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ONE LIBERTY PLAZA, 50TH FLOOR
NEW YORK, NY 10006

September 29, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth St., N.W.
Washington, DC 20549

Re: Proposed Regulation NMS; File No. S7-10-04

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") submits this additional comment letter in response to proposed Regulation NMS.[1] Nasdaq earlier submitted comments demonstrating that there is no need to apply the trade-through rule to the Nasdaq market.[2] Public testimony and statements suggest, however, that the Securities and Exchange Commission ("Commission") may be considering applying the trade-through rule to the Nasdaq market in the quest for regulatory symmetry. In the event that such a proposal is under active consideration, this comment letter focuses on the costs and technological impact of applying the trade-through rule as currently proposed to the Nasdaq market.

It is becoming increasingly apparent to Nasdaq, and those who depend on Nasdaq to achieve fair and efficient executions of their customer orders, that applying the proposed trade-through rule to Nasdaq will harm investors. In addition, retaining the trade-through restriction on the trading of New York Stock Exchange–listed ("NYSE-listed") securities will lock-in this market segment's inefficiencies and lack of competition.

In contrast, the Commission has publicly recognized that "even without a trade-through rule, the Nasdaq market does not appear to lack

1 Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) ("Regulation NMS Proposing Release").

2 Nasdaq's comment letter in response to the Regulation NMS Proposing Release is available on the Commission's web site at www.sec.gov/rules/proposed/s71004.shtml.

competitive quoting in the most actively traded securities."[3] In other words, the Commission has implied that the benefits of a trade-through rule for actively traded securities would be illusory because competitive quoting already exists. However, the costs of imposing the rule will be real, both in financial terms and in terms of the loss of customer choice. In addition, there will be practical difficulties in complying with the rule and surveilling for compliance.

Simply put, imposing the trade-through rule on Nasdaq stocks, and retaining these restrictions on NYSE-listed stocks, is inconsistent with the statutory obligation to ensure "fair and orderly markets." To the contrary, the trade-through rule will create a 21st century "train wreck" in cyberspace that will harm investors and the essential fabric of our market structure.

The rule will impose real costs on investors. First, investors will have to bear new, substantial compliance costs. Second, investors will be denied freedom of choice—the freedom to direct their order to the destination of their choice. The cost associated with this loss of freedom will also be substantial.

More specifically, the rule will have the perverse impact of requiring broker-dealers to chase "better" prices even though investors will often find that those prices will not be available when their orders arrive.[4] This set of complications underscores that technology cannot always deliver the regulator's vision. In attempting to force this regulatory round peg -- the trade-through rule -- into the technological square hole -- today's highly automated markets -- the rule creates the risk of needlessly harming a well functioning market and continuing to deprive the market for NYSE-listed securities the full benefits of this automation.

Let's examine the compliance costs in more detail. Of course, the ultimate success of any regulation depends on the ability of those subject to the rule to comply with it and the ability of those responsible for enforcing

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3 *Supra* note 1 at 11134.

The statement in the Regulation NMS proposing release was reinforced by a Commission staff person who stated, during the Commission's open meeting on Regulation NMS, that for the actively traded segment of the Nasdaq market the securities "could be traded in a closet someplace and it still would be a great market." The staff person went on to distinguish that other parts of the market trade differently. An archived web cast of the February 24, 2004 Commission open meeting is available on the Commission's web site at: www.sec.gov/news/openmeetings.shtml.

4 While the Commission has proposed an "opt-out" exemption that would allow investors to forgo the protections of the rule, as currently proposed, it would be extremely cumbersome for both the investor and their broker to use.

the regulation to detect violations of the rule. Nasdaq submits that compliance and enforcement of the trade-through rule will be frustratingly complex and costly for actively traded securities.

The practical difficulties of implementing the rule become evident when you analyze quote update rates. In deciding whether and where to route an order, a broker-dealer must identify the best price and the market center quoting that price. For the rule to be effective, the broker-dealer must be confident that the designated market center will be able to respond before the best price changes. Nasdaq's experience with ECNs has been that the process of routing an order and receiving a response averages approximately two-tenths of a second. There is considerable variation across ECNs (and throughout the day), however, and the average time to receive a response has been as much as one-half a second for some ECNs. Based on this experience, once the national best bid (or offer) is changing twice or more per second, then the NBBO when an investor enters an order cannot be reasonably be expected to be the NBBO at execution.[5]

Thus, high quote update rates will also make it difficult to enforce the trade-through rule because of the difficulty in distinguishing "real" trade-throughs from "perceived" trade-throughs. In the proposing release the Commission referred to this phenomenon as incidences of "false positives.[6]"

A trade-through is defined in general as the purchase or sale of a stock at a price that is lower than the best bid or higher than the best offer. Therefore, the current best quote (the bid or offer depending on whether the order is to sell or buy a stock) and the trade price are two of the key surveillance factors for determining whether or not a trade-through has occurred. The relationship between the time of the quote and execution time is the other critical element. In other words, to determine whether a trade price is in fact a trade-through, you must synchronize the quotes and trade reports to the millisecond to determine what price existed at the time of the trade. What at first glance would appear to be a trade-through may in fact be a "false positive" because, for example, the quotes changed at a faster

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5 Using data from mid-June, 2004, there are over 250 Nasdaq stocks where the best bid or best offer changes more than twice a second, for a total of ten minutes or more. The ten-minute benchmark is used to determine which stocks are consistently updating at this fast pace. According to SEC Rule 11Ac1-5 data, the volume-weighted average effective spread for the Nasdaq stocks with more than 2 quote updates per second is 1.3 seconds.

6 Rapid changes in the national best bid or best offer also will create compliance and enforcement issues with the locked/crossed quote provisions of proposed Regulation NMS.

rate than the time it took to submit and process the trade report. In addition, the phenomenon of "clock drift" can create false positives.[7]

To limit the incidences of false positives, the Commission would be forced to specify certain parameters in the rule that would more precisely define how long a quote must be standing before it can be considered traded through. For example, a particular trade would be deemed a trade-through if it was executed at a price inferior to a quote that had been standing X seconds before and Y seconds after the trade.[8] Quotes that do not stand for the requisite time before and after a trade could not, in effect, be considered "traded through". In other words, these quotes, and the trades that occur when these quotes are standing, are not subject to the trade-through rule.

Taking this approach we have estimated the percentage of trades for which the trade-through rule would apply. To be clear, the numbers below do not indicate the percentage of trades that traded through the best quote; the numbers quantify the universe of trades for which one would measure whether a trade-through has occurred.

An empirical analysis was conducted using three tests: 5/2, 3/1, and 1/1, where, for example, the 5/2 test requires that the national best quote be standing five seconds before and two seconds after the time the trade was executed. For example, suppose a trade was executed at 10:00:00, and the best bid was updated at 9:59:57 and again at 10:00:01. This bid and trade are subject to the trade-through rule with a 3/1 test and 1/1 test, but not with a 5/2 test. Using the broadest measure, the 1/1, Nasdaq found that, on average, for Nasdaq stocks, only about two-thirds of trades would be subject to the rule. Of course, the converse of this number is that <u>one-third</u> of the trades <u>would not</u> be subject to the trade-through rule because the best quotes were not standing for one second before and one second after the trade. For NYSE-listed securities, on average, 79% of trades would be subject to the rule under the 1/1 test.

As expected, once you require the quotes to be standing for a longer period of time, the universe of trades subject to the rule decreases. Specifically, for the 5/2 measure, the percentage of trades on Nasdaq that, on average, would be covered by the rule is 42%. For NYSE-listed stocks, the number decreases to 55%. The 3/1 test showed that 55% and 66% of the trades in Nasdaq-listed and NYSE-listed stocks, respectively, would be subject to the rule.

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7 "Clock drift" describes the situation in which even synchronized system can become asynchronous because the clocks in the systems run at different rates.

8 The Commission's Office of Economic Analysis employed this method when it determined the dollar value of trade throughs in the Nasdaq market.

Because of the synchronization and time drift problems discussed above, it would be agonizingly difficult to utilize the 1/1 test. Therefore, the Commission must, at a minimum, consider using a test with wider parameters, which, as demonstrated above, leads to a smaller percentage of quotes and trades being subject to the rule. For example, under the 5/2 parameter, less than half the trades for Nasdaq-listed, and just above half the trades for NYSE-listed stocks, would be covered by the rule. At this point, the cost of the rule coupled with its illusory benefits argue for an abandonment of the proposal to apply the trade-through rule to the Nasdaq market. Further, these factors also support eliminating the rule for exchange-listed securities.

In summary, Nasdaq respectfully submits that the trade-through rule should not be applied to the Nasdaq Stock Market because it would undermine the quality of our market, its costs to investors and market participants would be significant, and in many cases it would prove to be unworkable. Further, eliminating trade-through restrictions for exchange-listed securities will subject this trading for the first time to the competitive forces that have contributed to the quality of the Nasdaq market.

If you have any questions concerning Nasdaq's proposal, you can reach me at 202/912-3030, or call Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, at 301/978-8486.

Sincerely,

Edward S. Knight

Edward S. Knight

cc: Chairman William H. Donaldson
Commissioner Paul Atkins
Commissioner Cynthia A. Glassman
Commissioner Harvey Goldschmid
Commissioner Roel Campos
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation