



Barbara Z. Sweeney
Senior Vice President and
Corporate Secretary

November 23, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

**Re: File No. SR-NASD-2005-087 – Proposed Rule Change To Reflect
Nasdaq’s Separation From NASD Upon Nasdaq’s Anticipated
Approval as a National Securities Exchange; Response to Comments**

Dear Mr. Katz:

On July 11, 2005, NASD filed with the Commission proposed rule change SR-NASD-2005-087 to amend the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries (“Delegation Plan”), NASD By-Laws, NASD Regulation By-Laws, NASD Dispute Resolution By-Laws, and NASD rules to reflect Nasdaq’s separation from NASD upon Nasdaq’s anticipated approval as a national securities exchange, to make certain changes to the rules that govern quoting and trading through the NASD Alternative Display Facility (“ADF”) and to establish rules for the trade reporting of transactions otherwise than on an exchange through the new Trade Reporting Facility (the “original filing”).¹ On July 22, 2005, the Commission published for comment the proposed rule change in the Federal Register. The Commission received five comment letters, two of which were from the same commenter, in response to the publication of the proposed rule change in the Federal Register.² The commenters raise several issues relating to the proposed rule change that are summarized and responded to below.

First, the NYSE contends that the Trade Reporting Facility violates Section 11A of the Exchange Act, SEC Rules under the Exchange Act, Regulation NMS, the CTA

¹ The facility has been named the “Trade Reporting Facility” for purposes of this proposed rule change. The official name of the entity, however, has not yet been determined.

² See Letters dated August 12, 2005 and November 10, 2005 from Mary Yeager, Assistant Secretary, New York Stock Exchange, Inc. (NYSE); Letter dated October 13, 2005 from Edward S. Knight, Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc.; Letter dated November 4, 2005 from John Boese, Vice President and Chief Regulatory Officer, Boston Stock Exchange (BSE); and Letter dated November 10, 2005 from Kevin J. P. O’Hara, Chief Administrative Officer and General Counsel, of Archipelago Holdings, Inc. (Arca).

Plan and the OTC/UTP Plan by attempting to accomplish indirectly what NASD and Nasdaq allegedly cannot do directly. In making these arguments, the NYSE refers back to its 2001 and 2002 comment letters submitted in response to Nasdaq's application for registration as a national securities exchange.³ In those letters, the NYSE, among other things, argues that Nasdaq's Exchange proposal would permit the reporting by Nasdaq of transactions that were not effected through its exchange facilities, a result that the commenter believes to violate the federal securities laws. The NYSE also indicates that the proposed rule change is simply a formalistic attempt by Nasdaq to avoid the ramifications of exchange status and keep the economic benefit of off-exchange trades.

As noted in the original filing, the Trade Reporting Facility will be a facility of NASD and subject to NASD's registration as a national securities association. NASD will have regulatory responsibility for trades reported to the Trade Reporting Facility, while Nasdaq will provide systems to enable broker-dealers to report trades to the Trade Reporting Facility. These trades will not be Nasdaq exchange trades and will not be identified to the consolidated tape as such. Specifically, Trade Reporting Facility transactions will be disseminated to the media with a modifier indicating the source of such transactions that distinguishes them from transactions executed on or through the Nasdaq Stock Market. As such, NASD does not believe the proposed rule change is in violation of any of the rules, regulations or Plans noted by the NYSE.

Second, the NYSE argues that the proposal "propagates bad public policy" in that the proposed rule change permits two SROs to use market data to achieve "anti-competitive purposes." Notably, the NYSE does not specify the nature of the alleged anticompetitive purposes. However, later in its letter, it notes that transferring market data revenue from NASD to Nasdaq amounts to a subsidy by NASD of one of several competing exchanges and would give Nasdaq an unfair economic advantage over other national securities exchanges. Further, the NYSE notes that the proposed rule change does not attempt to explain why Nasdaq alone should receive the economic benefit of these trades. The NYSE also indicates that it believes the transfer of the Automated Confirmation Transaction Service (ACT) to Nasdaq was not proper and that, because ACT will not be available to other exchanges, there will be "barriers to entry" for other exchanges.⁴

The proposed rule change is neither anti-competitive nor gives an unfair economic advantage to Nasdaq over other national securities exchange. Nothing in the proposed rule change would preclude NASD from entering into similar arrangements

³ See Letter dated August 27, 2001, from James E. Buck, Secretary, NYSE and Letter dated February 15, 2002, from Darla Stuckey, Secretary, NYSE.

⁴ In this regard, the NYSE also suggests that ACT be "constituted as a neutral, cost-based NMS facility as required by Section 11A of the Exchange Act." NASD does not believe this comment is germane to this filing and would defer to the SEC's views regarding the application of Section 11A to ACT.

with other national securities exchanges, as appropriate, and NASD does not believe that the unavailability of ACT to other exchanges would result in “barriers to entry,” as the NYSE suggests. Finally, the issue of specific transfers of assets as part of the separation of Nasdaq from NASD is not germane to this filing.

Third, the NYSE and Arca state that the Trade Reporting Facility will promote the increased internalization of orders, although neither commenter provides support for the assertion. The NYSE further notes that it has urged the SEC to ban internalization of non-block facilitation trades. Yet the SEC has thus far declined the NYSE’s invitation to impose such a ban; accordingly, the NYSE’s request alone cannot be a legal basis to deny approval of the proposed rule change. Nonetheless, the proposed rule change provides a mechanism to report internalized trades that is substantially similar to the trade reporting mechanism that exists today. As such, the proposed rule change cannot fairly be interpreted to change or promote the use of internalized orders.

Fourth, the BSE asserts that NASD members enjoy the regulatory advantage of not having to interact with better-priced orders because there is no “consolidated book” with which their orders must interact. The BSE indicates that this “regulatory advantage” has led to a sharp increase in trading on Nasdaq, noting that several major trading firms have left the BSE and have changed their business model to “reap the profits that the Nasdaq marketplace offers.” Although, by definition, the BSE is correct that there is no “consolidated book” in the over-the-counter market, NASD members are subject to, among other rules, NASD Rule 2320, which requires that a member use reasonable diligence to ascertain the best market for a security and buy or sell in such market such that the resultant price is as favorable as possible under prevailing market conditions. Further, NASD members will be subject to the “Order Protection Rule” under Regulation NMS, once implemented, which is designed to limit executions of trades at prices inferior to protected quotations displayed by other trading centers. Accordingly, NASD disagrees with the BSE’s assertion that NASD members enjoy any “regulatory advantage” in this regard.

Fifth, both the NYSE and the BSE argue that the proposed rule change and Trade Reporting Facility structure are designed to divert revenues that might otherwise be used to fund NASD’s regulatory programs or reduce NASD fees charged to its members. The NYSE further notes that the proposed rule change also will impair NASD’s independence. As noted in the original filing, NASD will have regulatory responsibility for trades reported to the Trade Reporting Facility. Under the LLC agreement, Nasdaq bears the economic risks associated with the operation of the Trade Reporting Facility, including any losses should revenues not cover regulatory and other costs. Further, NASD’s independence will in no way be impaired by the proposed rule change. As described in the original filing, NASD, as the “SRO Member” of the Trade Reporting Facility, will have the sole regulatory responsibility for the activities of the Trade Reporting Facility, such that all regulatory responsibilities will be executed separate and

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independent from Nasdaq. Comments as to whether specific NASD membership fees are appropriate and consistent with the Exchange Act are not germane to the current proposal and are more properly raised in the context of filings with the SEC proposing such fees.

Sixth, the NYSE notes that separately identifying the Trade Reporting Facility trades for consolidated tape and media purposes is designed to permit Nasdaq to claim publicly credit for off-exchange trades and thereby inflate its trading share. As an initial matter, NASD notes that this comment seems inconsistent with the NYSE's previous concern that the proposal will permit the reporting of trades by Nasdaq that were not effected through its exchange facilities. As emphasized above, Trade Reporting Facility transactions will be disseminated to the media with a separate modifier distinguishing them from transactions executed on or through the Nasdaq Stock Market. The primary purpose of this separate indicator is to ensure transparency to the marketplace regarding the source of these trades.

Finally, the NYSE states its belief that the Trade Reporting Facility is redundant with NASD's existing ADF and that although NASD members would have the choice of either venue to report over-the-counter trades, Nasdaq's practice of rebating tape revenue leaves little doubt where firms will choose to report their trades. NASD does not believe that the choices available to members, as a result of the proposed rule change, would differ significantly from what is available today. NASD currently operates two facilities through which over-the-counter trades may be reported. These facilities will continue to operate in substantially the same manner as they do today. Under today's structure, some members have chosen to report their trades to the ADF, while others have reported to ACT. Members will continue to have this discretion to determine which facility will best meet their particular structure and trade reporting needs.

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If you have any questions, please contact Stephanie Dumont, Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8176.

Very truly yours,



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