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EDWARD S. KNIGHT
EXECUTIVE VICE PRESIDENT
GENERAL COUNSEL

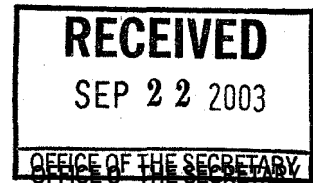
NASDAQ

THE NASDAQ STOCK MARKET INC
1801 K STREET NW
WASHINGTON, DC 20006
P 202.728.8212 F 202 728 8258
edward.knight@nasdaq.com

September 22, 2003

VIA COURIER

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



Re: Response to comments on SR-NASD-2003-120

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") appreciates the opportunity to respond to the comment letter that was submitted to the Securities and Exchange Commission (the "SEC" or the "Commission") by the New York Stock Exchange (the "NYSE") concerning the above-captioned rule filing,¹ which relates to the establishment of a revenue sharing program by Nasdaq. In SR-NASD-2003-120,² Nasdaq proposed to adopt a general revenue sharing program based on Rule 11.10(A)(j) of the Cincinnati Stock Exchange (the "CSE"), as adopted in 1999 and subsequently amended.³

As a threshold matter, Nasdaq wishes to correct the NYSE's assertion that Nasdaq's program to share revenue with Nasdaq Quoting Market Participants (*i.e.*, market makers and electronic communications networks ("ECNs") that quote in SuperMontage) is broader than the CSE program. It is Nasdaq's understanding, based on information received from a range of market participants, that the CSE shares substantial

¹ Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (September 4, 2003).

² Securities Exchange Act Release No. 48303 (August 8, 2003), 68 FR 48654 (August 14, 2003).

³ 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).

revenue with ECNs that report trades in Nasdaq-listed securities to the CSE: revenue equivalent to approximately 50-60% of the market data revenue associated with each trade.⁴ Moreover, it is Nasdaq's understanding that non-ECN trading activity in Nasdaq-listed securities on the CSE is negligible.' As a result, although ECN orders have a theoretical opportunity to interact with other orders on the exchange, the reality is that almost all trades in Nasdaq-listed securities reported to the CSE are executed through the facilities of the two ECNs that report trades there. It is these ECNs that are the primary beneficiaries of CSE Rule 11.10(A)(j). Moreover, it is Nasdaq's understanding that the vast majority of the CSE's revenues are market data revenues, which means that the CSE program is truly a market data revenue sharing program in all but name.

Nasdaq agrees, however, with the NYSE's assertion that the time has come for the Commission to articulate clear and even-handed policy on the issues associated with market data revenue sharing programs. It has been almost 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,⁶ but Nasdaq respectfully submits that the Commission's view of the issues raised in its concept release remains anything but clear.

In 2002, the Commission summarily abrogated, pursuant to Section 19(b)(3)(C) of the Securities Exchange Act of 1934 (the "Act"),⁷ several market data revenue sharing programs, including market data revenue sharing programs for both Nasdaq-listed and exchange-listed securities.* 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

⁴ In an effort to enhance its understanding of the CSE's program and its effect on trading in Nasdaq-listed securities, Nasdaq has filed a Freedom of Information Act request with the Commission to request records concerning the program and the Commission's evaluation thereof. Letter from John M. Yetter, Associate General Counsel, Nasdaq, to Freedom of Information Act Officer, SEC (August 1, 2003). Unfortunately, Nasdaq has not received a determination of the availability of records responsive to its request within the 20 business days specified by statute and regulation. 5 U.S.C. § 552(a)(6); 17 CFR § 200.80.

⁵ According to data available on their respective websites, during the four-week period beginning June 23, 2003, the CSE reported trades for 3,471,846,303 shares of Nasdaq-listed stocks, while The Island ECN reports that it sent trades for 3,650,695,007 shares of Nasdaq-listed stocks to the CSE. It is unclear why the CSE's reported volume is actually lower than the volume cited by its sole ECN market participant at the time, but the numbers are clearly indicative of the predominant position of ECNs in the CSE's reported volume.

⁶ Regulation of Market Information Fees and Revenues, Securities Exchange Act Release No. 42208 (December 9, 1999), 64 FR 70613 (December 17, 1999).

⁷ 15 U.S.C. § 78s(b)(3)(C).

⁸ Order of Summary Abrogation, Securities Exchange Act Release No. 46159 (July 2, 2002), 67 FR 45775 (July 10, 2002).

regulatory functions of self-regulatory organizations.”⁹ The Commission did not, however, choose to institute a rulemaking proceeding under Section 19(c) of the Act¹⁰ to abrogate CSE Rule 11.10(A)(j), although, as the NYSE correctly points out, the CSE rule permits the CSE to rebate market data fees associated with trades in Nasdaq-listed securities. Similarly, the Commission chose not to institute a proceeding under Section 19(c) to abrogate long-standing rules of other self-regulatory organizations (“SROs”) that allow sharing of market data revenue with persons trading exchange-listed securities.¹¹ 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.¹² By contrast, 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 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.¹³

Based on these scattered precedents, Nasdaq and other SROs are left to draw the following conclusions about Commission policy toward market data revenue sharing: (i) sharing of revenue associated with exchange-listed securities is consistent with the Act, (ii) sharing of revenue associated with Nasdaq-listed securities may or may not be consistent with the Act, but the time for deciding this question must be deferred, and (iii) sharing of revenue associated with Nasdaq-listed securities is consistent with the Act provided it is shared along with at least some other revenue. At no time has the Commission articulated a basis for distinguishing between exchange-listed and Nasdaq-

⁹ *Id.*

¹⁰ 15 U.S.C. § 78s(c).

¹¹ See, e.g., CSE Rule 11.10(A)(k).

¹² 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).

¹³ See, e.g., SR-NASD-2003-114 (July 22, 2003). Nasdaq questions whether the long-standing practice of the Commission or Commission staff refusing to publish certain SRO filings submitted under Section 19 of Act is consistent with the Commission’s statutory obligations. Section 19(b) of the Act states that each SRO “shall file with the Commission ... copies of any ... proposed rule change,” but likewise states that “[t]he Commission shall, upon the filing of any proposed rule change, publish notice thereof... shall give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule change ...[, and] shall by order approve such proposed rule change or institute proceedings to determine whether the proposed rule change should be disapproved. Such proceedings shall include notice of the grounds for disapproval under consideration and opportunity for a hearing...” 15 U.S.C. § 78s(b) (emphasis added). When it refuses to publish SRO filings, the Commission deprives the public of an opportunity to comment, deprives the SRO of the opportunity for a hearing before the Commission, and avoids final agency action reviewable under the Administrative Procedure Act. 5 U.S.C. § 704. Accordingly, Nasdaq believes that the refusal to publish SRO filings may, under certain circumstances, constitute the withholding or delay of final agency action. 5 U.S.C. § 706(1).

listed securities, or between sharing of market data revenue alone and market data revenue pooled with other revenue. Nevertheless, faced with precedents that make precisely these distinctions, as well as the competitive reality of the CSE's use of its revenue sharing program to entice ECNs to report trades to the CSE, Nasdaq concluded that there was at least a possibility that a revenue sharing program based on CSE Rule 11.10(A)(j) would allow Nasdaq to mount a competitive response.

Because the CSE's non-market data revenues are negligible, however, the CSE can rebate a sizeable percentage of the market data revenue that it earns for each reported transaction without incurring other costs under its rule. As a result, the CSE rule is a very effective tool for enticing market participants to report transactions to the CSE, and is virtually indistinguishable from a straight market data revenue sharing program. Accordingly, Nasdaq strongly believes that the Commission should either publish and approve the market data revenue sharing proposals filed by Nasdaq and other SROs, or should immediately institute rulemaking proceedings to establish clear and even-handed rules to govern or restrict revenue sharing. Pending final rules, the Commission should take all steps necessary to "level the playing field" by allowing or inhibiting revenue sharing programs on terms that are fair to all SROs.

That said, Nasdaq believes that SR-NASD-2003-120 is consistent with Section 15A of the Act,¹⁴ for the simple reason that the Commission found the CSE's similar program to be consistent with the identically worded provisions of Section 6 of the Act." The Commission may, of course, reconsider prior interpretations of the Act as long as it acts in accordance with applicable statutory and judicial standards. In light of the identical wording of the statutory provisions governing Nasdaq and the CSE, however, Nasdaq believes that if the Commission abrogates SR-NASD-2003-120 without also instituting a proceeding under Section 19(c) to abrogate CSE Rule 11.10(A)(j), the Commission's action would be arbitrary, capricious, an abuse of discretion, and not otherwise in accordance with the law.¹⁶ Moreover, in the event that the Commission abrogates SR-NASD-2003-120 without also instituting such a proceeding under Section 19(c), Nasdaq would refile the proposed rule change in accordance with the provisions of Section 19(b)(1) of the Act, and must, on these facts, consider a refusal by the Commission to publish the proposed rule change an instance of the withholding or delay of final agency action.¹⁷

¹⁴ 15 U.S.C. § 78o-3.

¹⁵ 15 U.S.C. § 78f.

¹⁶ 5 U.S.C. § 706(2)(A).

¹⁷ 5 U.S.C. § 706(1).

We would be pleased to discuss the issues raised in this letter and the NYSE letter with you further at your convenience. 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
Lawrence E. Harris, Chief Economist
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Stephen Williams, Assistant Director, Division of Market Regulation
John Polise, Senior Special Counsel, Division of Market Regulation