May 5, 2006

Via e-mail: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Attention: Mr. Jonathan G. Katz, Secretary

Re: Commission File Nos. SR-NASDAQ-2006-001 and SR-NASD-2006-048

Ladies and Gentlemen:

We appreciate the opportunity to comment on the request by the Securities and Exchange Commission (the "Commission") on two releases containing rule proposals relating to the Nasdaq Market Center ("Nasdaq"). The Nasdaq filings raise fundamental questions about the interrelation between a registered exchange's operation as a for-profit entity and its responsibilities as a self-regulatory organization ("SRO") to its members under the Exchange Act. For that reason, the Commission itself should focus carefully on the matters discussed below and should itself decline to approve these two Nasdaq filings.

The first filing, Securities Exchange Act Release No. 53583 (March 31, 2006), contains amendment no. 1 to two sets of rules proposed by the Nasdaq Stock Market, Inc. ("Nasdaq") for the integrated Nasdaq Stock Exchange, the system that will result from integrating operations of the existing Nasdaq Market Center with Nasdaq's BRUT and INET facilities. Our comments on this release focus on proposed Nasdaq Rule 4623(b)(5), which would eliminate Nasdaq's order-delivery functionality for independent ECNs — while preserving it for Nasdaq's own ECN facilities — and would instead assign executions against bids and offers entered in Nasdaq's integrated system by an alternative trading system ("ATS") or an electronic communications system ("ECN") participating in the system.

The second, Securities Exchange Act Release 53644 (April 13, 2006), contains amendment no. 1 to Nasdaq's proposed rule change shifting its order-delivery fee of 10 cents per 100 shares from order-entry participants to order-delivery participants on the Nasdaq system. Nasdaq plans to implement the proposed rule change, as amended, immediately upon approval by the Commission, if the Commission grants approval.

The two proposals currently before the Commission seek to accomplish the same goal. Nasdaq's initiatives taken together make it clear that Nasdaq's principal purpose in

advancing these proposals is to eliminate ECNs from participating in its market place. The ECNs that would be excluded from the Nasdaq market under these proposals currently represent 15% of the total Nasdaq volume. Causing them to "go dark" would severely disrupt the market and deprive investors of significant choices they today choose to make. That market disruption and reduction of investor choice would alone be sufficient reason for the Commission to press Nasdaq to find another solution.

These rule changes raise serious legal and policy problems on which the Commission itself should focus. The changes are inconsistent with the provisions of the Securities Exchange Act of 1934 (the "Exchange Act") applicable to Nasdaq, as explained below. Nasdaq has not given the Commission a legally or factually sound basis on which the Commission could lawfully approve these rules. Nasdaq's proposals raise a fundamental public policy question: how are investors and the national market system served by eliminating from the Nasdaq platform the competitive liquidity and investor choices provided by ECNs?

INTRODUCTION

These two proposals are an outgrowth of rule changes Nasdaq proposed in April 2005 and February 2006.[1] The earlier proposals both were advertised as seeking to create a "uniform pricing structure" for the Nasdaq system. In reality, both the earlier proposals and these would instead impose a non-uniform, highly discriminatory pricing structure prohibiting ECNs from charging any fee to broker-dealer clients that access them through the Nasdaq Stock Market. We pointed out in earlier comment letters that Nasdaq's proposals contravened express provisions of the Exchange Act.[2]

It seems clear that Nasdaq would achieve its core objective, pushing the ECNs off the Nasdaq market, by either one of these filings. It need not obtain approval of both to achieve that end. If the Commission approves SR-NASDAQ-2006-001, which would eliminate order delivery, the second filing, SR-NASD-2006-048, shifting order delivery fees, would be moot. Similarly, as we discussed in the March 21, 2006 letter with the other ECNs, if Nasdaq succeeds in getting the order-delivery fees shifted to the ECNs, that will effectively drive the ECNs off Nasdaq. What Nasdaq has in mind is to crush the ECNs by either route, which it can achieve even if only one filing is approved.

In footnote 3 to Exchange Act Release No. 53583, Nasdaq states that amendment no. 1 eliminated from its original filing with the Commission a proposed rule that would have

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[1] Securities Exchange Act Release No. 51609 (April 26, 2005) and File No. SR-NASDAQ-2006-001 (Feb. 7, 2006).

[2] *See* letter from Bloomberg Tradebook LLC to Brian G. Cartwright, General Counsel, SEC (March 6, 2006), a copy of which is attached, and authorities referred to therein.

reproposed a provision that would have prohibited members from charging access fees. Nasdaq's proposed ban on access fees was selective and discriminatory; Nasdaq has not withdrawn the original proposal, but Nasdaq was correct to eliminate the proposal in its amended filing. While the withdrawn proposal would have prohibited ECNs from charging any fee to broker-dealer clients who access them through the Nasdaq Stock Market, Nasdaq itself could have continued to charge access fees and use the resulting revenue to purchase order flow through a system of rebates. Thinly disguised as a program for introducing more rational and uniform pricing among Nasdaq participants, the clear purpose of the proposed ban was evident in its effect: the elimination from its system of members Nasdaq considered potential competitors.

In support of its proposals, Nasdaq claims its rules changes are driven by a need to align fees, eliminate expensive and complex functionality and prevent "slow" ECN quotations from harming Nasdaq's competitiveness. These claims are specious and indeed are belied by the facts. We consider Nasdaq's claims below.

THE ROLE OF ECNs IN THE NASDAQ SYSTEM

The role of the ECNs in the OTC market since the adoption of the Order Execution Rules has proved beneficial both to investors and other OTC market participants. ECNs benefited investors by providing cheaper and faster electronic, direct access to the national market system and by introducing innovative trading tools, such as "reserve", "pegging", "discretion" and "order slicing".[3] Ten years after the Commission adopted the Order Execution Rules, Nasdaq finally adopted the ECN model by acquiring BRUT and INET, thus recapturing the majority of Nasdaq order flow that previously had been lost to them. As a result of these acquisitions, the Nasdaq market has become substantially more concentrated and less competitive over the last two years. By driving the remaining independent ECNs off its system, Nasdaq would now perfect its monopolization of liquidity and put itself in a position to charge monopoly rents for access to its market and for market data. As a for-profit monopoly, Nasdaq is viewing itself as empowered to use its government-protected position to serve its private ends notwithstanding the affirmative obligations and negative injunctions the Congress placed on it as a national securities exchange under Exchange Act Section 6(b), as we discuss below.

[3] These features replicate electronically, and thereby faster and more inexpensively, many of the trading techniques and functions human beings have traditionally performed in executing large orders on a "not held" basis. Reserve allows investors to display only part of their trading interest. Discretion allows investors to indicate electronically a willingness to trade at higher bids or lower offers than they quote publicly. Pegging permits investors to tie their quotations to publicly available quotations. Order slicing permits investors to divide a large order into small pieces based on prior trading patterns.

SECURITIES EXCHANGE ACT RELEASE NO. 53583

ELIMINATION OF THE ORDER-DELIVERY FUNCTION

Proposed Nasdaq Rule 4623(b)(5) would eliminate Nasdaq's order-delivery function and would require participating ECNs to accept only auto executions, that is, orders via Nasdaq that directly take ECN liquidity. Currently, ECNs may participate on Nasdaq by electing order delivery.[4] When an order is presented to an ECN through Nasdaq, the ECN may either accept the order, fill it in part or decline it, depending on whether the contra order in the ECN has previously been filled. All the independent ECNs on Nasdaq have elected to receive order delivery rather than auto executions. The major advantage of Nasdaq's order-delivery function for ECNs is that it protects them from the risk of double executions in a race condition, a risk that would arise if they accepted auto execution and nevertheless remained subject to having their still-published quotations "hit" by other broker-dealers. Unlike market makers, ECNs are agency brokers and do not carry an inventory or act as principal. If they were forced to take executions, they would have to abandon their current business models and begin to act, involuntarily, as dealers. Unlike market makers, ECNs do not earn a market makers' bid/asked spread. Being forced to "eat" an execution could never be profitable for them on balance and instead would involve costs and the risk of adverse market movement.

SECURITIES EXCHANGE ACT RELEASE NO. 53644

ORDER DELIVERY FEES

Currently, in posting quotations on Nasdaq, all ECNs that participate in the Nasdaq Stock Market can charge liquidity takers an access fee of up to 30 cents per 100 shares ($0.003 per share). In addition, Nasdaq directly charges liquidity takers a fee of 10 cents per 100 shares ($0.001 per share) to deliver orders to such ECNs. Nasdaq currently caps its order-delivery fee at $10,000 per month for each order-entry firm.

Under its proposed rule change, Nasdaq would no longer charge liquidity takers an order-delivery fee. Instead, it would shift that charge to the independent ECNs that provide

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[4] This was a point of great contention in the past and the Commission decided this in favor of order delivery to promote greater market competition and innovation. Nasdaq's efforts several years ago to impose execution delivery on ECNs in its SuperMontage proposal, and then through its order-priority algorithm to penalize ECNs for electing order delivery, failed because of the anticompetitive and illegal purposes and effects of these regulatory abuses. *See*, e.g., *Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and Amendment Nos. 1, 2, 3, 4, 5, 6, 7 and 8 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 9 Relating to the Establishment of the Nasdaq Order Display Facility and Order Collector Facility and Modifications of the Nasdaq Trading Platform*, Securities Exchange Act Release No. 43863 (January 19, 2001), available at http://www.sec.gov/rules/sro/nd9953o.htm.

liquidity, that is, ECNs other than BRUT and INET. Under Nasdaq's proposal, there would not be any cap on the order-delivery fee it would charge the independent ECNs.

As the Commission knows, ECNs participating in the Nasdaq Stock Market provide valuable liquidity to the Nasdaq Market Center by revealing their trading interest and making it available to the central matching engine. This is native liquidity available for immediate execution through the order-delivery mechanism. It is therefore unclear why independent ECN participants should pay a service charge for receiving order deliveries, which are central to the design of the system.

Nasdaq's proposed rule change would effectively set a cap on ECN access fees that is 10 cents per 100 shares lower than the 30-cent cap in Rule 610(c) of Regulation NMS. Under the Nasdaq proposal, if Nasdaq is allowed to charge ECNs a 10-cent fee, the maximum amount an independent ECN could collect would be 20 cents per 100 shares, which is not enough to provide a competitive rebate. In that way, Nasdaq would prevent ECNs from collecting a 10-cent spread (standard industry practice is to charge 30 cents and rebate 20 cents) for providing liquidity (BRUT and INET can collect the 10 cents as well, since Nasdaq can collect the 30 cents for them and not suffer the 10-cent reduction).

BURDENS ON COMPETITION

THE ADVERSE EFFECTS OF ECN MEMBERS ON NASDAQ'S COMPETITIVENESS

Breaking with its established practice in previous rule filings, from SuperMontage to the uniform pricing proposal, Nasdaq has provided statements in both releases of the burdens its proposed rules would impose on competition, as required by Exchange Act Rule 19b-4. Since the effect of Nasdaq's proposed rules would be to put a subset of its members out of business, an analysis of the burdens those rules place on competition is essential. Nasdaq's analysis fails, however, to justify the use by a registered exchange of its self-regulatory rulemaking authority to advance the interests of its shareholders over its duties and responsibilities to its members and to the investing public.

Nasdaq's competitive analysis focuses on fostering competition among market centers, but it casts ECNs and other ATSs as well as other exchanges as competing market centers. It does not distinguish among ECNs or ATSs that primarily internalize and compete with Nasdaq and other exchanges for order flow and those that are primarily agency brokers and whose internalizations are incidental to their primary business. Nor does the list include market makers that internalize order flow. Nasdaq's competitive analysis singles out one subset of its members as competitors and then lists the ways in which this one subset of members threatens its ability to compete, that is, to return value to its shareholders.

Central to Nasdaq's analysis is a claim that the order-delivery function for ECNs slows the Nasdaq system's execution services, making Nasdaq less competitive. Nasdaq does not provide any data or other factual information in support of that claim. Indeed, Nasdaq's claim is not only false but also incredible on its face. Market participants in Nasdaq are not hostages to order-delivery functionality for they can elect auto executions. If the order-delivery

function were consistently slower and less efficient than Nasdaq's own system, the ECNs would have gone out of business. The Nasdaq system, moreover, routes orders to outside venues, serving for instance as a portal to Archipelago. There is no indication that Nasdaq's outbound function slows its system down even though, presumably, the time taken by Archipelago and other venues would affect Nasdaq's overall timeliness.

In addition, Nasdaq's claim that it must terminate order delivery to preserve its market speed is belied by what actually happens in its market. Quotation updates and not delays in transaction reports are what is slowing Nasdaq's system down. For example, the time to update quotations is an important factor in a trader's ability to follow market changes. Nasdaq's NQDS feed on average has a 30-millisecond (that is, 30 one-thousandths of a second) "latency" (i.e., lateness) between the source and the vendor, though during periods of high market activity this latency can grow to 500 milliseconds or more, which is much more than an ECN's order turnaround time. Nasdaq's arguments that it needs to impose execution rather than order delivery to preserve its speedy performance are specious.

Nasdaq's analysis is flawed also by the underlying assumption that execution speed is an absolute value. In fact, it is subject to multiple variables. Latency is not homogeneous. For example, orders that originate on the West Coast do not get auto executions as quickly as orders generated at the same time from the East Coast. Differences in connectivity are another variable. Latency interpenetrates and it is difficult at best to trace particular instances of latency to one group of market participants.

One of Nasdaq's principal arguments is that order-delivery ECNs threaten to render Nasdaq a non-automated or "slow" market center and render quotes on its market unprotected any time a single order-delivery participant's quote is slow. Citing to the Division of Market Regulation's response to Question 5 of its FAQs on the order protection and access rules of Regulation NMS,[5] Nasdaq asserts that it:

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[5] *See* Division of Market Regulation, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS under the Act, dated January 27, 2006 ("Market Regulation NMS Q&A"), at Question 5 (http://www.sec.gov/divisions/marketreg/rule611faq.pdf):

> **Question 5:** Under Rule 600(b)(3)(iii), an automated trading center is required to provide an immediate response to an IOC order without routing the order elsewhere. Can an SRO trading facility meet this requirement if it displays quotations submitted by an order delivery ECN?
>
> **Answer:** An SRO trading facility that displays quotations submitted by an order-delivery ECN can meet the requirement of Rule 600(b)(3)(iii) only if such quotations are closely integrated within the SRO trading facility. An 'order-delivery ECN' submits quotations that are displayed within an SRO trading facility, while also simultaneously executing buy and sell orders internally as agent for its subscribers. To preclude the potential for double liability on a single order (e.g., an order executing internally in the ECN immediately before the quotation that reflects such order is executed in the SRO trading facility), the SRO trading facility does

(Footnote continued)

> does not believe it can offer order delivery functionality and also continuously provide 'a response to incoming orders that does not significantly vary between orders handled entirely within the SRO trading facility and orders delivered to the ECN.'

Nasdaq's "belief" is unfounded and unsupported, and its interpretation of the Division's response to Question 5 is wrong. The Division's response does not authorize Nasdaq to drop order delivery without considering the factors the Division cited. In fact, the Division suggests that Nasdaq can continue to deliver orders to an ECN as long as Nasdaq's order-handling performance does not significantly vary between orders handled entirely within the SRO trading facility and orders delivered to the ECN.

Indeed, the Division suggested that this issue is a question of fact. Nasdaq can deliver orders to an ECN as long as three conditions are satisfied:

1. Nasdaq's trading facility must be capable of providing a response to incoming orders that does not significantly vary between orders handled entirely within the SRO trading facility and orders delivered to the ECN;

2. The systems that connect Nasdaq's trading facility and the ECN must be of very high reliability and speed; and

3. The Nasdaq rules that govern orders delivered to the ECN must assure fast and efficient handling and quotation updates, subject only to addressing the potential for double liability.

These are, of course, questions of fact, questions Nasdaq apparently chose not to confront. In fact, Bloomberg Tradebook responds to incoming orders from Nasdaq in a matter of

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(Continued footnote)

not immediately execute orders against the ECN quotation, but delivers the orders to the ECN to assure that the quotation is still available. If so, the order is executed automatically at the ECN and reported back through the SRO execution facility. Whether the quotations of an order-delivery ECN quotation are closely integrated within the SRO trading facility will be determined from the standpoint of those who route orders to the SRO trading facility. The SRO trading facility must be capable of providing a response to incoming orders that does not significantly vary between orders handled entirely within the SRO trading facility and orders delivered to the ECN. Consequently, the systems that connect the SRO trading facility and ECN must be of very high reliability and speed. In addition, the SRO rules that govern orders delivered to the ECN must assure fast and efficient handling and quotation updates, subject only to addressing the potential for double liability.

milliseconds, typically 5-20 milliseconds. That is far short of the one second test in Regulation NMS[6] for determining whether a market response is fast or slow.

The facts demonstrate that there is no valid basis for Nasdaq's proposed deletion of order delivery to ECNs that can respond within milliseconds. A response in milliseconds would not amount to the "significant variance" in the Division's response to Question 5. We respectfully suggest the facts are what should govern, as opposed to Nasdaq's commercial ambitions as a for-profit business — ambitions that find no support in the legal powers Nasdaq has as a national securities exchange — to use its self-regulatory powers to brush past the public interest and to crush the ECNs that are its members.

Nasdaq's approach also is inconsistent with its duties under the Exchange Act as an SRO. Nasdaq's analysis of the burdens its proposed rule changes would impose on competition does not consider the liquidity that ECN participants provide to investors, the advantage this brings to investors and the internal discipline and drive to innovation within Nasdaq itself that is provided by the ECNs. Instead, Nasdaq offers an undocumented analysis — an a priori judgment that has no valid factual basis — that unfairly singles out one subset of its members as the sole inhibitors of Nasdaq's ability to compete more efficiently with other exchanges. Its analysis can be formulated as follows:

(i) ECNs are a burden on Nasdaq's capacity to compete and impose fee changes;

(ii) Eliminating functions that will have the effect of driving independent ECNs off the Nasdaq system will remove those burdens, and

(iii) Nasdaq's proposed rule changes do not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of Nasdaq as a for-profit exchange.

As we show below, this analysis is deeply flawed. Nasdaq's proposed rules discriminate unfairly against ECNs, they are inconsistent with Nasdaq's obligation to have rules that promote a free and open market and they impose unnecessary and inappropriate burdens on competition.

BURDENS ON COMPETITION:
THE EFFECTS OF NASDAQ'S RULE CHANGES ON ITS ECN MEMBERS

If put into effect, Nasdaq's proposed changes would make the Nasdaq platform unavailable to the independent ECNs. They would deliberately hobble the ability of ECNs to

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[6] *See* Securities Exchange Act Release No. 51808 (June 9, 2005) in text at n.173. *See also* Market Regulation NMS Q&A at Response to Questions 11 & 24.

serve investors and other market participants because they would expose the ECNs to the risk of double execution — a risk that in the past the Commission found to justify requiring Nasdaq to provide order delivery as opposed to execution delivery.[7] The proposed rule changes would diminish investor choice, harm the markets and raise fundamental public policy issues in at least the following respects.

- Nasdaq's proposed Rule 4623(b)(5) unfairly discriminates against independent ECNs. The only "order delivery participants" on the Nasdaq system are the ECNs that are independent of Nasdaq. Nasdaq's rule proposal would apply solely to that subset of its members that are ECNs. Nasdaq's proposed fee change imposes considerable burdens on those ECNs in that, as noted above, it eliminates the ECNs' profitability and effectively prices them out of the business.

- Nasdaq's proposed Rule 4623(b)(5) is anti-competitive. One consequence of Nasdaq's revised fee structure would be to compromise the ability of ECNs to compete with Nasdaq in attracting liquidity. Nasdaq participants can use Nasdaq's BRUT and INET — two ECN-like facilities which Nasdaq purchased — just as they would use an independent ECN. If Nasdaq's fee proposal becomes effective, BRUT and INET would be able to charge liquidity takers 30 cents per 100 shares and provide a rebate to liquidity providers of between 20 cents and 25 cents. In the case of the independent ECNs, on the other hand, after paying Nasdaq's order-delivery fee under the new rule, the maximum amount available for rebates and other expenses would be only 20 cents per 100 shares (30 cents charged less the new 10-cent fee). That surely would put them at a significant competitive disadvantage to BRUT and INET. In that way, Nasdaq's proposal not only unfairly discriminates against independent ECNs but also inappropriately impairs competition.

- Nasdaq's proposal is an exercise in monopoly pricing power. Nasdaq's proposal does not merely shift its order-delivery fee from one participant in its marketplace to another. It would impose a tax on the independent ECNs by removing the cap on those fees, thus increasing the revenue it currently derives from the fees and using that increased revenue to subsidize the liquidity rebate BRUT and INET can provide. Nasdaq also could use the money it would collect on delivering orders to its independent ECN members to draw order flow to BRUT and INET. In that way, the proposed Nasdaq fee structure would first weaken and then eliminate independent ECN members, opening the path for Nasdaq to charge monopoly rents in future. Nasdaq does not explain or justify why the cap would be lifted.

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[7] Securities Exchange Act Release No. 43863 (January 19, 2001), *supra,* note 4,

- Nasdaq is attempting to do indirectly what it is prohibited from doing directly. The Exchange Act expressly prohibits an exchange from imposing any schedule or fixing rates of commission or other fees charged by its members. Requiring independent ECNs to pay Nasdaq's order-delivery fee and removing the cap on those fees deprives them of a substantial portion of the 30 cents per 100 shares they are permitted to charge in access fees. Nasdaq's fee proposal not only slashes the profitability of independent ECNs, but it effectively imposes a maximum fee they can charge. The proposal thus contravenes the statutory prohibition against fixing fees and, in effect, accomplishes indirectly much of what an outright ban on charging access fees would accomplish directly. Exchange Act Section 20(b) prohibits Nasdaq from doing indirectly anything it is prohibited from doing directly.

- Nasdaq's intent is clear from the timing of its fee proposal. As noted above, Nasdaq has twice filed with the SEC within the past year seeking to prohibit its ECN members from charging access fees. Nasdaq's two prior attempts to adopt rules imposing an outright ban on ECNs' charging access fees ran into legal problems, which forced Nasdaq to try a subterfuge in an effort to get around the statute. Nasdaq's fee proposal, in tandem with Nasdaq's proposal to eliminate the order-delivery function from its system, is designed to destroy independent ECNs and eliminate the choices they traditionally have provided to investors.

As mentioned above, Nasdaq's proposals raise a fundamental public policy question: how are investors and the national market system served by eliminating from the Nasdaq platform the competitive liquidity and investor choices provided by ECNs?[8]

Just as Nasdaq's earlier, failed attempts to eliminate ECN access fees contravened the Exchange Act, these additional proposals do so as well, in several respects:

- They discriminate against ECNs among all other members, violating the prohibition in Exchange Act Section 6(b)(5) against exchange rules that are "designed to permit unfair discrimination between . . . brokers, or dealers . . . ."

- They are inconsistent with Nasdaq's obligation under Exchange Act Section 6(b)(5) to promote a free and open market and a national market system.

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[8] Though a quotation facility, the Alternative Display Facility currently lacks a crucial element of display under Regulation NMS. When more than one ADF participant is at the best price, the ADF will apply a formula to determine one participant's quotation as protected. The others' quotations could be traded through since the market data distributed by the securities information processors ("SIPs") carry only an ADF Best Bid and Offer, not the best of each participant. Without full visibility in the national best bid/offer for each participant, the ADF cannot compete for order flow, as participants could not guarantee their clients best execution. We urge the Commission to address this issue with the SIPs.

- Since the purpose and effect of the discriminatory fee structure is to cap the fees ECNs can charge, the Nasdaq proposals violate the prohibition in Exchange Act Section 6(e)(1) against exchange rules that fix fees its members may charge.

- The proposals would violate the prohibition in Exchange Act Section 6(b)(8) by imposing burdens on competition that are not necessary or appropriate in furtherance of the purposes of the Exchange Act.

- Exchange Act Section 3(f) requires the Commission to consider whether Nasdaq rules promote competition. Eliminating ECNs and the competitive pressures they bring to bear on Nasdaq hardly would promote competition.

Rule proposals by each exchange must be considered in the context of its unique market structure. Commission action to prevent Nasdaq from putting these improper rule changes into effect does not imply an affirmative obligation on the Commission's part to require all national securities exchanges to provide for order delivery. Similarly, the individual features of other exchanges, such as the New York Stock Exchange's various "hybrid" market provisions, should not be imposed on Nasdaq.

Should the Commission decide, notwithstanding the serious problems and legal flaws discussed above, to approve these filings, at a minimum the effective date of the rules should be delayed to provide Nasdaq's ECN members a fair opportunity to migrate to another venue. This is a systems project that would require adapting to a new venue, adjusting computer protocols and other systems work that would take a minimum of three to six months to achieve. It also would require, we expect, the filing of SRO rules by the market that agreed to accept the ECNs and the Commission's approval of those rules.

CONCLUSION

Nasdaq should not be allowed to use its regulatory power, including its monopoly power as the entity running the Nasdaq Stock Market, to achieve illegal and anticompetitive ends. These proposals demonstrate graphically the evils of allowing self-regulatory organizations to de-mutualize and become for-profit entities unless they are subject to pervasive, exacting and continuous scrutiny. Given the problems discussed above, the Commission should reject Nasdaq's order-delivery fee proposal and require that the proposed rules for Nasdaq's integrated system be amended to delete the proposed elimination of order-delivery functionality.

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We hope our letter is helpful to the Commission and the staff in its review of the Nasdaq's proposed rule changes. If members of the Commission or of the staff believe we may be of further assistance in these matters, please let us know.

Respectfully submitted,

Kim Bang by R.D.B.

Attachment: letter from Bloomberg Tradebook LLC to Brian G. Cartwright, General Counsel, SEC (March 6, 2006)

cc(w/att.):
The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner
Robert L. D. Colby, Esq., Acting Director, Division of Market Regulation
David Shillman, Esq., Associate Director, Division of Market Regulation
Nancy J. Sanow, Esq., Assistant Director Division of Market Regulation
Mr. Stephen L. Williams, Economist Division of Market Regulation
Dr. Chester Spatt, Chief Economist
Brian G. Cartwright, Esq., General Counsel

ATTACHMENT

Bloomberg L.P. 731 Lexington Avenue Tel +1 212 318-2000
New York, NY 10022Fax +1 917 369 5000
bloomberg.com

March 6, 2006

Via Electronic Mail (cartwrightb@sec.gov)

Brian G. Cartwright, Esq.
General Counsel
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Commission File No. SR-NASDAQ-2006-001

Dear Mr. Cartwright:

We are writing to raise a substantial issue of legal authority with respect to the above captioned filing, which is the same issue we raised with respect to a filing by the NASD on behalf of Nasdaq, SR-NASD-2005-013, in our comment letters dated May 20, August 26 and December 19, 2005.[1] In its current filling, Nasdaq asks the Commission to approve a proposed rule change that would prohibit its members from "assessing fees triggered by the execution of a quote order to other broker-dealers that access their quotes and orders via the Nasdaq Market Center."[2]

The issue this presents relates to Nasdaq's ability as a national securities exchange to impose any schedule or fixing rates of commission or other fees charged by its members — as opposed to Nasdaq's setting rates it will itself charge members and other market participants. We demonstrated in our August 26 letter that Section 15A(b)(6) of the Securities Exchange Act of 1934 (the "Exchange Act") prohibited Nasdaq, as a facility of a national securities association, from imposing schedules or fixing rates of commissions or fees its members may charge. The

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[1] Letters from Bloomberg L.P. in SEC File No. SR-NASD-225-013, available at http://www.sec.gov/rules/sro/nasd/nasd2005013.shtml.

[2] SR-NASDAQ-2006-001 in text following n. 13 (page 61 of 158). To the best of our knowledge, the Commission has not yet published this filing for public comment. We may have additional comments on other aspects of the rule filing if it is published for comment.

analysis and conclusion are the same under Exchange Act Section 6(e)(1). The language in Section 6(e)(1) is based on and is indeed identical, *mutatis mutandis*, to the language in Section 15A(b)(6):

> no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members . . . .

That statutory prohibition is absolute and is not susceptible of being overridden by a Nasdaq rule. It does not apply only to schedules or fixed rates applied generally across all market venues. The prohibition applies to any Nasdaq rule fixing, even at zero, any fees charged by Nasdaq members. Bloomberg Tradebook and the other electronic communications networks ("ECNs") are Nasdaq members and the prohibition Nasdaq would apply to them flies directly into the Section 6(e)(1) prohibition, which as noted above is identical to the Section 15A(b)(6) prohibition.. As we demonstrated in our August 26 letter, the legislative history of the Maloney Act, which added Section 15A to the Exchange Act, makes it clear that, in Senator Maloney's words:

> [T]o provide safeguards against unreasonable profits, it is contemplated that associations may adopt rules designed to prevent each member thereof from exacting in any particular transaction a profit which reasonable men would agree was unconscionable in the light of all of the concrete facts and circumstances of that transaction; but an association, whether in a bona fide attempt to prevent or under the pretext of preventing unreasonable profits, may not impose any schedule of prices or commissions.[3]

Deficiency in Nasdaq's Form 19b-4 Filing

The deficiencies in the Nasdaq filing are not limited to contravening express statutory prohibitions. Once again, as in the earlier filing, Nasdaq has flouted the requirement in Form 19b-4 to discuss and justify burdens on competition. It has simply parroted the language of Section 6(b)(8) by asserting that Nasdaq "does not believe that its proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the Exchange Act."[4] That rote incantation of the Section 6(b)(8) standard, unsupported by any discussion or any demonstration at all, does not satisfy the requirements of the Commission's

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[3] *See* Regulation of Over-the-Counter Markets, Report of the Senate Comm. on Banking and Currency to Accompany S. 3255, S. Rep. No. 1455, 75th Cong., 3d Sess. 7 (1938). *See also,* Regulation of Over-the-Counter Markets, Report of the House Comm. on Interstate and Foreign Commerce to Accompany S. 3255, H.R. Rep. No. 2307, 75th Cong.. 3d Sess. 8 (1938).

[4] SR-NASDAQ-2006-001 at page 156 of 158.

Form 19b-4 that such burdens be explained and justified in detail.[5] As the Commission is aware, moreover, the courts have applied strict scrutiny to rule filings that do not meet statutory standards.

If the competitive impact of the Nasdaq rule proposal were trivial, an elaborate discussion would not be warranted. That is not the case here, however. Destroying the pricing power of a subset of members, that is, ECNs, distinguished solely by their business model is not trivial. Given the inadequacy of the record, the public would be effectively deprived of a meaningful opportunity for comment on the proposed rule.[6] The Commission, in turn, would be

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[5] The General Instructions to Form 19b-4, 5 Fed. Sec. L. Rep. (CCH) ¶ 32,356, are explicit on the point. They provide, with respect to "Information to be Included in the Completed Form", as follows:

> 4. *Self-Regulatory Organization's Statement on Burden on Competition*
>
> State whether the proposed rule change will have an impact on competition and, if so, (i) state whether the proposed rule change will impose any burden on competition or whether it will relieve any burden on, or otherwise promote, competition and (ii) specify the particular categories of persons and kinds of businesses on which any burden will be imposed and the ways in which the proposed rule change will affect them. If the proposed rule change amends an existing rule, state whether that existing rule, as amended by the proposed rule change, will impose any burden on competition. If any impact on competition is not believed to be a significant burden on competition, explain why. Explain why any burden on competition is necessary or appropriate in furtherance of the purposes of the [Exchange] Act. In providing those explanations, set forth and respond in detail to written comments as to any significant impact or burden on competition perceived by any person who has made comments on the proposed rule change to the self-regulatory organization. *The statement concerning burdens on competition should be sufficiently detailed and specific to support a Commission finding that the proposed rule change does not impose any unnecessary or inappropriate burden on competition* [emphasis added].

Id. at p. 22,318.

[6] To assist the Commission in its adjudicatory proceedings under the Exchange Act, such as the approval by order of a self-regulatory organization's proposed rule change under Exchange Act Section 19(b), Nasdaq must provide an adequate basis for comment on its rule proposals and, where significant competitive issues are involved, must provide an opportunity for the public to comment meaningfully on the issues involved. Perfunctory recitals do not provide that basis. *See Connecticut Light and Power Co. v. NCR*, 673 F.2d 525, 530-31 (DC Cir. 1982):

> The purpose of the comment period is to allow interested members of the public to communicate information, concerns, and criticisms to the agency during the rule-making process. If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals. As a result, the agency may operate with a one-sided or mistaken picture of the issues at stake in a rule-making. . . . To allow an agency to play hunt the peanut with technical information, hiding or disguising the

(Footnote continued)

denied the benefit of the comments that could arise from the fully informed dialogue and genuine interchange of data, views and arguments the Congress called for in the rule-approval process embodied in Exchange Act Section 19(b).[7]

We point these matters out to underscore the deficiency in the Nasdaq filing from the point of view of public disclosure, which presents an independent, *per se* basis on which the Commission cannot lawfully approve the filing — Nasdaq's failure to observe the disclosure requirements set forth in the Commission's own Form 19b-4. In this instance, though, given the even more serious and incurable statutory infirmities in Nasdaq's filing, to require Nasdaq to upgrade its filing before seeking public comment would not be useful. Instead, we recommend that the Nasdaq be told to withdraw that portion of the instant rule proposal that would fix at zero the fees ECNs can charge for access to the Nasdaq Market Center and, if Nasdaq is unwilling to do so, that the Commission commence proceedings to consider disapproval of the proposal.

(Continued footnote)

> information that it employs, is to condone a practice in which the agency treats what should be a genuine interchange as mere bureaucratic sport.

[7] The rigorous approach built into the Commission's Rule 19b-4 and Form 19b-4 responds to a direct, specific and unequivocal congressional mandate. *See* Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 29-30 (1975):

> In order to facilitate expeditious Commission review and evaluation of [proposed rule changes] and to assure informed public comment on them, Section 19(b)(1) would require all self-regulatory organizations to file with the SEC in connection with any proposed rule change a "concise general statement of the basis and purpose" of the proposed rule change. *It is the Committee's intention in adopting this standard to hold the self-regulatory organizations to the same standards of policy justification that the Administrative Procedure Act imposes on the SEC.*
>
> . . . [T]he Committee believes interested persons should have a meaningful opportunity to obtain accurate information about proposed changes in self-regulatory rules and to comment on the need or justification for these changes. Section 19(b)(1) would require the SEC to give notice and provide an opportunity for interested persons to participate in the process of reviewing a proposed change in a self-regulatory organization's rules. In addition, this section would require that all comment and all correspondence between the SEC and the self-regulatory agency concerning the proposal be available for public inspection. . . .
>
> . . . The Committee believes the Commission has a responsibility to see that self-regulatory rules are fully responsive to regulatory needs. By explicitly providing that the Commission's oversight authority encompasses major self-regulatory policies, the bill would make this responsibility clear and substantially decrease the possibility of slippage between regulatory need and self-regulatory performance [emphasis added]. . . .

* * *

Again, we appreciate the time you and your colleagues have given to considering these issues in the past in connection with the earlier filing. We believe the issues bear on fundamental questions of the scope of SRO and Commission rulemaking authority. We would be pleased to discuss them further, respond to any questions you may have or provide any additional comments or information you may request.

Respectfully submitted,

Kim Bang by R.D.B.

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner
Dr. Chester Spatt, Chief Economist
Dr. Lois E. Lightfoot, Economist
Office of Economic Analysis
Meridith Mitchell, Esq.
Principal Associate General Counsel for Legal Policy
Office of General Counsel
Janice S. Mitnick, Esq.
Assistant General Counsel for Market Regulation
Office of General Counsel
David Dimitrious, Esq.
Office of General Counsel
Robert L. D. Colby, Esq., Acting Director
Division of Market Regulation
Michael J. Gaw, Esq.
Division of Market Regulation
Mark McKayle, Esq.
Division of Market Regulation
Edward Cho, Esq.
Division of Market Regulation