



August 26, 2005

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

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Attention: Mr. Jonathan G. Katz, Secretary

Re: Commission File No. SR-NASD-2005-013

Ladies and Gentlemen:

We are writing in response to the letter of August 5, 2005 submitted by The Nasdaq Stock Market, Inc. to the Securities and Exchange Commission responding to comments we submitted to the Commission¹ in opposition to Nasdaq's proposal to prohibit ECNs that participate in the Nasdaq Market Center from charging access fees (the "Nasdaq Proposal").²

The Nasdaq Proposal effectively would dampen competition and reduce investor choice not only by disadvantaging Bloomberg Tradebook and other current ECNs³ but also by creating a strong disincentive to new entrants into the market for trading services that will harm the public interest by reducing investor choice.

Nasdaq's response to our earlier comments is not what one might expect from a self-regulatory body exercising quasi-governmental powers over its members in the public interest and for the protection of investors. It is, instead, Nasdaq's clear declaration, as a for-profit corporation that is about to magnify its market power through INET, that it will use what it construes to be its statutory power to eliminate existing competitors and preempt any new entry into its market. That Nasdaq should engage in this predatory behavior at a time when its

¹ Letter of Bloomberg Tradebook LLC to the Commission dated May 20, 2005 (Commission File No. SR-NASD-2005-013).

² Securities Exchange Act Release No. 51609 (April 26, 2005).

³ See letter of Track Data, to the Commission dated August 25, 2005 (Commission File No. SR-NASD-2005-013).

merger with INET is under Hart-Scott-Rodino scrutiny should lead one to ask how it would exercise its enhanced market power if it were ever allowed to go forward unchecked with the merger.

The recent record of Nasdaq's conduct following its acquisition of BRUT provides a blueprint of what the public should expect to result from the combined Nasdaq/INET entity. In our earlier comments, we identified the manner in which the Nasdaq Proposal would selectively favor INET, harm Bloomberg Tradebook and reduce investor choice by raising the barriers to entry for new trading systems. Under the Nasdaq Proposal, Nasdaq would appropriate as monopoly rents the margins of the few ECNs left on the Nasdaq Market Center — and any new entrants — and make it more expensive for those ECNs, including Bloomberg Tradebook, to operate in the Nasdaq Market Center. This is not an incidental by-product of the Nasdaq Proposal; it is the elaboration of a deliberate strategy initiated with Nasdaq's acquisition of BRUT.

Before it acquired BRUT, Nasdaq faced three especially significant ECN competitors: Instinet, Archipelago and BRUT. With the acquisition of BRUT, Nasdaq eliminated one competitor by acquisition; it now proposes to eliminate the second, also by acquisition. The third has been captured by the NYSE. Nasdaq's integration of BRUT now tells us about its role within the national market system. Nasdaq made BRUT a facility of the Nasdaq Market Center, instituted a preferential pricing structure through BRUT and now, if the Nasdaq Proposal were approved, would prevent any other ECN that participates in the Nasdaq Market Center from remaining a viable player.

Here is how that would work:

- Currently, Nasdaq collects access fees within its Market Center for trades conducted in the BRUT facility and it rebates parts of those fees to BRUT participants, as much as 25 cents per 100 shares. It can do so because Nasdaq collects on the other side of the trade — that is, from the liquidity taker — a tiered access fee of between 27 and 30 cents per 100 shares.
- Currently, Bloomberg Tradebook and the other ECNs operating in the Nasdaq Market Center charge an access fee of up to 30 cents per 100 cents and can compete with Nasdaq/BRUT for order flow.
- If the Nasdaq Proposal were approved, it would hobble the other ECNs. Those ECNs would not be able to charge their own access fees but instead would be limited to collecting from Nasdaq the rebates it gives to liquidity providers, which currently range between 20 and 25 cents per 100 shares.
- Having thus curtailed the other ECNs' revenues, Nasdaq would be able to give customers placing orders in the Nasdaq Market Center

through BRUT greater rebates than the other ECNs could give them for orders placed in the Nasdaq Market Center.

- The other ECNs would thus not be able to compete for liquidity with the Nasdaq/BRUT combination within the Nasdaq Market Center because they could not pay as much for order flow.

Nasdaq is taking this step to disadvantage independent players that may be potential competitors and innovators. If the INET acquisition goes through, this effect will simply be amplified, and investors' choices will be substantially reduced.

Nasdaq's assertion that Bloomberg is simply interested in preserving its business model misses the point. The Congress set out standards that the NASD and all exchanges have to observe in their rulemaking. Those standards make it clear that the Nasdaq rules cannot be designed to achieve corporate purposes — in this case, the purposes of an aggressive for-profit company seeking to push other market participants aside — at the expense of the public interest and the protection of investors. Instead, to be legally valid and approvable by the Commission, Nasdaq's rules must meet exacting standards, including the following:⁴

- Nasdaq's rules must be designed to remove impediments to and perfect the mechanism of a free and open market and a national market system.
- Nasdaq's rules must be designed to protect investors and the public interest.
- Nasdaq's rules must not be designed to permit unfair discrimination between brokers and dealers.
- Nasdaq's rules must *not* be designed to impose any schedule or fix fees to be charged by its members.
- Nasdaq's rules must *not* be designed to impose any burdens on competition that are not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Section 19(b)(2) of the Exchange Act is explicit: the Commission must not approve a Nasdaq rule unless it finds that the rule is consistent with the Exchange Act provisions applicable to Nasdaq, including the above. If the Commission finds the rules are not consistent with those Exchange Act provisions, or in a doubtful case the Commission cannot affirmatively

⁴ See Sections 15A(b)(6) and 15A(b)(9) of the Securities Exchange Act of 1934 (the "Exchange Act").

find the proposed rule to be consistent with those provisions, it must in either case disapprove the rule.

Nasdaq did not address these key statutory issues in its original filing or, remarkably, in its response to our earlier comment letter. For example, it did not give the Commission a basis to find the rule's discriminatory aspects consistent with the statutory standard. Also, as we noted in our earlier comments, Nasdaq did not make even a minimally compliant showing that the burdens on competition its proposed rule change would impose are necessary or appropriate in furtherance of the purposes of the Exchange Act notwithstanding the explicit requirement in the Commission's Form 19b-4 that it provide a statement concerning burdens on competition that is "sufficiently detailed and specific to support a Commission finding that the proposed rule change does not impose any unnecessary or inappropriate burden on competition."

On the merits, the Commission cannot find that the Nasdaq proposal is consistent with the relevant Exchange Act provisions. Certainly, Nasdaq's response to our earlier comments does not give the Commission a basis for such a finding. For example, the fact that INET does not currently display or execute through the Nasdaq Market Center does not mean that Nasdaq can ignore the benefits its proposal confers upon INET in assessing the competitive impact of the Nasdaq Proposal or the detriments its proposal would impose on investors by diminishing competitiveness in the market and reducing investor choice. Given the relation between Nasdaq and INET — the recent transformation of a major competitor into a merger partner — it is incumbent upon Nasdaq to address the impact of its interest in INET upon its proposed rulemaking as an SRO.

As we noted in our earlier comments, the Nasdaq Proposal favors INET at the expense of other ECNs using the Nasdaq Market Center. As we stated, the access fee revenue INET would gain will ultimately accrue to Nasdaq. To argue, as Nasdaq does, that Bloomberg Tradebook's participation in the Nasdaq Market Center is voluntary and that it can take its business to the ADF or, like INET, it can use the National Stock Exchange, does not answer the question whether the Nasdaq rule meets the Exchange Act standards. Nasdaq's job is to foster a free and open market and a national market system, not to exercise its rulemaking powers to benefit its commercial interests while harming other ECNs, erecting barriers to entry and constricting investor choice.

In support of its proposal, Nasdaq cites to Regulation ATS's Rule 301(b)(4), but invoking the regulation does not meet Nasdaq's burden as an SRO to justify the differential treatment its proposal imposes on Bloomberg Tradebook or its rule fixing fees charged by its members. We repeat here what we stated in our comment letter. The Nasdaq proposal would be inconsistent with the statutory requirement that Nasdaq rules perfect the mechanism of a free and open market and not impose unnecessary and inappropriate burdens on competition and inconsistent with the prohibition against Nasdaq rules fixing member fees.

Section 15A(b)(6) prohibits Nasdaq from "impos[ing] any schedule or fix[ing] rates of commissions, allowances, discounts, or other fees charged by its members" That

prohibition, which is not affected by, e.g., any rule of the Commission such as Rule 301(b)(4) of Regulation ATS, is absolute. 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 ECNs are Nasdaq members.

The legislative history of the Securities Acts Amendments of 1975 does not suggest any different result and in any event, as a matter of law, is not relevant and cannot trump the clear and unambiguous language in the statutory text. In fact, the prohibition in Section 15A(b)(6) on fixing fees did not originate with the 1975 Amendments but instead dates, with only minor revisions, from the Maloney Act, which added Section 15A to the Exchange Act in 1938, authorizing the registration of national securities associations. The report submitted by Senator Maloney of the Senate Committee on Banking and Currency described the rationale for the prohibition on fixing fees as follows:

[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.⁵

In putting forward the Nasdaq Proposal, Nasdaq is proposing to impose and fix a schedule of fees on ECNs participating in the Nasdaq Market Center in direct and unambiguous contravention of an express statutory prohibition in Section 15A(b)(6). The Nasdaq Proposal is an example of the very conduct that Senator Maloney expressly identified as being caught by the prohibition. A Commission order approving the Nasdaq Proposal would thus contravene that statutory prohibition, would be an abuse of the Commission's power and would be reversible as a matter of law.

* * *

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

⁵ 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).

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
Robert L. D. Colby, Esq., Deputy Director,
Division of Market Regulation
Elizabeth K. King, 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
Mark F. McKayle, Esq.
Division of Market Regulation
Dr. Chester Spatt, Chief Economist
Giovanni P. Prezioso, Esq., General Counsel

George S. Baranko, Esq.
Antitrust Division
U.S. Department of Justice
Scott N. Sacks, Esq.
Antitrust Division
U.S. Department of Justice