THE NASDAQ STOCK MARKET
ONE LIBERTY PLAZA, 50TH FLOOR
NEW YORK, NY 10006

May 8, 2006

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

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: **Response to Comments - SR-NASDAQ-2006-001**

Dear Ms. Morris:

The NASDAQ Stock Market LLC ("Nasdaq") welcomes the opportunity to respond to comments submitted in connection with Nasdaq's proposal to integrate three execution systems into one – the "Single Book" – that will operate in price and time priority from a single pool of liquidity. Nasdaq views the Single Book as a significant and positive step in the evolution of Nasdaq and of the US equities markets because it will accomplish four critical goals of the Securities and Exchange Act of 1934 ("Act"). If approved, the Single Book will:

- benefit investors by offering a faster, fairer, more efficient and more transparent system that executes trades in strict price/time priority;
- promote competition by allowing Nasdaq to increase efficiency, decrease overall trading costs, and provide better service to market participants;
- promote the development of the national market system by integrating separate trading systems into a single pool of exchange liquidity for market participants to access; and
- improve regulation by complying with the Regulation NMS Access and Order Protection Rules to prevent locked and crossed markets and trade throughs.

Nasdaq notes that no investors or investor representatives have opposed the Single Book Proposal. In fact, only one market participant, Bloomberg Tradebook, LLC ("Bloomberg"), has filed a detailed comment letter opposing this important development,[1] and that letter largely re-argues self-interested objections that Bloomberg has raised and the Commission has rejected in connection with Nasdaq efforts to automate its market. In truth, Bloomberg has one and only one dispute with the Single Book Proposal: Nasdaq is proposing to eliminate the order-delivery functionality that is available only to Electronic Communications Networks and only within Nasdaq. Thus, it is Bloomberg's position that Nasdaq should be required to offer order delivery functionality for Bloomberg's special benefit. Bloomberg's demand flies in the face of the policy underlying Regulation NMS, which determined that automated executions are the lifeblood and future of the national market system.[2]

Bloomberg is unable to identify in the Act any requirement that national securities exchanges offer order delivery participation in their execution systems. No such requirement exists. No other exchange market has been required to or chosen to offer order delivery to its participants. Thus, for example, there is no order delivery functionality in the recently-approved Hybrid System of the New York Stock Exchange or the systems of the American, Boston, Chicago, and National Stock Exchanges. A statutory requirement such as Bloomberg seeks to create must, of course, apply equally to all SRO markets or else contradict the Exchange Act goal of equal regulation and be adjudged arbitrary and capricious under the Administrative Procedures Act of 1946 (5 U.S.C. 706).

Bloomberg also fundamentally misconstrues the Single Book Proposal in claiming that Nasdaq is "unfairly discriminating" among order delivery participants. Bloomberg claims that Nasdaq would eliminate Nasdaq's order-delivery functionality for the so-called "independent ECNs" while "preserving it for Nasdaq's own ECN facilities." In fact, Nasdaq is not only eliminating order delivery functionality completely, it is also eliminating its own Brut and INET execution facilities. As clearly stated in the Single Book Proposal, Nasdaq is integrating the Brut and INET execution systems with Nasdaq's own platform and eliminating the separate operation of its broker-dealer execution systems. After implementing the Single Book Proposal, the only functions to be performed by Nasdaq's Brut broker-dealer will be routing, a function that is

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1 BATS Trading, Inc. ("BATS"), DirectEdge ECN LLC, and TrackECN filed brief comments that without offering additional analysis endorse Bloomberg's claim that Nasdaq is eliminating competitors and limiting investors' choices. Nasdaq notes that just two weeks before BATS' Chief Executive Officer David Cummings filed BATS' comment letter on Single Book, Mr. Cummings informed subscribers that BATS would begin quoting and trading via the facilities of the National Stock Exchange ("NSX"). *See* Exhibit A. BATS has, in fact, already begun quoting via NSX, providing concrete evidence that Bloomberg's assertions regarding the impact of Single Book on competition are unfounded. The DirectEdge ECN currently quotes in the NASD Alternative Display Facility.

2 Bloomberg also misconstrues the standard of review applicable to the Single Book Proposal. According to Bloomberg, the question is "how are investors and the national market system served by eliminating from the Nasdaq platform the competitive liquidity and investor choices provided by ECNs?" In fact, the question is just the opposite: the proposal must be approved unless the Commission concludes that it is not in the best interest of investors or the public or is otherwise inconsistent with the Act. As demonstrated by the filing and amplified in this response, the benefits to investors are abundant and far overwhelm Bloomberg's proprietary concerns.

completely unrelated to Bloomberg's current issue and that is specifically contemplated by Regulation NMS.

Unable legitimately to impede Nasdaq's efforts to make its market more automated, Bloomberg resorts to obfuscation. Bloomberg attempts to entwine its opposition to the Single Book Proposal with its opposition to SR-NASD-2006-048, a separate proposal regarding order delivery fees ("Order Delivery Fee Filing").[3] Bloomberg weaves the two proposals together in an attempt to fashion a fantastic conspiracy by Nasdaq to "eliminate ECNs from participating in its market place", to exclude them, to cause them to "go dark" and to reduce investor choice.[4] By weaving the proposals together, Bloomberg hopes to obscure the fact that none of these claims is true of Nasdaq's Single Book proposal (or of the Order Delivery Fee Filing).

Bloomberg's arguments fail because it obscures a key, dispositive fact: Nasdaq is not excluding ECNs at all. Nasdaq welcomes Bloomberg, DirectEdge, TrackECN and any other ECN to participate in its execution systems *provided* that they, like all other Nasdaq members, make their trading interest available for automatic execution when using the Nasdaq Market Center.[5] ECNs such as Bloomberg are technically capable of participating in Nasdaq on an automatic execution basis as proposed (their own execution systems are fully automated), but Bloomberg has voluntarily declined to do so for reasons completely within its own control. Bloomberg voluntarily chooses not to participate on an automatic execution basis because its business model is to isolate orders within its own system and to preserve internal executions as much as possible.[6] Nasdaq should not

[3] The Order Delivery Fee Filing, submitted by The Nasdaq Stock Market, Inc., a legal entity separate and distinct from the Nasdaq exchange, focuses on the fees proposed to be assessed for Nasdaq's existing order delivery functionality. Bloomberg correctly notes that approval of the Single Book proposal would render the Order Delivery Fee Filing meaningless after the Single Book is launched.

[4] Bloomberg mistakenly attempts to resurrect an issue that Nasdaq has eliminated from the Single Book Proposal. Bloomberg correctly notes that Nasdaq originally proposed to address access fees in the Single Book Proposal but then eliminated that aspect of the proposal in Amendment 1. Bloomberg half-heartedly and incorrectly implies that that aspect of the original Single Book Proposal remains a live issue. It is not.

[5] To put the issue into perspective, according to Nasdaq records for the month of April 2006, the market participants that use order delivery functionality accounted for just over four (4.12) percent of total execution volume in Nasdaq securities. This market share may be overstated because a large portion of certain ECNs' volume is in sub-$1 securities. For example, TrackECN offers rebates as high as $0.0027 for securities with a minimum price variation of $0.0001, resulting in a rebate that is 27 times the MPV. This outsized rebate risks creating distortions in market participant behavior that Nasdaq has referred to the NASD for further investigation.

[6] Bloomberg points out that unlike market makers, which take risk, "ECNS are agency brokers and do not carry an inventory or act as principal." Bloomberg neglects to mention the scores of agency brokers that participate in Nasdaq systems and accept automatic executions. These agency brokers manage their risk of double executions by canceling the quote or order on Nasdaq (or another automatic execution system) before matching the order internally. If internal executions are only "incidental" to its business model, as Bloomberg claims, the elimination of order delivery functionality would have minimal impact on Bloomberg's business model.

be forced to conform to Bloomberg's business model and thereby impair its own ability to compete effectively.

Bloomberg also seeks to obscure the voluntary nature of Nasdaq's system and Bloomberg's freedom to conduct its business activity elsewhere. As the Commission is well aware, there is no provision of the Act and no regulation that requires Bloomberg to post orders in Nasdaq. Indeed, many ECNs that once posted orders within Nasdaq have since elected voluntarily to move their activities to regional exchanges, including Brut and Instinet, and before them Island (while separate from Instinet), Archipelago, and Attain. Most recently, one of the commentors to the Singe Book Proposal, BATS, announced plans to move to NSX.[7] Bloomberg could also post quotes in the NASD's Alternative Trading Facility ("ADF") with ECNs such as OnTrade (formerly NextTrade). Indeed, the creation of the ADF was designed (in no small part for Bloomberg itself) and approved by the Commission to provide such freedom to market participants.

Instead, Bloomberg pretends to be a "prisoner" of Nasdaq, albeit a privileged one, that must be allowed to continue to use Nasdaq under terms and conditions materially different than those applicable to the vast majority of other users. The false premise of a Nasdaq monopoly is essential to Bloomberg's assertion that it is a burden on competition for Nasdaq to offer uniform automatic execution functionality to all of its members and uniform automatic execution opportunities to all investors. Underneath the hyperbole and posturing, Bloomberg's real concern is that it may lose its privileged position (within the limited class of participants that are permitted to use order delivery) *vis a vis* competitors that are not permitted order delivery and that it may be forced to innovate in order to compete.

Unable to find statutory support and unwilling to admit that it is free to compete elsewhere, Bloomberg instead questions Nasdaq's conclusion that order delivery harms market quality and investors, makes Nasdaq less competitive, and is contrary to the main thrust of Regulation NMS. Contrary to Bloomberg's claim, Nasdaq regularly studies the response times and rejection rates of ECNs that operate within the Nasdaq market. Based upon Nasdaq's detailed review, there is no doubt that compared to automatic execution, order delivery results in slower executions, lower fill rates, and worse prices for investors that involuntarily interact with order delivery firms. [8]

Bloomberg argues that Nasdaq's concerns about delayed executions are overblown. This is simply incorrect. Nasdaq's interaction with order delivery participants is inherently more time-consuming than its interaction with an automatic execution participant. In the case of an order delivery participant, upon ascertaining that

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7 See supra n. 2.

8 The Commission has already acknowledged the potential harm to investors. In approving a new order type for Nasdaq, the Division stated "[I]f an order is rejected and returned to SuperMontage, market conditions, especially during a fast market, may change and the order may receive an inferior execution." Exchange Act Release 49020 (Jan. 5, 2004).

the participant's quote or order is next in line to receive an incoming order, Nasdaq first transmits the order to the participant. If the participant decides to accept the order (which is optional), it transmits a message back to Nasdaq either accepting or rejecting the order, and then Nasdaq either executes the order against the order delivery participant's quote or order or cancels and reprocesses the order. By contrast, when an automatic-execution participant's quote is next in line, Nasdaq simply executes the order. Although an order delivery participant such as Bloomberg may automate the evaluation of orders, the back-and-forth message traffic between Nasdaq and the order delivery participant involves delays not present in the case of automatic executions.

In addition, as Bloomberg must concede, there is always a possibility that orders presented to an order delivery participant will be rejected because the shares reflected in the participant's quote have already been accessed through subscribers' direct connections to the participant. Bloomberg's business model is based on the opportunity to reject orders that are presented to a quote that is still displayed in Nasdaq. Thus, an investor whose order is randomly and involuntarily routed to an order delivery participant faces a substantial risk that its order will not be executed. By contrast, when an automatic execution participant is next in queue, the investors that enter orders in Nasdaq are guaranteed that an execution will occur.

Although Bloomberg claims both rapid response times and low rejection rates, Bloomberg is not the only order delivery participant in Nasdaq and the damage of slow response times and high rejection rates is clear. These dangers are acute at the critical opening and closing of the market. For the week of March 13 through 17, 2006[9]:

- 100 percent of automatic execution orders that Nasdaq attempted to execute actually executed.
- 14 percent of total orders that Nasdaq delivered to order delivery participants failed to execute; for one order delivery participant the overall failure rate exceeded 25 percent.
- 55.6 percent of orders delivered to order delivery participants prior to 9:30:15 failed to execute.
- 27.9 percent of orders delivered to order delivery participants between 9:30:15 and 9:30:30 failed to execute.
- 12.7 percent of orders delivered to order delivery participants between 9:30:30 to 3:59:30 failed to execute.

[9] Nasdaq notes that Friday, March 17 was a so-called "expiration Friday." On that day, various options contracts expired, making the opening and closing periods on Nasdaq especially important to investors.

- Prior to 9:30:15, three order delivery participants had during that week mean response times of over four, nine, and twenty seconds per order.[10]

Nasdaq has been working with order delivery participants for years now, and those participants have still not found it technologically feasible to provide the response times and fill rates to which investors are entitled and have come to expect.

Alone, these poor market quality statistics harm Nasdaq's ability to compete, and that problem is compounded by the fact that order delivery functionality is costly to Nasdaq. Offering order delivery functionality demands disproportionate system capacity and unique specifications, requirements, and programming not available to or needed by the vast majority of Nasdaq participants. No other SRO market incurs these costs. In addition, Bloomberg intentionally ignores Nasdaq's long-standing concern that ECN response times and rejection rates create strong disincentives for market participants to use Nasdaq systems because they cannot anticipate whether, and if so at what speed, their orders will be executed. This uncertainty is clearly not in the interest of the overwhelming majority of Nasdaq participants and investors who demand certainty and the highest quality executions possible.

The harm to investors caused by slow response times and unacceptable rejection rates will be exacerbated under Regulation NMS. Bloomberg does not refute that, as Nasdaq stated in the original filing, providing order delivery would risk making Nasdaq a "slow" market and, when an order delivery participant experienced technical problems, would permit other trading centers to declare "self-help" and stop routing orders to Nasdaq. As the response numbers above demonstrate, offering order delivery functionality will impair Nasdaq's ability to 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 an ECN" as required under Regulation NMS.

Having failed to demonstrate that the proposal violates the Act, Bloomberg concludes by seeking to delay the effective date of approval. This would serve only to delay the time when investors receive the benefits offered by a faster, fairer, more efficient and more transparent system. Nor is delay needed. BATS migrated its order flow to the National Stock Exchange in several weeks, proving that ECNs can migrate

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[10] Bloomberg states it typically responds to delivered orders within 5-20 milliseconds. In high activity periods, however, response times typically degrade. Nasdaq would be at risk of having the self-help exception declared against it not only during times of market stress as detailed in the response statistics above, but also at any time any ECN experienced a degradation in response. In addition, the INET system, upon which the integrated system is based, responds to orders in 1 millisecond (excluding network latency). Assuming this is true and putting aside the critical periods of the day when this is certainly not true, responses ranging from 5 times to 20 times longer than an internal automatic execution would not meet the standard set forth in response to question 5 of the Responses to Frequently Asked Questions Concerning Rules 611 and 610 of Regulation NMS.

quickly. Bloomberg first commented on the Single Book Proposal on March 6, 2006, providing Bloomberg with over three months of lead time to make the system changes that BATS made in a matter of weeks.

Moreover, the Commission lacks the statutory authority to give Bloomberg what it really wants: delay while it negotiates a beneficial arrangement to post quotes in another venue.[11] Even if Bloomberg supported its claims with evidence (it has not), there simply is no authority under the statute to accommodate the business schedule of an individual market participant. Section 19(b) of the Act directs the Commission to determine promptly whether a rule proposal is consistent with the Act and to approve or reject it accordingly.

Bloomberg's complaints about the Single Book Proposal have nothing to do with investors, the public interest, or competition in the marketplace as a whole, and everything to do with how the proposal may impact Bloomberg's individual interests. It is not that Bloomberg cannot adjust to an auto-ex environment or move to another quotation venue; rather, Bloomberg does not want to do so. This is in keeping with Bloomberg's attempts to equate "impact on competition" with "impact on Bloomberg." The fact is that approval of the Single Book Proposal will spur competition in the provision of technological services to the investing public, stimulate further innovation, and preserve the United States as a leader in the financial markets.

If you have any further questions, please do not hesitate to contact me at 301-978-8480.

Sincerely,

Edward S. Knight

Edward S. Knight
Executive Vice President and
General Counsel

Attachment: Exhibit A

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
Robert L. D. Colby, Esq., Acting Director, Division of Market Regulation

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[11] Bloomberg also demands extra delay to allow another SRO to file special execution rules for Bloomberg. It appears that Bloomberg will not deign to participate in another market according to its existing rules for ordinary members; it demands specially-tailored rules that maintain its privileged position *vis a vis* ordinary members.

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

EXHIBIT A

From: David Cummings [mailto:dave@batstrading.com]
Sent: Tuesday, April 18, 2006 11:37 AM
To: David Cummings
Subject: BATS & NSX - action required

Dear Subscribers & Prospects:

BATS has become an National Stock Exchange(NSX) member. This week, we plan to start using NSX to display our top of book and for some of our trade reports.

Subscribers should make plans to access BATS directly instead of via Nasdaq.

Market participants using vendors to route their orders should ask their vendors if they will have direct or indirect connectivity to BATS.

BATS currently displays its orders in the Nasdaq Market Center. Starting this week, BATS also plans to reflect its top of book at NSX. We will start with JNPR and ramp up other symbols as technology allows.

Because of the competitive situation, we cannot guarantee that BATS liquidity will continue to be accessible via Nasdaq in the future. We will consider removing some or all of our quotes from the Nasdaq system if it benefits our Subscribers.

The BATS PITCH market data feed remains the most reliable and timely indication of the displayed liquidity available in the BATS system. Subscribers that relied on seeing the BATS MPID in Nasdaq Level 2 should make plans to modify their systems. Unlike some competitors, BATS does not charge for its market data.

BATS plans to offer trading in AMEX Listed (Tape B) securities soon. Top of book quotes for Tape B stocks will be represented only at NSX, not via Nasdaq. Details and pricing will be made in a separate announcement.

Trade reports that are eligible to be reported at NSX will be reported at NSX, with the remainder reported to Nasdaq via ACT.

BATS continues to seek the most economical place to represent your orders. We appreciate your support during this time of transition.

Sincerely,

Dave Cummings
President & CEO
(816) 285-9910
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BATS