EDWARD KNIGHT

EXECUTIVE VICE PRESIDENT

NASDAQ®

February 10, 2004

By Hand

The Honorable William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: **SR-NASD-2003-173; NASDAQ Closing Cross**

Chairman Donaldson:

On November 24, 2003, The Nasdaq Stock Market, Inc. ("NASDAQ") submitted an important rule proposal to improve certainty and transparency of the closing process on NASDAQ. The proposal establishes a Closing Cross for certain Nasdaq National Market securities ("Closing Cross") that is designed to bring together the maximum buy and sell interest at the close, execute it in a single cross, and quickly disseminate the crossing price to investors. NASDAQ believes that the Closing Cross is another beneficial step in NASDAQ's continuing efforts to improve its market structure and the way that market structure serves all investors.

After the official comment period ended, the American Stock Exchange ("Amex") and Bloomberg Tradebook LLC ("Bloomberg") submitted comments regarding that proposal.[1] Both Amex and Bloomberg have suggested ways that Nasdaq can improve the Closing Cross and thus better serve investors. NASDAQ addressed these comments in the enclosed letter. To summarize, Amex focuses primarily on a single aspect of the Closing Cross algorithm -- the threshold values that make up the "circuit breaker" for the Closing Cross -- that Amex mistakenly labels as subjective and discretionary. NASDAQ believes that the circuit breaker for the Closing Cross is necessary and appropriate to protect public investors and carefully tailored to operate only in those rare instances where such protection is needed.

Bloomberg objects to NASDAQ's determination that to participate in the Closing Cross, trading interest must be subject to automatic execution. NASDAQ firmly believes that the

---

[1]   *See* letters dated January 6, 2004, from Michael Ryan of The American Stock Exchange and from Kim Bang of Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Securities and Exchange Commission.

RECEIVED

FEB 1 1 2004

OFFICE OF THE SECRETARY
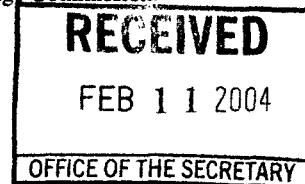
proposal is consistent with Section 15A of the Act, in that the Closing Cross requirement of automatic execution strikes an appropriate balance between providing an effective, rapid, and certain closing process for all market participants and providing ECNs with the opportunity to make their liquidity 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 Archipelago's closing auction. In light of the benefits to investors of this proposal – increased transparency, predictability, and reliability of closing prices on NASDAQ – NASDAQ strongly urges the Commission to approve the proposal quickly.

Thank you for considering our views.

Very truly yours,

Edward S. Knight

Enclosure

cc: The Honorable Paul Atkins, Commissioner
        The Honorable Roel Campos, Commissioner
        The Honorable Cynthia Glassman, Commissioner
        The Honorable Harvey Goldschmid, Commissioner
        Robert L.D. Colby, Deputy Director, Division of Market Regulation
        Annette Nazareth, Director, Division of Market Regulation
        Giovanni Prezioso, General Counsel

NASDAQ

January 23, 2004
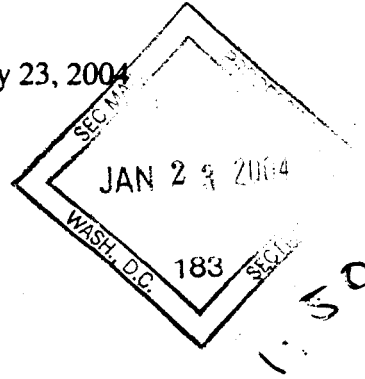
By Hand

Katherine England
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: **SR-NASD-2003-173; Response to Comments**

Dear Ms. England:

On November 24, 2003, The Nasdaq Stock Market, Inc. ("NASDAQ") submitted a rule proposal to establish a Closing Cross for certain NASDAQ National Market securities ("Closing Cross"). After the official comment period ended, the American Stock Exchange ("Amex") and Bloomberg Tradebook LLC (collectively, "Commentors") submitted comments regarding that proposal.[1] Both Amex and Bloomberg have suggested ways that NASDAQ can improve the Closing Cross and thus better serve investors. In addition, Bloomberg suggests erroneously that NASDAQ is statutorily obligated to accommodate Bloomberg's individual business model (ie, Bloomberg's choice to participate in SuperMontage via order delivery rather than automatic execution) in designing its closing cross. NASDAQ will address these comments in order.

Suggested Improvements To the Closing Cross. NASDAQ appreciates Amex's recognition that the proposed Closing Cross was undertaken to improve NASDAQ's closing process. While we welcome Amex's suggestions for ways to improve NASDAQ's close (and have modified the proposal as described below), we note that Amex considers itself to be a competitor of NASDAQ's and that Amex's comments are based largely on competitive animus and, to that extent, should be given little weight. The securities laws are designed to promote the process of competition and, as such, each market should be free to determine its own closing price methodology, provided its chosen method is consistent with the Exchange Act ("Act"). Putting aside Amex's vague hyperbole and misstatements, it has not identified a single way in which the Closing Cross proposal is inconsistent with the Act.

---

[1] *See* letters dated January 6, 2004, from Michael Ryan of The American Stock Exchange and from Kim Bang of Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Securities and Exchange Commission.

Amex focuses primarily on a single aspect of the Closing Cross algorithm -- the threshold values that make up the "circuit breaker" for the Closing Cross. In response, NASDAQ states unequivocally that it does not favor the use of a circuit breaker. We have designed the Closing Cross to avoid ever triggering the circuit breaker, but have included a circuit breaker as a prophylactic measure to protect investors. NASDAQ has strong incentives to design a Closing Cross that works and that does not rely on a circuit breaker. Market participants would much prefer to guarantee their customers an execution than rely on a circuit breaker and risk having orders cancelled and returned unexecuted. Market participants can offer such guarantees during the proposed Closing Cross by entering Imbalance Only orders to offset potential excess supply or demand. The dissemination of indicative price ranges for the continuous market and for the expected on close orders will enable market participants to plan their closing trading strategies and should produce a highly rational and predictable closing value.

Amex mistakenly labels the criteria for the circuit breaker as subjective and discretionary. Contrary to Amex's misstatements, the threshold percentage for the circuit breaker will be established well in advance and will be modified only in rare instances, such as index adjustments and options expirations, where the price discovery mechanism at the close is historically volatile. In no event will the threshold values be adjusted just prior to the close or even during the trading day. In fact, NASDAQ expects that any changes to the threshold value will be widely disseminated to market participants one week prior to adjustment.

Far from being a subjective adjustment process, as Amex claims, the Closing Cross algorithm, including the threshold comparison, will be completely automated and closely tied to market values at the close of the trading day. As stated in the original filing, NASDAQ carefully selected as benchmark values representing market conditions approximately five seconds prior to the close: (1) the Volume Weighted Average NASDAQ Inside ("VWAI") over the period from 3:59:54 to 3:59:57; and (2) the Volume Weighted Average Price ("VWAP") based upon SuperMontage executions over the period from 3:59:55 to 4:00:00. NASDAQ believes that the use of time and volume weighted benchmarks that are based on trading immediately before the close best reflect trading interest in NASDAQ on which to base any circuit breaker.

Based upon feedback from the industry, including Amex's comments, NASDAQ has decided to modify its proposal slightly to establish the VWAP as the exclusive benchmark value rather than rely on both the VWAP and the VWAI. NASDAQ believes that the VWAP accurately reflects actual trading interest just prior to the close. While the addition of the VWAI adds slightly to that information, it also appears to create unnecessary confusion about the algorithm, raising questions such as Amex's about the difference between the VWAI and VWAP and whether NASDAQ would use one or both benchmarks. Accordingly, NASDAQ will simplify the proposal by eliminating the VWAI as a benchmark.

Amex also ignores the fact that, to the extent that the circuit breaker is used, the threshold comparisons will be part of the Closing Cross calculation and not a later adjustment. If

the expected NASDAQ Crossing Price is within X% of the VWAP, the cross will occur at the expected NASDAQ Crossing Price. If the expected NASDAQ Crossing Price is more than X% from the benchmark, the NASDAQ Crossing Price will be calculated such that it is within the threshold percentage of the VWAP. The calculation of the closing price will follow the principles for crosses unaffected by the threshold percentages: maximizing volume executed, minimizing the imbalance of On Close orders, and minimizing the distance from the 4:00 SuperMontage bid-ask midpoint. The single-price execution that establishes the Closing Price will always be disseminated immediately at the close, even in rare cases where the threshold may be triggered. It will not be subject to any later adjustments.

Use of the NASDAQ Closing Cross is completely voluntary and competition will determine whether market participants consider the NASDAQ Closing Cross meaningful. NASDAQ's proposal simply improves one alternative closing process for industry participants to use. NASDAQ has no desire to coerce industry participants to use the Closing Cross, and it has no such coercive power. NASDAQ's proposal does not preclude the use of other closing processes that exist today, such as Amex's. If, as Amex argues, NASDAQ's methodology is flawed, then market participants will not utilize the Closing Cross and NASDAQ's attempt to compete will fail.

Based upon the overwhelmingly positive feedback NASDAQ has received, NASDAQ is confident that its chosen methodology is valid and likely to be accepted in the marketplace. NASDAQ's Closing Cross addresses market participants' stated desire for a rapid, certain closing price based upon the maximum trading interest possible. It also avoids pitfalls of other markets' closing processes, such as the inherent conflict of interest in giving specialists virtually unfettered discretion to set closing prices when those specialists have a large proprietary interest in those stocks. If market participants believe that more effective methods are available, NASDAQ will listen to all suggestions. In the meantime, market participants have many options open to them. In either case, competition will have occurred as contemplated by the Exchange Act.

Requirement of Automatic Execution. As stated in the original filing, NASDAQ has determined that to participate in the Closing Cross, trading interest must be subject to automatic execution. Bloomberg contends that this requirement is unfairly discriminatory and burdensome to competition because concerns about the response times of order-delivery ECNs are unfounded or could be addressed by mandating speedier responses or by different processing. On that basis, Bloomberg contends that the proposal is inconsistent with Section 15A(b)(6), (b)(8) and (b)(9) of the Exchange Act. NASDAQ disagrees.

First, it is important to understand the scope of the issue that Bloomberg is raising. Every market participant has the choice to participate in the Closing Cross in various capacities. They can participate on an agency basis by entering, or (in the case of ECNs) facilitating the entry of, Market-on-Close and Limit-on-Close orders, as well as Imbalance Only Orders, which will only execute during the Closing Cross. They can also have the opportunity, but not a

guarantee, to participate in the Closing Cross by entering standing limit orders into the continuous SuperMontage book that will interact in the Closing Cross if, and only if, the Closing Cross price intersects with the price of the standing orders. It is only those standing limit orders in the continuous SuperMontage book about which Bloomberg is commenting.

Second, Bloomberg fails to mention a key, even dispositive fact: Bloomberg can participate in the NASDAQ Closing Cross as proposed, but it has declined to do so at this time. Bloomberg like other ECNs, can participate in SuperMontage throughout the day on an automatic execution basis across all orders. In that case, Bloomberg's customers would participate in the NASDAQ Closing Cross by submitting On-Close and Imbalance Only orders that would only execute during the Closing Cross, as well as submitting standing limit orders that are available for automatic execution in the continuous market leading into the Closing Cross. Bloomberg voluntarily chooses not to participate on an automatic execution basis because its business model is designed to isolate orders within its system and to preserve internal executions as much as possible. This choice is certainly understandable but not one that should limit NASDAQ to a less effective closing process.

Alternatively, Bloomberg can participate in SuperMontage on an order delivery basis throughout the day but participate in the Closing Cross on an automatic execution basis, changing its participation for only a few seconds each day. NASDAQ has programmed the Closing Cross such that all quotes and orders entered by order delivery participants (like Bloomberg) that reside on the book at market close would be cancelled unless the order delivery firm elects to participate in the Closing Cross. If an order delivery participant elects to join the Closing Cross, NASDAQ will not cancel their quotes or orders and will execute them in the Closing Cross on the same basis as the orders of automatic execution participants. In that case, Bloomberg customers would have the same options as automatic execution participants: to enter quotes and orders that are specifically designated as Market-on-Close, Limit-on-Close or Imbalance Only or to submit standing limit orders into the SuperMontage continuous book. Customers choosing those options would understand that such orders would be eligible for execution in the Closing Cross if appropriately priced.

It is clear that there are multiple options that Bloomberg could pursue to satisfy its customers' interest in participating fully in the NASDAQ Closing Cross. In addition to the options described above, Bloomberg could also route standing limit orders through another participant that participates on an automatic execution basis or could discuss with NASDAQ the possibility of establishing a second market participant identifier for the entry of orders eligible to participate in the Closing Cross. Instead, for its own business reasons, Bloomberg prefers its customers to execute orders internally within Bloomberg's book, rather than choosing to offer its customers the ability to participate in the NASDAQ Closing Cross. It is Bloomberg's choice to make, and it should not impede NASDAQ from proceeding with this important, yet optional, market enhancement.

Third, the inherent risks to market participants and to NASDAQ of order delivery participation in the close – execution delay and possible rejection of orders – are fundamentally inconsistent with the operation of a closing cross. NASDAQ sought input from all quarters of the securities industry and determined that the most effective closing process for the NASDAQ market and for SuperMontage would be a single closing cross. To effect a closing cross, NASDAQ must take a snapshot of the marketplace at the instant of the close, determine the most accurate value for each security based on trading interest within the system, and then execute the most shares possible at that instant at a single price for each security. To accomplish all three goals, all trading interest in the closing cross must be available for automatic execution. The cross is inherently a "match" – matching interest of buyers and sellers at a single instant in time – and is not conducive to an iterative order delivery process.

Rather than participate on an automatic execution basis, Bloomberg suggests including order delivery trading interest in the Closing Cross.[2] NASDAQ believes this would create substantial technical difficulties for NASDAQ and unwarranted risk to other market participants. The Closing Cross algorithm was carefully designed to select a closing price based upon all trading interest within SuperMontage at a given time. If any of that interest were unavailable for execution, NASDAQ would have to rerun the Closing Cross algorithm, potentially multiple times, to identify and execute at a new closing price. This would needlessly delay the execution of the Closing Cross and would often result in less beneficial price for other investors whose trading interest is subject to automatic execution.

Bloomberg argues that any concerns about delayed executions are overblown or could be addressed by establishing more stringent standards for the response times of order-delivery ECNs. This is simply incorrect. 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. If the ECN decides to accept the order (which is optional), 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 cancels and reprocesses the order.[3] 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

---

[2] Bloomberg has offered several interesting options for improving the Closing Cross in a manner that satisfies Bloomberg, and NASDAQ is engaged in an on-going dialogue with Bloomberg to accomplish that result. Regrettably, however, Bloomberg rebuffed NASDAQ's attempts to discuss the Closing Cross proposal during the months that NASDAQ made key decisions and began programming the system and brought these suggestions to NASDAQ only recently. NASDAQ is open to including Bloomberg's suggestions in a later iteration of the Closing Cross, but it is unable to do so at this late date.

[3] In approving a new order type for NASDAQ, the Division stated "[I]f an order is rejected and returned to SuperMontage, market conditions, especially during a fast market, may change and the order may receive an inferior execution." Exchange Act Release 49020 (Jan. 5, 2004). This problem could be magnified during the Closing Cross because a rejected order may receive an inferior execution or no execution at all.

between SuperMontage and the ECN, involve delays not present in the case of automatic executions.

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. Although, in non-peak hours of the trading day, 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 response times are much higher during the market open and market close. In fact, the average round-trip processing time for all order-delivery orders during the market close exceeds one second on the majority of trading days. For example, during November 2003, 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. By contrast, the processing time for automatic executions is between 0.006 and 0.01 seconds. While NASDAQ always seeks to work with ECNs to improve response times during peak-hours, it is not feasible to expect ECNs to guarantee a sub-second response time for every order. Without that guarantee, NASDAQ risks unnecessary and harmful delays to the execution of the Closing Cross.

In addition, as Bloomberg concedes, there is always a 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 or if another SuperMontage participant's order arrives first. By rule, ECNs are given the opportunity to reject orders that are presented to a Quote/Order that is still displayed in SuperMontage. Although Bloomberg claims a rejection rate of only 3%, Bloomberg is not the only ECN that participates in SuperMontage. During the month of November 2003, 23% of orders delivered to an ECN's Quote/Order were rejected and rejection of orders is particularly prevalent during the current market close. That being said, if Bloomberg believes that its acceptance rate, even during peak hours, is as high as 97%, it should not view automatic execution at one instant each day to be a burdensome risk, in exchange for enabling all of its clients to participate in the Closing Cross.

Fourth, it is important to remember that the Closing Cross is just one aspect of NASDAQ's operations, and that NASDAQ has accommodated ECNs in almost every aspect of trading, and certainly far more than any other market. 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 were 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
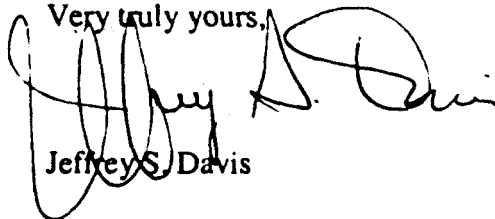
SuperMontage to be a bad credit risk that may not promptly pay the ECN's access fee. As a result, the ECN has considerable flexibility to determine the terms and conditions under which its orders will interact with SuperMontage orders.

No other market offers ECNs the flexibility that NASDAQ does. For example, the Archipelago Exchange 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 does route orders to other market centers for execution, but only after they have accessed all liquidity available through Archipelago, and even then, Archipelago allows a market participant to forgo this routing function. Thus, Archipelago effectively excludes ECNs from direct participation in its market. In fact, the Commission recently approved Archipelago's closing auction as an automatic execution only algorithm that effectively excludes ECN participation.[4]

Conclusion

NASDAQ firmly believes that the proposal is consistent with Section 15A of the Act, and should be approved. The circuit breaker for the Closing Cross is reasonably designed to protect public investors and carefully tailored to operate only in the rarest of instances where such protection is absolutely needed. The Closing Cross requirement of automatic execution strikes an appropriate balance between providing an effective, rapid, and certain closing process for all market participants 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 Archipelago's closing auction. In light of the benefits to investors of this proposal – increased transparency, predictability, and reliability of closing prices on NASDAQ – NASDAQ strongly urges the Commission to approve the proposal quickly.

Very truly yours,

Jeffrey S. Davis

---

[4] The Archipelago closing auction also includes several features about which Amex has commented. For example, like the NASDAQ Closing Cross, Market-on-Close Orders that are eligible for, but not executed in the Archipelago Closing Auction, would be cancelled immediately upon conclusion of the Closing Auction. Also, Archipelago, like NASDAQ, has reserved the ability to adjust certain aspects of its auctions in the interest of maintaining fair and orderly markets.