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Via Electronic Mail (preziosog@sec.gov)

Giovanni P. Prezioso, Esq.
General Counsel
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Commission File No. SR-NASD-2005-013

Dear Mr. Prezioso:

Thank you for the opportunity you afforded us and our counsel on December 7, 2005 to explore both the legal and anticompetitive issues raised by our letters to the Commission of May 20, and August 26, 2005 commenting on the proposed NASD rule that would prohibit ECNs that participate in the Nasdaq Market Center from charging access fees. We appreciated the opportunity to discuss these issues with you and your colleagues, including Dr. Spatt, Dr. Lightfoot and staff of the Division of Market Regulation.

We are writing to respond more fully to two questions that were raised and discussed on the call:

1) To what extent would the proposed NASD rule impose a burden on competition?

2) Does the prohibition in Section 15A(b)(6) of the Securities Exchange Act of 1934 (the "Exchange Act") against NASD rules fixing rates of commissions or other fees charged by their members effectively limit the NASD's ability to regulate ATSs and ECNs as opposed to members generally?

Anticompetitive Effects of the Proposed Rule

As you know, we have criticized Nasdaq's rule on the basis that it restrains competition. Dr. Spatt noted that the Alternative Display Facility provides an alternative venue of sorts and asked us whether there are any published data concerning ADF volume. As it happens, volume data concerning the ADF and all trading in Nasdaq-quoted securities are available right on the BLOOMBERG PROFESSIONAL Service. To access ADF data, type

MVOLUD, hit the Index key at the top right of the keyboard (a yellow key F10 on many Bloomberg keyboards), type GP and then hit the GO key (the Enter key on some keyboards). To access data on all trading in Nasdaq-quoted securities, type MVOLQE, hit the Index key, type GP and then hit the GO key. You will see the ADF is hardly a competitive venue. Reported daily volume on the ADF averages around fifteen million shares out of a total daily volume in Nasdaq-quoted securities of approximately 1.7 billion shares. The regional exchanges currently offer little more, individually or in the aggregate.

In its December 8, 2005 letter, Nasdaq points out (on pp, 2-3) that Nasdaq's fee regime causes liquidity takers that take liquidity from a fee-charging ECN to pay a $0.10 per 100-share charge they would not incur if they took liquidity either from a Nasdaq market maker or from an order-entry firm supplying liquidity through the Nasdaq Market Center. What this demonstrates is that the disparity, which Nasdaq characterizes as uncompetitive and excessive, is due to Nasdaq's own fee, which is charged only with respect to liquidity taken from a fee-charging ECN and not with respect to liquidity taken from a Nasdaq market maker or a Nasdaq order-entry firm. In effect, Nasdaq is imposing a surcharge exclusively on ECNs. That surcharge would make ECNs' liquidity more expensive than others'. If it deleted that surcharge, Nasdaq could achieve the greater uniformity it claims to seek. Instead, Nasdaq is seeking through this surcharge to require ECNs as a commercial matter to fund the Nasdaq surcharge by reducing the access fee the Commission allows them to charge.

In any event, in assessing the anticompetitive effects of Nasdaq's rule, it is not sufficient to posit that there are or may in future be other, less anticompetitive alternatives available. While the presence of other venues may diminish the anticompetitive force of a Nasdaq rule, it does not justify the imposition of burdens on competition that are not necessary or appropriate to achieve valid Exchange Act goals. In this instance, of course, the presence or absence of the ADF — a quotation facility that does not offer execution — hardly makes any difference at all. We explained in our August 8, 2005 letter how the Nasdaq rule, coupled with the rebate system, would competitively disadvantage ECNs, including Bloomberg Tradebook, participating in the Nasdaq Market Center. If still further information on that point is needed, please let us know.

Section 15A(b)(6) of the Exchange Act prohibits Nasdaq rules fixing rates of commission or other fees charged by NASD members

Nasdaq rules setting fees Nasdaq charges its members must be distinguished from a Nasdaq rule that purports to set or regulate the fees or commissions its members can charge. The former are permitted, subject to Commission oversight, but Nasdaq is expressly and

unequivocally prohibited from fixing commissions or fees charged by its members. The legislative history on that point, quoted in our letter of August 26, 2005, is clear.[1]

Nasdaq's suggested reading of the Section 15A(b)(6) and of the related legislative history is incorrect. That section's prohibition against Nasdaq rules fixing member fees is unconditional and absolute. It does not apply only to the fees that a member charges its customers as a "broker-dealer" — in any event, of course, an ECN has to be a broker-dealer to operate under the Commission's rules. Nor does it apply only where Nasdaq would seek to regulate the commissions or fees charged by *all* its members — a Nasdaq rule fixing or regulating commissions or fees charged by a subset of its members would be illegal as well. Nor does the limitation apply only to attempts by Nasdaq "to dictate what a firm may charge its own customers directly."[2] Nor does it apply only where Nasdaq is not using access to a Nasdaq facility such as its Market Center as a basis not for charging fees to its members but for fixing, even at zero, the fees or commissions its members charge others.[3] Nor, of course, as noted above, does the Exchange Act's prohibition on Nasdaq rules regulating fees charged by its members "mean that Nasdaq is not authorized to impose any fees for use of its systems."[4]

Nasdaq's assertion that the Commission's rules and interpretations permit it to fix or regulate its members' access fees is similarly unavailing. The Commission could no more override the Exchange Act than can Nasdaq. Whatever its policy objectives, a Nasdaq rule fixing or regulating the fees a Nasdaq member can charge is illegal because it contravenes Exchange Act Section 15A(b)(6). A Commission order approving such a rule would be reversible as a matter of law.

Continued Deficiency in Nasdaq's Form 19b-4 Filing

Nasdaq has asserted in its December 8, 2005 letter that Nasdaq satisfied the requirement in Form 19b-4 to discuss and justify burdens on competition through the statement

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[1] The legislative history allows that securities associations may impose limits on unreasonably high fees — as the NASD's 5% mark-up policy does, but that is not at issue here. The Commission has determined that a 30 cent per 100 share access fee is permissible.

[2] Letter of The Nasdaq Stock Market to the Commission dated December 8, 2005 responding to Bloomberg Tradebook's letter to the Commission dated August 26, 2005 (File No. SR-NASD-2005-013).

[3] To make that distinction might, for example, validate exchange rules establishing the commission rates its members could charge to third parties as a condition for using the exchange's execution facilities, which the Securities Acts Amendments of 1975 prohibited.

[4] Letter of The Nasdaq Stock Market to the Commission dated December 8, 2005 responding to Bloomberg Tradebook's letter to the Commission dated August 26, 2005 (File No. SR-NASD-2005-013).

in its Form 19b-4 filing that Nasdaq does not believe its rule imposes any burdens on competition that are not necessary or appropriate in furtherance of the purposes of the Exchange Act, together with its subsequent discussion, presumably in its August 8 comment letter, of Sections 15A and 6 and the ADF. Nasdaq's statements, however, still fail to satisfy the requirements of the Commission's Form 19b-4 that burdens on competition be explained and justified in detail. Nor has Nasdaq either remedied or explained its failure to meet the Form 19b-4 requirements in its recent letter to the Commission responding to Bloomberg Tradebook's comment letter.[5] The fact remains that Nasdaq's failure to meet the requirements of Form 19b-4 leaves its filing deficient as a matter of law.

Nasdaq's rote incantation of the statutory standard in Section 15A(b)(9) in its filing, unsupported by any discussion or any demonstration at all, that "Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended,"[6] does not satisfy the requirements of the Commission's Form 19b-4 that such burdens be explained and justified in detail.[7] As the Commission is aware, moreover, the courts have applied strict scrutiny to rule filings that do not meet statutory standards.

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5 *Id.*

6 Securities Exchange Act Release No. 51609 (April 26, 2005), Section II(B).

7 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 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].

(Footnote continued)

If the competitive impact of the Nasdaq rule proposal were trivial, an elaborate discussion would not be warranted. That is not the case here, however. Destroying the pricing power of a subset of members, that is, ECNs, distinguished solely by their business model is not trivial. Neither Nasdaq's filing nor the summary dismissal of Bloomberg Tradebook's concerns in Nasdaq's December 8, 2005 letter to the Commission elucidate the issue and, as a result, Nasdaq's filing does not provide a sufficient basis for public comment on, or Commission approval of, the proposed rule change. Given the inadequacy of the record, the public is effectively deprived of a meaningful opportunity for comment on the proposed rule.[8] The Commission, in turn, is denied the benefit of the comments that could arise from the fully informed dialogue and genuine interchange of data, views and arguments the Congress envisioned in fashioning the rule-approval process embodied in Section 19(b) of the Exchange Act.[9]

(Continued footnote)

Id. at p. 22,318.

[8] To assist the Commission in its adjudicatory proceedings under the Exchange Act, Nasdaq must provide an adequate basis for comment on its rule proposals and, where significant competitive issues are involved, must provide an opportunity for the public to comment meaningfully on the issues involved. Perfunctory recitals do not provide that basis. *See Connecticut Light and Power Co. v. NCR*, 673 F.2d 525, 530-31 (DC Cir. 1982):

> The purpose of the comment period is to allow interested members of the public to communicate information, concerns, and criticisms to the agency during the rule-making process. If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals. As a result, the agency may operate with a one-sided or mistaken picture of the issues at stake in a rule-making. . . . To allow an agency to play hunt the peanut with technical information, hiding or disguising the information that it employs, is to condone a practice in which the agency treats what should be a genuine interchange as mere bureaucratic sport.

[9] The rigorous approach built into the Commission's Rule 19b-4 and Form 19b-4 responds to a direct, specific and unequivocal congressional mandate. *See* 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. 29-30 (1975):

> In order to facilitate expeditious Commission review and evaluation of [proposed rule changes] and to assure informed public comment on them, Section 19(b)(1) would require all self-regulatory organizations to file with the SEC in connection with any proposed rule change a "concise general statement of the basis and purpose" of the proposed rule change. *It is the Committee's intention in adopting this standard to hold the self-regulatory organizations to the same standards of policy justification that the Administrative Procedure Act imposes on the SEC.*

(Footnote continued)

We point these matters out to underscore the deficiency in the Nasdaq filing from the point of view of public disclosure, which presents an independent, *per se* basis on which the Commission cannot lawfully approve the filing — Nasdaq's failure to observe the disclosure requirements set forth in the Commission's own Form 19b-4. In this instance, though, given the even more serious and incurable statutory infirmities in Nasdaq's filing, to require Nasdaq to upgrade its filing and seek further public comment would not be useful. Instead, we recommend that the Commission request that Nasdaq withdraw the instant rule proposal and, if it is unwilling to do so, that the Commission commence proceedings to consider disapproval of the proposal.

* * *

Again, we appreciate the time you and your colleagues have given to considering these issues. We believe they bear on fundamental questions of the scope of SRO and Commission rulemaking authority. We would be pleased to discuss them further, respond to any questions you may have or provide any additional comments or information you may request.

Respectfully submitted,

Kim Bang by R.D.B.

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner

(Continued footnote)

> . . . [T]he Committee believes interested persons should have a meaningful opportunity to obtain accurate information about proposed changes in self-regulatory rules and to comment on the need or justification for these changes. Section 19(b)(1) would require the SEC to give notice and provide an opportunity for interested persons to participate in the process of reviewing a proposed change in a self-regulatory organization's rules. In addition, this section would require that all comment and all correspondence between the SEC and the self-regulatory agency concerning the proposal be available for public inspection. . . .
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> . . . The Committee believes the Commission has a responsibility to see that self-regulatory rules are fully responsive to regulatory needs. By explicitly providing that the Commission's oversight authority encompasses major self-regulatory policies, the bill would make this responsibility clear and substantially decrease the possibility of slippage between regulatory need and self-regulatory performance [emphasis added]. . . .

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