Bloomberg
TRADEBOOK LLC
Member NASD/SIPC

May 20, 2005

<u>Via e-mail: rule-comments@sec.gov</u>

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

Attention: Mr. Jonathan G. Katz, Secretary

Re: <u>Commission File No. SR-NASD-2005-013</u>

Ladies and Gentlemen:

We are writing to express our concern about what we believe to be the anticompetitive and unfairly discriminatory effects of the above-captioned proposed rule change (the "Nasdaq Proposal") submitted to the Securities and Exchange Commission (the "Commission") by the National Association of Securities Dealers, Inc (the "NASD") through its wholly controlled subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"). The Commission published the Nasdaq Proposal for public comment in Release No. 34-51609 (April 26, 2005), 70 Fed. Reg. 22733 (May 2, 2005).

The Nasdaq Proposal is a direct result of Nasdaq's recent acquisition of INET ECN. Following closely upon Nasdaq's acquisition of BRUT ECN, the acquisition of INET ECN will more than double Nasdaq's share of trading volume in Nasdaq listed securities. The merger of the New York Stock Exchange (the "NYSE") and Archipelago Holdings, together with the Nasdaq acquisitions, have eliminated three of the most dynamic and innovative ECNs in the United States, effectively transforming the U.S. securities markets into a duopoly. Consistent with Nasdaq's enhanced market power, a key goal of the Nasdaq Proposal is to consolidate Nasdaq's market dominance by eliminating any remaining competition and erecting barriers to the entry of new competitors. It demonstrates vividly the risk to the public interest that follows from the merger of two 25%-market-share competitors in a highly concentrated market.

The Nasdaq Proposal, insofar as it would prohibit ECNs from charging access fees, is unnecessary in light of the Commission's Regulation NMS, which already caps access fees. The Nasdaq Proposal in effect trumps the SEC's regulation and has no legitimate regulatory purpose. Its true purpose is to further Nasdaq's commercial objectives at the expense of investors and the public interest.

The Nasdaq Proposal gives the appearance of creating a uniform pricing structure applicable to all users of the Nasdaq Market Center, but given the broader market context in which it would operate, it would instead impose a non-uniform and highly discriminatory pricing structure. To accomplish this, Nasdaq proposes, among other things, to require that electronic communications networks ("ECNs") and alternative trading systems ("ATSs") that participate in the Nasdaq Market Center not charge any fee to broker-dealer clients that access them through the Nasdaq Market Center.[1]

If Nasdaq were allowed to impose that prohibition, ECNs would be unable to charge for access to their own quotations within the Nasdaq Market Center environment. Nasdaq states that ECNs unhappy with the new rule would have a choice: they could display on the Alternative Display Facility (the "ADF") and charge access fees. That suggestion is specious. The ADF was a possibly viable alternative when Nasdaq's SuperMontage competed for order flow with several other large market venues — most notably Instinet, which bypassed SuperMontage and printed its trades on the National Stock Exchange. With the advent of the Nasdaq and NYSE duopoly, however, the ADF will no longer be an alternative venue. In practice, no market participant will be able to forego participation in one or the other of these concentrated liquidity pools.

Bloomberg Tradebook has long opposed ECN access fees and we have long argued for their complete elimination across all market centers. We have not unilaterally ceased charging access fees because we are compelled to pay them to other market centers and it would be extremely disadvantageous to have to pay them and then not be able to collect offsetting fees. Nasdaq's Proposal, however, would put Bloomberg Tradebook exactly in that box. INET will still be able to charge access fees because it quotes its prices on the National Stock Exchange rather than on the Nasdaq Market Center.[2] ARCA has its own exchange and will be able to continue charging access fees. Bloomberg Tradebook has to be able to access liquidity on both INET and ARCA and will have to continue to pay access fees to do so.

The access fee revenue INET would gain will ultimately accrue to Nasdaq. In effect, Nasdaq would appropriate the margins of its ECNs as monopoly rents and make it more

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[1] The Nasdaq Proposal also would eliminate the separate $0.001 fee it currently imposes on market participants for non-directed or preferenced orders that access the quotes/orders of ECNs. That fee should indeed be deleted because it imposes a toll on the sending of orders to an ECN.

[2] Access fees are an important source of revenue for INET. Instinet reports: "INET's revenues consist primarily of fees charged to customers for trade execution services, including matching shares in our marketplace or routing orders to other marketplaces, as well as market data revenue we earn related to trades reported to exchanges." (Instinet Group Incorporated, Annual Report on Form 10-K for the fiscal year ended December 31, 2004, Part II, Item 7, Management Discussion and Analysis of Financial Condition and Results of Operations, Revenues.)

expensive for Bloomberg Tradebook and the other ECNs to operate in the Nasdaq Market Center. There is no legitimate regulatory reason for that result.

There is an additional, hidden aspect to the Nasdaq proposal. Upon its acquisition of BRUT, Nasdaq has converted BRUT into a facility of Nasdaq. As a result, Nasdaq can charge an access fee to participants who access liquidity on BRUT and Nasdaq uses those access fees to grant rebates to participants posting liquidity on the BRUT facility. This preserves the pricing power of BRUT and enables BRUT to attract order flow by offering rebates which other ECNs participating in the Nasdaq Market Center would no longer be able match if the Nasdaq Proposal is approved. We can foresee that Nasdaq may well pursue the same end with INET.

The Nasdaq Proposal is thus designed to undercut the viability of ECNs that participate in the Nasdaq Market Center and erects a regulatory barrier to the entry of new ECNs into the securities markets. The Nasdaq Proposal not only is anticompetitive in that the burden of the new rule would fall exclusively on ECNs, but it is also unfairly discriminatory. The resulting burdens on ECNs would tend to diminish their competitive force and their innovative contributions to the markets, both of which the Commission has recognized as important for investors.

The Nasdaq Proposal would impose a burden on competition in contravention of Section 15A(b)(9) of the Securities Exchange Act of the 1934 (the "Exchange Act"). In disadvantaging only certain brokers participating in the Nasdaq Market Center, that is, ECNs that use the Nasdaq Market Center, the Nasdaq Proposal also is designed to discriminate unfairly against those broker-dealers, in contravention of Exchange Act Section 15A(b)(6). We note that in both its Form 19b-4 filing and in the release, the NASD provides little more than a standard, boilerplate disclaimer regarding the burdens on competition its proposed rule would impose. That of course does not constitute even minimal compliance with Item 4 of Form 19b-4,[3] nor

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[3] As the Commission is aware, the General Instructions to Form 19b-4, 5 Fed. Sec. L. Rep. (CCH) ¶ 32,356, are explicit on the point. They provide, with respect to "Information to be Included in the Completed Form," as follows:

> 4. *Self-Regulatory Organization's Statement on Burden on Competition*
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> State whether the proposed rule change will have an impact on competition and, if so, (i) state whether the proposed rule change will impose any burden on competition or whether it will relieve any burden on, or otherwise promote, competition and (ii) specify the particular categories of persons and kinds of businesses on which any burden will be imposed and the ways in which the proposed rule change will affect them. If the proposed rule change amends an existing rule, state whether that existing rule, as amended by the proposed rule change, will impose any burden on competition. If any impact on competition is not believed to be a significant burden on competition, explain why. Explain why any burden on competition is necessary or appropriate in furtherance of the purposes of the [Exchange] Act. In providing those explanations, set forth and respond in detail to written comments as to any significant impact or burden on

(Footnote continued)

does it put the Commission in a position to comply with the congressional directive to balance burdens on competition against the purposes of the Exchange Act.[4]

The effects of the Nasdaq Proposal, and we expect the intent behind it, are hardly consistent with Chairman Donaldson's vision, expressed yesterday in his testimony before the Senate Banking Committee, that Regulation NMS will lead to greater competition:

> In the future, I anticipate a continuation of the longstanding battle for market share in Nasdaq stocks, particularly after implementation of the new trade-through rule. . . . After the trade-through rule is implemented, this enormous volume of trading will be required to interact with the best displayed prices on the electronic limit order books. This heightened competition among orders is likely to produce significant benefits for investors in the form of deeper, more liquid markets and more efficient pricing. . . .
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> In addition, . . . I would expect smaller, innovative markets to continue to compete effectively even after the consolidations. The trade-through rule will enhance the ability of smaller markets to attract order flow by offering the best

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(Continued footnote)

> competition perceived by any person who has made comments on the proposed rule change to the self-regulatory organization. *The statement concerning burdens on competition should be sufficiently detailed and specific to support a Commission finding that the proposed rule change does not impose any unnecessary or inappropriate burden on competition* [emphasis added].

Id. at p. 22,318.

4 *See*, e.g., *Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing, and Urban Affairs to Accompany S. 249,* S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975), at 29: "It is the Committee's intention in adopting [the Section 19(b)] standard to hold the self-regulatory organizations to the same standards of policy justification that the Administrative Procedure Act imposes on the SEC." Those standards require that the public notice — in this case public notice concerning burdens on competition — be sufficiently detailed and truthful to give the public a chance to decipher what is going on. *See, Home Box Office v. Fed'l Communications Comm'n,* 567 F.2d 9, 36 (D.C. Cir. 1977):

> [A]n agency proposing informal rulemaking has an obligation to make its views known to the public in a concrete and focused form so as to make criticism or formulation of alternatives possible. Second, the 'concise and general' statement that must accompany the rules finally promulgated 'must be accommodated to the realities of judicial scrutiny, which do not contemplate that the court itself will, by a laborious examination of the record, formulate in the first instance the significant issues faced by the agency and articulate the rationale of their resolution. . . . [The record must] enable us to see what major issues of policy were ventilated by the informal proceedings and why the agency reacted to them as it did [citations omitted].'

> price, and I believe market participants will have an interest in sending order flow to these additional markets to preserve multiple options for order executions.[5]

The Nasdaq Proposal goes in just the opposite direction. It would take away the independent pricing power of ECNs that participate within the Nasdaq Market Center. And we believe this is motivated by, and the result of, Nasdaq's merger with INET ECN and the resulting duopoly. Nasdaq is taking this step to crush the smaller players that may be potential competitors and innovators. Having just paid for BRUT and INET, Nasdaq is now strong enough to say there will be no more alternative systems. The remaining ECNs are easy prey.

We expect Nasdaq is showing the Commission and the public the thin edge of a wedge. As Nasdaq/INET uses and abuses its new market power, it will manifest its market dominance in other ways. For instance, once exchanges crush the remaining ECNs, we can fully expect to see the disappearance of the ECN model of free distribution of depth-of-book data and the disappearance of the innovation competition they have provided to the traditional exchanges. The Nasdaq Proposal is a harbinger of what can be expected to result from excess market concentration. It is an outgrowth of burgeoning and excessive market power that is inherently anticompetitive. It should not be permitted to grow unchecked.

The solution, in connection with this particular filing, would be for the Commission to reject that part of the Nasdaq Proposal that would prohibit ECNs using the Nasdaq Market Center to charge access fees allowable under the Commission's Regulation NMS. The solution more broadly is for the Commission to use its powers under the Exchange Act to promote competition and to reject regulatory approaches that inappropriately burden or suppress competition in this suddenly concentrated market.

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

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5 Chairman Donaldson, Testimony Concerning Recent Developments in the Equity Markets, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (May 19, 2005), available at: http://www.sec.gov/news/testimony/ts051905whd.htm. Of course, the fact that the Commission's trade-through rule will allow dominant markets to match better prices quoted elsewhere rather than ship orders to those other venues will give them the power and the incentive never to ship orders, thereby taking away from the other venues the incentive to offer price improvement and destroying their ability to offer meaningful competition to the dominant markets. Indeed, the New York Stock Exchange's "hybrid" market proposal, if approved in its current form, would give NYSE specialists the ability to install matching engines, erecting a reinforced barricade against ever having to ship orders to market venues outside the NYSE. *See*¸ e.g., proposed NYSE Rule 15A.50 and 104 (c) SEC File No. SR-NYSE-2004-05, published in SEC Release No. 34-50667 (November 15, 2004) at pp. 11, 19-21, available at http://www.sec.gov/rules/sro/nyse/34-50667.pdf.

Respectfully submitted,

Kim Bang by R.D.B.

cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
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