



July 13, 2004

**Via e-mail: rule-comments@sec.gov**

U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549-0609

Attention: Mr. Jonathan G. Katz, Secretary

**Re: SR-NASD-2004-071**

Ladies and Gentlemen:

Bloomberg Tradebook LLC (“Bloomberg Tradebook”) wishes to comment on the above-captioned proposed rule change filed by the National Association of Securities Dealers, Inc. (the “NASD”), through its subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), which the Commission published for comment in Securities Exchange Act Release No. 49842 (June 9, 2004) (the “Release”). Nasdaq’s proposal (the “Opening Cross Proposal”) would introduce certain changes into the opening process for Nasdaq securities.

As described in the Release, the Opening Cross Proposal has four components: (1) creation of the Nasdaq Opening Cross; (2) creation of a Modified Opening Process for Nasdaq-listed securities that do not participate in the Nasdaq Opening Cross; (3) elimination of the Trade-or-Move process contained in NASD Rule 4613(e) and opening quotations at 9:25 a.m. rather than 9:29:30 a.m.; and (4) creation of voluntary order types designated On Open, Imbalance Only and Extended Hours as well as the application of new time-in-force rules for existing orders. As with Nasdaq’s closing cross,<sup>1</sup> in calculating an official price for the opening, Nasdaq would exclude orders of ECNs that opt to take order delivery via SuperMontage. That is, the opening price would be based solely on the liquidity of auto-execution participants in SuperMontage and would exclude liquidity of ECNs that have elected to receive order delivery rather than executions.

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<sup>1</sup> See Securities Exchange Act Releases No. 48878 (December 4, 2003) and 49406 (March 11, 2004).

With the elimination of the current Trade-or-Move process, all market-maker quotations displayed in the pre-market between 7:30 a.m. and 9:25 a.m. will become firm orders at 9:25 a.m. Those orders will be processed in the SuperMontage algorithm and will be subject to automatic execution. To the extent a quotation from an ECN participating in SuperMontage locks or crosses a market-maker order, we understand from Nasdaq representatives the SuperMontage algorithm will match the two and provide an auto-execution to both the participating ECN and the market maker. This means that, in effect, the Nasdaq market will open at 9:25 a.m. This development is nowhere discussed, nor is the rationale behind it explained, in the Release.

### **Nasdaq's Proposed Rule Change Would Harm Investors and the Nasdaq Market**

Nasdaq's proposed treatment of pre-opening pricing information is confusing and inappropriate. Market makers' "quotations" are in fact indicative only, but participating ECNs treat their pre-9:30 quotations as firm and effect transactions at their quoted prices before 9:30. Mixing firm and indicative quotations into an undifferentiated data stream is not in the public interest. We have recommended to Nasdaq a number of times over the past several years that they do away with their "opening spin", in which the prior evening's closing quotations are rebroadcast at 7:30 a.m. the following morning as the new day's quotations. The markets would be better served with a rule akin to the one in the Nasdaq after-market, in which market makers may voluntarily quote but their quotations must be firm.

Nasdaq represents that its Opening Cross Proposal is intended to "improve the pre-open trading environment for Nasdaq-listed securities. . . . [and] is designed to create a more robust opening that allows for price discovery, and executions that result in an accurate, trading opening price."<sup>2</sup> We note, however, that Nasdaq's Opening Cross Proposal is hobbled by the same defect, one that compromises the accuracy and utility of its closing cross. To be executable at the Nasdaq closing cross, Nasdaq requires all orders and quotes to be subject to automatic execution on SuperMontage.<sup>3</sup> In effect, requiring automatic execution on SuperMontage for inclusion in the closing cross eliminates from the closing cross the open orders of participating ECNs. Nasdaq has now introduced the same defect in its Opening Cross Proposal, though the exclusion of participating ECNs is not explicitly set forth in the Release. We support Nasdaq's goal of improving the pre-market trading environment and creating a more robust opening that allows for price discovery, but we believe that excluding the liquidity of participating ECNs is unnecessary and inappropriate for it impedes broker-dealers seeking to obtain best-execution and harms investors.

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<sup>2</sup> See Securities Exchange Act Release No. 49842 (June 9, 2004), in text before note 6.

<sup>3</sup> See Securities Exchange Act Release No. 48878 (December 4, 2003), Section II.A.1. Purpose.

In our comment to the Commission on Nasdaq's closing cross proposal, we noted that a significant portion of trades in Nasdaq securities occurs on participating ECNs, all of which have elected order delivery rather than auto-execution, and that the closing cross likely will exclude significant liquidity — particularly given the aggregate market share of ECNs that participate in SuperMontage (principally BRUT and Bloomberg Tradebook).<sup>4</sup> Inevitably, the result is an inaccurate, incomplete and misleading closing price.

Nasdaq's proposal now to exclude participating ECNs from its proposed opening process would lead to similar problems and would harm participating ECNs and their investor participants. Ignoring participating ECN liquidity that may offer price improvement also would make it more difficult for broker-dealers participating in SuperMontage to meet their best-execution obligations.

Our earlier prediction about Nasdaq's closing cross in fact proved accurate. At the Nasdaq closing price on June 25, 2004, Altera Corp. (ALTR) crossed some \$4.00 above the continuous market for a total of 847,500 shares. At \$4.00 per share, the cost to investors (and the windfall to others) was \$3,390,000. The trading price in ALTR immediately before the closing cross was between \$21.50 and \$21.60. At the closing cross, the price changed to \$25.50. Immediately after the closing cross, ALTR was trading between \$21.55 and \$21.65. Attached as Exhibit A is a graph showing the trading prices of ALTR 10 days before and five days after the Russell rebalancing.

Two other stocks exhibited similar deviations from their continuous markets. At its Nasdaq closing price on June 25, 2004, Cisco Systems Inc. (CSCO) crossed at 50¢ below the continuous market for a total of 7,452,000 shares. At some 50¢ per share, the cost to investors (and the windfall to others) was \$3,726,000. The trading price in CSCO immediately before the closing cross was between \$23.40 and \$23.45. At the closing cross, the price changed to \$22.97. Immediately after the closing cross, CSCO was trading between \$23.35 and \$23.40.

At its Nasdaq closing price on June 25, 2004, Integrated Device Technology, Inc. (IDTI) crossed at some 57¢ below the continuous market for a total of 1,393,000 shares. At 57¢ per share, the cost to investors (and the windfall to others) was \$794,000. The trading price in IDTI immediately before the closing cross was between \$13.66 and \$13.77. At the closing cross, the price changed to \$13.20. Immediately after the closing cross, IDTI was trading between \$13.70 and \$13.85.

These three examples were among a sampling of closing cross prices on that date where the price variation was at or near the 20% maximum Nasdaq allows before stopping the closing cross. The fact that Nasdaq will permit closing crosses to occur where there is a variance

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<sup>4</sup> Letter dated January 6, 2004 from Bloomberg Tradebook LLC in SEC File No. SR-NASD-2003-173, available at: <http://www.sec.gov/rules/sro/nasd/nasd2003173.shtml>.

of as much as 20% testifies to the problem of the lack of liquidity in SuperMontage and disregard for best-execution practices and the interests of investors.

These occurrences are not isolated. They show in graphic terms the problems arising from the Nasdaq decision to exclude participating ECNs from the close. That decision has harmed the broader market, including brokers who offer their clients' orders at the Nasdaq opening price, particularly given the percentage of SuperMontage volume attributable to participating ECNs. Especially at risk are mutual funds and others who calculate their net asset value at the closing price. The result in the case of mutual fund pricing is that investors buying or selling shares of a fund that holds one or more of the affected securities in its portfolio and that calculates its net asset value on the basis of faulty Nasdaq closing prices are treated either too well or not well enough.

Nasdaq had no legitimate basis for excluding ECNs participating in SuperMontage from its closing cross and it has offered none for excluding such ECNs from its opening process. Excluding participating ECNs from the proposed opening process will ensure similar inaccuracy and uncertainty for price discovery. We offered Nasdaq an alternative algorithm to resolve the technical issues it claimed underlay its exclusion of participating ECNs from its then proposed closing cross. Nasdaq responded to our offer by having a series of meetings, none of which led to any changes.

If there are any technical concerns underlying Nasdaq's exclusion of participating ECNs from the Opening Cross Proposal, they are not identified in the Release. We are, however, prepared to work with both Nasdaq and the Commission in resolving such issues. We believe that a filing that fully discloses all relevant information regarding Nasdaq's Opening Cross Proposal also would offer opportunities for interested market participants to propose alternative solutions. Pending such fuller disclosure of its proposal and the opportunity for fully informed public comment, we think the Commission must withhold approval of Nasdaq's Opening Cross Proposal.

### **Nasdaq Has Buried Secret Rules In Its Technical Specifications**

As we recently noted in our comment to the Commission on proposed amendments to Rule 19b-4, we believe the Commission should require SROs to file as rule changes on Form 19b-4 significant regulatory requirements embedded in technical specifications, contracts, and other materials that they have up to now declined to file with the Commission.<sup>5</sup> The current Release provides further evidence of the urgency of the problem.

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<sup>5</sup> See letter of Bloomberg Tradebook LLC to the Commission, dated June 8, 2004, in SEC File No. S-7-18-04 commenting on proposed amendments to Rule 19b-4.

The question of when an SRO action constitutes a rule was recently the subject of the Commission's well-reasoned opinion in *Matter of Bloomberg L.P.*, in which the Commission set aside display requirements the NYSE had inserted into its vendor display agreements.<sup>6</sup> The Commission pointed out in its opinion that requirements amounting to rules must be subjected to the Exchange Act Section 19(b) procedures for self-regulatory organization rule changes even if they are buried in contracts or other documents the SRO does not label as "rules". We are concerned that the several characteristics of the Nasdaq system discussed above impose "extensive and specific limitations on particular types of . . . conduct" that are not apparent from the face of the[proposed] rule"<sup>7</sup> and that have significant regulatory effects and should have been the subject of public disclosure and public comment. They should not have been buried in technical specifications Nasdaq did not include in its filings or make public on its website.<sup>8</sup>

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<sup>6</sup> Securities Exchange Act Release No. 49076 (January 14, 2004), available at: <http://www.sec.gov/litigation/opinions.shtml>. We think the Commission's comment on the scope of interpretations not constituting rules was particularly appropriate:

Although we have stated that the 'limits' of the 'reasonably and fairly implied' exception [to the definition of "rule" in Rule 19b-4] will be determined on a case-by-case basis, we have warned that 'a stated policy, practice, or interpretation that prescribes extensive and specific limitations on particular types of transactions or conduct that are not apparent from the face of the existing rule is not 'reasonably and fairly implied' by the rule.' We also have explained that the 'concerned solely with the administration' exception applies to 'policies, practices, or interpretations that deal solely with 'housekeeping' matters.

*Id.* in text at nn. 19-20 [footnotes omitted].

<sup>7</sup> *Id.*

<sup>8</sup> We made a similar observation about *de facto* rules in the SuperMontage software. In our letter of September 12, 2000, in SEC File No. SR-NASD-99-53, commenting on the need for greater disclosure about the proposed workings of SuperMontage, we stated:

Even in the case of more routine filings, the Commission's review of self-regulatory organization rules should be done in a way that permits both the Commission and the public to understand key aspects of a self-regulatory organization's proposal. In the case of a conduct rule, the text of the rule, together with whatever interpretive or explanatory information the self-regulatory organization chooses to append, normally would suffice. In the case of a filing having the market-wide significance and impact of the SuperMontage, however, it is not sufficient for the NASD to publish just the text of what it chooses to print in its rulebook, together with a brief description. What is needed is a full explanation, either in the rule filing itself or on a website or other identified, publicly available source, of how the system would function, including the text of the specifications or, in the NASD's case, system "requirements" (the "SuperMontage Requirements"). Indeed, in this instance, we believe the SuperMontage Requirements, which instruct the programmers on what the programs are to achieve, should be regarded as an integral part of the proposed rules the Commission should review under the Exchange Act and, accordingly, should be published . . . for public inspection and comment.

As technology advances and more and more regulatory requirements are built into software and market algorithms rather than written out into the SROs' official rulebooks, the importance of subjecting these electronic requirements to Commission jurisdiction and approval will become ever more apparent. Here, Nasdaq has failed to include in its Rule 19b-4 filing with the Commission significant aspects of its proposed Nasdaq opening process that are imposed electronically and that clearly short change investors. At a minimum, before approving the proposed rule changes, the Commission should require Nasdaq to make the relevant software specifications available to interested members of the public on the SROs' websites to facilitate fully informed public comment.

Nasdaq's Opening Cross Proposal would significantly short change investors, but that result cannot be identified by a reading and analysis of the Release alone. In addition, the 9:25 a.m. opening of SuperMontage under the proposal will for the first time force ECNs to take auto executions. As noted above, we became aware of these issues solely on the basis of conversations with Nasdaq technical staff.

### **Nasdaq's Proposed Rule Change is Illegal**

The Opening Cross Proposal, in addition to being flawed in its design, is illegal. As the Commission knows, Section 15A(b)(6) of the Securities Exchange Act of 1934 (the "Exchange Act") requires that the rules of a securities association not be designed "to permit unfair discrimination between customers, issuers, brokers, or dealers." Nasdaq has not provided any basis for excluding from its Opening Cross Proposal ECNs that elect not to accept automatic executions on SuperMontage nor for imposing on those ECNs automatic executions at the 9:25 a.m. opening. Section 15A(b)(6) also requires the rules of a national securities association to "remove impediments to and perfect the mechanism of a free and open market and a national market system." By walling off an essential facility of its market from key participants, Nasdaq's proposal would impose a direct impediment to free and open markets and would weaken the national market system.

Section 15A(b)(8) of the Exchange Act requires the rules of a national securities association to provide a fair procedure for "the prohibition or limitation by the association of any person with respect to access to services offered by the association or a member thereof." We respectfully submit to the Commission that Nasdaq's Opening Cross Proposal also constitutes a constructive denial to participating ECNs of access to an essential service offered by Nasdaq, that is, full participation in the proposed opening cross.

### **Conclusion**

For these reasons, we respectfully advise the Commission that it may not lawfully approve the Proposed Rule Change as submitted and we recommend that the Commission direct the NASD to revise its proposal (i) to build into the proposed rule change submitted for approval those elements of the software that properly should be regarded as rules, (ii) to include ECNs that do not accept automatic executions on SuperMontage in the opening cross and (iii) to conduct its proposed 9:25 a.m. opening so that it is consistent with the rest of the SuperMontage

processing day in delivering orders to ECNs rather than requiring them to take automatic executions.

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We hope our letter is helpful to the Commission and the staff in their review of the Opening Cross Proposal. If members of the Commission or of the staff believe we may be of further assistance in these matters, please let us know.

Respectfully submitted,

BLOOMBERG TRADEBOOK LLC

By:

*Kim Bang* by R.D.B.

President and Chief Executive Officer

Attachment

cc(w/att.): The Hon. William H. Donaldson, Chairman  
The Hon. Paul S. Atkins, Commissioner  
The Hon. Cynthia A. Glassman, Commissioner  
The Hon. Harvey J. Goldschmid, Commissioner  
The Hon. Roel C. Campos, Commissioner  
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**EXHIBIT A**

