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September 5, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule Change, File Number SR-EDGX-2012-33

Dear Ms. Murphy:

The NASDAQ OMX Group, Inc. ("NASDAQ OMX") respectfully submits this comment to express its serious concerns about a proposal by the EDGX Exchange, Inc. ("EDGX") to amend its Rule 11.5(c) to add a new order type, the Edge Market CloseSM ("EMC"). NASDAQ OMX operates three national securities exchanges in the United States – The NASDAQ Stock Market LLC, NASDAQ OMX PHLX LLC, and NASDAQ OMX BX, Inc., as well as financial exchanges in other countries. NASDAQ OMX is submitting this comment in its capacity as the operator of exchanges in order to highlight for the Commission the unprecedented, ill-conceived and poorly reasoned nature of the EDGX proposal.

As described in the EDGX filing with the Commission, an EMC Order would be an order to buy or sell a security on EDGX at the official closing price published by either the New York Stock Exchange LLC ("NYSE") or The NASDAQ Stock Market LLC ("NASDAQ"), depending on where the security is listed. In other words, EDGX is seeking to perform a function traditionally associated with a broker-dealer: executing buy and sell orders at a reference price determined through the interaction of orders occurring elsewhere – in this case on exchanges other than EDGX itself – and not in any way contributing to price discovery. For EDGX to be acting as a broker-dealer while reneging on a core exchange responsibility is a clear case of abuse of its exchange license.

With its proposal, EDGX is not only failing in its responsibility to contribute to market transparency, but it is also threatening the ability of other national securities exchanges to do so. As further discussed below, we believe that the EDGX proposal: (a) is contrary to the Securities Exchange Act of 1934 (the "Act"), (b) is harmful to investors and to the operation of the national market system for securities, (c) is incomplete in several respects as it omits specific critical information regarding the EMC, and (d) would

establish an extremely dangerous and destabilizing precedent. As discussed below, EDGX's justification for the EMC – promoting competition – is devoid of basis and substance. We urge the Commission to reject the EDGX proposal.

A. The EDGX Proposal is Contrary to the Act

Section 6(b) of the Act provides that the rules of a national securities exchange must be designed, *inter alia*, "to remove impediments to and perfect the mechanism of a free and open market and a national market system." Far from removing such impediments, the EDGX proposal would create them by blurring the distinction between a broker-dealer and an exchange while ignoring the *raison d'être* of an exchange and by interfering with the ability of other national securities exchanges to fulfill their duties within the national market system.

As envisioned under the Act and Commission rules, a broker-dealer is generally permitted to "internalize" trades, subject to its best execution and other fiduciary duties, as well as other conditions and reporting obligations. Trade internalization by broker-dealers need not contribute to price discovery and, at certain levels, may lead to markets becoming "darker." By contrast, a national securities exchange exists to make markets more transparent and efficient. Price discovery in a given security occurs through the interaction of orders on exchanges, and the quality of price discovery depends, in part, on the depth of the market.

With the EMC proposal, EDGX is attempting to renege on its obligation to facilitate price discovery. By its nature, the EMC would be incapable of contributing to price discovery at the time of market close. Worse than that, the EMC may lead to a reduction in the number of limit-on-close orders being submitted to NASDAQ and NYSE because rational market participants would have to weigh anew in each instance the economic desirability of placing such an order against the extra expense, when compared with the fee-free EMC order. Finally, the EMC process would increase the amount of risk and uncertainty associated with trading during the auctions by the undisclosed netting of market orders, thereby concealing from auction participants the gross amount of liquidity demand during the auction process.

To be clear, NASDAQ OMX is not opposed to exchanges performing certain functions that may have traditionally been associated with broker-dealers. However, we believe that this type of functionality must be incidental to, and not at the expense of, the exchange's core functions, and it certainly must not interfere with the core responsibilities of other national securities exchanges. Under Section 6 of the Act, the Commission should not and would not register a firm as a national securities exchange if the firm's proposed market structure envisioned merely matching orders at last sale prices reported by other exchanges. If so, then a rule change by an existing exchange to implement such a scheme would likewise be contrary to the Act.

B. The EDGX Proposal is Harmful to Investors and the National Market System

The NASDAQ closing price, which would be the basis for the EMC in NASDAQ-listed securities, is determined through an electronic closing auction conducted by the NASDAQ system. This auction was established in response to the need of many market participants to execute their orders at the close and at a price that is established within a relatively deep pool of orders. It follows that if the volume of orders participating in the closing auction is reduced, the value of the auction to market participants is correspondingly diminished.

Interestingly, the EDGX filing acknowledges the value of price discovery and anticipates the concern about the impact of the EMC. However, the filing attempts to dismiss this concern with a single sentence that explains that the EMC would be “replicating only market-on-close type orders, as opposed to limit-on-close orders.” The Commission should not accept such a simplistic response to a serious issue. The question that the EDGX filing does not even acknowledge is the impact of the EMC proposal on the relative attractiveness of limit-on-close orders that may be submitted to NASDAQ and NYSE. For instance, might the proposed fee-free EMC Orders lead to a material reduction in the volume of limit-on-close orders and harm price discovery at market close? We believe that this issue needs to be properly studied and carefully analyzed.

The Commission should also note that the notion of a “market order” in an auction is very different from a market order during continuous trading, since a market order in an auction is, in fact, accepting a delayed execution. The execution price of such an order is bounded by the exchange’s “clearly erroneous” safeguards. It is, therefore, possible to think of a market order in an auction as an aggressively priced limit order. As EDGX sets (or adjusts from time to time in the future) its “clearly erroneous” numerical thresholds applicable to the EMC, the distinction between the EMC and limit-on-close orders may become ever more evanescent.

In this regard, the EDGX filing ignores the possibility of there being no limit-on-close orders to be matched in particular securities.¹ When this occurs in the NASDAQ process, the market-on-close orders are matched at the mid-point of the bid and ask. However, if all market-on-close orders in a particular security have been placed with EDGX under the EMC, and there are no on-close orders in the NASDAQ system, then a potentially “stale” price of the most recent trade executed in the NASDAQ system would become the official closing price. In this scenario, both the quality of order executions received by EDGX’s EMC users and the quality of the official closing price used by all market participants could be negatively affected.

¹ Our preliminary research also suggests that market orders that are matched to market orders are a very substantial portion of the NASDAQ closing cross volume. For example, in the most recent full week prior to the date of this letter (the week of August 27-31, 2012), such matches were the majority (53%, based on our preliminary data) of the closing cross activity, and were in the 90-100% range in a significant number of individual securities.

While NASDAQ OMX has not had the opportunity to conduct an appropriate study of all of these issues, we believe that the burden to provide to the Commission credible economic evidence to support the proposed rule change lies with EDGX. Under section 19 of the Act, the Commission “shall disapprove a proposed rule change of a self-regulatory organization if it does not make a finding” that the proposal is consistent with the Act and applicable rules. Given the clear risk of harm to at-close price discovery and without any evidence to mitigate this risk, we believe that a credible independent study would be essential for any further consideration of the EMC proposal.

The EDGX filing charges that the NYSE and NASDAQ fees for on-close executions are “not being sufficiently challenged by competitive forces” and relies on this charge to justify the EMC proposal. Yet, instead of basing the claim of insufficient competition on economic studies, EDGX relies on a handful of self-serving, out-of-context examples of fee increases by competitors and completely ignores the history and benefits of legitimate competition between exchanges for auction volume. If insufficient competition is the reason why the EMC is needed (and especially if it is the kind of reason that outweighs other concerns), then EDGX must at a minimum demonstrate with credible evidence both the existence of competitive inadequacies and the EMC’s potential to cure them.

The equities trading business in the United States today is intensely competitive; the entry barriers are low, and viewing any specific order type, such as on-close orders, as a distinct product market is not economically justified. Supra-competitive pricing of on-close orders would inevitably lead market participants – including major U.S. and foreign financial institutions – to shift to other types of orders or to support other execution venues to conduct on-close auctions. Moreover, the NYSE and NYSE-Amex closing auctions are certainly subject to direct competitive discipline today from the NASDAQ closing auctions in those exchanges’ listed securities. The mere existence of all of these actual and potential competitive alternatives stimulates innovation, promotes cost efficiency and guarantees competitive fee levels.

Equally critical is the fact that the EMC would not actually enhance competition in any meaningful sense. Generally, a firm can be meaningfully regarded as a competitor if it seeks to provide the same or similar product or service. The product in this case is the closing price that is generated by NASDAQ and NYSE in their respective closing processes. For example, NASDAQ offers a meaningfully competitive alternative to the NYSE and NYSE-Amex closing auctions. By contrast, EDGX is not proposing to generate its own closing price.

In theory, EDGX could also seek to compete “downstream” by reselling a NASDAQ or NYSE service to customers. However, EDGX is not proposing that either. It is not seeking to buy a service from NASDAQ or NYSE, and so there is nothing for EDGX to “resell.” The EMC’s “contribution” to competition in equities trading would be analogous to the contribution made by the street peddlers of fake Rolex watches to “competition” in Swiss watches. Again, to say that EDGX’s competitive analysis is “flawed” would be an understatement, since EDGX has not presented any economic analysis.

C. The EDGX Proposal Omits Specific Critical Information About the Functioning of the EMC

As discussed above, the EDGX proposal does not appear to be supported by any research regarding the possible impact of the EMC on the existing closing auctions, and it is based on flawed assumptions regarding the nature of competition in this space. Sound, professional research is needed with regard to both of these issues.

In addition, the proposal does not adequately explain how the EMC would actually work. For example, EDGX has not described a mechanism for clearing market orders should a failure occur with the NASDAQ or NYSE auctions or should the price of those auctions be adjusted or broken. This is an issue that should be important not just to EDGX and its users but to all market participants because of its potential to exacerbate associated market-wide risks.

Nor has EDGX explained how it would avoid using a possibly “stale” price should there be EMC orders at EDGX but no auction at NASDAQ or NYSE due to there being either no orders submitted to those auctions (among other reasons, this can happen when EMC orders are paired and so no EMC orders are sent to the listing market’s auction) or no market clearing price at NASDAQ or NYSE. As noted above, market-order-to-market-order matches can on many occasions constitute up to 100% of the closing cross activity in particular securities. Given EDGX’s proposal, it is not implausible to expect that, on occasion, all such orders would find their way to EDGX, leaving NYSE or NASDAQ with no orders in certain securities for their auctions and resulting in a “stale” reported official closing price based on the price of the last trade. Our reading of the EDGX proposal suggests that, in the absence of a closing auction for a security, the EMC orders would be matched at the price of the last trade on the listing exchange, rather than at a potentially more recent bid and ask mid-point price, which would likely have become the official closing price had those orders made it to the listing exchange.

D. The EDGX Proposal Would Create a Dangerous and Destabilizing Precedent

The fundamental issue with EDGX’s EMC proposal is not simply that it would contribute to the blurring of the lines between exchanges and broker-dealers. Rather, the long-term concern is creating a precedent that would jeopardize the role of exchanges in the national market system. The key question for the Commission is whether national securities exchanges should be permitted to adopt order types that free-ride on price discovery performed by other exchanges. This is the sort of development that may contribute to general degradation of the price discovery process.

Furthermore, EDGX has not demonstrated any compelling long-term benefit of the EMC to the national market system. The EMC is not an innovative service that would enhance the quality or efficiency of our markets. Nor is it a different, competitive version of the existing at-close orders provided by NASDAQ or NYSE. It is a get-market-share-quick scheme, which would put at risk important existing services of the EDGX’s competitors. Rather than a 2 plus 1 equals 3, this scheme is a 2 plus 1 equals 0.

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Elizabeth M. Murphy
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We would be pleased to answer any questions in connection with this letter.

Sincerely,

A handwritten signature in black ink, appearing to read "Alex Kogan". The signature is fluid and cursive, with a large initial "A" and a long, sweeping underline.

Alex Kogan