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December 17, 2012

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

Re: Response to Comments
File No. SR-NASDAQ-2012-030

Dear Ms. Murphy:

The NASDAQ Stock Market LLC (“NASDAQ” or “Exchange”) submits this letter to respond to comments filed in connection with the above-referenced proposal (the “Proposal”) to amend Nasdaq Rule 4751(f) to establish a new “Benchmark Order.” NASDAQ filed the Proposal on May 1, 2012, and the Securities and Exchange Commission (“Commission”) published it for comment on May 18, 2012.¹ On June 26, August 14, and November 9, 2012, the Commission issued orders extending its time for consideration of the Proposal.² The Commission sought comment on two issues: whether NASDAQ will subject Benchmark Orders to adequate risk controls, and whether Benchmark Orders would receive preferential treatment. No individual NASDAQ member objected to the Proposal. SIFMA filed a comment letter raising various issues,³ and a respected academician urged the Commission to approve it.⁴

The Proposal will, if approved, establish initially three varieties of Benchmark Orders, each based on a simple, well-established benchmark: Volume Weighted Average Price, Time Weighted Average Price, and Percent of Volume. Benchmark Orders share identical attributes with existing NASDAQ orders, including the entry of trading interest (security, buy/sell side,

¹ See Securities Exchange Act Release No. 66972 (May 11, 2012), 77 FR 29435 (May 17, 2012) (“Notice”).

² See Securities Exchange Act Release No. 67258 (June 26, 2012), 77 FR 39314 (July 2, 2012); Securities Exchange Act Release No. 67655 (August 14, 2012), 77 FR 50191 (August 20, 2012) (“Proceedings Order.”); Securities Exchange Act Release No. 68199 (Nov. 9, 2012), 77 FR 27868 (Nov. 16, 2012).

³ See Letter to the Commission from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, dated October 5, 2012.

⁴ See Letter to the Commission from James J. Angel, dated August 16, 2012.

number of shares, price) with instructions for the Exchange to process that trading interest (in this case, selecting the benchmark, the start time and duration of the order, and where appropriate the percent of volume target). NASDAQ members will enter Benchmark Orders via existing NASDAQ ports, using existing protocols; no new protocols or ports will be required. In other words, from the perspective of a NASDAQ member firm, Benchmark Orders will be entered into NASDAQ in precisely the same manner as existing NASDAQ orders.

Following order entry, Benchmark Orders will operate much like already-approved NASDAQ orders. Like all NASDAQ orders, Benchmark Orders will be assigned unique identification numbers for tracking and risk management. Also like other NASDAQ order types, following order entry Benchmark Orders will generate “Child Orders” that NASDAQ tracks back to the “Parent Order.” Additionally, like existing NASDAQ order types, Benchmark Orders will reflect the entering firm’s general instructions for processing its trading interest; once entered, those instructions will be followed without deviation until the order is either fully executed or cancelled. Finally, like all orders that can cause NASDAQ to route trading interest to away markets,⁵ Benchmark Orders will be subject to NASDAQ’s procedures governing compliance with the SEC’s Market Access Rule.⁶

There are two notable differences between the proposed Benchmark Orders and NASDAQ’s already-approved order types; neither of these differences presents an impediment to Commission approval. First, NASDAQ is proposing to utilize a third-party software provider to process Benchmark Orders, rather than its typical practice of writing such software in-house. Commenter James Angel, in urging the Commission to approve the Proposal, assessed this issue correctly:

Nasdaq proposes to use technology provided by an outside vendor. This is a typical make-versus-buy analysis that financial firms do all the time. Firms often use software developed by outside entities. For example, firms don’t write their own computer operating systems but use commercially available systems such as Windows or Linux. The order types contemplated here (VWAP, TWAP, and POV) are widely offered by many brokerage firms and represent a relatively mature and reliable technology. The use of an outside vendor to provide this functionality is not a bug, it’s a feature. And a good one.⁷

In addition, NASDAQ, to fulfill its heightened obligations as a self-regulatory organizations (“SRO”), has taken and will continue to take substantial precautions to ensure that

⁵ NASDAQ’s routing broker, NASDAQ Execution Services (“NES”), routes trading interest on behalf of NASDAQ whenever NASDAQ members enter orders that can result in NASDAQ routing to away markets. This exchange/broker-dealer routing relationship was prompted, in fact demanded, by the Commission’s adoption of Regulation NMS.

⁶ SEC Rule 15c3-5 under the Exchange Act.

⁷ See Angel Letter at 2.

the third-party software meets the same high standards NASDAQ sets for itself, and that the SEC sets for all SROs. For example, NASDAQ has subjected the software to rigorous design and stress testing prior to integration with NASDAQ systems. NASDAQ will also conduct both periodic operational testing and change-management testing following launch. Additionally, NASDAQ will continually monitor the third-party software via a dashboard of tools designed jointly by NASDAQ and the software provider. Finally, NASDAQ has open access to examine the third-party provider, and has preserved the rights of the SEC to examine aspects of the software that the Commission determines are subject to its oversight. Accordingly, NASDAQ believes that its use of a third-party software provider is consistent with the Exchange Act and should present no impediment to Commission approval of the Proposal.⁸

The second difference between Benchmark Orders and NASDAQ's already-approved orders is that NASDAQ will apply NASDAQ's Market Access Rule policies and procedures more strictly to Benchmark Orders and their Child Orders. NASDAQ has long recognized the importance of maintaining strong risk management and supervisory procedures that control the access they provide to markets. NASDAQ's early advocacy for the standardized risk management rules ultimately culminated in the adoption of the SEC's Market Access Rule. NASDAQ risk checks, controls and procedures currently in place for existing orders already satisfy NASDAQ's SRO and broker-dealer obligations. Benchmark Orders will be subjected to those existing checks. Importantly, broker-dealers are required to run their own market access checks before entering Benchmark Orders on NASDAQ (or any marketplace).

Moreover, recognizing the special role that the Exchange has in that marketplace, NASDAQ has committed to provide additional safeguards for Benchmark Orders. Specifically, whereas existing orders are subjected to NASDAQ's system enforced risk management checks only once – upon the Parent order at time of entry, Benchmark Orders will be subjected to those checks twice – once upon the Parent Order at the time of entry, and a second time upon each Child Order attributable to the Parent. Thus, for example, the system will apply NASDAQ's suite of standardized checks including but not limited to duplicative and erroneous order and credit threshold checks to the Benchmark Order itself, and then apply these again to each Child Order attributable to it.

In addition, NASDAQ will provide new safeguards specifically designed for Benchmark Orders. These checks operate to compare each Child Order to its Parent to ensure that the system cannot mistakenly create excess Child Orders or otherwise “spray” orders to the detriment of market participants. There are four “comparison” checks:

⁸ The Commission has endorsed SRO and broker-dealer use of third-party providers in other contexts, including for purposes of complying with the SEC Market Access Rule and, as described in more detail below, Regulation ATS.

- Child Order limit price cannot violate the Parent Order limit price;⁹
- Child Order quantity cannot exceed the original Parent Order quantity;
- Child Order quantity cannot be exceed the “leaves” balance of the Parent Order;¹⁰ and
- Child Order quantity cannot be greater than the eligible routing quantity.

With the addition of these “comparison” checks, NASDAQ will conduct order checks at four stages of the Benchmark Order process: (1) at the point of entry; (2) during the processing of any child orders; (3) after the processing of child orders; and (4) when child orders are sent to be booked on NASDAQ or routed to an away destination. If any of those checks fail, at any stage in the process, the entire order is cancelled.

Thus, the SIFMA Letter is inaccurate when it suggests that 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, and other regulatory requirements that apply to broker-dealers. In fact, NASDAQ believes that the opposite is true; NASDAQ holds itself and the Commission holds NASDAQ to a higher standard as an SRO, than applies to independent broker-dealers. For the same reasons, NASDAQ is not permitted to give and it will not give Benchmark Orders any preferential treatment *vis a vis* other orders entered into NASDAQ systems.¹¹

The SIFMA Letter suggests that Benchmark Orders differ from NASDAQ’s already-approved orders because they compete with services offered by broker-dealers, and that providing Benchmark Orders should be viewed as a broker-dealer function rather than an exchange function. SIFMA has identified no salient feature of Benchmark Orders that distinguish them from NASDAQ’s already-approved order types. Nor has SIFMA explained how Benchmark Orders compete with broker systems any differently than the many features of NASDAQ’s system that already compete with broker systems (*i.e.*, routing and order execution). SIFMA urges the Commission to disapprove Benchmark Orders, but it fails to identify the statutory basis for that disapproval; SIFMA cites no authority, precedent or regulation to support its objection.

In fact, Benchmark Orders are consistent with the Exchange Act, and there is no statutory basis for a contrary finding. The Commission foresaw and addressed precisely this question in

⁹ If the entering firm does not set a limit price, the system will establish a limit price at the time of order entry based on a conservative tolerance for price movements applicable to orders of various sizes and durations.

¹⁰ The “leaves” balance of a Benchmark Order is determined by subtracting from the entered size of such order the total number of shares of that order executed up to that time.

¹¹ SIFMA offers no substantiation for its assertion that NASDAQ Benchmark Orders will receive preferential treatment. Child Orders of Benchmark Orders will be entered into NASDAQ systems under the same terms as all other orders. They will be time-stamped and entered in queue in the same manner and subject to the same terms and conditions as all other orders and subject to the same (plus additional) regulatory checks as all other orders.

adopting Regulation ATS.¹² There, the Commission specifically acknowledged increasing competition and overlapping services between exchanges and ATSS:

As discussed above, the rapid growth and technological advancements of alternative trading systems have eroded the distinctions between the roles played by alternative trading systems and by traditional exchanges. Alternative trading systems today provide services more akin to exchange functions than broker-dealer functions, such as matching counterparties' orders, executing trades, operating limit order books, and facilitating active price discovery.... The rule helps modernize the Commission's approach to these systems because it adapts the concept of what is "generally understood" to be an exchange to reflect changes in the markets brought about by automated trading.¹³

In fact, the Commission specifically stated that systems providing Volume Weighted Average Price executions perform exchange functions because they use "established, non-discretionary methods" as defined in SEC Rule 3b-16:

A system uses established non-discretionary methods either by providing a trading facility or by setting rules governing trading among subscribers. The Commission intends for "established, non-discretionary methods" to include any methods that dictate the terms of trading among the multiple buyers and sellers entering orders into the system. Such methods include those that set procedures or priorities under which open terms of a trade may be determined. For example, traditional exchanges' rules of priority, parity, and precedence are "established, non-discretionary methods," as are the trading algorithms of electronic systems. *Similarly, systems that determine the trading price at some designated future date on the basis of pre-established criteria (such as the weighted average trading price for the security on the specified date in a specified market or markets) are using established, non-discretionary methods* (emphasis added).¹⁴

The Commission gave as an example of systems falling within the definition of exchange, systems that achieve participants' objectives through the use of mathematical algorithms:

System I permits participants to enter a range of ranked contingent buy and sell orders at which they are willing to trade securities. These orders are matched based on a mathematical algorithm whose priorities are designed to achieve the

¹² See Exchange Act Release No. 34-40760 (Dec. 8, 1998) (Regulation of Exchanges and Alternative Trading Systems).

¹³ *Id.* at footnote 33 and accompanying text.

¹⁴ *Id.*, at text following footnote 49.

participants' objectives. System I does not display orders to any participants. System I is included under Rule 3b-16.¹⁵

The Commission went on to say that a trading system that uses established, non-discretionary methods would include the use of an algorithm:

... a computer system (whether comprised of software, hardware, protocols, or any combination thereof) through which orders interact, or any other trading mechanism that provides a means or location for the bringing together and execution of orders. *For example, the Commission considers the use of an algorithm by an electronic trading system that sets trading procedures and priorities to be a trading facility that uses established, non-discretionary methods* (emphasis added).

The Commission could not have more aptly anticipated the non-discretionary methods of the system by which NASDAQ proposes to execute Benchmark Orders, complete with algorithm and established trading procedures and priorities.¹⁶

NASDAQ's proposed Benchmark Orders also qualify as an exchange function because NASDAQ has imposed rules for their usage that constitute established non-discretionary methods under SEC Rule 3b-16.

Alternatively, a system may use established, non-discretionary methods through the imposition of rules under which parties entering orders on the system agree to the terms of a trade.... In addition, rules imposing execution priorities, such as time and price priority rules, would be "established, non-discretionary methods." Similarly, a system that standardizes the material terms of instruments traded on the system, such as the system operated by Delta at the time the Commission published the Delta Release, will be considered to use established, non-discretionary methods.¹⁷

¹⁵ *Id.*, at text following footnote 83.

¹⁶ The Commission also addressed approvingly the use of third-party software providers:

The Commission will attribute the activities of a trading facility to a system if that facility is offered by the system directly or indirectly (such as where a system arranges for a third party or parties to offer the trading facility). Thus, if a system that brings together the orders of multiple parties arranges for a third party vendor to distribute software that establishes non-discretionary methods under which orders interact, that system will fall within Rule 3b-16.

¹⁷ *Id.* at footnote 57 and accompanying text.

NASDAQ's Benchmark Orders fit squarely within the definition of an exchange function, possessing multiple characteristics that the Commission specifically identified as belonging to exchanges rather than to broker-dealers.

Conversely, Benchmark Orders possess no characteristics that the Commission described as belonging to broker-dealer functions. For example, the Commission opined that block trading desks perform traditional brokerage functions because they exercise discretion and judgment when working customer orders. The Commission also excluded systems that require the commitment of capital because "Commission generally views the willingness to predictably commit capital as a traditional broker-dealer activity." The Commission also excluded from the definition of exchange routing facilities and single-dealer quotation or execution systems because neither brings together multiple buyers and sellers as exchanges do. Viewed through this lens, it is clear that Benchmark Orders bear little or no resemblance to traditional brokerage functions as defined and applied by the Commission.

Finally, SIFMA contends that NASDAQ's Proposal raises "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."¹⁸ SIFMA "urge[s] the Commission to clarify that the Benchmark Order functionality would not be considered part of NASDAQ's role as a self-regulatory organization."¹⁹

NASDAQ did not raise common law immunity in its Proposal. In any event, that judicially recognized doctrine is not at issue in connection with the Commission's review of NASDAQ's Benchmark Order Proposal. There is no need for the Commission to discuss immunity in analyzing the consistency of NASDAQ's Proposal with the Exchange Act. Nevertheless, NASDAQ believes it is important to address the false distinction that SIFMA attempts to draw between "regulatory" and "commercial" functions of the Exchange.²⁰

SIFMA draws its purported concerns from NASDAQ's factual statement that the system Application that will process Benchmark Orders "will be integrated closely with the NASDAQ system and provided to members subject to NASDAQ's obligations and responsibilities as a self-regulatory organization."²¹ NASDAQ made that statement

¹⁸ SIFMA Letter at 3.

¹⁹ SIFMA Letter at 3.

²⁰ SIFMA's constrained description of the immunity doctrine is wrong and self-serving. Courts have consistently applied the immunity doctrine to SROs, and the Act expressly delegates authority to exchanges to "facilitate transactions in securities [and] to remove impediments to and perfect the mechanism of a free and open market." See, e.g., *Standard Investment Chartered, Inc. v. NASD*, 637 F.3d 112 (2d Cir. 2011); *Barbara v. New York Stock Exchange, Inc.*, 99 F.3d 49, 59 (2d Cir. 1996) ("[A]bsolute immunity is particularly appropriate in the unique context of self-regulation of the national securities exchanges.").

²¹ See Notice.

in the context of explaining that although the Application is based on technology licensed from a third-party, it will be a functional offering of the NASDAQ Stock Market – similar to other functions that process member trading interest, including other order types, order routing, and order matching capabilities – and that, among other things, NASDAQ has taken steps to provide that the Application performs to the standards that the Commission sets for all SROs and that the Application complies with applicable SEC regulations and NASDAQ rules.²² It is beyond dispute that in providing access to a facility of the Exchange, NASDAQ is subject to regulation by the Commission. Indeed, that is precisely why NASDAQ has filed its proposed rule change with the Commission. It is likewise beyond dispute that NASDAQ must regulate its members' use of facilities of the Exchange.

Nevertheless, SIFMA contends that in making its Proposal NASDAQ is acting as a national securities exchange and a “market participant,” not as a self-regulatory organization.²³ This distinction, and the implication it compels, are illogical and inconsistent with the plain language of the Act. As a national securities exchange under the Act, NASDAQ is, by definition, a self-regulatory organization.²⁴ And surely SIFMA cannot seriously contend that NASDAQ could provide an order type for use in trading cash equities – and thereby provide market participants a means of making use of a facility of the Exchange – while acting outside the bounds of its obligations and responsibilities as a self-regulatory organization.

For all of the foregoing reasons, and as further explained in its Rule 19b-4 filing and the prior Nasdaq Letter, NASDAQ submits that its Benchmark Orders Proposal is consistent with the Exchange Act and requests approval of the Proposal by the Commission.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeffrey S. Davis". The signature is fluid and cursive, with the first name being the most prominent.

Jeffrey S. Davis
V.P. and Deputy General Counsel

²² See 77 FR at 29436-29437.

²³ SIFMA Letter at 4 and 4 n.8.

²⁴ See 15 U.S.C. § 78c(a)(26) (defining “self-regulatory organization” as, *inter alia*, “any national securities exchange”); 15 U.S.C. § 78s(a)(1) (section entitled “Registration, Responsibilities and Oversight of Self-Regulatory Organizations” refers to, *inter alia*, “a national securities exchange”).