



October 5, 2012

**Via Electronic Mail ([rule-comments@sec.gov](mailto:rule-comments@sec.gov))**

Ms. Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: File No. SR-NASDAQ-2012-059: Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Establish “Benchmark Orders” under NASDAQ Rule 4751(f) (Securities Exchange Act Release No. 34-67655)

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> appreciates the opportunity to respond to the request for comment by the U.S. Securities and Exchange Commission (“SEC” or “Commission”) on the above-referenced proposed rule change filed by the NASDAQ Stock Market LLC (“Nasdaq” or “Exchange”) to establish “Benchmark Orders” under Nasdaq Rule 4751(f).<sup>2</sup> For the reasons set forth below, SIFMA believes the Commission should disapprove Nasdaq’s proposal.

Under the proposal, Nasdaq would offer algorithmic trading services to its members. More specifically, Benchmark Orders would seek to achieve the performance of a specified benchmark over a specific period of time for a specified security where all terms are defined by the entering party. A third-party system application dedicated to processing Benchmark Orders (the “Application”) would process each Benchmark Order and would generate one or more “Child Orders” for execution. Nasdaq states that the Application itself is not capable of

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<sup>1</sup> The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

<sup>2</sup> Securities Exchange Act Release No. 66972 (May 11, 2012), 77 FR 29435 (May 17, 2012).

executing orders, and that the Application would generate messages and instructions to be carried out by the Nasdaq system in accordance with Nasdaq Rules.<sup>3</sup>

The Commission has instituted proceedings to determine whether to approve or disapprove the proposed rule change.<sup>4</sup> SIFMA supports the Commission's decision to institute proceedings in this matter, and we share the Commission's stated concerns.

At the outset, we note that Nasdaq's proposal to offer Benchmark Orders raises issues about the roles and obligations of exchanges and broker-dealers in today's equity market structure. As the Commission noted, Nasdaq's Benchmark Order functionality would compete with the algorithms that broker-dealers and other market participants currently use and offer. SIFMA questions whether it is appropriate for Nasdaq, as a national securities exchange, to offer the proposed Benchmark Order functionality. SIFMA and its members strongly support competition among market participants. However, Nasdaq's proposal could create regulatory disparities that would give Nasdaq an inappropriate advantage over broker-dealers providing the same services, both in terms the Commission's Market Access Rule,<sup>5</sup> and other regulatory requirements that apply to broker-dealers. If the Commission ultimately approves Nasdaq's proposal, we urge the Commission to assure that the same regulatory requirements and obligations would apply to Benchmark Orders and Child Orders effected by Nasdaq that would apply to those orders if they were effected by a broker-dealer.

Interestingly, Nasdaq raised similar concerns recently in its comments on a proposed offering by the EDGX exchange.<sup>6</sup> In particular, Nasdaq stated, "[a]s envisioned under the [Exchange] 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... 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." In addition, Nasdaq stated that, when exchanges offer functionality associated with broker-dealers, "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." SIFMA believes that an algorithmic trading function clearly is not "incidental" to an exchange's core functions. The Commission should disapprove the proposal unless Nasdaq explains how its proposed Benchmark Order functionality would

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<sup>3</sup> *Id.* at 29437.

<sup>4</sup> Securities Exchange Act Release No. 67655 (August 14, 2012), 77 FR 50191 (August 20, 2012).

<sup>5</sup> Rule 15c3-5 under the Securities Exchange Act of 1934 ("Exchange Act").

<sup>6</sup> *See* Letter from Alex Kogan, Vice President and Deputy General Counsel, Nasdaq OMX, to Elizabeth M. Murphy, Secretary, Commission, dated September 5, 2012 (commenting on File No. SR-EDGX-2012-33), available at <http://sec.gov/comments/sr-edgx-2012-33/edgx201233-1.pdf>

make markets more transparent and efficient, and how the proposal would not be at the expense of Nasdaq's other functions.

SIFMA also notes that Nasdaq has described the Benchmark Order as part of its function as a self-regulatory organization. As described below, this description raises another set of concerns about an exchange's attempt to characterize its market functions as regulatory functions so that it can claim regulatory immunity for a commercial offering. We urge the Commission to clarify that the Benchmark Order functionality would not be considered as part of Nasdaq's role as a self-regulatory organization.

We also share the concerns that the Commission raised in its order instituting proceedings. First, the Commission expressed concern about whether orders executed through the Benchmark Order service would be subject to appropriate controls to manage risk. As described below, we believe that it is inappropriate for an exchange to offer the Benchmark Order functionality, or any other type of algorithmic trading offering, when it is not subject to the Market Access Rule.

Second, the Commission expressed concern that the proposal could permit unfair discrimination or impose an unnecessary burden, on competition if Nasdaq enabled Benchmark Orders and Child Orders to receive preferential treatment by Nasdaq as compared to orders generated by broker-dealers that choose to use a competing algorithm. While we have no reason to expect that Nasdaq would provide such beneficial treatment to Benchmark Orders and Child Orders, it would be helpful for Nasdaq to provide assurances in that regard.

#### **I. Nasdaq's Proposed Benchmark Order Functionality is a Commercial Offering, not a Regulatory Function**

As we have stated previously, SIFMA believes that the commercial offerings of a national securities exchange are distinct from the functions that an exchange carries out in its role as a self-regulatory organization. In this case, SIFMA believes that Nasdaq plans to characterize the Benchmark Order functionality as a regulatory function rather than a commercial offering. In particular, Nasdaq stated in its proposal that "the Application will be integrated closely with the Nasdaq system and provided to members subject to Nasdaq's obligations and responsibilities as a self-regulatory organization."<sup>7</sup> Nasdaq's characterization of the proposal leads to concern that it would use the doctrine of regulatory immunity to protect itself from any liability that arises out of the Benchmark Order functionality, through systems issues or otherwise. In light of recent events in the markets, it would be an incongruous result if Nasdaq were permitted to use the doctrine of regulatory immunity as a shield against liability, while competing algorithm providers offering the same services may assume unlimited liability for systems issues unless the provider and its customer agree otherwise by arms-length agreement.

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<sup>7</sup> 77 FR at 29436.

SIFMA has noted previously that the Exchange Act recognizes that national securities exchanges act in two distinct statutory roles: (1) as national securities exchanges, where they act as market participants; and (2) as Self-Regulatory Organizations (“SROs”), where they act as market regulators.<sup>8</sup> Further, SIFMA has recognized that some courts have extended regulatory immunity to SROs in cases where they “stand in the shoes”<sup>9</sup> of the Commission to perform a variety of regulatory functions that would otherwise be performed by the Commission.<sup>10</sup> However, SROs do not enjoy complete immunity from suits; it is only when they are acting under the aegis of the Exchange Act’s delegated authority that they so qualify. When conducting private business, they remain subject to liability.<sup>11</sup>

SIFMA questions how a proposal that is not only designed to mimic the existing functionality of its members, but also has been expressly created to attract order flow and execute transactions on the Exchange could be characterized as a regulatory function. Proposals such as these continue to blur the lines between an exchange’s separate functions as market participants and as SROs. In SIFMA’s view, Nasdaq has not provided any justification that this rule proposal is in furtherance of its role as a market regulator. Rather, it is clear that Nasdaq in this instance is acting as a market participant by providing a commercial offering. As noted above, SIFMA strongly supports competition among market participants, and we do not object to the efforts of Nasdaq, or any other national securities exchange, to expand its commercial offerings. However, the commercial offerings of a national securities exchange should not enjoy an immunity from liability that is not available to broker-dealers providing identical services. Accordingly, we request that any final disposition by the Commission on the proposed rule change, whether disapproval or approval, explicitly recognize the distinction between regulatory and commercial functions of an exchange.

## **II. Lack of Controls to Manage Risk**

SIFMA shares the Commission’s concerns that the Benchmark Orders and Child Orders would not be subject to appropriate controls to manage risk, and we agree that Nasdaq has not adequately addressed how or whether the Child Orders would be subject to adequate pre-trade risk checks. In its proposal, Nasdaq states that Child Orders would be generated by a third-party

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<sup>8</sup> See Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA to Elizabeth M. Murphy, Secretary, Commission Dated August 22, 2012 (“NASDAQ Proposed Rule 4626 Response”). By noting that national securities exchanges have two distinct roles under the Exchange Act, SIFMA is not implying that national securities exchanges operate only as a market participant, not as an SRO. Rather, national securities exchanges have two separate roles that they perform concurrently, one as a market participant and the other as a market regulator.

<sup>9</sup> See *D’Alessio v. NYSE, Inc.*, 258 F.3d 93, 105 (2d Cir. 2001).

<sup>10</sup> See *DL Capital Group, LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 97 (2d Cir. 2005).

<sup>11</sup> See *Sparta Surgical Corp. v. National Ass’n of Securities Dealers, Inc.*, 159 F.3d 1209 (9th Cir. 1998).

application and outside of the control and supervision of the broker-dealer that submitted the overlying Benchmark Order. As a result, Child Orders would not be subject to the risk controls that the entering firm is required to have in place pursuant to the Market Access Rule. Although Nasdaq has stated that Child Orders will comport with existing Nasdaq rules, including those intended to enforce the Market Access Rule, Nasdaq has provided no details regarding how Child Orders will meet these requirements.<sup>12</sup> This lack of detail raises concerns about the potential for market disruptions that Nasdaq's proposed algorithmic functionality could cause.

Accordingly, we object to the proposal because it would allow Nasdaq to offer a functionality associated with broker-dealers without the same regulatory obligations and controls that apply to broker-dealers. Nasdaq states in its proposal that it will test the Application rigorously and regularly to ensure that it is performing the desired calculations in accordance with the Market Access Rule on both the Benchmark and Child Orders.<sup>13</sup> However, Nasdaq is not subject to the Market Access Rule, and its affiliated routing broker-dealer benefits from significant exceptions to the Market Access Rule.

When broker-dealers offer the algorithmic trading services that Nasdaq proposes, they are subject to *all* of the requirements under the Market Access Rule, which are reinforced through regulatory examination and oversight. Nasdaq states in its proposal that only Child Orders that have to be routed will be executed by Nasdaq's affiliated routing broker-dealer. However, those Child Orders potentially would be subject only to a portion of the requirements of the Market Access Rule. As a result, a failure by Nasdaq to comply with the Market Access Rule in connection with the Benchmark Order functionality generally may not be subject to direct regulatory oversight under the terms of the Market Access Rule. This end result would create a regulatory disparity that is incompatible with the goals of the Market Access Rule and, we believe, makes Nasdaq's proposed rule change inconsistent with the Exchange Act.

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For all of the reasons noted above, SIFMA requests that the Commission disapprove SR-NASDAQ-2012-059.

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<sup>12</sup> For example, Nasdaq has not explained how it will supervise the financial risk management controls required under the Market Access Rule.

<sup>13</sup> 77 FR at 29436.

Ms. Elizabeth M. Murphy, Securities and Exchange Commission  
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SIFMA greatly appreciates the Commission's consideration of the issues raised above in connection with Nasdaq's Benchmark Order rule filing. SIFMA would be pleased to discuss these comments in greater detail with the Commission and the Staff. If you have any questions, please contact me at [REDACTED] or [REDACTED].

Sincerely,



Theodore R. Lazo  
Managing Director and  
Associate General Counsel

cc: Mary L. Schapiro, Chairman  
Luis A. Aguilar, Commissioner  
Troy A. Paredes, Commissioner  
Elisse B. Walter, Commissioner  
Daniel J. Gallagher, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets