thank the Commission again for providing us with the opportunity to respond to comments on its proposed EMC Order.

Sincerely,



William O'Brien
Chief Executive Officer

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
The Hon. Daniel M. Gallagher, Commissioner

Robert Cook, Director, Division of Trading and Markets
James Burns, Deputy Director, Division of Trading and Markets
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