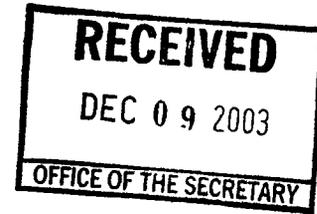


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December 8, 2003

**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-2003-143

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") appreciates the opportunity to respond to comment letters that were submitted to the Securities and Exchange Commission (the "SEC" or the "Commission") concerning the above-captioned rule filing,<sup>1</sup> which proposes a new "auto-ex" order for Nasdaq's SuperMontage system.<sup>2</sup> The proposed order would execute solely against the Quotes/Orders of participants in SuperMontage's automatic execution functionality that do not charge a separate quote-access fee. Although the order can access liquidity available at multiple price levels, it will not trade through the Quote/Order of a market participant that is not eligible to receive the order.

**Summary of Comments**

Bloomberg contends that the proposed auto-ex order is unfairly discriminatory and anticompetitive because it offers market participants greater ability to determine the circumstances under which their orders will be routed to market participants that do not accept automatic executions or that charge access fees. Inet, by contrast, argues merely

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<sup>1</sup> Letter from Alex Goor, President, Inet ATS, Inc. ("Inet"), to Jonathan G. Katz, Secretary, SEC (November 18, 2003); Letter from Kim Bang, President, Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, SEC (November 20, 2003).

<sup>2</sup> Securities Exchange Act Release No. 48675 (October 21, 2003), 68 FR 61528 (October 28, 2003) (SR-NASD-2003-143).

that the proposal is unnecessarily discriminatory because concerns about the response times of order-delivery ECNs could be addressed by mandating speedier responses.

### **Response to Comments**

Contrary to Inet's and Bloomberg's contentions, the proposed auto-ex order is not unfairly discriminatory or anticompetitive in intent or effect. Rather, the order provides market participants with greater flexibility in determining the terms and conditions under which their orders will route and execute. At present, market participants have essentially three choices: they can (i) direct an order to a particular market participant, (ii) preference an order to a market participant if that market participant is at the inside market, or (iii) use a non-directed order, which will access liquidity available from all market participants at one or more price levels. In the latter case, the market participant can currently select from three execution priority algorithms, but because these algorithms merely determine the order in which liquidity available at a given price level is accessed, they do not actually provide market participants with much flexibility in determining how their orders will be routed. As a result, and because the alternative algorithms receive little usage, Nasdaq recently proposed eliminating its price/size and price/time with fee consideration algorithms in favor of a default price/time priority algorithm for non-directed orders.<sup>3</sup>

The proposed elimination of these algorithms does not mean, however, that market participants want less choice in determining how their orders will be routed. The auto-ex order will give market participants the option to access liquidity available at the inside market without the possibility of the order being routed to an order-delivery participant or a participant that charges an access fee. Speed is one of the reasons that a market participant would choose this option; avoidance of ECN access fees (and Nasdaq's \$0.001 per share ECN routing fee) is another. The market participant may also choose this option because it is already routing orders to ECNs and cannot allow SuperMontage to perform a duplicative routing function for it.

Nasdaq adopted the concept of the order-delivery ECN to accommodate the business model of ECNs. Although Regulation ATS requires ECNs to display their best prices and make them accessible through Nasdaq or an exchange, the business model of most ECNs relies upon establishing direct connections to subscribers that post orders on the ECN's book. By delivering orders to ECNs, Nasdaq allows them to determine whether the liquidity represented by their Quote/Order in SuperMontage is still available or whether it has been executed against by another order within the ECN, thereby avoiding the dual liability that would arise if the ECN's Quote/Order was matched against a SuperMontage order and an ECN order simultaneously. Order delivery also allows the ECN to determine whether it considers the party submitting an order through SuperMontage to be a bad credit risk that may not promptly pay the ECN's access fee. As a result, the ECN has considerable flexibility to determine the terms and conditions under which its orders will interact with SuperMontage orders.

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<sup>3</sup> Securities Exchange Act Release No. 48501 (September 17, 2003), 68 FR 56358 (September 30, 2003) (SR-NASD-2003-128).

Similarly, the auto-ex order will provide other market participants with greater flexibility. Just as an ECN would not wish to have the same Quote/Order matched against two orders simultaneously, a market participant sending its orders directly to an ECN may not want SuperMontage to send orders to the ECN also. The auto-ex order will allow the market participant to access liquidity at the Nasdaq inside without being concerned that its SuperMontage orders will interact with or duplicate orders that it has already submitted to an ECN. Similarly, just as an ECN may decline to do business with a market participant because of concerns about payment of access fees, the auto-ex order will allow a market participant to exercise better control over its costs of execution.

It should be noted that Nasdaq has proposed capping ECN access fees at \$0.003 per share.<sup>4</sup> If this fee cap is approved, the potential variation in the cost of accessing liquidity from different classes of market participants will be considerably reduced. As a result, Nasdaq expects that fewer market participants would use the auto-ex order solely to avoid paying access fees than would be the case currently. However, because the fees charged by Nasdaq for order executions and routing, and the fees charged by ECNs to subscribers and non-subscribers for access will continue to change, differences in the cost to access different liquidity providers through different methods will undoubtedly persist. As a result, Nasdaq believes that just as ECNs have some ability to determine to whom they will provide liquidity, market participants should have greater control over routing decisions that have financial consequences associated with them.

Market participants that seek to use SuperMontage as a single point of order entry to access liquidity available from a wide range of sources at multiple price levels will opt to use regular non-directed orders. Market participants that seek to exercise direct control over the circumstances under which their orders are routed to ECNs by using direct connections to ECNs and eschewing SuperMontage routing, who wish to have a particular order access liquidity at the inside as quickly as possible, or who seek to control execution costs may opt to use the auto-ex order. Giving market participants the means to achieve a range of possible trading goals will enhance, not inhibit, competition. Moreover, in a competitive environment where ECNs have a range of venues available for displaying quotes/orders and can compete successfully for order flow through direct connections, and where market participants can opt to use SuperMontage or any of a variety of competing venues to access deep pools of liquidity available through numerous market centers, it is difficult to see how providing market participants with the choice of forgoing the use of SuperMontage's order delivery functionality on an order-by-order basis results in unfair discrimination.

This is particularly true since the order will never trade through the Quote/Order of a participant that is not eligible to receive the order, a fact that Inet and Bloomberg fail to acknowledge. As a result, as the Commission found when it determined that SuperSOES's comparable order processing functionality was consistent with the Act, "it is not likely that ECNs that choose order entry participation will be marginalized[.]

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<sup>4</sup> Id.

because ECNs are frequently at the best quote in the market.”<sup>5</sup> Market participants that seek to achieve greater certainty that their orders will be executed in full, or that prefer to access all available liquidity through a single order, will not opt to use the auto-ex order. Moreover, when an ECN Quote/Order is the predominant source of liquidity at the inside in a particular stock, the auto-ex order would simply not be used by market participants.

Bloomberg asserts that Nasdaq’s comparison of the auto-ex order to SuperSOES processing approved by the Commission in 2000 is “factually inaccurate,” but fails to explain why. SuperSOES, the predecessor to SuperMontage, offered automatic executions of orders against the quotes of market participants that opted to accept automatic executions. SuperSOES accessed liquidity offered by all automatic execution participants at a given price level, but cancelled an order if a participant that did not accept automatic execution was alone at the inside. Participants that did not accept automatic executions were accessible solely through SelectNet, which allowed market participants to route orders to specified recipients. Thus, the processing of SuperSOES orders was virtually identical to that of the proposed auto-ex orders, in that SuperSOES orders accessed liquidity available from automatic execution participants and then cancelled upon encountering the quote of a participant that did not accept automatic executions.<sup>6</sup> Of course, SuperMontage differs from SuperSOES/SelectNet, insofar as it offers market participants the option of accessing both automatic execution participants and order delivery participants through a single, non-directed order (as well as through directed orders, which function like SelectNet orders). As a result, Nasdaq offers market participants wider and more flexible options for accessing order-delivery ECNs than were available through SuperSOES/SelectNet. It is difficult to see why Nasdaq, having chosen to provide these additional options, should be foreclosed from also providing market participants the same option that existed through SuperSOES/SelectNet.

Similarly, Inet contends that Nasdaq’s comparison of the auto-ex order to the fill-or-return order offered by the Archipelago Exchange (“Archipelago”) is “inapposite.” Although Inet’s description of the fill-or-return order is accurate as far as it goes, it is incomplete. Inet fails to mention that Archipelago does not allow its market participants to operate in a status comparable to an order-delivery ECN (thereby making its market structure less conducive than Nasdaq’s to the direct participation of ECNs). Rather, all participants must accept automatic execution of orders that they submit to Archipelago. Archipelago, however, routes orders to other market centers for execution once they have accessed all liquidity available through Archipelago, and the fill-or-return order allows a market participant to forgo this routing function. Thus, Archipelago effectively excludes ECNs from direct participation in its market, puts ECNs last in line after the liquidity available on Archipelago, and allows market participants to use the fill-or-return order to

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<sup>5</sup> Securities Exchange Act Release No. 42344 (January 14, 2003), 65 FR 3987, 3998 (January 25, 2000) (SR-NASD-99-11).

<sup>6</sup> In contrast to the proposed auto-ex order, SuperSOES orders could be executed against the quote of an automatic-execution participant that charged an access fee. However, it should be noted that none of SuperMontage’s current automatic execution participants charges an access fee. Accordingly, until such time as a participant opts to accept automatic executions and charge an access fee, the auto-ex order would be processed identically to SuperSOES orders.

avoid accessing ECN liquidity under any circumstances. By contrast, Nasdaq adopted the concept of the order-delivery ECN in order to encourage direct ECN participation, Nasdaq's default order execution algorithm makes no distinction between the Quotes/Orders of automatic execution participants and order-delivery ECNs, and the auto-ex order will not trade through an order-delivery ECN. In this environment, the auto-ex order, like the fill-or-return order, will simply give market participants the opportunity to exercise more control over order routing, which they may choose to exercise for any of the reasons discussed in this letter. Hence, the proposed auto-ex order is comparable to the fill-or-return order in that both order types allow a market participant (i) to seek speedy, automatic executions, followed by the immediate return of portions of the order that cannot be automatically executed, (ii) to avoid routing orders to market centers with which they may already be doing business through direct connections, and (iii) to avoid fees that may be associated with accessing liquidity at other market centers. Finally, Nasdaq notes that Instinet and The Island ECN (the ECNs from which Inet will be formed) and Bloomberg have order types that allow their subscribers to determine whether orders routed to them may also be routed to other market centers, or whether they may be executed solely within the ECN. It is disingenuous, to say the least, for these ECNs to work to prevent Nasdaq's market participants from enjoying similar flexibility.

Bloomberg and Inet also fail to acknowledge the similarity between the auto-ex order and the existing SuperMontage preferenced order, which allows a market participant to access liquidity offered by a specified automatic execution participant (or order-delivery ECN) at the inside market. Market participants can already partially replicate an auto-ex order by using one or a series of preferenced orders, but might incur higher charges and sacrifice speed, because multiple orders might be required to access available liquidity at the inside. Nasdaq sees no reason why market participants should be prevented from accomplishing their routing goals with greater efficiency and at a lower cost.

Inet focuses on one of the purposes of the auto-ex order – to give market participants greater certainty about the speed of order execution – and argues that any concerns about speed of execution could be addressed by establishing more stringent standards for the response times of order-delivery ECNs. As discussed in the original filing, speed of execution is indeed a factor (although not the only factor) that may make the auto-ex order attractive to a market participant. Currently, NASD Rule 4710 provides that an order-delivery ECN should generally respond to delivered orders within five seconds, and that if it fails to respond to a particular order within 30 seconds, its quote at the applicable price level will be set to zero and the order will be processed against Quotes/Orders of other market participants. An ECN that regularly fails to meet a five-second response time over a period of orders will have all of its quotes removed until the ECN certifies that it can meet the five-second requirement with regularity sufficient to maintain a fair and orderly market.

It must be recognized that SuperMontage's interaction with an order-delivery ECN is inherently more time-consuming than its interaction with an automatic-execution

participant. In the case of an order-delivery ECN, upon ascertaining that the ECN's Quote/Order is next in line to receive an incoming order, SuperMontage first transmits the order. The ECN then ascertains whether the liquidity reflected in its Quote/Order is available and whether it considers the party to be a good credit risk, it transmits a message back to SuperMontage either accepting or rejecting the order, and then SuperMontage either executes the order against the ECN's Quote/Order or continues to process the order against other Quotes/Orders. By contrast, when an automatic-execution participant's Quote/Order is next in line, SuperMontage simply executes the order. Although the ECN's evaluation of orders may be automated, the back-and-forth message traffic between SuperMontage and the ECN, as well as the necessity for the ECN to evaluate the incoming order, involve delays not present in the case of automatic executions. Moreover, while an order delivered to an order-delivery ECN is being processed, the system does not stand still: other non-directed orders continue to be processed against Quotes/Orders, accessing liquidity that will then no longer be available to the order that has been delivered.

The ECN response times mandated by Rule 4710 must balance the goal of speedy order processing against the goal of providing ECNs with a reasonable time to determine whether they are able to fill orders delivered to them. Although Nasdaq agrees that it and its ECN market participants should seek continual improvement in response times, Nasdaq does not believe that it is technically feasible at this time to impose a response time standard that would ensure that executions of ECN-delivered orders are always as fast as automatic executions. Moreover, Nasdaq does not believe that it would necessarily be beneficial to the overall market to impose heightened standards that some current ECN market participants might not be able to meet, thereby denying them the opportunity to quote in SuperMontage and depriving market participants of the ability to access them through SuperMontage.

From time to time, Nasdaq experiences response times that exceed 5 seconds, and the prevalence of these slow response times has varied from ECN to ECN throughout the time that SuperMontage has been operational. Although enforcement of Rule 4710 is important to maintaining market quality, it cannot prevent the response times for particular orders from exceeding a five-second standard. Moreover, response times for particular orders fall within a one- to five-second time range on a daily basis, with the majority of the slower responses occurring during the market open and close, when assurance of rapid execution may be particularly important to a market participant. During November 2003, for example, the response time for orders delivered during the market close fell within the one- to five-second range for 10.2% of all such orders.

In addition, as noted above, the ECN's response time is only one component of the total round-trip processing time, and total processing time from all delivered orders increases when an ECN's response time is slow, since subsequent orders must be queued while awaiting an ECN's response. As a result, the processing time for particular orders exceeds five seconds on most trading days. Thus, although average response time and average processing time for all order-delivery ECN orders are less than one second, particular orders may be much slower, and the averages are invariably higher during the

market open and market close, such that the average round-trip processing time for all order-delivery orders during the market close exceeds one second on the majority of trading days. By contrast, the processing time for automatic executions is between 0.006 and 0.01 seconds. The auto-ex order will simply provide market participants with a voluntary tool to use when they wish to ensure a rapid execution, rather than running the risk of delay in a fast-moving market.

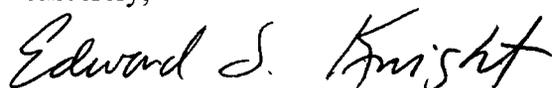
Finally, as noted in the original filing, there is a good possibility that orders presented to an order-delivery ECN will be rejected because the shares reflected in the ECN's Quote/Order have already been accessed through subscribers' direct connections to the ECN. Bloomberg counters that an automatic execution participant's Quote/Order that is observed by a participant entering an order may also prove unavailable if another SuperMontage participant's order arrives first. The difference is that liquidity available in the ECN is routinely accessed through direct connections to the ECN, which means that the shares are less likely to be available. Moreover, the ECN is given the opportunity to reject orders that are presented to a Quote/Order that is still displayed in SuperMontage. During the month of November 2003, for example, 23% of orders delivered to an ECN's Quote/Order were rejected. Rejection of orders can be particularly problematic during the market close, since the opportunity for execution during regular market hours of an order rejected by an ECN may be foreclosed. By contrast, the unavailability of shares previously reflected in an automatic execution participant's Quote/Order must be reflected in the decrementation of its Quote/Order; the participant cannot simply back away from its Quote/Order because of trades performed elsewhere, or because it chooses not to do business with a counterparty.

## **Conclusion**

The auto-ex order strikes an appropriate balance between providing market participants with greater flexibility in determining the terms and conditions under which their orders will route and execute and providing ECNs with the opportunity to make their liquidity accessible through SuperMontage on terms that are consistent with their business models. Moreover, the proposal is consistent with precedents established by the Commission through its approval of Nasdaq's SuperSOES order processing and preferenced order processing, and Archipelago's fill-or-return order. Accordingly, NASDAQ firmly believes that the proposal is consistent with Section 15A of the Act, and should be approved.

We would be happy to discuss the proposed rule change with you 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  
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