



THE NASDAQ STOCK MARKET
ONE LIBERTY PLAZA, 50TH FLOOR
NEW YORK, NY 10006

October 13, 2005

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

Re: Securities Exchange Act Release No. 52049 (SR-NASD-2005-087)

Dear Mr. Katz:

Although the comment period on the above-captioned filing has closed, staff of the Division of Market Regulation of the Securities and Exchange Commission (the “Commission” or the “SEC”) have indicated that it would be appropriate for The Nasdaq Stock Market, Inc. (“Nasdaq”) to file a comment letter for the purpose of providing Nasdaq’s views to the Commission regarding the filing and the New York Stock Exchange’s (the “NYSE”) comment letter on it.¹ Nasdaq welcomes the opportunity to do so.

In SR-NASD-2005-087,² the National Association of Securities Dealers, Inc. (“NASD”) proposed the establishment of a new limited liability company, tentatively named The Trade Reporting Facility LLC (the “LLC”), that would operate for the purpose of collecting reports of trades in securities subject to SEC-approved transaction reporting plans (i.e., securities listed on Nasdaq, the NYSE, the American Stock Exchange, or a regional exchange). The LLC would be regulated by the NASD in accordance with rules approved by the NASD Board of Governors and filed with the SEC. Nasdaq or a subsidiary of Nasdaq would serve as technology provider and business manager of the LLC, and as consideration for its services, would receive the revenues associated with its operation (net of all associated costs, including costs incurred by NASD in connection with the regulation of the LLC and NASD members’ use of it). As discussed in more detail below, this proposed structure relies upon the precedent established by the operation of the Archipelago Exchange (“ArcaEx”) as a facility of the Pacific Exchange, Inc. (“PCX”), a precedent from which the NYSE itself expects to gain

¹ See Letter from Mary Yeager, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (August 12, 2005) (the “2005 Letter”).

² Securities Exchange Act Release No. 52049 (July 15, 2005), 70 FR 42398 (July 22, 2005) (SR-NASD-2005-087).

substantial benefits through its acquisition of ArcaEx, its parent, Archipelago Holdings, Inc. (“Arca Holdings”), and PCX.

For nearly five years, the NYSE has lobbied tirelessly against the efforts of Nasdaq, its primary competitor, to register as a national securities exchange. Through exchange registration, Nasdaq seeks to complete its transition from a wholly owned subsidiary of the NASD to an independent public company, thereby, among other things, eliminating any remaining perception of a conflict of interest between Nasdaq’s business and the regulatory functions performed by the NASD and achieving greater flexibility in its business operations. The focus of the NYSE’s challenge to exchange registration has been on Nasdaq’s view that Congress and the SEC have defined the term “exchange” with sufficient breadth to allow a variety of market models,³ including one in which an exchange may regulate the collection of reports of trades executed by its members. The NYSE, by contrast, has contended that an electronic exchange may regulate only transactions executed directly through the systems operated by the exchange (“System Trades”), and that only the NASD, by virtue of its status as the sole national securities association, may regulate the collection of trade reports for transactions executed through other means (“Non-System Trades”).

Although Nasdaq continues to question the legal basis for the NYSE’s conclusions with regard to allocation of regulatory responsibility, it is clear that the NASD’s LLC filing, and an amended exchange registration filing published for comment in the Federal Register on October 11, 2005,⁴ fully accommodate the NYSE’s views with regard to appropriate regulation of Non-System Trades. As a result, the NYSE must resort to unsupported assertions and factual misstatements in its ongoing effort to prevent Nasdaq from achieving exchange status. The NYSE’s central assertion with regard to the LLC is that it violates various provisions of law. Rather than explain its views in the context of the NASD’s actual proposal, however, the NYSE attaches 24 pages of stale comment letters on Nasdaq’s original exchange registration filing.⁵ The NYSE appears to believe the following points from these letters to be relevant:

Regulation of Non-System Trades: In the 2001 and 2002 Letters, the NYSE argued that as an exchange, Nasdaq may not adopt rules that regulate the reporting of Non-System Trades, because they allege that there is not an adequate nexus between the rules and the exchange. This argument is entirely irrelevant to the NASD proposal and

³ See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70852 (December 22, 1998) (“Nasdaq’s use of established, non-discretionary methods bring it within the revised interpretation of “exchange” in Rule 3b-16.”).

⁴ Securities Exchange Act Release No. 52559 (October 4, 2005), 70 FR 59097 (October 11, 2005) (File No. 101-131).

⁵ See Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (August 27, 2001) (the “2001 Letter”); Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (February 15, 2002) (the “2002 Letter”) (collectively, the “2001 and 2002 Letters”).

Nasdaq's amended exchange registration application. All rules relating to the reporting of Non-System Trades will be NASD rules. The only trade reporting rules to be adopted by Nasdaq as an exchange will be rules to provide for the automated reporting of transactions executed through Nasdaq's automated transaction execution facilities.

Nevertheless, in its 2005 Letter, the NYSE distorts the facts in an effort to preserve this argument. The NYSE states that the LLC "in reality, ... is a Nasdaq facility", that "Nasdaq controls the entity", and that "Nasdaq administers the rules regulating the [LLC and] regulates the [LLC's] activities." However, the limited liability company agreement for the LLC clearly assigns the NASD sole responsibility for all duties or responsibilities of a self-regulatory organization with respect to the LLC, granting the NASD direct authority with regard to LLC rules and rule filings and regulation of the LLC's activities and regulatory budget, and requiring consent of the NASD-appointed member of the LLC's Board of Directors with respect a range of activities, including pricing decisions, fundamental market structure changes, and entry into new lines of business. The agreement further provides that, to the extent directly related to the LLC's activities, the books, records, premises, officers, directors, agents and employees of Nasdaq shall be deemed to be the books, records, premises, officers, directors, agents and employees of NASD for purposes of the Act, and that all such persons submit to the jurisdiction of the U.S. federal courts, the SEC, and the NASD for purposes of the federal securities laws and rules and regulations thereunder.

Transaction Reporting Plans: In the 2001 and 2002 Letters, the NYSE argued that under SEC Rule 11Aa3-1(b)(1) and the terms of the Consolidated Tape Association Plan (the "CTA Plan"), Non-System Trades must be reported through the NASD and must be clearly identified as Non-System Trades when disseminated to investors. The NYSE further argued that Nasdaq's proposal to allow reporting of Non-System Trades through Nasdaq would be misleading and cause confusion. Again, the NYSE's four-year old argument has no relevance to the proposal on which the NYSE is commenting. Trades reported to the LLC will be reported pursuant to NASD rules. Moreover, as SR-NASD-2005-087 clearly states: "Based on discussions with SEC staff, NASD is also noting that it intends to work with the appropriate parties to ensure that Trade Reporting Facility and [Alternative Display Facility ("ADF")] transactions are disseminated to the media with a modifier indicating the source of such transactions that would distinguish them from transactions executed on or through the Nasdaq Stock Market."⁶

Rather than accept the fact that the plain meaning of this statement is entirely consistent with the arguments made by the NYSE in the 2001 and 2002 Letters, the 2005 Letter asserts that the proposal "seems designed to permit Nasdaq to publicly claim credit for off-exchange trades and thereby inflate its trading share", and to compromise "the transparency and utility of market data." In other words, in the NYSE's view, distinguishing LLC trades from trades executed through Nasdaq's electronic systems will

⁶ 70 FR at 42402.

allow Nasdaq to conflate the two types of trades, while clearer disclosure will result in less transparency. The logic of these conclusions is elusive, to say the least.

LLC trades will be reported using technology provided by Nasdaq. Nasdaq accepts the fact that it cannot claim that these trades are executed through its exchange systems, however. The separate identification of these trades will make their regulatory status abundantly clear to all investors. Accordingly, it is time for the NYSE to abandon this line of argument and recognize that the proposal achieves the result that it has long advocated.

Fair Competition. In the 2001 and 2002 Letters, the NYSE argued that Nasdaq's receipt of market data revenues associated with Non-System Trades would be inconsistent with principles of fair competition and equal regulation enshrined in the Securities Exchange Act of 1934 (the "Act"). The NYSE reiterates this argument in the 2005 Letter, contending that the NASD may not "divert" revenue that might otherwise be used by NASD or its members and asserting that no effort has been made to explain why Nasdaq should receive economic benefits from trades reported to the LLC. It is surprising that the NYSE should continue this line of argument in 2005 after entering into a merger agreement with Arca Holdings, the entity that has made the most effective use of the Commission precedent that the NASD and Nasdaq are proposing to follow; specifically, this precedent permits a self-regulatory organization to use a third party to provide services, and, in return for services provided, the third party may receive the related revenues. Since 2002, Arca Holdings has operated ArcaEx as the exclusive equities trading facility of PCX. The Commission found that "the PCX's proposal to establish ArcaEx as an exchange facility is consistent with the Act, as well as with previous proposals of national securities exchanges ... to use the personnel and equipment of third parties to operate trading platforms."⁷ Thus, although neither Arca Holdings nor any of its subsidiaries are registered with the SEC as a self-regulatory organization, according to Arca Holdings' most recent annual report on Form 10-K, ArcaEx has "the right to receive all transaction fees, all market data fees and all listing fees from the operation of ArcaEx." Arca Holdings has, in turn used these fees to enhance its electronic trading platform and to enter into an agreement to acquire the PCX's regulatory license to operate an options exchange, thereby making itself an attractive merger partner for the NYSE.

Nevertheless, the NYSE contends that the NASD may not enter into an arrangement with a third party to operate the LLC, even if the third party is itself an SRO. The NYSE's only basis for this conclusion appears to be a belief that the NASD, as a national securities association, should be treated differently from all other SROs. The NYSE's argument, however, finds no support in the Act and is belied by the ArcaEx order itself, which cited approval of the Nasdaq's operation of the OptiMark System as a

⁷ Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225, 55229 (November 1, 2001) (SR-PCX-00-25).

facility of the NASD in support of its determination regarding ArcaEx's operation as a facility of PCX.⁸ The conclusion also lacks a policy justification, since it would deprive NASD of the flexibility enjoyed by exchanges in using their revenues to contract with third parties to provide technology solutions that meet the needs of their members and fulfill their regulatory obligations. Nevertheless, the NYSE goes so far as to suggest that unless the NASD uses all tape revenue to fund regulation or reduce fees, the Commission should adopt punitive amendments to the national market system plans that would bar it from receiving any market data revenue. The NYSE makes no effort to supply the Commission with a legal basis for the arbitrary rulemaking that it proposes, but it is difficult to see how the Commission could earmark all NASD market data dollars for regulation or fee reductions, thereby leaving none for procurement or development of the systems being regulated. It is equally difficult to understand how the Commission could impose such a restraint upon one SRO without also imposing it on the NYSE.

The NYSE claims to be troubled at once by the fact that the LLC reflects an arrangement with only "one of several competing exchanges" and that it is "totally redundant with the NASD's existing ADF." The NYSE also proposes that the Commission enact a ban on internalization. Read together, these arguments seem to suggest that the NYSE feels at once that market participants have too much and too little choice with regard to executing and reporting Non-System Trades. First, neither the NASD's LLC filing nor Nasdaq's exchange registration application provide an appropriate forum for debating the merits of internalization. Despite the NYSE's urgings, the Commission has not seen fit to propose limits on the practice; if it seeks to propose such limits, it must conduct a rulemaking in accordance with the requirements of the Administrative Procedure Act. Continued inaction on Nasdaq's exchange registration may serve the NYSE's competitive interests, but it will not affect the extent to which broker-dealers opt to internalize order flow. Second, the NASD operates ADF because the Commission directed it to provide broker-dealers with more options for quoting and reporting Non-System Trades in Nasdaq-listed stocks. Because we defer to the Commission's judgment with regard to the need for the NASD to provide this choice, we likewise do not believe that market participants would benefit from a forced denial of access to the systems that most of them currently use for reporting Non-System Trades. The operation of the LLC in the manner proposed will preserve the choice that the Commission mandated.⁹ Third, and most important, the availability of the arrangement

⁸ Id. at 55229 & n.61.

⁹ In this regard, it should be noted that market participants are not required to quote on the ADF to report trades there, and that the rules of the LLC will allow market participants to allocate trade reporting between the LLC and the ADF on a trade-by-trade basis. The NYSE asserts, however, that market participants entering into Non-System Trades will not have a meaningful choice between the LLC and the ADF, because "Nasdaq's practice of rebating tape revenue leaves little doubt where firms will choose to report their trades." It is true that Nasdaq currently shares a portion of the revenues associated with Non-System Trades with the market participants that report them. Whether revenue associated with the trades will continue to be shared by the LLC, however, is a question for the NASD as well as Nasdaq, since any fees and rebates associated with the LLC must be approved by the NASD and filed by the NASD with the Commission. If the

reflected in the LLC is not limited to only one exchange. Section 9(e) of the proposed LLC Agreement clearly contemplates that the NASD may enter into a similar agreement with another exchange to operate a facility for Non-System Trading (provided it does so on terms that are no more favorable to the other exchange than to Nasdaq). Thus, in contrast with PCX's relationship with ArcaEx, the LLC is not exclusive to Nasdaq.

In fact, Nasdaq would welcome other exchanges making similar arrangements with the NASD, because the NASD would undoubtedly require new entrants to pay a share of the fixed regulatory costs that Nasdaq alone must pay at present. Notwithstanding the retention by Nasdaq of net revenues associated with the operation of the LLC, the LLC's prospects for long-term profitability are by no means assured. The percentages of trades executed through exchanges or exchange-like electronic facilities has steadily increased in recent years, while internalization has decreased. Moreover, although the NYSE characterizes the regulatory costs associated with operating the LLC as "moderate," in fact a significant portion of Nasdaq's \$41 million regulatory budget is attributable to regulation of Non-System Trades. Thus, we expect that the "subsidy" that the NYSE decries will represent at best a modest return on Nasdaq's continued investment in the systems that process and surveil reports of Non-System Trades.

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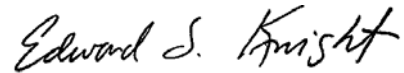
It is notable that the NYSE filed the only comment letter on the NASD proposal, and notable also that the NYSE recycles its old arguments against Nasdaq's independence rather than reacting to the proposal that the NASD has actually filed. We believe that most market participants view Nasdaq's exchange registration as a positive step and would be reluctant to see their options for Non-System Trade reporting diminished. The NYSE, by contrast, benefits greatly from perpetuating the uncertainty and inefficiencies associated with Nasdaq's current status as an NASD subsidiary. As a result, the NYSE cannot abandon its solitary opposition even when the proposal has been modified to accommodate its arguments. We urge the Commission to recognize the narrow self-interest that underlies the NYSE's letter and move forward with prompt approval of the NASD's filing and Nasdaq's application for exchange registration.

NASD opts to continue Nasdaq's modest revenue sharing programs for Non-System Trades, however, the decision would be entirely consistent with Regulation NMS, in which the Commission determined that it would be appropriate to evaluate the merits of particular revenue sharing proposals through the notice and comment process of Section 19(b). See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37567 n. 645 (June 29, 2005).

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We thank the Commission for providing this opportunity to comment. If you have any question, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink that reads "Edward S. Knight". The signature is written in a cursive style with a large, prominent "K".

Edward S. Knight
Executive Vice President and
General Counsel

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