

**Mary Yeager**  
*Assistant Secretary*

New York Stock Exchange, Inc.  
11 Wall Street  
New York, NY 10005

tel: 212.656.2062  
fax: 212.656.3939  
myeager@nyse.com



Via email to [www.rule-comments@sec.gov](http://www.rule-comments@sec.gov)

August 12, 2005

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: NASD/Nasdaq Trade Reporting Facility  
Release No. 34-52049; File No. SR-NASD-2005-087

Dear Mr. Katz:

The National Association of Securities Dealers, Inc. ("NASD") has filed new rules relating to its proposed separation from The Nasdaq Stock Market, Inc. ("Nasdaq") and Nasdaq's application for approval as a national securities exchange. The major substantive aspect of the referenced filing is the establishment of an NASD Trade Reporting Facility ("TRF"), which would funnel trade revenues from certain off-exchange trades from the NASD to Nasdaq. The New York Stock Exchange is submitting this letter to comment on that aspect of the TRF Filing because it seeks to pass through to Nasdaq market data revenue that is derived from off-exchange trades and is required to be allocated to the NASD. That pass-through contravenes the Securities Exchange Act of 1934 (the "Act"), various Commissions rules and the provisions of the CTA Plan and the Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Basis (the "OTC/UTP Plan").

In November 2000, Nasdaq submitted to the Commission an application for registration as a national securities exchange.<sup>1</sup> A year later, in anticipation of the approval of Nasdaq's exchange application, the NASD submitted a proposed rule change to establish its Alternative Display Facility ("ADF") for reporting off-exchange trades. The Exchange commented on

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<sup>1</sup> Release No. 34-44396, File No. 10-131 (June 6, 2001).

both filings, stating that it was inappropriate for the NASD and Nasdaq to attempt to define trades executed on Nasdaq to include off-exchange trades such as those executed on ECNs and upstairs trading desks outside of Nasdaq facilities.<sup>2</sup> We explained that Nasdaq's attempt to take credit (both financially and for disclosure and marketing purposes) for trades that do not take place through its facilities would violate the terms of the CTA Plan and the OTC/UTP Plan and was inconsistent with the Act and the Commission's rules under the Act. We further explained that, by breaking the nexus between the location of a trade (i.e., the place of the making of a contract for the delivery of stock against payment) and the market claiming credit for the trade report, the NASD and Nasdaq proposed to convert Nasdaq into a "print facility" for off-exchange trades.

Under the guise of a nominal NASD subsidiary, the NASD and Nasdaq are now attempting to do exactly what they cannot do, namely creating a jointly-owned facility of the NASD for the sole purpose of passing through to Nasdaq the revenue pertaining to off-exchange trades that the CTA and OTC/UTP Plans require to be allocated to the NASD. Functionally, the TRF is totally redundant with the NASD's existing ADF.<sup>3</sup> Net of payments for regulatory services, Nasdaq retains all economic benefit derived from market data revenues paid to the nominal NASD subsidiary. NASD members would ostensibly have the choice of reporting off-exchange trades to the TRF or to the ADF. However, Nasdaq's practice of rebating tape revenue leaves little doubt where firms will choose to report their trades.

The Commission should not permit two SROs to engage in behavior that mocks the rule of law, contravenes sound public policy, undermines the NASD's functional independence from Nasdaq, and sanctions the impermissible subsidy of an exchange by the NASD.

- Violations of Law. By attempting to accomplish indirectly that which NASD and Nasdaq cannot do directly, the TRF arrangement violates Section 11A of the Act, Commission Rules under the Act, Regulation NMS, the CTA Plan and the OTC/UTP Plan. Rather than reiterate these arguments in this letter, we refer back to our 2001 and 2002 NYSE Comment Letters, which describe the illegality of this arrangement in detail.
- Against Public Policy. The Filing propagates bad public policy. Trafficking in tape revenues is the reason the SEC went to such lengths in Regulation NMS to lessen the

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<sup>2</sup> See letter dated August 27, 2001, from James E. Buck, Secretary, Exchange, to Jonathan G. Katz, Secretary, Commission (the "2001 NYSE Comment Letter") and letter dated February 15, 2002, from Darla Stuckey, Secretary, Exchange, to Mr. Katz (the "2002 NYSE Comment Letter"). To facilitate your review, we have attached those letters as Exhibits A and B to this letter.

<sup>3</sup> Although the NASD and Nasdaq characterize the TRF as a NASD facility, in reality, it is a Nasdaq facility. The TRF would be operated by a limited liability company named the "The Trade Reporting Facility, LLC" jointly owned by the NASD and Nasdaq the sole purpose of which is to transfer the revenue resulting from reporting of non-Nasdaq OTC trades from the NASD to Nasdaq. Nasdaq controls the entity. Nasdaq appoints two of the three members of the Board of Managers, names all officers, controls the company's day-to-day operations, administers the rules regulating the TRF, regulates the TRF's activities and budget, provides real-time surveillance, manages the TRF's business affairs, and provides systems to enable broker-dealers to report trades to the TRF. Although the NASD performs regulatory functions for the TRF, it is paid to do so by Nasdaq.

impact of trade reporting on the allocation of market data revenues. The TRF Filing goes in exactly the opposite direction, permitting two SROs to use market data to achieve anticompetitive purposes. The TRF will also promote the increased internalization of orders. The NYSE has long been on record as urging the Commission to ban the internalization of non-block facilitation trades, which removes these orders from the price discovery process.

- Inconsistent with NASD Regulation's Functional Independence. Prior to this proposal, both Nasdaq and the NYSE were seeking to assure that the economic relationships between them and their former regulatory divisions were at "arm's length" and confined to assuring adequate funding of their regulatory functions. The NASD's creation of a subsidiary controlled by Nasdaq that is designed to divert revenue that might otherwise be used to fund the NASD's regulatory programs or reduce the NASD's fees charged to its members and member organization impairs the NASD's independence. Equally troubling is the NASD's willingness to lend its registration as a national securities association to enable one of several competing exchanges for which it provides regulatory services to attempt indirectly what the law prevents it from doing directly.
- Inconsistent with Nasdaq's Requested Exchange Status. When Nasdaq made the decision to seek exchange status, it made a decision to leave the OTC market behind with the NASD. The TRF Filing is simply a formalistic attempt by Nasdaq to avoid the ramifications of exchange status and keep the economic benefit of off-exchange trades. Nothing changes in this NASD/Nasdaq operation before separation and after. Moreover, the suggestion in the Filing that TRF trades should be separately identified on the Consolidated Tape and in the media seems designed to permit Nasdaq to publicly claim credit for off-exchange trades and thereby inflate its trading share. The transparency and utility of market data would be compromised if Nasdaq could claim liquidity that in fact did not exist in its market.
- Unfair Competition among Exchanges. Transferring market data revenue from the NASD to Nasdaq amounts to a subsidy by the NASD of one of several competing exchanges. The amount of market data revenues at stake is considerable. The last month Nasdaq separately reported SuperMontage volume, Nasdaq's reported trading share was 52.5%, of which 37% (or 19.4% of total volume) was attributable to SuperMontage. Nasdaq has never broken out CAES or SuperMontage volume for listed stocks, but we believe it was de minimis in 2004. Based on these numbers, the separation of NASD and Nasdaq, and the appropriate allocation of market data revenue between them, the NASD would have received most of the \$16.5 million that NASD received under the CTA Plan and \$40.3 million of the \$64 million that NASD received under the OTC/UTP Plan. NASD's giveaway to Nasdaq of more than \$55 million for 2004 would have given Nasdaq an unfair economic advantage over other national securities exchanges, even after deducting Nasdaq's moderate expenses in operating the TRF. The Filing makes no attempt to explain why Nasdaq alone should receive the economic benefit of trades that have no nexus whatsoever with its facilities.

- Appropriateness of Allocating Market Data Revenue to Off-Exchange Trades. The NASD is entitled to this revenue under the existing CTA and OTC/UTP Plans. As discussed above, the NASD could use this revenue stream to expand its regulatory programs or reduce fees charged to its member organizations. In the absence of the NASD doing either, we propose that the Commission should adopt amendments to the national market system plans that would make trades that do not take place through the facilities of an exchange ineligible to participate in the sharing of the markets' data revenues.

We thank the Commission for granting us this opportunity to comment and are prepared to answer any questions that the Commission may have.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Max Gey". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

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

ATTACH:

EXHIBIT A: NYSE's August 27, 2001, comment letter.

EXHIBIT B: NYSE's February 15, 2002, comment letter.



August 27, 2001

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: NYSE Comments on the Nasdaq Stock Market's Application  
for Registration as a National Securities Exchange  
Release No. 34-44396, File No. 10-131

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Dear Mr. Katz:

The New York Stock Exchange, Inc. (the "NYSE" or the "Exchange") submits this letter to the Securities and Exchange Commission (the "Commission" or "SEC") to comment on several aspects of the proposed rules of the Nasdaq Stock Market, Inc. ("Nasdaq Exchange") submitted by its parent, the National Association of Securities Dealers, Inc. (the "NASD").<sup>1</sup> Perhaps the most troubling aspect of the rule proposals is the process being followed. Commentators are asked to evaluate the proposed rules of the Nasdaq Exchange without knowing either the complementary changes that the NASD will have to make or the rationale of the Nasdaq Exchange for its proposed rules. The Exchange believes that, under these circumstances and regardless of any amendments to the Nasdaq Exchange's filing, the Commission should not approve its status as a national securities exchange until all commentators have had an opportunity to review and comment on the rules of the new NASD as well as the Nasdaq Exchange.

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<sup>1</sup> The NASD has submitted those rules to the Commission on Form 1 in connection with its registration of the Nasdaq Exchange as a national securities exchange under Section 6 of the Securities Exchange Act of 1934 (the "Act"). See letter dated November 9, 2000, to Annette Nazareth, Director, Division of Market Regulation, Commission, from Edward S. Knight, Executive Vice President and General Counsel, the Nasdaq Exchange.

Other matters that need to be addressed are:

- Transaction reporting rules that encompass off-exchange contracts<sup>2</sup>;
- The failure to seek approval of the SuperMontage rules under the standards applicable to exchanges;
- Enabling market makers on the Nasdaq Exchange to displace agency and other's proprietary interest in violation of the negative trading obligations applicable to market makers on exchanges; and
- Applying a short sale rule differing from that applicable to exchange transactions.

## **I. The Process**

The Form 1 registration process has three significant flaws as applied to the registration of a continuing market as an exchange:

- Commentators are asked to evaluate the proposed rules of the Nasdaq Exchange without knowing the complementary changes that the NASD will make to its rules.
- The proposed rules are silent about the presumptive core facility of the Nasdaq Exchange, SuperMontage, which the Commission approved as an NASD facility under the materially different statutory criteria applicable to exchanges.
- The filing does not set forth the rationale of the Nasdaq Exchange for its proposed rules.

**Companion NASD Rules:** The public is being asked to comment on the proposed Nasdaq Exchange rules without knowing what rules NASD will propose for amendment or adoption after it divests the Nasdaq Exchange -- or, indeed, without any information regarding what the residual off-exchange market will look like or what systems the NASD will offer. Nor does the NASD provide any information about whether and under what conditions it will divest itself of the AMEX. An understanding of the contours of NASD's post-divestiture would facilitate review of Nasdaq Exchange's proposed rules. Yet, commenters will have had no opportunity to see proposed changes to NASD rules prior to the end of the comment period on Nasdaq Exchange's filing. By the same token, the Commission itself is being asked to approve the separation of the Nasdaq Exchange from the NASD without being able to evaluate the NASD rules that will govern the regulation, and establish the structure, of the off-exchange market to be operated by the NASD.

**SuperMontage:** The Form 1 submitted by the Nasdaq Exchange is incomplete. Specifically, rules relating to SuperMontage,<sup>3</sup> presumably the core facility of the Nasdaq Exchange, are not

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<sup>2</sup> To avoid confusion, this letter uses the term "OTC" in its more narrow, traditional context of trading in securities not listed on the NYSE, the American Stock Exchange LLC ("AMEX"), or regional exchanges. It uses the term "off-exchange" to describe trading that takes place otherwise than on the Nasdaq Exchange or any other exchange (i.e., in the traditional OTC market and the Third market).

<sup>3</sup> The SuperMontage 19b-4 process included an original Form 19b-4 and nine amendments. SuperMontage collectively refers to the Nasdaq Order Display Facility, the Order Collection Facility, and the Nasdaq National Market Execution System. See Commission Release No. 34-43863 (January 19, 2001) (the "SuperMontage Release").

included in the Form 1. This deficiency is by no means technical or ministerial in nature. From a legal standpoint, the Nasdaq Exchange's proposed rules are wholly new. Thus, the Nasdaq Exchange is free to submit SuperMontage rules that differ from the NASD rules in any way it desires, just as it has with its proposed transaction reporting rules, as discussed below. Additionally, the public should not have to review all ten Forms 19b-4 filed by the NASD and piece together the missing SuperMontage rules.

Moreover, the Commission approved SuperMontage as being "consistent with the requirements of the Act applicable to the NASD", i.e., section 15A. Section 15A deals with the registration of national securities associations, whereas the current filing deals with registration of the Nasdaq Exchange as a national securities exchange pursuant to section 6(a) of the Act. If the Commission approves the Form 1 in its current form, the Exchange believes that, as a matter of law and Commission rule, SuperMontage would not be an authorized Nasdaq Exchange system. To remedy that deficiency, the Commission would have to require the Nasdaq Exchange to amend its Form 1 to include SuperMontage rules. In the alternative, the Commission could order a delay in the use of SuperMontage until the Nasdaq Exchange, as an exchange, files the requisite Form 19b-4, and the Commission approves the filing. In either case, the Commission should require the Nasdaq Exchange to make publicly available a red-lined copy of the SuperMontage rules comparing the proposed rules against the rules approved in the SuperMontage Release.

**No Rationale:** The Nasdaq Exchange has filed its proposed rules in Form 1, its application for registration as a national securities exchange. Unlike a proposed rule change on Form 19b-4, Form 1 does not require an applicant exchange to explain why it is adopting a new rule or changing an existing one. However, the Nasdaq Exchange's long history as a market differentiates it from a start-up exchange and justifies requiring the Nasdaq Exchange to explain why it is making changes to rules such as its transaction reporting rules.<sup>4</sup> Those explanations would greatly facilitate the review process.

## **II. Transaction Reporting Rules**

The Nasdaq Exchange's proposed transaction reporting rules break the nexus between the location of a trade (i.e., the place of the making of a contract for the delivery of stock against payment) and transaction reporting. Until now, each exchange has reported only those trades that take place on that exchange -- and has not reported trades that do not take place on that exchange. The NASD, as the self-regulator of the off-exchange market, has reported trades that

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<sup>4</sup> Indeed, on the Nasdaq Exchange's "Exchange Registration Fact Sheet," which the Nasdaq Exchange has published on its web site, the Nasdaq Exchange suggests that its "proposed" rules have already been subjected to public comment and the Commission's approval process. While that is true, albeit in the context of national securities association regulation (as opposed to exchange regulation), it is difficult to discern what changes to the NASD's existing rules the Nasdaq Exchange is proposing for its new exchange market.

When NASD acquired the AMEX in 1998, the new AMEX succeeded to the exchange registration of the old AMEX, with an amended Form 1 filed to reflect that change. In advance of the acquisition, AMEX made a 19b-4 filing that described in detail the changes being made to the AMEX constitution and rules, which included marked copies of the amended constitution and the rules. We understand that AMEX did this specifically to allow the public to understand and comment upon the changes being effected in connection with the AMEX/NASD transaction.

The Nasdaq Exchange needs to follow the AMEX's lead.

do not take place on an exchange. Under the Nasdaq Exchange's proposal, it would report not only trades that are effected through its exchange facilities, but also off-exchange trades that are executed without using its exchange facilities.

#### A. The Issues

The Nasdaq Exchange's proposed transaction reporting rules broadly define "transaction executed on Nasdaq"<sup>5</sup> in a way that promotes confusion and is misleading to investors because it contradicts accepted rules of contract law, conflict of laws, equal regulation, fair competition and accurate disclosure.<sup>6</sup> Since the mid-1970's, United States securities exchanges and the NASD have jointly disseminated last sale price information and quotation information on a consolidated basis.<sup>7</sup> For receipt of the consolidated data streams, broker-dealers, and institutional investors pay fees to the joint ventures that make the information available (i.e., to Network A and Network B under the CTA and CQ Plans and to NASD under the "OTC Plan"<sup>8</sup> and the OTC/UTP Plan). The markets that participate in each network share that network's revenues. The number of trades (and also shares in the case of the OTC/UTP Plan) that each market reports to the network's central processor for processing, consolidation and dissemination to the public determine sharing of each network's expenses and revenue.

Until now, each exchange has reported a trade (and therefore received the revenue benefit) where the trade is effected through its facilities. However, the Nasdaq Exchange's proposed definition of "transaction executed on Nasdaq" would allow the Nasdaq Exchange to report -- and receive revenue for -- internalized and other off-exchange trades, even though those trades never touch

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<sup>5</sup> See proposed Nasdaq Rules IM 4630-1 (in respect of securities listed on the Nasdaq Exchange) and 6410(g) (in respect of securities listed on exchanges other than the Nasdaq Exchange).

<sup>6</sup> The Nasdaq Exchange sets forth its proposed transaction reporting rules for its listed securities in its proposed 4630 series of rules and sets forth its counterpart rules for securities listed on exchanges other than the Nasdaq Exchange in its 6400 series of rules.

<sup>7</sup> Since 1973, the NASD and the exchanges have jointly disseminated consolidated last sale price information relating to securities listed on NYSE or AMEX via the Consolidated Tape System ("CTS") pursuant to the Consolidated Tape Association ("CTA") Plan. Since 1978, they have jointly disseminate consolidated quotation information relating to those securities via the Consolidated Quotation System ("CQS") pursuant to the CQ Plan.

Pursuant to a pilot transaction reporting plan ("OTC/UTP Plan"), NASD and certain exchanges (though not NYSE) jointly disseminate consolidated last sale price and quotation information relating to OTC securities that have been admitted to trading on one or more exchanges pursuant to unlisted trading privileges ("UTP"). Once the Nasdaq Exchange becomes registered, those securities presumably will become listed on the Nasdaq Exchange. We understand that the OTC/UTP Plan participants are discussing amendments to continue the reporting in those securities pursuant to a substantially modified the OTC/UTP Plan.

<sup>8</sup> The reference to the "OTC Plan" is to the "Transaction Reporting Plan with Respect to NASDAQ/NMS Securities" that NASD filed with the Commission on February 5, 1982. The Commission approved the OTC Plan on March 24, 1982 (See Release No. 18590; File No. 37-737.) NASD has represented to NYSE that the OTC Plan only covers securities not subject to unlisted trading privileges. However, in NASD's comments on the first draft of the Report of the Commission's Advisory Committee on Market Information, NASD represented that "NASD does not maintain a separate plan relating to securities that are not multiply traded." (See p. 33 of NASD mark-up of first draft of Report of the Commission's Advisory Committee on Market Information as transmitted by e-mail from Richard Strasser, NASD, to Dean Joel Seligman, Chairman, Advisory Committee on Market Information, dated July 18, 2001.) As a result, the continued applicability of the OTC Plan and NASD's method for complying with Rule 11Aa3-1's transaction reporting plan requirements in respect of Nasdaq-listed securities that are not subject to UTPs appears unclear.

the Nasdaq Exchange's trade-execution facilities.<sup>9</sup> In addition to the issue of market data revenues, the Nasdaq Exchange's proposal to capture these trades would allow the Nasdaq Exchange to inflate its volume of trading activity.

Competitive and financial reasons would compel other exchanges to follow suit. Since the delineation of an exchange's self-regulatory authority and trade reporting responsibilities spring from the jurisdictional nexus to trade location, the Nasdaq Exchange's proposed reporting rules also violate the Act, SEC rules under the Act, the CTA Plan, and NASD's agreement with the CTA Plan processors.

### **B. The Proposal Exceeds the Nasdaq Exchange's Jurisdiction**

Clearly, a trade that is executed through CAES or any other Nasdaq Exchange system that automatically produces trade reports is properly characterized as being "executed on Nasdaq". But the Nasdaq Exchange reaches beyond its jurisdiction by requiring or permitting its members to report to the Nasdaq Exchange:

- A trade that is *facilitated* through a Nasdaq Exchange system that produces a trade report.

The Exchange notes that the Nasdaq Exchange's proposed rules differentiate a trade that is *facilitated* through a Nasdaq Exchange system from one that is *executed* through a Nasdaq Exchange system. While the Nasdaq Exchange's proposed rules do not define what it means to "facilitate" a trade through a Nasdaq Exchange system, Nasdaq Exchange staff state that it refers to the use of a Nasdaq Exchange system to deliver an order, which system also captures and reports the trade.<sup>10</sup> If, in using the term "facilitate", the Nasdaq Exchange is referring to situations where a Nasdaq Exchange system delivers orders to a different venue (e.g., to an OTC/UTP exchange, ECN or market maker), and, in fact, the execution occurs in that venue, then the trade report should be made, in the case of an OTC/UTP Exchange, directly to the OTC/UTP Plan; and, in the cases of an ECN or market maker, as an off-exchange trade, directly to the NASD.). To permit the Nasdaq Exchange to report these trades would be tantamount to the NYSE requiring its members to report to it trades executed in other CTA markets at prices derived from NYSE quotations on the theory that the NYSE "facilitated" those transactions.

- A trade in a security as to which *one party is a registered* Nasdaq Exchange market maker.

Whether a party to a trade is a registered Nasdaq Exchange market maker is irrelevant to the determination of where a trade takes place. If the trade is executed through the proprietary facilities of a registered Nasdaq Exchange member, rather than through Nasdaq Exchange facilities, then the trade has not occurred within the jurisdiction of the Nasdaq Exchange and cannot be reported to it. If the trade is executed through the

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<sup>9</sup> As reported by the Commission in its approval order of the NASD's SuperMontage, 26% of the share volume and 36% of trades on the NASD are executed through SOES or SelectNet, Nasdaq's two primary execution facilities. SuperMontage Release, fn. 222.

<sup>10</sup> Phone conversation between Karen Lorentz, NYSE, and Gene Lopez, Nasdaq, August 14, 2001.

facilities of another exchange, it should be reported to the other exchange. If it is not executed through the facilities of any exchange (including the Nasdaq Exchange), it should be reported to NASD, just as today.

- A trade that a registered Nasdaq Exchange market maker *facilitates*.

According to the Nasdaq Exchange staff, in this context, the term “facilitate” refers to a registered Nasdaq member crossing or matching (i.e. executing) orders through the member’s proprietary facilities.<sup>11</sup> Those internalized trades are not executed through Nasdaq Exchange facilities and should be reported to NASD, as today.

- A trade that a non-registered Nasdaq Exchange member executes off an exchange and *voluntarily* elects to report to the Nasdaq Exchange.

In this rule provision, the Nasdaq Exchange at least acknowledges that it is claiming a trade executed in the off-exchange market. That is a trade “executed otherwise than on a national securities exchange” (including the Nasdaq Exchange) is an off-exchange trade and should be reported to NASD, as today.

### C. Existing Legal and Regulatory Scheme

As noted, the Nasdaq Exchange’s proposal to report trades that have no meaningful nexus to its facilities conflicts with the Act, SEC Rules under the Act, the CTA Plan, and the Commission-approved agreements that the processor under the CTA Plan has executed with each of the current exchanges and the NASD.

#### 1. The Act

**No Adequate Nexus:** Section 6(b)(5) of the Act provides that an exchange shall not be registered as a national securities exchange if

[t]he rules of the exchange [seek] to regulate . . . matters not related to the purposes of this title or the administration of an exchange.

To approve the Nasdaq Exchange’s proposed transaction reporting, the Commission must “determine” that there is an adequate nexus between those rules and the “administration of” the Nasdaq Exchange as a stock exchange. No such nexus exists.

The Exchange’s experience in amending its Rule 92 is instructive in this regard. In SR-NYSE-94-34, the Exchange proposed, among other matters, to extend the applicability of NYSE Rule

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<sup>11</sup> For instance, according to the matrix set forth in paragraph (b) a of each of IM-4633-3 and IM-6420-1, if a Nasdaq Exchange-registered ECN facilitates (matches) a trade between, say, two customers or two broker-dealers that are not Nasdaq Exchange members, the Nasdaq Exchange requires the ECN to report the trade to the Nasdaq Exchange. (If the ECN is also an NASD member and does not use Nasdaq Exchange facilities to “facilitate” the match, the Nasdaq Exchange would allow the ECN to report the match to NASD instead, pursuant to paragraph (d) of each of those rules).

92's prohibitions against members' trading ahead of customers to any such transactions effected by its members or member organizations *in any market center*. The Exchange believed that concepts of agency law and fiduciary duty applicable to its members and member organizations should be extended to all customer relationships irrespective of the market center on which a member effected a transaction.

Several commentators objected on the ground that the Exchange's proposal constituted an inappropriate extension of the Exchange's regulatory jurisdiction to transactions that were not connected to the NYSE. Following discussions with the Commission staff, the Exchange narrowed its original proposal to apply only when one or both trades (proprietary or agency) of a customer facilitation are effected on the NYSE.

In its order approving the amended proposal, the Commission observed that the Exchange had sufficiently narrowed the focus of Rule 92 to be consistent with the requirements of the Act. In this regard, the Commission pointed out that Section 6(b)(5) of the Act "requires that an exchange's rules not be designed to regulate matters not related to the purposes of the administration of the exchange." The Commission further noted that the Exchange's revised proposal was "*narrowly tailored to be applicable only to orders that have an adequate nexus to activities on the NYSE.*" (Emphasis added).<sup>12</sup>

The Nasdaq Exchange's proposal to collect and disseminate reports of trades that do not take place through its exchange facilities amounts to regulation of a matter not related to the administration of the Nasdaq Exchange. This is especially clear in light of the Commission's Rule 3b-16(a) explanation of the functions commonly performed by an exchange, discussed below.

**Fair Competition:** In section 11A(a)(1)(C)(ii) of the Act, Congress finds that:

It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition . . . among exchange markets, and between exchange markets and markets other than exchange markets.

Section 11A(c)(1)(F) of the Act precludes a self-regulatory organization from distributing market data in contravention of Commission rules designed to assure equal regulation of all markets.

The Nasdaq Exchange's proposed transaction reporting rules would violate the Congressional principles proscribing unfair discrimination and promoting fair competition and equal regulation. If the Nasdaq Exchange were to report internalized and other off-exchange trades, the Nasdaq Exchange would capture an ongoing subsidy from its competitor exchanges and the NASD.

## 2. SEC Rules

**SEC Trade Reporting Rule:** SEC Rule 11Aa3-1(b)(1) under the Act requires every exchange to "file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities

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<sup>12</sup> See SEC Release 34-44139 (March 30, 2001).

*executed through its facilities.*” (Emphasis added.) It also requires every association to “file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed by its members *otherwise than on an exchange.*” (Emphasis added.) Thus, the regulatory scheme for trade reporting contemplates that broker-dealers would report trades that are not executed on the facilities of an exchange through NASD, the only registered national securities association. As noted above, this allocation of authority and responsibility springs from the jurisdictional nexus to trade location.

**SEC’s Definition of Exchange:** SEC Rule 3b-16(a) clarifies what it means to be an “exchange” as defined in section 3(a)(1) of the Act.<sup>13</sup> An exchange “[b]rings together the orders for securities of multiple buyers and sellers ... [and] [u]ses established, non-discretionary methods ... under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.” Under the SEC’s definition, the Nasdaq Exchange would not function as an “exchange” in respect of internalized trades executed in the proprietary systems of registered Nasdaq Exchange members.<sup>14</sup> In these cases, all of the functions described in the definition take place in those proprietary trading systems and not on the facilities of the Nasdaq Exchange.<sup>15</sup>

### **3. CTA Plan and Processor Contracts**

SEC Rule 11Aa3-2(d) requires each self-regulatory organization to comply with the terms of any effective national market system plan in which it participates and enforce compliance by its members. As a result, the Nasdaq Exchange will be required to comply with the CTA Plan. As discussed below, the Nasdaq Exchange’s proposed transaction reporting rules would not comply with the plan.<sup>16</sup>

Under Rule 11Aa3-1, the Nasdaq Exchange may not report transactions except pursuant to a SEC-approved transaction reporting plan. For that reason, the Nasdaq Exchange is working with the other exchanges and the NASD<sup>17</sup> to join the CTA and CQ Plans (and, presumably, the OTC/UTP Plan) once it becomes an exchange. Joining the CTA and CQ Plans would allow the Nasdaq Exchange to comply with Rule 11Aa3-1 in respect of securities listed on NYSE or AMEX.

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<sup>13</sup> Section 3(a)(1) of the Act defines “exchange”, in part, as a “marketplace or facilities for bringing together purchasers and sellers of securities.” Rule 3b-16(a) was adopted by the Commission in Release No. 34-40760; December 8, 1998 (Regulation of Exchanges and Alternative Trading Systems) (“Regulation Release”).

<sup>14</sup> Rule 3b-16(b)(2) places such proprietary systems outside the definition of an exchange; indeed, in the Regulation Release, the Commission noted that “... systems designed for the purposes of executing orders against a single counter-party, such as a dealer operating a system, would not be considered to have multiple buyers and sellers.”

<sup>15</sup> Note that a broker-dealer’s submission to the Nasdaq Exchange’s ACT system of an executed trade for comparison purposes falls outside the SEC’s definition. ACT plays no role in creating the trade contract -- ACT is not an execution facility.

<sup>16</sup> Similar issues may arise under the OTC/UTP Plan.

<sup>17</sup> Participants in the CTA and CQ Plans currently include the AMEX, Boston Stock Exchange, Inc. (“BSE”), Chicago Board of Options Exchange, Inc., Chicago Stock Exchange, Inc. (“CHX”), Cincinnati Stock Exchange, Inc. (“CSE”), NASD, NYSE, Pacific Exchange, Inc. (“PCX”), and Philadelphia Stock Exchange, Inc. (“PHLX”).

Section VIII(a) of the CTA Plan requires each exchange to report all trades occurring through its facilities. This section further requires NASD (which the Plan accommodates in ways different from exchanges) to report all trades *not* taking place on the facilities of an exchange. The contracts with the CTA Plan processor contain parallel provisions.<sup>18</sup>

Thus, the CTA Plan contemplates that an exchange may only report transactions taking place through its facilities, and that NASD must report trades not taking place through the facilities of an exchange, including internalized trades executed in the proprietary facilities of a broker-dealer. The Nasdaq Exchange's proposed transaction reporting rules would cause both it and NASD to violate section VIII(a).

In addition, Section VI(f) of the CTA Plan requires identification of the market of execution for each trade and to identify those trades that do not take place on an exchange. The Nasdaq Exchange's proposal to report off-exchange trades would cause confusion in the marketplace and would defeat the purposes of this requirement.

#### **4. Withdrawal from the Data Plan**

The Nasdaq Exchange has suggested it may withdraw from CTA, CQ and OTC/UTP Plans in keeping with the anticipated recommendations of the Commission's Advisory Committee on Market Information. Its withdrawal would not resolve any of these issues. The Commission must approve transaction reporting plans for the Nasdaq Exchange, the other exchanges and the NASD that prevent duplicative reporting and comply with the Act and SEC rules. If the Nasdaq Exchange withdraws from the data plans, the question of fair sharing of revenues should not be converted to one of intermarket competition for the collection of trade reports in order to present the strongest value proposition for the sale of market data.

#### **E. Rationale for the Existing Regulatory Scheme**

Commission rules, the applicable transaction reporting plans and the existing processor contracts clearly contemplate that the Nasdaq Exchange and each other exchange will report only trades that take place through its facilities, and that the NASD will report internalized trades and other off-exchange trades. The core concept -- that the market on which a trade takes place should report the trade -- is grounded in the conflict of law principles reflected in practices that date back 130 years or more.

Congress, the Commission and the industry faced this issue a quarter of a century ago when they sought to create a national market system with market data at its heart. Their solution was to follow well-established legal principles and market practices that confined an exchange to reporting only those trades take took place through its facilities, leaving to the NASD the right

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<sup>18</sup> Under the CTA Plan, the plan participants must report last sale prices in accordance with agreements that each market has entered into with the plan's processor. (The forms of processor agreements can be found as Exhibit B to the CTA Plan.) Those agreements require each exchange participant to report transactions that take place through its facilities. They state that an exchange participant "will *not* report ... any last sale prices other than as above provided in . . . [this] Article FIRST." (Emphasis added.) NASD's agreement requires it to report "last sale prices relating to transactions [that] . . . do not take place on a national securities exchange."

and obligation to report off-exchange trades. We see no intervening developments that justify a change to that rational structure.

More recently, the Commission addressed a similar issue with regard to compliance with Rule 11Ac1-5 requiring disclosure of order execution data.<sup>19</sup> The Commission interpreted the rule -- at the Nasdaq Exchange's request -- to apply to SuperSoes as a separate "market center" as to which the Nasdaq Exchange has responsibility to issue monthly disclosure reports.<sup>20</sup> In contrast, market makers executing transactions off-SuperSoes are deemed to be separate "market centers" with individual reporting responsibility. In that context, the Commission draws the distinction between executions occurring on the facilities of the Nasdaq Exchange and those internalized by Nasdaq Exchange members. We know of no rationale that would suggest a different result as to transaction reporting.

### **III. Negative Trading Obligations**

Sections 11(b) and 15(c)(5) of the Act give the Commission broad authority over exchange specialists and market makers. More specifically, these sections give the Commission the power to determine whether specialists and market makers are permitted to act as both broker and dealer or are limited to only one of these functions.<sup>21</sup>

The Commission used this authority to adopt Rule 11b-1. The rule sets forth provisions that must be included in an exchange's rules before the exchange can permit a member to register as a specialist and to act as both a broker and a dealer. For instance, if the Nasdaq Exchange market makers/dealers are also going to act as brokers in the securities in which they are registered, then the Nasdaq Exchange is responsible for maintaining rules that impose negative trading obligations on them.

The Exchange believes that a SuperMontage feature would cause Nasdaq and its market makers to be in violation of the negative obligation requirement. SuperMontage provides for a "matching (preferencing)" function whereby a market maker quoting at the BBO can direct its customer's order to itself for execution, i.e., internalize the order. This is the case even when the market maker's bid/offer does not have time priority, i.e., where the market maker's bid or offer, for example, is tenth in the queue behind public customers and other market makers. Yet, SuperMontage is programmed to let the market maker's bid/offer jump to the front of the queue to trade with its own customer's order.

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<sup>19</sup> See letter dated June 22, 2001, from Annette Nazareth, Director, Division of Market Regulation, Commission, to Richard S. Ketchum, President, the Nasdaq Exchange.

<sup>20</sup> Issues to the interpretation led the Nasdaq Exchange to abandon this service.

<sup>21</sup> The term "specialist" is not defined in the Act. The term, in the context of exchange regulation, is commonly understood to apply to an exchange member who is registered and authorized to act both as a "dealer" and as a "broker" (as those terms are defined in section 3(a)(4) and (5), respectfully, of the Act).

The Report of the Committee to Study the Stock Allocation System (NYSE/January 27, 1976) notes that the term finds its origin on the Exchange in the late 1800s. At that time, the Floor brokerage function evolved with a single member "specializing" in one or more stocks as a "broker's broker", i.e., representing limit orders for other members. By the early 1900's, specialists also began to act as dealers. The duality of the functions is recognized in the definition of the term "market maker", which reads in part as "... any specialist [broker] permitted to act as a dealer, ..." (see section 3(a)(38) of the Act).

That aspect of SuperMontage is clearly at odds with the negative obligations to which exchange market makers are required to adhere. An exchange market maker cannot participate in a trade when other willing buyers/sellers are present in the market at the same price, let alone when those buyers/sellers have time priority over the market maker's bid/offer.

The Commission stated in the SuperMontage Release that:

The Commission reiterates, however, that its approval of this aspect [matching] of the proposal is based on the *structure of the existing dealer market* and the voluntary nature of SuperMontage. (Emphasis added.)

The market structure of the Nasdaq Exchange as a freestanding registered national securities exchange will be quite different from the market structure of the NASD's current off-exchange market. The Commission acknowledged this when it noted in the SuperMontage Release that market makers are not likely to enter customer orders in SuperMontage when they can internalize them. In an exchange environment, SuperMontage will function like the automatic execution systems of the regional stock exchanges. Presumably, the NASD will continue to operate the decentralized dealer market.

The Exchange also believes that the voluntary nature of SuperMontage should not be a consideration in permitting preferencing on the Nasdaq Exchange. Since the repeal of NYSE Rule 390 (and similar rules of other exchanges), the entry of orders by members of all exchanges is voluntary. All exchanges also offer competitive systems and fee structures to attract order flow. However, none -- to our knowledge -- compete for the order flow by routinely allowing market makers to jump to the front of the book, thereby displacing execution priority, particularly the priority of public customers.

CSE's preferencing program permits a CSE preferencing dealer to trade with its own customer's order by displacing pre-existing, or priority, trading interest of other CSE dealers on the CSE book at the same price. However, any agency interest on the CSE book at the price has to be executed in priority order before a preferencing dealer is allowed to trade with its own order. The Commission insisted on the same provisions when it approved the competing specialist programs of the BSE and PCX. Furthermore, in the case of BSE and PCX, the Commission went further by insisting that the quotes of the competing specialists be executed in time priority order so that, unlike CSE, one dealer cannot displace another dealer with priority. While the SuperMontage matching -- or preferencing -- scheme might be acceptable in the context of the OTC dealer environment, the Commission has already set precedent for what it requires from an exchange market. We question why the Nasdaq Exchange broker-dealers should be permitted to disadvantage customers with time priority in contravention of the negative obligations set forth in Rule 11b-1 when the Commission has not permitted other exchange markets to do so.

#### **IV. Short Sale Rule**

In the Form 1 release, the Commission observes that Nasdaq Exchange members would be subject to section 10(a), and thus to Rule 10a-1, the Commission's Short Sale Rule. However, the Nasdaq Exchange proposes to apply to transactions executed on the Nasdaq Exchange in its listed stocks the form of short sale rule that NASD currently applies on a pilot basis to OTC stocks. This rule compares a proposed sale to the best bid, rather than the last trade.

Furthermore, it contains a broad exemption for market makers alone that Rule 10a-1 does not contain. The Exchange believes that, from a regulatory and competitive perspective, the Commission should not approve the Nasdaq Exchange's proposed short sale rule. Once the Nasdaq Exchange becomes a national securities exchange, it should be required to comply with all provisions of the Act and all Commission rules applicable to national securities exchanges.

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In summary, the Exchange believes that:

- The Nasdaq Exchange's Form 1 is inadequate because it fails to explain what changes the Nasdaq Exchange is proposing to existing NASD rules and why it is making these changes, and omits rules regarding NASD's residual off-exchange market. Furthermore, the Form 1 is incomplete because it fails to address the rules governing the engine of the Nasdaq Exchange, SuperMontage.
- The proposed transaction reporting plan violates the Act, SEC rules, the CTA Plan and the NASD's agreement with the CTA Plan processors.
- Previously-approved rules governing priority of orders on SuperMontage would violate the negative obligations SEC Rule 11b-1 imposes on registered exchanges.
- The proposed Nasdaq Exchange rule governing short sales would not conform to Section 10(a) of the Act and SEC Rule 10a-1.

We thank you for this opportunity to comment and would be pleased to respond to any questions you may have.

Sincerely,



cc: Chairman Harvey L. Pitt  
Commissioner Laura S. Unger  
Commissioner Isaac C. Hunt, Jr.  
Annette L. Nazareth  
Robert L.D. Colby  
Elizabeth King  
Rebekah Liu  
Geoffrey Pemble



February 15, 2002

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: National Association of Securities Dealers ("NASD") Establishment of an Alternative Display Facility. Release No. 34-45156, File No. SR-NASD-2001-90 (December 14, 2001; the "NASD Filing")

Nasdaq Stock Market ("Nasdaq Exchange") Form 1 Application for Registration as National Securities Exchange. Release No. 34-44396, File No. 10-131 (June 6, 2001; as amended, the "Nasdaq Exchange Filing")

Dear Mr. Katz:

The New York Stock Exchange, Inc. (the "Exchange" or "NYSE") submits this letter to the Securities and Exchange Commission (the "Commission") to comment on the above-captioned filings. The Exchange wishes to comment upon the implications of the filings for transaction reporting and the Intermarket Trading System ("ITS").

The Exchange has previously commented on the Nasdaq Exchange Filing<sup>1</sup> as Nasdaq Exchange submitted it in its original Form 1 Application for Registration as a National Securities Exchange (the "Original Form 1"). As of this date, however, Nasdaq Exchange has twice amended the Original Form 1 to revamp its proposed transaction-reporting rules.<sup>2</sup> Both efforts merely tinker with definitional language but do not cure the

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<sup>1</sup> See Letter dated August 27, 2001, from James E. Buck, Secretary, Exchange, to Jonathan G. Katz, Secretary, Commission ("August NYSE Letter").

<sup>2</sup> See letter dated December 5, 2001 from Edward G. Knight, Executive Vice President and General Counsel, Nasdaq Exchange, to Jonathan G. Katz, Secretary, Commission (the "December 5 Letter") and letter dated January 8, 2002, from Edward Knight to Annette Nazareth, Director, Division of Market Regulation, Commission. Amendment No. 3 is Nasdaq Exchange's most recent iteration of the proposed  
(footnote continues on next page)

deficiencies of the Nasdaq Exchange transaction-reporting rules as described in the August NYSE Letter.

The August NYSE Letter stated that a full assessment of the Nasdaq Exchange rules package is impossible without knowing how NASD will propose to amend its rules after divesting Nasdaq Exchange. Now that we have had the opportunity to review the NASD Filing, we see that it complements and facilitates at least Nasdaq Exchange's original attempt to circumvent the statutory, regulatory and contractual safeguards that prevent the reporting of off-exchange trades to an exchange. It seems apparent that NASD's proposed transaction-reporting rules were designed to maximize Nasdaq Exchange's market data revenues to its own detriment and that of its members. Nasdaq Exchange's amendments to its Original Filing seem to have uncoupled the two proposals. Given the linkage of the Nasdaq Exchange Filing and the NASD Filing, the Exchange believes it is not only appropriate but necessary to comment on both filings in one letter.

Basically, the Nasdaq Exchange proposes that it receive credit for market share of trades and volume, and thus market data revenues, for trades executed in another market. We believe that Nasdaq Exchange's proposal will perpetrate a fraud on the investing public. There is an axiom in the securities industry that liquidity begets liquidity. Nasdaq Exchange's proposal would perpetuate the illusion of liquidity on Nasdaq Exchange, when in fact a substantial portion of that liquidity would not relate to executions occurring on Nasdaq Exchange. Not only public investors would be harmed by such a practice, but so would Nasdaq Exchange's competitor markets. The inappropriate inflation of Nasdaq Exchange's market share of trades and share volume, and its inflated share of market data revenue would result, on one hand, in the illusion that Nasdaq Exchange's competitive stature is greater than it really is, and, on the other hand, in real revenues that would give Nasdaq Exchange a distinct advantage over its competitors.

A brief summary of the Nasdaq Exchange and NASD Filings follows:

I. Nasdaq Exchange Proposed Transaction-Reporting Rules

A. Nasdaq Exchange Original Form 1 Proposal

As more fully explained in the August NYSE Letter, Nasdaq Exchange's Original Form 1 sought to appropriate to Nasdaq Exchange reports of trades that occur "otherwise than on an exchange".<sup>3</sup> Such a notion deviates from current trade-reporting requirements. Currently, broker-dealers are required to report transactions that they execute "otherwise

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Nasdaq Exchange trade-reporting rules of which the Exchange is aware. The Commission has not yet published these amendments in the Federal Register for comment.

<sup>3</sup> To avoid confusion, this letter uses the term "OTC market" in its more narrow, traditional context of trading in securities not listed on a registered exchange, including Nasdaq Exchange. It uses the term "third market", to refer to trading in listed stocks that takes place otherwise than on a registered exchange. It also uses the term "off-exchange" to describe all trading (in listed and OTC stocks) which takes place otherwise than on an exchange and which is regulated by NASD.

than on an exchange” to NASD, and to report trades that they execute through an exchange’s facilities to that exchange.

Nasdaq Exchange’s Original Form 1 proposed to expand the plain and natural meaning of the term “transactions executed on Nasdaq.” Nasdaq Exchange proposed to include in that definition substantially all internalized off-exchange trades of its members, even though such trades would never touch Nasdaq Exchange’s trade-execution facilities.

The August NYSE Letter demonstrated how the Original Form 1 proposal would violate the Act, Commission rules under the Act, the Consolidated Tape Association (“CTA”) Plan, and agreements with the CTA Plan processor.<sup>4</sup>

#### B. Nasdaq Exchange Amendment No. 2

Subsequently, Nasdaq Exchange, on December 5, 2001, filed Amendment No. 2, in which it conceded that internalized trades are actually executed “otherwise than on an exchange”. In this filing, Nasdaq Exchange abandoned its proposal to define such trades, in an unnatural way, as “transaction[s] executed on Nasdaq”. However, rather than recognizing that broker-dealers are required to report trades executed “otherwise than on an exchange” to NASD, as trade-reporting rules have required for the past 30 years, Nasdaq Exchange proposed to allow broker-dealers to elect to report internalized trades to any exchange or association of which they are members.

#### C. Nasdaq Exchange Amendment No. 3

Amendment No. 3, filed on January 8, 2002, proposes to retract the more democratic, though legally flawed, approach of Amendment No. 2. It reverts to the more Nasdaq Exchange-centric proposal of the Original Form 1. Under it, Nasdaq Exchange market makers, ATSS and ECNs (collectively, Registered Reporting Members (“RRMs”)) must, with one significant difference, report internalized trades to Nasdaq Exchange. However, Amendment No. 3 does this without using the Original Form 1’s tortured definition of “transaction executed on Nasdaq.”

Instead, Amendment No. 3 proposes to require RRM to report to Nasdaq Exchange the internalized trades in securities that they quote through Nasdaq Exchange. Since Nasdaq Exchange allows only its RRM to communicate quotations through Nasdaq Exchange, Amendment No. 3 requires the same universe of Nasdaq Exchange members to report the same universe of off-exchange trades to it as did the Original Form 1. Significantly, in this iteration, Nasdaq Exchange acknowledges that the RRM trades in questions are executed “otherwise than on an exchange”, i.e., executed in the OTC or third market. But, Nasdaq Exchange nevertheless would mandate that such trades be reported to it, rather than recognizing that the trades should be reported to the NASD.

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<sup>4</sup> The Nasdaq Exchange’s proposed transaction-reporting rules would also violate section viii.B. of the Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Basis (the “OTC/UTP Plan”).

## II. NASD Proposed Trade-Reporting Rules

Although it was the original proposed Nasdaq Exchange rules that extended Nasdaq Exchange's jurisdictional reach to capture reports of trades that broker-dealers do not execute through Nasdaq Exchange facilities, proposed NASD Rule 4200(a) offers Nasdaq Exchange a definitional means for doing so in compliance with NASD rules. It proposes to define "otherwise than on an exchange" in a manner that facilitates the overreach of Nasdaq Exchange's Original Form 1:

(13) "*Otherwise than on an exchange*" means a trade effected by a NASD member otherwise than *on or through* a national securities exchange. The determination of what constitutes a trade "on or through" a particular national securities exchange *shall be determined by that exchange* in accordance with all applicable statutes, rules and regulations, and with any necessary SEC approval. (Emphasis added.)

NASD would thus bow to Nasdaq Exchange's unnaturally-expanded definition of trades executed on Nasdaq Exchange. Now that Nasdaq Exchange, in Amendment No. 3, has abandoned that expanded definition, it would appear that there can be a conflict between Nasdaq Exchange and NASD reporting requirements.

## III. NYSE Comments on Amendment No. 3

### A. Applicability of August NYSE Letter

The August NYSE Letter describes why it is inappropriate for Nasdaq Exchange to require off-exchange trades to be reported to it:

The [Nasdaq Exchange's] proposed transaction reporting rules break the nexus between the location of a trade (i.e., the place of the making of a contract for the delivery of stock against payment) and transaction reporting.<sup>5</sup>

Breaking this nexus "contradicts accepted rules of contract law, conflict of laws, equal regulation, fair competition and accurate disclosure."<sup>6</sup> As the August NYSE Letter explains, Congress, the Commission and the industry fashioned the "heart" of the national market system -- market data dissemination -- "to follow well-established legal principles and market practices that confined an exchange to reporting only those trades that took place through its facilities."<sup>7</sup> Nothing has changed to warrant Commission abrogation of those principles and practices through Commission approval of Nasdaq Exchange as a "print" facility for trades occurring in other markets.

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<sup>5</sup> August NYSE Letter at p. 3.

<sup>6</sup> August NYSE Letter at p. 4.

<sup>7</sup> August NYSE Letter, at p. 9

In addition, the August NYSE Letter points out that, if Nasdaq Exchange prints trades that do not touch its facilities, it will inflate its reported trading activity and allow it to claim an unwarranted portion of market data revenues. The August NYSE Letter predicted that other exchanges would soon follow Nasdaq Exchange's lead by adopting similar "tape-printing" rules, causing confusion in the marketplace.<sup>8</sup> The August NYSE Letter also points out that the Original Form 1 trade-reporting rules would violate Commission Rule 11Aa3-1(b) (the "Transaction Reporting Rule"), the CTA Plan, and existing contracts with the CTA Plan processor.<sup>9</sup>

All of those arguments apply with equal force to Amendment No. 3. As in the Original Form 1, Amendment No. 3 would require broker-dealers to report to Nasdaq Exchange (rather than to NASD) trades that they internalize or otherwise execute outside of the execution facilities of an exchange, including those of Nasdaq Exchange. As a result, Amendment No. 3 would produce the same violations of the Transaction-Reporting Rule, the CTA Plan and existing contracts with the CTA Plan processor and the same distortions of trade activity reports and revenue allocation.<sup>10</sup>

Amendment No. 3 continues to require that trades "facilitated" by, but not executed through, Nasdaq Exchange systems be reported to Nasdaq Exchange, even though it no longer attempts to define such a trade as one "executed on" Nasdaq Exchange. In the August NYSE Letter, we noted that the venue reporting such "facilitated" trades should be the venue of their execution, i.e., if the execution occurs in a Nasdaq Exchange

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<sup>8</sup> "It's an electronic function, it's where the trade gets reported. We will now report that information to Cincinnati," said Andrew Goldman, executive vice president of the New York-based electronic communications network. Currently, Island, which allows buyers and sellers to trade securities over the Internet, reports electronically its market data generated from *consummated trades* of Nasdaq-securities to Nasdaq, which then sells the data. Goldman said Cincinnati will return the revenue, which will be split equally among the sellers, buyers and Island, which has become the largest ECN by trade volume." (emphasis added) USA: Island ECN to Send Trade Reports to Cincinnati Market, Jan 30, 2002, Reuters English News Service.

Since we submitted the August NYSE Letter, the Cincinnati Stock Exchange ("CSE") has entered into a payment for market data display arrangement with Island ECN ("Island") relating to OTC stocks in which CSE has taken unlisted trading privileges ("UTP"). According to the above article, Island will report its *already-executed* trades in OTC stocks through CSE. In exchange, CSE will rebate to Island a portion of the market data revenue it derives from the OTC/UTP transaction reporting plan ("OTC/UTP Plan").

Up until recently, Island reported these off-exchange trades to NASD which, based on our understanding of the Commission's Transaction-Reporting Rule and the OTC/UTP Plan, is where the trades should continue to be reported. File No. SR-CSE-2001-05, SEC Release No. 34-45148, December 11, 2001.

<sup>9</sup> See August NYSE Letter at pp. 6-9.

<sup>10</sup> We are not aware that Nasdaq Exchange has petitioned the Commission to amend the Transaction-Reporting Rule to cure the problem. Similarly, Nasdaq Exchange has not proposed to amend the CTA Plan or its agreement with the CTA Plan processor.

system, then the trade should be reported to Nasdaq Exchange; but if the execution occurs in a broker-dealer's system, then the trade should be reported to NASD.

Nasdaq Exchange does not define the term "facilitated". We understand, however, that there are at least two applications where trades would not be executed on Nasdaq Exchange systems but where Nasdaq Exchange would consider a trade "facilitated" by Nasdaq Exchange systems and reportable to it.<sup>11</sup> In the case of an "order delivery" ECN, Nasdaq Exchange "facilitates" by routing an order to the ECN for execution in the ECN's system. In addition, Nasdaq Exchange describes its ACES system as a facility "that permits brokers/dealers to automate *their internal execution* and record-keeping functions". (Emphasis added). While Nasdaq Exchange systems may be helpful in "facilitating" these trades, it is clear that the executions occur "otherwise than on [Nasdaq Exchange]" and should be reported to NASD.

#### B. The December 5 Letter

In its December 5 Letter, the Nasdaq Exchange includes a section entitled Response to Comments. Nasdaq Exchange offers a number of descriptive comments about its marketplace, but these hardly address the legal impediments to its proposal.<sup>12</sup> While the proposed rule text in Nasdaq Exchange Amendment No. 3 supersedes much of that was submitted in Amendment No. 2, the December 5 Letter provides much of the faulty logic for the proposals in Amendment 3.

Nasdaq Exchange states that its market structure is unlike that of any other national securities exchange. It implies that those purported differences justify the awarding of exemptive relief from the securities laws and rules and joint industry plans that govern trade reporting. The Exchange strongly disagrees.

If Nasdaq's market structure would hinder its compliance with existing laws once it converts into an exchange, it must either modify its structure or receive special exemption from the Commission. For the Commission to grant Nasdaq Exchange exemptive relief, it would have to find that the relief does not violate the concept of equal regulation of the markets, as Congress prescribed in section 11A(c)(1)(F) of the Act. In addition, Nasdaq Exchange must convince the participants in the CTA Plan to modify the Plan to eliminate the requirement that members must report all off-exchange trades to NASD.

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<sup>11</sup> Conversations with Nasdaq Exchange staff Gene Lopez. Without any codified definition, however, the term "facilitate" is open to numerous, subjective interpretations. For example, the NYSE might require its members to report to the NYSE trades executed in other CTA markets at prices derived from NYSE quotations on the theory that the NYSE "facilitated" those transactions.

<sup>12</sup> The Exchange notes that the December 5 Letter does not respond to the observations in the August NYSE Letter that Nasdaq Exchange's proposed transaction-reporting rules would violate the Act, Commission rules under the Act, and agreements with the CTA Plan processor and our comments on the applicability of section 11(b) of the Act and Commission Rule 11b-1 to RMM trading in SuperMontage (i.e., negative trading obligations).

The Exchange also notes that, on one hand, every market has unique market structure features, not just Nasdaq Exchange. On the other hand, however, Nasdaq Exchange's proposed market structure is not materially different from CSE's and, prospectively, the Pacific Exchange's ("PCX") ARCA Facility. Like Nasdaq Exchange, CSE and PCX are electronic markets that consolidate and disseminate to the public the trading interest of their members' customers, and of their multiple market makers. In addition, Nasdaq Exchange would only follow the lead of other exchanges in allowing for the automatic execution of orders against published quotes and the routing of orders between members.

Nasdaq Exchange also states that:

The Commission has not addressed the issue of whether non-exchange system and internalized trades *can* be reported to an exchange. (Emphasis added)<sup>13</sup>

Nasdaq Exchange is wrong. The Commission spoke clearly 30 years ago when it required the NASD to file a transaction reporting plan regarding securities executed by its members "otherwise than on an exchange" and required such members to report such off-exchange transactions to the NASD as an association.

### C. Standards for Locus of a Trade

In Amendment No. 3, Nasdaq Exchange hangs its off-exchange trade-reporting rules on the concept of assigning a trade in a security to the market on which a RRM communicates its quotes in that security. Nasdaq Exchange claims that the benefits that a market confers on a RRM, and the obligations that the market imposes, supplies a sufficient nexus between the market and the RRM's off-exchange trades to warrant assigning those trades to that market. To support this claim, Nasdaq Exchange supplies a list of regulations, rules and other obligations to which Nasdaq Exchange RRMs must adhere in order to post quotations through Nasdaq Exchange, adding that it is their status as Nasdaq Exchange RRMs that allows them to attract business.

First, we note that the RRM-benefit/obligation standard has never been recognized by the markets or the Commission as the industry standard for establishing the locus of the execution of a trade. Rather, the standard is the use of an exchange's execution facilities. If a trade is executed through an exchange's facilities, the trade must be reported to that exchange. If a trade is executed without the use of an exchange's facilities, the trade must be reported as an off-exchange trade to the NASD. Nasdaq Exchange has provided **no justification** for abandoning that standard. Since the NASD began reporting trades, it has been the sole venue for the reporting of off-exchange trades.<sup>14</sup>

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<sup>13</sup> December 5 Letter, p. 6.

<sup>14</sup> Moreover, investors who monitor trading activity on a regular basis have come to know the trade identifier "T" as designating such trades as being executed off an exchange and reported to NASD. We understand NASD/Nasdaq Exchange intend to allow Nasdaq Exchange to adopt NASD's "T" identifier for trades that it reports to the Consolidated Tape System and NASD will adopt a new identifier "D". This will only confuse investors. Nasdaq Exchange seems to want to create the impression that it will remain the  
(footnote continues on next page)

Second, we note that Amendment No. 3 amounts to a clear admission by Nasdaq Exchange that internalized RRM trades are *not* in fact trades that are executed on Nasdaq Exchange. Because Nasdaq Exchange is seeking to re-invent trade-reporting rules by assigning off-exchange trades to an exchange, Nasdaq Exchange must persuade the Commission and the other CTA Plan participants of the appropriateness of the change. It must convince the Commission that deceptive representations of trading activity on a market are not important and it must convince the CTA Plan and OTC/UTP participants to amend those Plans to accommodate the revised trade-reporting concept.

Third, the conclusion that a broker-dealer's communication of quotes to Nasdaq Exchange is so essential to the trading process as to justify assigning the broker-dealer's off-exchange trades to Nasdaq Exchange is unfounded. Most RRM order flow emanates from their own public customers or from paying other broker-dealers for their order flow. Furthermore, RRMs principally trade by matching the NBBO (and in some cases, providing price improvement better than the NBBO). However, their own quotes do little to attract order flow. The Exchange notes, however, that if quality quotations were the standard upon which to determine where a trade should be reported, then the NYSE would benefit by being the recipient of some 94% of the trades in its listed stocks that are executed on the Regional stock exchanges and in the third market. That is because those markets derivatively price executions off the NBBO, and the NYSE quotations are the NBBO 94% of the time. We cannot believe, however, that Nasdaq Exchange or any other market would agree to that outcome.

#### IV. Conflict between NASD Proposed Rules and Nasdaq Exchange Proposed Rules

##### A. Conflict No. 1 -- Required Reporting

As we have noted, the proposed NASD transaction reporting rules facilitated the original Nasdaq Exchange transaction reporting proposals. However, the proposed Nasdaq Exchange transaction-reporting rules proposed in Amendment No. 3 seem to conflict with the NASD proposal, in that a literal reading would appear to require broker-dealers to report certain off-exchange trades to both NASD and Nasdaq Exchange.

NASD rules currently require its members to report to NASD trades effected "otherwise than on an exchange."<sup>15</sup> The NASD Filing would retain that concept. On the other hand, Nasdaq Exchange Amendment No. 3 would require RRMs to report to Nasdaq Exchange trades that its RRMs internalize, even though, as Nasdaq Exchange acknowledges, the RRMs do not execute those trades through Nasdaq Exchange facilities. Thus, NASD and

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place to report off-exchange trades, ignoring the fact that NASD will remain a registered national securities association after its divestiture of Nasdaq Exchange. The fact is that Nasdaq Exchange is not the successor to NASD as the facility for the reporting of off-exchange trades, despite Nasdaq Exchange's efforts, in its three disparate filings, to foster this impression.

<sup>15</sup> Rule 4633(b) for Nasdaq-listed securities and Rule 6420 for Network A and B securities.

Nasdaq Exchange would each require a Nasdaq Exchange RRM to report to it trades that the RRM executes otherwise than on Nasdaq Exchange.

This inherent conflict between the proposed Nasdaq Exchange and NASD trade-reporting rules presumably will have to be resolved.

We note that proposed Nasdaq Exchange Information Memos 4633-2 and 6413-1 would partially relieve an RRM of this conflicting double reporting obligation. If an RRM is also a member of one or more other national securities exchanges or an association, the RRM can choose to report its internalized trades to either Nasdaq Exchange or another market where its quote resides. Thus, if the RMM reported the trade to NASD, there would be no conflict since NASD rules require that and Nasdaq Exchange rules permit it. However, if an off-exchange trade were reported to Nasdaq Exchange or another exchange, the conflict with NASD rules would continue.<sup>16</sup>

#### B. Conflict No. 2 -- Voluntary Reporting

Amendment No. 3 would permit, but not require, Nasdaq Exchange members that are not RRM to report to Nasdaq Exchange off-exchange trades at the members' discretion.<sup>17</sup> NASD rules require NASD members to report all off-exchange trades to NASD.<sup>18</sup>

A broker-dealer could only comply with both markets' requirements by continuing to report all off-exchange trades to NASD and ignoring the Nasdaq Exchange's permissive transaction reporting provision rule.

#### C. The Proper Resolution

The discretion that Nasdaq Exchange proposes to allow for the reporting of off-exchange trades evidences that Nasdaq Exchange places little weight on assigning trades to the appropriate market and great weight on promoting a trade-report free-for-all.<sup>19</sup> Nasdaq

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<sup>16</sup> As we stated in the August NYSE Letter, competitive and financial reasons would compel other exchanges to amend their rules to invite their members to report off-exchange trades to them. In the end, each exchange's reports of its trading activity would bear little resemblance to actual activity, promoting confusion in the marketplace and misleading investors. Nasdaq Exchange agreed when it stated at p. 7 of the December 5 Letter:

Allowing non-exchange system and internalized trades to be reported to any market in which a broker-dealer is a member has the potential to convert trade reports into a commodity that can be sold to the highest bidding market.

<sup>17</sup> Proposed Nasdaq Exchange Rule 6413(b)(2) and 4633(b)(2).

<sup>18</sup> This means that the proposed NASD rules would require NASD members to report all trades that they internalize to the NASD, just as they always have, while the proposed Nasdaq Exchange rules would permit those same members that are not RRMs to report their internalized trades to Nasdaq Exchange.

<sup>19</sup> Another example of emerging trends is reflected in a recent article, Nasdaq Mulls Free Internalization on SuperMontage, *Securities Industry News* Feb 4, 2002, which states that Nasdaq is currently discussing (footnote continues on next page)

Exchange has provided no basis for dismissing the sound reasons for assigning trades to the market of execution.

The Exchange believes that the NASD should continue to be the repository for off-exchange trades, just as it has always been. The Exchange perceives no change in the structure of the securities markets that justifies over-turning this long-standing practice and regulatory requirement. Therefore, the above-cited conflicts between the proposed off-exchange trade-reporting rules of Nasdaq Exchange and NASD should be resolved in favor of the NASD rules. Nasdaq Exchange should be required to conform its proposed trade-reporting requirement to that of the other exchanges by limiting its reporting requirement to trades that are executed through Nasdaq Exchange facilities.

#### V. Rule Conformity between NASD and Nasdaq Exchange

The NASD Filing acted as a complement to the tape-printing rules that Nasdaq Exchange's Original Form 1 proposed. NASD's proposed transaction-reporting rules require its members to report to NASD trades executed "otherwise than on an exchange" but also permits the "determination of what constitutes a trade "on or through" a particular national securities exchange [to] be determined by that exchange".

By specifying in its rule that "otherwise than on an exchange" has the meaning that a competitor exchange assigns to that term, NASD implicitly endorses the radically expanded meaning that Nasdaq Exchange's Original Form 1 filing assigned to the term "executed on Nasdaq." This coincidental drafting by NASD appears to be an attempt to reconcile NASD rules with Nasdaq Exchange rules. The result of that drafting, however, would have amounted to NASD ceding to Nasdaq Exchange unearned trading activity and revenues. The inescapable conclusion is that NASD agreed to allow each exchange to determine what constitutes a trade on or through that exchange solely to give credence to Nasdaq Exchange's distortion of its rules for that determination.<sup>20</sup>

The above result would have significantly frustrated one of Congress's primary goals under the Act: inter-market competition. The NASD Filing and the Nasdaq Exchange Filing should reflect arms' length dealings between two independent entities. Instead, NASD would have surrendered its market share and market data revenues to Nasdaq Exchange in connection with the divestiture.

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the future pricing structure for SuperMontage, providing for free execution for orders that are crossed in-house which would also allow for cutting down on system traffic for orders "that just need a trade report."

<sup>20</sup> Before approving the NASD Filing or the Nasdaq exchange registration, the Commission must make a finding (whether in the notice or elsewhere) that the Nasdaq Exchange/NASD transaction-reporting rules do not violate the "no unrelated regulation" portion of section 6(b)(5) of the Act. See August NYSE Letter at pp. 6-7. In section 11A(a)(1)(C)(ii) of the Act, Congress finds that fair competition among exchange markets "is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets." Section 6(b)(8) and section 15A(b)(9) of the Act require NASD and Nasdaq Exchange to ensure that its rules "do not impose any burden on competition not necessary or appropriate in furtherance of [the Act]."

The NASD financial statements for calendar year 2000 indicate revenues from market information totaling \$353.9 million. This amount has several components: (1) market data revenue that NASD received in respect of CTA Tape A (\$17.5 million); (2) market data revenue that NASD received in respect of CTA Tape B (\$19.4 million); (3) the AMEX's share of CTA Tape B and OPRA revenues (an amount estimated to aggregate approximately \$86.7 million); and (4) the amount NASD collected in respect of OTC/UTP market data revenues (estimated at about \$230.2 million).

If the Nasdaq Exchange divestiture had been effective for the year 2000 with today's trade reporting ground rules extant, what portion of these revenues would likely have accrued to each of NASD and Nasdaq Exchange? Using the trade and share volume numbers the Commission reported in its approval order of NASD's SuperMontage, 64% of third market trades in CTA Tape A and Tape B securities would have been reported via the NASD, yielding \$23.7 million for the account of NASD and \$13.2 million for Nasdaq Exchange. As regards OTC/UTP trading, NASD broker-dealers would have reported 64% of the such trades via the NASD and in turn received upwards of two-thirds to three-quarters of OTC/UTP market data revenues based that Plan's formula that uses a weighted average to determine revenue sharing. Accordingly, we estimate NASD would have received between \$153.5 and \$172.7 million. Given that it is a wholly-owned subsidiary, the American Stock Exchange's revenues from CTA Tape B, would have been the same in NASD's consolidated statement. In summary, by our calculation, had NASD Rule 4200 (permitting exchanges to determine which off-exchange trades could be transformed into exchange trades) been in effect for calendar year 2000, it would have put in play for the highest bidder an amount somewhere between \$187 and \$207 million in revenues that otherwise would have accrued to NASD.

Now that Nasdaq Exchange has abandoned the "executed on Nasdaq" approach (and even if it had not), NASD should remove from its proposed trade-reporting rules the deference to an exchange's definition of what it means for trades to be executed on the exchange.

#### VI. Timeliness of Reporting

In proposed Rule 6420(f)(4), NASD "emphasize[s] the obligations of members to report securities transactions [in CTA eligible securities] within 90 seconds after execution." In contrast, Section VIII(a) of the CTA Plan requires all CTA Plan Participants to report transactions "as promptly as possible." For most trades, 90-second reporting would fail to satisfy the "as promptly as possible" standard. The Exchange believes that CTA Plan obligates the NASD it to conform its standard for the timing of member reports to the CTA standard.

#### VI. Implications for ITS Plan

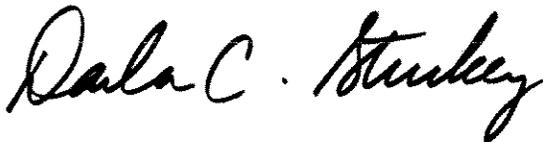
NASD and Nasdaq Exchange have proposed that Nasdaq Exchange should replace NASD as the Participant in the ITS Plan. According to them, NASD would apply to become a new ITS Plan Participant.<sup>21</sup>

NASD proposes a number of amendments to its 5200 series of rules, which currently govern NASD members' use of ITS.<sup>22</sup> In the Exchange's view, several of the proposed amendments substantively change the manner in which NASD currently participates in ITS. A subcommittee of the ITS Operating Committee has just begun to negotiate ITS Plan amendments designed to accommodate NASD's participation. Because those negotiations may impact some of the substantive issues raised by the proposed changes to NASD's 5200 series, the Exchange believes that it is premature to discuss those issues in this letter. We note, however, that the proposed NASD rules must ultimately conform to any Commission-approved amendments to the ITS Plan that the negotiations may yield.

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We thank you for this opportunity to comment and would be pleased to respond to any questions you may have.

Sincerely yours,



c: Chairman Harvey Pitt  
Commissioner Isaac D. Hunt  
Commissioner Cynthia Glassman  
Annette L. Nazareth, Director, Division of Market Regulation, Commission  
Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission  
Elizabeth King, Associate Director, Division of Market Regulation, Commission  
Rebekah Liu, Special Counsel, Division of Market Regulation, Commission

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<sup>21</sup> Nasdaq Exchange's transition to exchange status would require an amendment to the ITS Plan.

<sup>22</sup> The NASD Filing redesignates the 5200 Series as the 6500 Series.