

May 15, 2008

**Via Electronic Mail (rule-comments@sec.gov)**

U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549  
Attention: Ms. Nancy M. Morris, Secretary

**Re: SEC Release No. 34-57599 (April 1, 2008); File No. SR-NASDAQ-2008-027**

Ladies and Gentlemen:

We are writing to raise a substantial issue of policy and legal authority with respect to the above-captioned rule change (the “Rule Change”) The NASDAQ Stock Market LLC (“Nasdaq”), filed with the Securities and Exchange Commission (the “Commission”) to establish fees for trading on the Nasdaq Options Market LLC (“NOM”), a facility of Nasdaq. The Commission announced in the above-captioned release that Rule Change had become effective upon filing under Section 19(b)(3)(A)(ii) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 19b-4(f)(2) thereunder because Nasdaq designated this proposal as one establishing or changing a member due, fee, or other charge imposed by Nasdaq. We urge the Commission to abrogate the Rule Change and order that, if Nasdaq chooses to refile the Rule Change, it do so pursuant to Exchange Act Section 19(b)(2).

Nasdaq is introducing fees and credits for the execution of options contracts within NOM and for routing orders to other options markets. The fees are based on the pricing model currently in place for the trading of equities via the Nasdaq Market Center, with variations to reflect Nasdaq’s understanding of the different competitive conditions in the markets that trade options. Specifically, Nasdaq will assess fees for the execution of options contracts based upon which member provides liquidity to the market and which member takes liquidity from the market.

The filing raises a number of important public policy questions including, among others, (i) the appropriate use of filings for immediate effectiveness by for-profit exchanges that no longer have significant industry representation on their boards of directors; (ii) the proper cost justification for fees; (iii) the proper aggregate levels of fees; (iv) whether payment for order flow should be actively encouraged in this market; and (v) how moving toward a predominately

“maker-taker” model will operate in a world of new Regulation NMS requirements and expanding best execution obligations.

Underlying these questions is a bedrock issue — namely, what do we want our options markets to look like? Nasdaq has based its fee proposal on the pricing model currently in place for the trading of equities. Why should that be the model? If access fees had developed in the equities market because of a threshold assessment that such fees were collectively good for markets and investors, it still would not be clear that the equity model would work best in the very different options market.

In fact, of course, access fees were not adopted in the Nasdaq market because of any methodical threshold assessment that such fees made good sense as a matter of public policy. The fees were allowed as a necessary evil to accommodate the pre-existing business model of a major market participant at the time when the Commission adopted the Order Execution Rules,<sup>1</sup> the effect of which was to provide for substantially enhanced competition from new entrants into the alternative trading system arena. It was always understood that the existence of access fees resulted in market distortions. Since the Commission was not working off a clean slate, however, investors, the Commission and the markets were reconciled to the existence of those access fees and to the fact adjustments at the margins to ameliorate their worst impacts was the best that could be had.

Why transplant that system — which grew out of unique circumstances in the Nasdaq equities market in the early- to mid- 1990s — to the options market of 2008? Why transplant that system at all, when developments in the options market are at a sufficiently preliminary stage that the Commission is not compelled to do so? Nasdaq’s proposal has been characterized as offering “potentially market-altering features.” This clearly is not the type of rule change that should be permitted to become immediately effective as the mere establishment of a fee.<sup>2</sup>

Nasdaq’s filing should not have been characterized simply as establishing or changing fees, for which immediate effectiveness on filing is available. The proposed “make or take” fee scheme is, in effect, a system of payment for order flow.<sup>3</sup> Regardless of whether there is

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<sup>1</sup> See SEC Release No. 34-37619A (September 6, 1996).

<sup>2</sup> “Nasdaq Options Delayed as Market Braces for New Maker-Taker Exchange”. Securities Industry News, December 10, 2007.

<sup>3</sup> The effects of payment for order flow in the options markets have been a continuing focus of Commission concern and study. See, e.g., Report Concerning Examinations of Options Order Routing and Execution, Office of Compliance Inspections and Examinations, Division of Market Regulation, Office of Economic Analysis, SEC (March 8, 2007); Competitive Developments in the Options Markets, SEC Release No. 34-49175 (February 3, 2004), 69 Fed. Reg. 6124, 6128-6131; Office of Compliance Inspections and Examinations and Office of Economic Analysis, SEC, Special Study: Payment for Order Flow and

economic utility in providing an economic incentive for market participants to post liquidity on Nasdaq's market — a point we do not discuss in this letter and should be the subject of public comment and analysis — the fee scheme raises significant issues under the Exchange Act and should be the subject of notice and public comment.

It is true that certain equity exchanges have put in place rules that discriminate in favor of “makers” of liquidity and against “takers” of liquidity. In a recent speech, Dr. Erik R. Sirri, Director of the Division of Trading and Markets, noted that such payment schemes present complex policy issues:

I note that among markets that trade stocks, several different pricing structures co-exist, with the maker-taker model being one of them. There is no reason to believe that the options markets also cannot support various pricing schemes. However, I believe that an exchange's displayed prices should reliably represent the true prices that are actually available to investors. The wider the disparity in the level of fees among the different exchanges, the less useful and accurate are the prices displayed by the markets. Further, I believe it would be untenable for a market to set its fees at a level that effectively blocks fair and efficient access to that exchange's displayed prices. This is particularly important in a market structure where broker-dealers have a duty of best execution, and with a trade-through rule that provides for intermarket price protection. The benefits of intermarket price protection could be compromised if exchanges were able to charge substantial fees for accessing their quotes.<sup>4</sup>

The instant Rule Change presents just such issues, which makes it an appropriate subject of prior notice and comment before it is permitted to go into effect. Are the fees Nasdaq is charging inclined to undermine the reliability of Nasdaq's displayed prices? Do they compromise the benefits of intermarket price protection? Questions such as that would alone justify summary abrogation of the Rule Change. These questions and the concerns articulated by Director Sirri, however, are not addressed in the Commission's order approving the Rule Change, nor were they analyzed in the Commission's order approving the establishment of NOM

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(Continued footnote)

Internalization in the Options Markets, (December 2000), available at:  
<http://www.sec.gov/news/studies/ordpay.htm>

<sup>4</sup> *Remarks before the 2008 Options Industry Conference*, Erik R. Sirri, Director, Division of Trading and Markets, SEC (May 1, 2008), available at: <http://www.sec.gov/news/speech/2008/spch050208ers.htm> (“Sirri Speech”).

and its trading rules.<sup>5</sup> We submit that it is imperative that the Commission carefully evaluate the impact that NOM's execution fees may have on the accuracy and reliability of prices displayed on NOM, and the impact of the fees on fair and efficient access to those prices. As Director Sirri notes: "[Such scrutiny] is particularly important in a market structure where broker-dealers have a duty of best execution, and with a trade-through rule that provides for intermarket price protection."<sup>6</sup>

In addition, as has frequently been the case with exchange rules setting dues, fees and other charges, Nasdaq has not presented any cost justification for these fees.<sup>7</sup> To comply with Exchange Act Section 6(b)(4), NOM fees must represent an "equitable allocation of dues, fees, and other charges among [Nasdaq's] members and issuers and other persons using its facilities." Nasdaq's claim that the NOM fees are consistent with this statutory requirement rests on four disparate bases:

1. "Nasdaq will be the seventh options market in the national market system;"
2. "Joining Nasdaq and electing to trade options is entirely voluntary;"
3. "Nasdaq's fees must be competitive and low in order for Nasdaq to attract order flow, execute orders, and grow as a market;" and
4. "The Commission has already determined that Nasdaq's pricing model for executions — charging the liquidity taker and crediting the liquidity provider — is consistent with the Exchange Act."<sup>8</sup>

None of these points satisfies the Section 6(b)(4) requirement. The first two points are factual. The third point generally will be true unless Nasdaq's fees for NOM provide distorting incentives for market participants to send order flow to NOM rather than other markets. The fees set in the Rule Change may have such a distorting effect. The fourth point is technically correct, because the NOM "make or take" trading rules were approved as part of the

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<sup>5</sup> SEC Release No. 34-57478 (March 12, 2008), 73 Fed. Reg. 14521.

<sup>6</sup> Sirri Speech.

<sup>7</sup> In the Rule Change, Nasdaq also establishes fees and surcharges for routing orders that are executed on another options market. Nasdaq "believes that these routing fees and surcharges are competitive, fair, and reasonable, and non-discriminatory in that they approximate the cost of Nasdaq executing routed orders at an away market." Release 34-57599 (April 1, 2008), 73 Fed. Reg. 18848. Nasdaq, however, provides no data to support this belief.

<sup>8</sup> SEC Release No. 34-57599, 73 Fed. Reg. at 18849.

Commission's approval of the establishment of NOM.<sup>9</sup> As noted above, however, this key element of NOM's operation was not analyzed in the approval order.<sup>10</sup> In any event, the question of fee structure — whether Nasdaq may properly charge “takers” of liquidity more than it charges “makers” of liquidity — is separate and apart from whether the aggregate *level* of the fees Nasdaq proposes to charge meets the statutory standards in Section 6(b)(4) that the fees represent an “equitable allocation of dues, fees, and other charges among [Nasdaq's] members and issuers and other persons using its facilities.” Nasdaq did not present any cost justification of the aggregate levels of such fees and thus, for the reasons that impelled the Commission to grant the NetCoalition petition with respect to exchange fees,<sup>11</sup> the Commission should abrogate this rule change summarily.

Exchange Act Section 19(b)(3)(C) (second sentence) permits the Commission 60 days from the date Nasdaq filed the Rule Change for immediate effectiveness to abrogate the Rule Change summarily and require Nasdaq, if it wishes to go forward with the Rule Change, to refile it as a proposed rule change for public notice and comment. The Commission may summarily abrogate the Rule Change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. The Commission has taken that action quite recently in the case of an exchange rule filing that raised significant policy issues.<sup>12</sup> In light of the several important policy issues the Rule Change presents, the Commission should issue an order summarily abrogating the Rule Change.

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<sup>9</sup> SEC Release No. 34-57478, footnote 5 above.

<sup>10</sup> Nor was it discussed in the Commission's order publishing the NOM rules for comment. See SEC Release 34-55667 (April 25, 2007), 72 Fed. Reg. 23869.

<sup>11</sup> See *Order Granting Petition for Review and Scheduling Filing of Statements*, Release 34-55011 (December 27, 2006), and comment letters filed in response thereto, available at: <http://www.sec.gov/comments/34-55011/3455011.shtml>

<sup>12</sup> *Order of Summary Abrogation*, Release 34-57648 (April 11, 2008). The Commission has summarily abrogated rule changes setting fees where the rule change “raises questions as to whether the fee is consistent with the [Exchange] Act.” *Order of Summary Abrogation*, Release 34-44528 (July 9, 2001) (abrogating a fee imposed on clearing firms by the Chicago Board Options Exchange).

We would be pleased to discuss these matters further with the Commissioners or the Staff, respond to any questions that you may have, or provide any additional comments or information that you may request.

Respectfully submitted,

*Gary Stone* by R.D.B

cc: The Hon. Christopher Cox, Chairman  
The Hon. Paul S. Atkins, Commissioner  
The Hon. Kathlene L. Casey, Commissioner  
Dr. Erik R. Sirri, Director,  
Division of Trading and Markets  
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