NASDAQ®
THE NASDAQ STOCK MARKET
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December 13, 2007

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-2007-004**

Dear Ms. Morris:

The NASDAQ Stock Market LLC ("Nasdaq") welcomes the opportunity to respond to comments submitted in connection with Nasdaq's proposal to establish NASDAQ Options Market LLC ("NOM") as an options exchange facility of Nasdaq. NOM will operate as a price and time priority execution system. Nasdaq views the NOM as a significant and positive step in the evolution of the US options markets because it will accomplish four critical goals of the Securities and Exchange Act of 1934 ("Act") by providing an innovative, low cost competitor. If approved, the NOM 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 routing services for orders when trading interest in not present in NOM; and
- support regulation by complying with the Plan for the Purpose of Creating and Operating an Intermarket Linkage to systematically prevent locked and crossed markets and trade throughs.

Nasdaq received five comment letters on the proposal, including a letter from

Global Electronic Trading Company ("GETCO") generally supporting the proposal, a letter from the Securities Industry and Financial Markets Association ("SIFMA") raising various questions,[1] and letters from the International Securities Exchange ("ISE"), the American Stock Exchange ("Amex") and Citadel opposing certain aspects of it.[2] Nasdaq will address each comment below.

GETCO Comment. GETCO believes that the NOM will bolster competition among, and introduce efficiencies to, the U.S. options markets. Furthermore, several features within Nasdaq's proposal will promote liquidity including the ability of (i) market makers to register in only those series for which they are willing to create a market, and (ii) investors to manage their trading interest through the use of reserve and non-displayed orders. GETCO also noted that the NYSE Arca was the first options market to use a price / time priority execution methodology for the options on the NASDAQ 100 Trading Index ("QQQQ"). Following the NYSE Arca's conversion to price / time priority, GETCO noted that the effective spreads in the QQQQs decreased by 63% while average daily volume increased by 10%.

SIFMA Comment. SIFMA's comment letter raises, among other things, issues related to Nasdaq's proposed easing of the barriers to entry for market participants seeking to trade option contracts, as well as other minor technical concerns. SIFMA's comment letter contains a myriad of hypothetical problems or issues that are not unique to this proposal. Exchanges normally resolve similar issues through the surveillance and enforcement process. As discussed in further detail below, Nasdaq believes that its rules adequately address the issues discussed in SIFMA's comment letter.

SIFMA comments that Nasdaq's proposal does not provide enough detail about the rights and responsibilities of NOM's market participants. As a general matter, Nasdaq believes that providing a wider array of eligible participants with greater access to its market will result in greater competition among the market centers, as well as a highly competitive quoting environment on NOM. Such quote competition is generally thought to narrow spreads and add liquidity to a market. This open access model is very similar to the Nasdaq's equity market structure. Nasdaq does not believe that improved market access raises any unique or challenging issues for order entry firms and investors. We believe that most members are familiar with the regulatory and surveillance requirements associated with access to NOM from their extensive businesses in equity securities. As stated in the proposing release, registered market makers will receive favorable margin treatment that is provided to them under Regulation T but only in proportion to the actual

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1 *See* letter dated July 20, 2007 from Stephen Shuler and Daniel Tierney to Nancy M. Morris, Securities and Exchange Commission; letter dated. May 22, 2007 from Christopher Nagy to Nancy M. Morris, Securities and Exchange Commission.

2 *See* letter dated June 1, 2007 from Michael J. Simon to Nancy M. Morris, Securities and Exchange Commission; letter dated. May 24, 2007 from Michel T. Bickford to Nancy M. Morris, Securities and Exchange Commission; letter dated June 11, 2007 from John C. Nagel to Nancy M. Morris, Securities and Exchange Commission.

trades they execute in their market making capacity.[3]

More specifically, SIFMA was also concerned that Nasdaq may not disseminate quotes in a particular options series, if during the trading day, a market maker withdraws his or her quotations, or if the only registered market maker in an options series chooses not to enter quotations. The NOM Rules provide that only one registered market maker is required to initially start trading in any series of options.[4] The NOM Rules will ensure that market makers actively quote. For example, NOM Rule Chapter VII Section 6(d)(i) states that, on a daily basis, a market maker must maintain continuous two-sided quotations and participate in the pre-opening phase in 75% of the options series in which the market maker is registered. In addition, NOM will provide functionality that will allow registered market makers to instruct the NOM System to automatically input a quotation on the side of the market that has been depleted. Moreover, pursuant to paragraph (d)(ii) of Section 6, Nasdaq Regulation may call upon a market maker registered in a particular series to maintain continuous bids or offers. Thus, Nasdaq may require a market maker to continuously quote if it is the only registered market maker in the series. Nasdaq is not unique in proposing such a rule, and in fact, each market center faces the risk that a registered market maker will withdraw its quotes during the trading day.

Nasdaq believes that SIFMA's concerns are also unwarranted since, in the event a market maker temporarily is not maintaining its quotations, NOM would continue to route and execute orders. For instance, orders received by NOM at a time that another market center is quoting at the national best bid or offer ("NBBO") will automatically be routed to that market center. Whereas an order displayed on NOM that becomes marketable may be accessed through the intermarket linkage by another market center. In addition, brokers must also fulfill their fiduciary duty if they determine that orders on NOM are not receiving best execution. Finally, Nasdaq will use its regulatory powers to bring an appropriate disciplinary action against a market maker that fails to fulfill its quoting obligations.

Nasdaq is proposing to modify Chapter IV, Section 5 to clarify that NOM will not leave open for execution any option series in which there is no registered options market maker. In the event that the sole registered market maker for an options series withdraws its registration and ceases making markets, NOM will, in accordance with revised Chapter IV, Section 5, place that options series into a non-regulatory execution suspension until such time as a member registers to make markets in that series. In such circumstances, NOM will not execute orders on its book, and will have no rights and privileges under the Linkage Plan to accept inbound orders from away markets. Nasdaq will continue to accept and route member orders that are designated for routing and execution at the best price in away markets.

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3 See Exchange Act Release No. 34-55667 (April 25, 2007) at text preceeding FN 7.

4 *See* Chapter IV. Section 5.

SIFMA also suggests that market makers may use the matching system for new customer orders after withdrawing as a market maker. Nasdaq believes that the NOM Rules clearly state under Section 6(b) of Chapter VII that if a market maker enters a bid in a series in which he is registered that he or she must also enter an offer. Thus, a market maker is not able to enter customer orders without maintaining a two-sided quote. In addition, Section 10 of Chapter VII, which sets forth the limitations on a market maker's dealings, prohibits a market maker from functioning as an Order Entry Firm (as the term is defined under Chapter I Section 1(a)(25)) without instituting appropriate information barriers. Finally, as stated above, a NOM Participant that has withdrawn as a market maker and is participating in an order entry capacity will not receive favorable margin treatment under Regulation T.

SIFMA's comment letter also raises issues relating to the function and responsibilities of market makers including (i) the consequences of a withdrawal of a market maker that is serving as the InterMarket Linkage Market Maker, and (ii) conforming the 75% participation standard for market makers to the requirements imposed by other options exchanges. With regards to the first issue, Nasdaq indicated in its proposal that it intends to utilize its broker-dealer subsidiary, Nasdaq Options Services LLC ("NOS"), to fulfill its order routing obligations under the Linkage Plan.[5] Nasdaq also indicated that it would rarely, if ever, need to appoint an InterMarket Linkage Market Maker. Section 5(a)(ix) provides Nasdaq with the ability to designate a market maker as the Intermarket Linkage market maker for a particular series. In the event that a designated market marker substantially fails to engage in a course of dealings under this rule, Nasdaq Regulation may bring a disciplinary action pursuant to Paragraph (c) of the same rule. Neither Nasdaq nor any NOM market participant will face liability for trade throughs because NOM is programmed to comply with the requirements of the Linkage Plan. In the event that Nasdaq has a system malfunction that results in a trade-through it will fall under the exception in Section 8(c)(iii) of the "Plan for the Purpose of Creating and Operating an Intermarket Option Linkage." If NASDAQ receives a Satisfaction Order from an away market, NOM will execute the Satisfaction Order against trading interest available on the NOM book.

With respect to trade errors, NOM's proposed rules only recognize Obvious Errors as defined in Chapter V, Section 6. If a trade does not meet the definition of an Obvious Error, NOM will take no action with respect to that trade. In the event of an Obvious Error on NOM involving an away market, the away market is authorized as a party to the transaction to file with NOM for review of an Obvious Error. In the event of an Obvious Error on an away market, NOM's proposed Obvious Error rule authorizes NOM to file for review of that Obvious Error on behalf of the NOM Participant. If necessary, NOM will file for such review through NASDAQ Options Services LLC or the member of the away market which it used to route the order.

Finally, SIFMA's requests that Nasdaq amend its 75% participation standard to

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[5] Id. at text preceeding FN. 11.

conform with the 80% participation standard that is generally applied by the other exchanges. Nasdaq does not believe that it should make a conforming change. First, NOM market makers may register in a particular options series instead of an entire class. This distinguishes Nasdaq's participation standard from all other exchanges and should result in active participation in all series for which a market maker voluntarily registers. Second, Nasdaq's approach is numerically superior to other options exchanges. The Boston Stock Exchange ("BOX") requires a market maker to post continuous two sided quotations in at least eighty percent (80%) of the options series but the rule also qualifies the 80% "for at least ninety percent (90%) of the classes to which the Market Maker is appointed, provided that at no time shall a Market Maker be quoting on a continuous basis in less than sixty percent (60%) of the options series of any class to which the market maker is appointed."[6] In effect, the BOX rules require market makers to maintain continuous two-sided quotes in only 72 percent (80% x 90%) of the series in which they are registered or at times in only 60 percent of the series. Nasdaq believes that this provides sufficient basis to conclude that its proposed standard of quotation will offer meaningful transparency and price discovery opportunities, consistent with the goals of the Exchange Act.

Nasdaq has addressed SIFMA's concern regarding the unspecified closing time by amending Chapter VI, Section 2 to specify that the market will close at 4:00 p.m. Eastern Time ("E.T.") except that the market for options on fund shares or broad-based indexes will close at 4:15 p.m E.T. Nasdaq is also proposing to modify the system opening time from 8:00 a.m E.T. as originally proposed to 9:00 a.m E.T. This change occurs primarily in Chapter VI which governs the trading system, but does appear occasionally throughout the rule proposal.

Nasdaq categorically states that SIFMA's concern that NOM Options Market Makers will enjoy special privileges or priorities within NOM systems are meritless. The NOM System will use a strict price/time priority execution algorithm that matches trading interest without regard to the status of the entering party either at the time of entry or at the time of execution. NOM Options Market Makers will be entitled to favorable margin treatment consistent with the current application of Regulation T and subject to the limitation that 75 percent of their executed volume must occur in options series in which they make markets.

ISE Comment. The ISE raises three main concerns in its comment letter regarding Nasdaq's proposal including that the (i) Price Improving Orders are quotations that Nasdaq must make available to vendors under Rule 602 (the "Quote Rule") of the Securities Exchange Act of 1934, as amended ("Exchange Act"), (ii) Attributable Orders inappropriately provide market participants with order information in violation of information barrier requirements, and (iii) price / time priority will foster internalization. As discussed in further detail below, Nasdaq does not believe that ISE has demonstrated that this proposal is harmful to investors or inconsistent with the Exchange Act.

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6 *See* BoX Rule Chapter VI Section 6(d)(i).

Nasdaq believes that the Price Improving Order provides investors with the benefit of possible price improvement. The nickel and dime quoting increments used by the current option market structure creates an artificially wide spread which prevents investors from not only posting a quotation which reflects the real price at which they are willing to buy or sell an option, but it also inhibits the ability of other investors to obtain a better execution price. Nasdaq would support an expansion of the SEC's Penny Pilot program which would permit Nasdaq to display the true price of a Price Improving Order rather than display the price permitted by the current quotation increments. This would narrow the spread and benefit investors greatly.

Nasdaq fully appreciates the important role that the Quote Rule plays in providing brokers with the information they need to execute their customer orders in the best available market. However, bids and offers made by market participants on the floor of an exchange are not transparent to brokers making order routing decisions based upon the consolidated quotation system. Like the auction market, the Price Improving Order provides brokers with the opportunity to improve their customer's execution by finding the non-displayed trading interest that exists between the spread.[7] The benefit to investors created by the opportunity for price improvement far outweighs any perceived harm from the non-display of the true price of the Price Improving Order.

In response to ISE's and Amex's comments, Nasdaq will propose limited modifications to the Nasdaq Order Imbalance Indicator ("NOII") that is disseminated in advance of the proposed opening and closing crosses and not throughout the trading day. As such, the NOII disseminated prior to the Opening Cross is disseminated prior to 9:30 am when the SEC Quote Rule is not in effect. With respect to the Closing Cross, set forth in Chapter VI, Section 9 of the proposed NOM rules, Nasdaq will propose to modify the NOII to ensure that it fully complies with the SEC Quote Rule. This will require that the NOII data point known as the "Current Reference Price" (defined at subsection (a)(7)(A)) and the "Near Clearing Price" (subsection (a)(7)(E)(ii)) be disseminated in the minimum price increment applicable to the option in question and never at a price that would expose undisplayed interest on the NASDAQ book. Only the Current Reference Price and Near Indicative Price is affected by this restriction because it is the only aspect of the NOII that may involve the dissemination of price information based on specific non-displayed orders resting on the NOM book. The remaining data elements of the NOII do not transmit information regarding the pricing of specific orders and therefore do not implicate the SEC Quote Rule.

ISE also misconstrues the function of Nasdaq's Attributable Order type. ISE assumes that Nasdaq will disseminate, upon entry of an order into NOM, the identification of the market participant to some or all of the market participants in much

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7 The Citadel comment letter states that Non-Displayed Orders will promote "gaming," erroneously implying that Non-Displayed Orders are not firm under Rule 602 of Regulation NMS. Nasdaq disagrees with Citadel's reading of Nasdaq's proposal but is nonetheless proposing to modify proposed Section 6(c)(1) of Chapter VII to state explicitly that all quotes and orders entered into NOM are firm.

the same manner that the BOX permits the identity of an order entry firm using the Directed Order Process to be revealed under BOX Rule Chapter V Section 14(e). First, Attributable orders are a voluntary feature of the Nasdaq system. Any firm wishing not to reveal their identity can do so. In addition, as proposed, the identity of the party entering an Attributable Order would only be revealed if the order is posted to the NOM book. If an Attributable Orders is marketable and at or within the NBBO, it will execute anonymously; if non-marketable, it would be posted on the NOM book with the entering party's market participant identifier. There is no selective disclosure; Nasdaq would publish the identity of the NOM Participant that submits the Attributable Order simultaneously to all market participants in a proprietary data feed. No market participant has a time or place advantage in learning the identity of the Attributable Order.

The ISE's concern that the identification of the market participant's ID breaches its information barrier is unfounded. Nasdaq's systems, not the market participants, control the execution of an order after it is entered into NOM. Information barriers are designed to prevent a registered market maker from obtaining and using information about customer orders prior to execution. Order entry firms must route customer orders to the best available market which may be the market displaying the firm's Attributable Order. For this reason, we do not believe that ISE's assertion is correct.

Finally, Nasdaq notes that the Attributable Order will not be fully operational to reveal attribution information until Nasdaq implements a data feed that carries attribution information. Nasdaq has not currently proposed such a data feed and would be required to file a proposed rule change seeking approval prior to implementing such a data feed. ISE will have an opportunity to comment on the proposal at that time.

With respect to internalization, Nasdaq notes that the comments of both ISE and Citadel overlook beneficial aspects of Nasdaq's proposed Price Improving Orders. First and foremost, Price Improving Orders will result in better execution prices for market participants and could add liquidity to the marketplace that would not otherwise be entered or displayed in any venue. ISE and Citadel also overstate the potential for internalization because they overlook the possibility that a participant entering a Price Improving Order one side of the market will meet a Price Improving on the opposite side of the market. In other words, the unknown risk of execution will provide substantial discipline against those seeking only to internalize. Given the internalization vehicles already operating in the marketplace, there is no reason to think that Nasdaq's market structure will increase the overall level of internalization that exists today.

Nonetheless, Nasdaq will respond to the comments of both ISE and Citadel by proposing to modify two key aspects of its order exposure requirements set forth in proposed Chapter VII Section 12 and attendant commentaries. First, Nasdaq is proposing to amend Commentary .03 to remove the statement that the order exposure requirement is satisfied if a non-displayed order is entered into the System and would have been displayed for three seconds but for its non-display status. Third, Nasdaq is proposing to amend Commentary .04 by prohibiting communication regarding the entry of an order both prior to the entry ***and*** afterwards, as suggested by the commentors. Nasdaq believes that these three modifications adequately address the commentors' underlying concerns by establishing a check on internalization that resembles those that exist in currently-approved markets.

Finally, ISE makes several inaccurate statements about Nasdaq's price / time execution methodology. ISE wrongly states that NOM will serve as mechanism by which firms can knowingly internalize trades due to the absence of a pro rata allocation method. In fact, NOM's proposed price-time algorithm provides for *less* internalization than under ISE's existing pro rata allocation which guarantees 40 percent allocation to the market maker itself. ISE suggests that a firm routing an order can see and execute fully against an Attributable Order. ISE fails to consider the possibility that incoming orders will execute against Price Improving Orders and non-displayed orders at better prices. The Price Improving Order will not only prevent a firm from knowingly internalizing an order but it will also provide the investor with a better price. ISE also fails to consider how this function is distinguished from the directed order programs offered by other exchanges. ISE has provided no support for its allegations and no basis for concluding that "Price Improving" and "Attributable" Orders will harm investors.

AMEX Comment.

The Amex raises several points in its comment letter opposing Nasdaq's proposal, most of which are technical concerns or addressed by Nasdaq already in its response to other comment letters[8], however Nasdaq will respond to the comments relating to (i) the one market maker standard for the initiation of trading in an option series, (ii) the dissemination of the Order Imbalance Indicator in penny increments, (iii) the use of non-displayed orders, (iv) compliance with the Linkage Plan and the routing of options through NOS, (v) the One Point and 2 ½ Point Strike Price Pilot Programs, (vi) position limits, and (vii) Nasdaq's definition of an index option.

The Amex suggests that NOM needs more than one market maker to begin trading an options series. It is not clear that the depth or liquidity in a market will increase through the addition of more than one market maker. The NOM structure fulfills the objectives of Section 11A of the Exchange Act by providing an options trading platform that allows customer orders to meet without the intervention of a dealer. Lower barriers to participation will attract liquidity and market depth from order entry firms and other market participants. The Amex's concern appears to be form over substance. Neither the Exchange Act nor the SEC's rules require a market to provide for

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[8] Nasdaq will not address issues already covered in this response including the specific time the market will close. Nasdaq made several amendments to the proposal to address several of the technical questions raised. For example, Nasdaq is proposing to amend Chapter I, Section 1(a)(21) to amend the definition of an "index option" to eliminate the reference of a "contract on a tradable instrument which tracks such prices." Furthermore, Nasdaq is proposing to amend Chapter VI, Section 2(a) to clarify that the referenced index is "broad-based."

more than one market maker. In fact, the specialist system is the supreme form of the one market maker model. Nasdaq intends to provide an environment whereby robust competition between multiple market makers will provide depth and liquidity. However, Nasdaq does not believe that market participants should be prevented from trading directly with one another due to the absence of multiple dealers.[9]

The Amex also objects to Nasdaq's (i) Minimum Increments Rule (Chapter VI, Section 5), (ii) the dissemination of the Order Imbalance Indicator in one penny increments, and (iii) the non-displayed order types. Nasdaq believes that Amex has misread the proposal. Nasdaq is not proposing to quote all options in penny increments. Subsection (a) of Section 5 governs minimum quotation increments, and that provision is entirely consistent with the Penny Pilot program. Subsection (b), to which Amex refers, governs minimum trading increments and is therefore unrelated to the Penny Pilot.

As discussed above, Nasdaq is proposing to modify the dissemination of Order Imbalance Information in price increments smaller than the applicable minimum price variation where the indicative price is based upon a booked, non-displayed order. The remaining NOII information does not implicate the SEC Quote Rule, and it will improve transparency by providing market participants with information that will permit them to route customer orders to the best market. Nasdaq believes that distribution of such indicative information highlights possible price improvement opportunities to brokers. Nasdaq's innovative approach will benefit investors and is drawing comment primarily because it creates a competitive disadvantage for those markets, such as the Amex, without similar offerings. Nasdaq believes that the Order Imbalance Indicator is beneficial to investors and consistent with the Exchange Act.

While Nasdaq believes that NOM's Non-Displayed Order type is consistent with the Exchange Act and the best interests of investors, NASDAQ will respond to the comments of Amex and Citadel by removing the Non-Displayed Order type from its proposal. NASDAQ is proposing to retain the Price Improving, Discretionary, and Reserve Orders which involve an element of non-displayed trading interest that is common in the options market today. Through the use of sophisticated technology and algorithms, current options market participants essentially mimic this order functionality through electronic communications between the exchange and their own order book. The order functionality offered by Price Improving, Discretionary, and Reserve Orders merely allows market participants to keep their order on NOM's book rather than in their servers upstairs. This functionality increases the efficiency of the market by reducing the amount of message traffic and the speed of executions in accordance with the objectives of Section 11A of the Exchange Act. It also provides investors with the possibility of

[9] Nasdaq is proposing to amend Chapter III, Section 4(f) to remove the term "trading crowd" from the proposal. That rule clearly establishes that the electronic crowd will be comprised of all NOM participants, as it is for numerous other markets with an electronic model.

obtaining price improvement.[10] The Amex asserts that Nasdaq should be prevented from using non-displayed orders in options due to the different legal requirements. The Amex's failure to cite or explain such legal requirements prevents Nasdaq from fully responding. Nasdaq does not believe that the use of such order types is inconsistent with its obligations under the Linkage Plan.

Nasdaq's System is programmed to ensure its compliance with the Linkage Plan. Amex requested additional information relating to the execution and routing of orders, specifically as to whether orders submitted to NOM may lock or cross the market. Chapter VI, Section 7(b)(3)(C) sets forth the process that NOM will utilize to ensure compliance with the trade through and lock or cross provisions of the Linkage Plan. Pursuant to this provision, do-not-ship orders that, upon receipt, would either cause a trade through or lock or cross the market will be re-priced and displayed at a price that is one minimum price variance below the national best offer for an order to buy or one minimum price variance above the national best bid for an order to sell. The do-not-ship order will remain on Nasdaq's book until it is either cancelled or accessed by another NOM participant or market center.[11] Simply put, Nasdaq's System will systematically avoid executing a trade that would trade through a superior price on another market and to prevent Nasdaq from displaying a quotation that would lock or cross a quote being displayed by another market. In addition, Nasdaq will also program the System to avoid joining a locked or a crossed market when the market is already locked or crossed.[12]

Nasdaq agrees with Amex's suggestion that Chapter VI, Section 9 of Nasdaq's proposed rules, governing the Closing Cross failed properly to identify when the Closing Cross would be processed for ETFs which have a market close of 4:15 p.m. Nasdaq is proposing to amend that section to provide that the Closing Cross will operate at 4:15 p.m. and that all other order entry and processing deadlines for the Closing Cross for ETFs will be set with reference to that market closing time. The Closing Cross occurs automatically and generally occurs in under one second but can take several seconds on high-volume trading days.

Amex is correct in noting that Market on Close orders are not guaranteed to execute in the Closing Cross. Chapter VI, Section 9(b) provides the process by which the

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[10] Nasdaq is proposing to amend Chapter VI, Section 10(3), governing price improvement, to clarify that the "taker of liquidity" is the party entering an order that removes liquidity previously posted to the Book.

[11] Nasdaq is proposing a minor change to Chapter VI, Section 7(b)(3)(C) with respect to Displayed Orders only. When a Displayed Order would create a locked or crossed market or cause a trade through, Nasdaq will re-price the order to the national best bid or offer and then display the order at one price increment below or above the national best bid and offer. Nasdaq believes this approach is superior to its original proposal to convert the order to a Non-Displayed Order. Moreover, as stated in the original proposal, if the market has moved through the price of a Non-Displayed order, that Non-Displayed Order will be cancelled back to the entering party.

[12] It is Nasdaq's understanding that all options markets are similarly prohibited from joining a locked market that already exists.

closing cross occurs. Paragraph (3) indicates that MOC orders receive the highest execution priority during the closing cross process. Thus, all MOC orders should execute at the cross price provided that there enough shares on the other side of the market. An MOC order may not receive an execution in the event that the trading interest on the other side of the market at the cross price is less than the number of shares represented in the MOC order.

Amex has raised a valid concern regarding NOM order routing. In response to Amex's question, Nasdaq is amending proposed Chapter VI, Section (1)(b) to define Non-System Securities as those that are not currently trading on NOM pursuant to Chapter IV. For Non-System Securities, Nasdaq will accept orders for routing but will not execute any orders in the NOM System. System and Non-System securities will be clearly identified via the NOM data feed and in NOM's electronic daily list in a "File Transfer Protocol" file posted on the NOM website. In addition, the NOM System will be programmed to differentiate between System Securities and Non –System Securities and will process them each in accordance with the proposed NOM rules.

Nasdaq also proposes to modify Section 11 of Chapter VI, governing Order Routing, to establish that NOM's exclusive order router shall be NASDAQ Options Services LLC, a broker-dealer facility of Nasdaq. NASDAQ Options Services shall perform only two functions, the routing of orders with respect to System Securities (those that are listed and open for trading on NOM) and the routing of orders in Non-System Securities (those that are not open for trading on NOM). NASDAQ Options Services shall be regulated as a facility of NASDAQ only with respect to the routing of orders in System Securities. Whether routing orders for System or Non-System Securities, NASDAQ Options Services will be programmed to follow the algorithm and order type instructions established in the NOM rules, and it will have no discretion to change the terms of an order or the routing instructions that are entered by a member.

The proposed rule provides multiple protections for NOM members, including requiring the routing broker-dealer to: (1) be a member of an unaffiliated SRO that is the designated examining authority; (2) file proposed rule changes with the SEC, (3) maintain information barriers; and (4) maintain books and records and remain subject to inspection as though it were in the shoes of the Nasdaq Exchange facility itself. In addition, there is no requirement that NOM Participants use Nasdaq's routing broker-dealer to route any specific order or any orders at all. Each NOM Participant is free to route its orders through any available router it selects.

Nasdaq believes that Amex's position with regards to the One Point and Two and a half Point Strike Price Pilot Program is anticompetitive. Nasdaq believes that it should be able to compete in all programs to the fullest extent possible for the One Point and Two and a half Point Strike Price Pilot Program.

Finally, Amex comments indicated that Nasdaq should develop its own rules governing position and exercise limits. Nasdaq does not believe that it is required to develop its own expertise in position limits. The SEC has encouraged the consolidation of supervision for rules that are identical among exchanges. Nasdaq's reliance on the position and exercise rules of the Chicago Board Options Exchange, Inc. and / or other options exchanges assures equal regulation among the markets.

Citadel Comment.

Citadel's comments relate to Nasdaq's introduction of non-displayed orders into the options market structure. Nasdaq believes that it has appropriately addressed this issue by agreeing to withdraw its proposal to introduce a completely non-displayed order type. Nasdaq will address Citadel's remaining comments relating to (i) the impact of other non-displayed trading interest on transparency and their use in the facilitation of gaming, (ii) Citadel's allegation that the proposal is inconsistent with Section 6(b)(5) of the Exchange Act, and (iii) the interaction of Price Improving Orders with orders received through the intermarket linkage.

Citadel's unsubstantiated comments center on the allegedly harmful impact of non-displayed trading interest on the options markets. Citadel raises the same arguments that many firms have raised throughout the years to avoid market developments that jeopardize artificially wide spreads and large profits. In fact, Citadel analogizes to Boston's PIP and ISE's PIM both of which have the effect of narrowing spreads and benefiting investors, and all of which have been approved by the SEC without any detriment to the market. Nasdaq's proposal to create Price Improving Orders would offer the same benefit of narrower spreads and the opportunity for price improvement, without the potential downside of "freezing" the entered order for a period of time, as is done in existing price improvement facilities.

As stated above, Nasdaq believes that non-displayed trading interest such as Price Improving and Reserve Orders will promote liquidity within the marketplace. The additional liquidity will reduce the volatility within the market and provide investors with a better execution. Citadel's concern regarding the possibility of "pennying" or gaming is overstated because there are sufficient incentives for market participants to display liquidity on NOM, including the prerequisites for market makers to receive favorable margin treatment such as displaying continuous two-sided quotes and executing a high percentage of their orders in options in which they maker markets. Furthermore, Nasdaq supports the expansion of the penny pilot so as to increase the overall transparency of the option markets.

Citadel suggests that Nasdaq's proposal is inconsistent with Section 6(b)(5) of the Exchange Act which requires the rules of an exchange be designed to, among other things, "promote[s] just and equitable principles of trade" and "facilitate[s] transactions in securities, to remove impediments to and perfect the mechanism of a free and open and a national market system." Citadel fails to acknowledge that both the Limit Order Display Rule and Regulation NMS provide investors with the ability to choose whether their orders should be displayed in the market. The SEC has long acknowledged the impact on the market caused by the display of certain orders. The SEC has further recognized that some investors do not display the full size of their orders in an effort to minimize this impact on the market. As stated earlier, Nasdaq's proposal meets all of the requirements of Section 11A of the Exchange Act by using automation to increase the efficiencies in the market, linking the markets together through NOS, providing the ability for investors to receive an execution in the market, as well as providing investors with a means to execute orders directly without the intervention of a dealer. As such, Nasdaq believes that its proposal meets the requirements set forth in Section 6(b)(5).

Finally, Nasdaq will address Citadel's question relating to how incoming orders from the intermarket linkage will interact with non-displayed trading interest. Incoming orders from the intermarket linkage will automatically execute against any Price Improving Orders with a price better than the displayed bid or offer.

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I hope this information is useful to you in making a determination under Section 19(b) of the Act that Nasdaq's proposal to create the NASDAQ Options Market is consistent with the Act. NOM will spur competition in the provision of technological services to the investing public, and stimulate further innovation. Competition and innovation will benefit investors by increasing the speed and efficiency of executions, reducing quoted and effective spreads, lowering the overall costs of trading options. Competition and innovation will preserve the United States' position as a leader in the financial markets

If you have any further questions, please do not hesitate to contact me at 301-978-8484.

Sincerely,

Jeffrey S. Davis
Vice President and
Deputy General Counsel

cc: Robert L. D. Colby, Esq., Acting Director, Division of Trading and Markets
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