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Nasdaq's Proposal to Fairly Allocate Order Delivery Fees
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Background - Since the time the Nasdaq Stock Market ("Nasdaq") voluntarily became the first market to permit Electronic Communication Networks ("ECNs") access to its trading systems, issues surrounding that participation have unnecessarily consumed significant Securities and Exchange Commission ("Commission" or "SEC") and Nasdaq resources. Never-ending complaints to the SEC by ECNs about Nasdaq decisions concerning execution priority, system functionality, and other matters have become the surrogate for ECN innovation and a willingness to compete. In turn, these actions have delayed the delivery of innovative new products and services to investors and have served to limit competition.

Current ECN complaints about Nasdaq's planned changes to its pricing schedule for order delivery functionality continues this pattern. Under the proposal, Nasdaq would change its fee schedule to impose fees associated with delivering orders to ECNs on the ECNs themselves. All ECNs that have orders delivered to them will be assessed a $0.001 fee per-share executed. Today, the SEC permits similar fees related to order delivery to be imposed on parties entering an order (including firms representing significant numbers of individual investors) that is delivered to and executed by an ECN.

While ECN abuse of the rule-making process hasn't changed, the market for the trading of equity securities has. The expansion of private trading linkages, the growth of automatic execution, and the significant reduction in execution costs and trading profits have all combined to create a hyper-competitive trading environment where the pricing of execution-related services is a key driver in order-flow decision making and the main method by which competition among market centers takes place. Given these competitive realities, Nasdaq cannot continue to be a trading laboratory for ECNs.

In particular, ECNs should pay for the unique order delivery services they receive. In other words, Nasdaq must be allowed to control its pricing structure and make fee decisions that enhance its overall competitiveness and are fair to all categories of system users. Nasdaq's pricing ability cannot be limited to only imposing or retaining fees that are acceptable to an extraordinarily small number of ECN market participants that already enjoy special order-delivery privileges not available to any other Nasdaq system user.

As the Commission is aware, in January 2005 Nasdaq submitted another filing to attempt to create a uniform fee structure and regain control over its pricing schedule equal to that of its SRO-market competitors. The delay in approving that filing has impaired Nasdaq's ability to fairly compete to win and retain trading market share. The Commission should not subject Nasdaq to further delay in connection with this proposal. ECNs, anxious to do just that, and retain the unfair competitive advantages that Nasdaq's current mixed order-delivery/automatic execution trading environment and fee structure provide them, have noisily and preemptively complained about Nasdaq's fee proposal asserting that it is discriminatory. For the reasons set forth below, Nasdaq strongly disagrees with such assertions.

- **ECN participation in Nasdaq is <u>absolutely voluntary</u>.** The Commission itself has stated:

  > ***A market participant, such as an ECN, may elect not to display, or provide access to, its quotes/orders through Nasdaq and instead display and provide access to its quotes/orders on other markets, such as the Chicago Stock Exchange, the Cincinnati Stock Exchange, and possibly in the future, the Pacific Exchange ("PCX"). In addition, the NASD has agreed to create an alternative quote reporting mechanism that will allow an ECN, ATS, or market maker to maintain its quotes in an NASD facility without being a participant in Nasdaq, and therefore the SuperMontage.***

  Any complaint by ECNs about Nasdaq's fee proposal must be viewed against this backdrop and take proper account of the dynamic domestic and international competitive environment for the trading of equity securities that the Commission helped create. Nasdaq should not have a key component of its competitive pricing flexibility constrained based on the hyperbolic comments of self-described "independent" ECNs that in the same breath maintain (i) they cannot compete outside of Nasdaq and (ii) they must impose on others the costs of special services from which they are the only beneficiaries.

- **Order delivery functionality is unique to the current method of ECN participation in Nasdaq.** No other category of Nasdaq market participant has access to order delivery functionality and instead must have their quotes/orders automatically executed against by Nasdaq systems. The ECNs' own comments to the Commission about order delivery clearly indicate that they view such functionality as important to them. As such, it is absolutely fair and reasonable that any fees associated with that delivery processing be borne by the privileged few it supports. Nasdaq's fee proposal does just that.

- **Nasdaq's proposal to apply the order delivery fees on ECNs that *choose* to take advantage of Nasdaq's order delivery functionality promotes efficiency, transparency, and lower prices, and is therefore pro-competitive.** Under today's fee structure, order delivery ECNs are able to free-ride on Nasdaq's neutral execution algorithms that deliver orders to the ECNs despite their higher costs and thus provide them with little incentive to enhance their product or services. Nasdaq's proposal will ensure that

ECNs more fully support the costs of Nasdaq's distribution of their services. In return, the overwhelming majority of Nasdaq's users will benefit from lower execution prices (and equally important, from the predictability of trade execution charges), while the ECNs will have increased financial incentives to operate more efficiently. Finally, to the extent that the pricing change enhances Nasdaq ability to attract order flow, the overall competitive environment among market centers is enhanced.

- **Nasdaq's authority to set fees for the use of its systems is specifically permitted by Section 19 of the Securities Exchange Act of 1934**. This authority is so well recognized that such fees are one of the few categories of self-regulatory filings that are generally eligible for immediate effectiveness prior to a notice and comment period.

- **ECN assertions about the dire impact of Nasdaq pricing changes on their business model should be viewed with skepticism.** Many of the ECNs complaining about Nasdaq's pricing change harming their ability to "compete" charge higher rates for orders delivered to them via Nasdaq, and then use that higher cost to encourage those same market participants to link with the ECN directly at a lower fee rate. Apparently, the need for ECNs to be able to charge the highest fees, unreduced by having to pay for order delivery, only occurs when it drives private business to the ECN by making the Nasdaq market system as a whole uncompetitive on price. The same hypocrisy applies to ECN statements about the importance of order-delivery functionality to the structure of the marketplace when none of them provide it in their own internal systems which are exclusively based on automatic execution.