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EDWARD KNIGHT
EXECUTIVE VICE PRESIDENT

THE NASDAQ STOCK MARKET
1801 K STREET NW
WASHINGTON, DC 20006
P 202.912.3030 F 202.912.3191
edward.knight@nasdaq.com



January 8, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609



Re: File No. SR-BSE-2003-22

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. (“Nasdaq”) respectfully submits comments on the proposed rule change of the Boston Stock Exchange, Incorporated (the “BSE”) to establish a general revenue sharing program, SR-BSE-2003-22.¹ The proposed revenue sharing program is based on the program of the National Stock Exchange (the “NSX”), as adopted in 1999 and subsequently amended,² which also provided a basis for a rule change filed by Nasdaq on an immediately effective basis in 2003.³

Background

As both Nasdaq and the New York Stock Exchange (“NYSE”) have previously asserted, the time has come for the Securities and Exchange Commission (the “SEC” or the “Commission”) to articulate clear and even-handed policy on the issues associated

¹ Securities Exchange Act Release No. 48914 (December 12, 2003), 68 FR 70550 (December 18, 2003) (SR-BSE-2003-22).

² Securities Exchange Act Release No. 41082 (February 22, 1999), 64 FR 10035 (March 1, 1999) (SR-CSE-99-02) (notice of filing); Securities Exchange Act Release No. 41286 (April 14, 1999), 64 FR 19843 (April 22, 1999) (SR-CSE-99-02) (approval order); Securities Exchange Act Release No. 46688 (October 18, 2002), 67 FR 65816 (October 28, 2002) (SR-CSE-2002-14) (notice of filing and immediate effectiveness).

³ Securities Exchange Act Release No. 48303 (August 8, 2003), 68 FR 48654 (August 14, 2003) (SR-NASD-2003-120).

with market data revenue sharing programs.⁴ It has been four years since the Commission issued a concept release seeking comment on the role of such programs in the efforts of market centers to compete for order executions and trade reporting.⁵ Since that time, Nasdaq has repeatedly been informed that the Commission does, in fact, plan to conduct a comprehensive rulemaking on the allocation and use of market data revenue. In light of the tangled state of current policy and its implications for competitive balance and the regulatory functions of self-regulatory organizations (“SROs”), we are at a loss to understand why this rulemaking has not yet been commenced.

In 2002, the Commission summarily abrogated, pursuant to Section 19(b)(3)(C) of the Securities Exchange Act of 1934 (the “Act”),⁶ several market data revenue sharing programs, including market data revenue sharing programs for both Nasdaq-listed and exchange-listed securities.⁷ In its Order of Summary Abrogation, the Commission stated that it believed the abrogated programs “raise serious questions as to whether they are consistent with the Act and with the protection of investors, includ[ing], among other things, the effect of market data rebates on the accuracy of market data and on the regulatory functions of self-regulatory organizations.”⁸ The Commission did not, however, choose to institute a rulemaking proceeding under Section 19(c) of the Act⁹ to abrogate NSX Rule 11.10(A)(j) (the “NSX Rule”), although the NSX Rule permits the NSX to rebate market data fees associated with trades in Nasdaq-listed securities.¹⁰ Moreover, despite the Commission’s finding in the Order of Summary Abrogation that “the [notice and comment] procedures provided by Section 19(b)(2) of the Act will provide a more appropriate mechanism for determining whether the proposed rule changes are consistent with the Act,” the Commission has so far refused to publish for

⁴ Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission (September 22, 2003); Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (September 4, 2003).

⁵ Regulation of Market Information Fees and Revenues, Securities Exchange Act Release No. 42208 (December 9, 1999), 64 FR 70613 (December 17, 1999).

⁶ 15 U.S.C. § 78s(b)(3)(C).

⁷ Order of Summary Abrogation, Securities Exchange Act Release No. 46159 (July 2, 2002), 67 FR 45775 (July 10, 2002).

⁸ *Id.*

⁹ 15 U.S.C. § 78s(c).

¹⁰ Similarly, the Commission chose not to institute a proceeding under Section 19(c) to abrogate long-standing rules of other SROs that allow sharing of market data revenue with persons trading exchange-listed securities. *See, e.g.*, NSX Rule 11.10(A)(k). As a result, Nasdaq and the Pacific Exchange filed proposals to reinstitute their market data revenue sharing programs for exchange-listed securities on an immediately effective basis, and the Commission accepted and published these filings. Securities Exchange Act Release No. 46232 (July 19, 2002), 67 FR 48691 (July 25, 2002) (SR-NASD-2002-94); Securities Exchange Act Release No. 46293 (August 1, 2002), 67 FR 51314 (August 7, 2002) (SR-PCX-2002-41); Securities Exchange Act Release No. 46662 (October 15, 2002), 67 FR 64948 (October 22, 2002) (SR-PCX-2002-61).

public comment proposals submitted by Nasdaq and other SROs under Section 19(b)(2) to allow sharing of market data revenue associated with Nasdaq-listed securities.

Commission staff have informed Nasdaq staff that both the decision not to pursue abrogation of the NSX Rule and the decision not to publish various SROs' market data revenue sharing proposals stem from a desire to maintain the status quo until such time as the planned rulemaking on market data is initiated. Whether by design or accident, however, this means that the NSX Rule has been blessed as an acceptable method – indeed, the only acceptable method – by which an SRO may share market data revenue from Nasdaq-listed securities. Moreover, because the status of the NSX Rule has become apparent not as the result of formal rulemaking, but rather through Commission inaction, the Commission and its staff have given the NSX and its market model an unwarranted advantage in the competition for trade reports.

The NSX Rule

In essence, the NSX Rule and the rules based on it provide that in any quarter in which “total operating revenue” exceeds “actual expenses” and “working capital needs,” an SRO’s Board of Directors may share a percentage (ranging from 0% to 100%) of a pool of “operating revenue” provided by various sources (including market data revenue) with the market participants to whom it is attributable. The terms used in the NSX Rule are not generally accepted accounting terms. As a result, their exact meaning is subject to interpretation, and the possibility exists that each SRO with this rule in effect will interpret the key terms of the rule in a different manner. For example, it is unclear from the NSX’s filings whether the term “operating revenue” contemplates the NSX sharing a portion of the funds that it receives from a particular source such as market data on a gross basis, or whether it contemplates the deduction of a portion of associated expenses from the shares provided to market participants. Market participants have informed Nasdaq, however, that the NSX applies its rule on a net basis (i.e., that it allocates expenses to its market participants on a pro rata basis).¹¹ Accordingly, Nasdaq has likewise interpreted the term “operating revenue” to mean revenue net of associated expenses, and plans to commence sharing under its equivalent rule on this basis in the first quarter of 2004.

Similarly, it would appear that each SRO is free to determine what its “working capital needs” are in a particular quarter in order to increase the amount available for sharing. Although the Commission cautioned the NSX to be mindful of its regulatory responsibilities when determining its working capital needs,¹² and other SROs with this rule have expressed their intention to do likewise, it is clear that different markets have historically made very different judgments about the appropriate level of expenditure on

¹¹ See also Letter from Jeffrey T. Brown, Senior Vice President and General Counsel, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, SEC (May 23, 2003) (stating that rule to share specialist operating revenue with Designated Dealers serves to mutualize revenues and expenses among members).

¹² Securities Exchange Act Release No. 41286 (April 14, 1999), 64 FR 19843, 19844 (April 22, 1999) (SR-CSE-99-02).

regulatory oversight. For example, for calendar year 2003, Nasdaq is paying the NASD \$62 million for regulatory services. By contrast, during the twelve months ending June 30, 2003, the NSX's total expenses were \$16.29 million.¹³ Market participants inform Nasdaq that the NSX shares an amount of money equivalent to 50-60% of its market data revenues, which were \$18.2 million during the period.¹⁴ Thus, if the NSX shared at least \$9.1 million under its program during this period, it would have spent, at most, \$7.19 million for all of its other expenses, including regulation.¹⁵ Given the explosive growth of the NSX's volume of trade reports during this period, Nasdaq questions whether the NSX's expenditures on regulation have been adequate. We note that the Chicago Stock Exchange was recently censured for failing to improve and increase its surveillance and disciplinary capabilities to match an increase in its volume of trading in Nasdaq-listed stocks.¹⁶

Several things are quite clear about the NSX and its use of the rule, however. The NSX is a "print shop" – a shell market that exists solely to provide a venue for trade reporting. Despite its status as a national securities exchange, the NSX does not seek to provide a venue for interaction and execution of orders and quotes for Nasdaq-listed securities. Rather, it seeks to attract the reports of transactions executed by electronic communications networks ("ECNs") and other broker-dealers, so that it may earn the market data revenues associated with those transactions. Orders that are matched by ECNs or other broker-dealers have a theoretical opportunity to interact with orders on the NSX book, but the liquidity made available through the NSX is quite limited because the NSX sets its prices to ensure that it is not an economical trading venue. Insofar as ECN quotes are posted on the NSX, the NSX's charges ensure that market participants seeking to access those quotes will route to the ECN directly rather than to the NSX. In fact, in its examination of publicly available trading data, Nasdaq has found no evidence that a single transaction in a Nasdaq-listed security has been executed through the NSX in the last two years.

The NSX Rule, however, allows the NSX to pay broker-dealers to report their own trades to the NSX and still keep some of the market data revenue that the NSX earns under the Nasdaq UTP Plan. This, and this alone, explains why ECNs and other broker-

¹³ Condensed Financial Statements of the Cincinnati Stock Exchange, Chicago Board Options Exchange Annual Report 2003 at 18 (August 15, 2003).

¹⁴ A recent article in The Economist stated that NSX's rebates are now ranging as high as 70% of its market data revenue. "Printing Money: A New Name for a Peculiar American Stock Exchange," The Economist (November 13, 2003).

¹⁵ The Economist article also stated that the NSX's regulatory budget is less than 1% of either the NYSE's or the NASD's.

¹⁶ In the Matter of the Chicago Stock Exchange, Securities Exchange Act Release No. 48566 (September 30, 2003).

dealers report trades to the NSX. As David Colker, the NSX's President and CEO put it, "We pay people to do business with us."¹⁷

It is also clear that the NSX free-rides on the regulatory activities of the NASD, which are funded largely by Nasdaq, while at the same time diminishing the effectiveness of those activities. As detailed in the Petition for Commission Action Concerning the Trading of Nasdaq-Listed Securities filed by Nasdaq last year,¹⁸ information is provided to the NASD's Order Audit Trail System ("OATS") by NASD members about trades that they report to the NSX. Although the NSX receives the market data revenue attributable to those trades, the NASD and Nasdaq bear the costs of receiving and storing the OATS data as well as regulating the conduct of the members in question. Moreover, although the NASD eventually receives quote and trade report data concerning such trades through the Intermarket Surveillance Group (the "ISG"), the information is less timely and less complete than information received about trades reported to Nasdaq.

The BSE's Entry into the Market for Nasdaq-Listed Securities

All indications are that the BSE has filed its own version of the NSX rule in an effort to emulate the NSX's business model for trading Nasdaq-listed stocks. The BSE began trading all Nasdaq-listed stocks in mid-December without making any effort to link itself into the larger marketplace. In particular, market participants inform Nasdaq that the BSE does not offer market participants a means to access its quotes electronically, nor does it offer automatic execution of orders. Thus, it is probable that the BSE is seeking to provide a venue for reporting, rather than execution, of trades. To the extent that meaningful quoting on the BSE actually does occur, however, it will compound the difficulties already faced by market participants in today's increasingly fragmented market structure: locked and crossed markets, the best execution conundrums posed by balancing a favorable price available in a marginally accessible market against the time and uncertainty involved in obtaining that price, and the regulatory arbitrage arising from the absence of consistent rules to govern trading of Nasdaq-listed stocks. To the extent that the BSE merely acts as a print shop, it will compound the problems of regulatory arbitrage, inequitable allocation of regulatory costs, and diminished regulatory effectiveness discussed in Nasdaq's Petition.

Accordingly, Nasdaq believes that the Commission should require the BSE to answer some key questions about its intentions with respect to its revenue sharing program, and should abrogate the BSE's proposed rule change if the BSE's responses do not reflect an intent to improve the national market system. First, the BSE should explain why it believes that sharing market data revenue is a better use of its resources than investment in the systems needed to link the BSE to other markets trading Nasdaq-listed securities and to make its quotes easily accessible to market participants. Second, the

¹⁷ "Printing Money: A New Name for a Peculiar American Stock Exchange," The Economist (November 13, 2003).

¹⁸ Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, SEC (April 11, 2003).

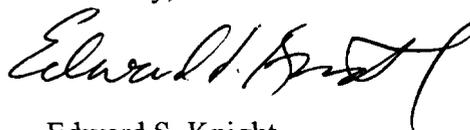
BSE should explain how it plans to surveil trades reported to it for violations of BSE and SEC rules. In particular, it should describe the size of its regulatory budget for Nasdaq-listed securities, the systems that it will use for surveillance of trades in these securities, and any changes in budget or system functionality that it is making as a result of its entry into this market. If any such changes are minimal, the BSE should explain why it believes that sharing market data revenue is a better use of its resources than investment in the quality of regulation that it offers investors.

Conclusion

Nasdaq understands that the issues associated with the allocation and use of market data, market linkage, regulatory funding by SROs, and regulatory arbitrage are difficult, and that rulemaking by the Commission in these areas will inevitably have far-reaching implications for the national market system. They are also issues of vital importance to market quality, investor protection, and competitive balance. Accordingly, Nasdaq urges the Commission to its allow long-deferred rulemakings on market data use and allocation finally to see the light of day, as the first step toward the development of comprehensive and coherent policy in this area. As a fundamental part of such a policy, the Commission should take all steps necessary to ensure that print shops such as the NSX and the BSE do not operate in a manner that degrades the quality of market regulation.

If you have any questions, please do not hesitate to contact me at (202) 912-3030, or John M. Yetter, Associate General Counsel, at (202) 912-3039.

Sincerely,



Edward S. Knight

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel S. Campos
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
David Shillman, Associate Director, Division of Market Regulation
John Polise, Senior Special Counsel, Division of Market Regulation