

Q10. Should a competitive bidding process be required to determine which entity will serve as the single regulator?

B. Allocation of Regulatory Costs

Nasdaq urges the Commission to equitably allocate regulatory costs across markets that trade Nasdaq-listed securities to ensure that intermarket competition does not come at the cost of adequate regulation. As set forth in the Regulation White Paper, Nasdaq believes that all markets that trade the same securities should share the responsibility of equal regulation. In Nasdaq's view, these shared responsibilities include the uniform rules, surveillance, and enforcement discussed above.

Nasdaq claims that in the absence of a framework for adopting uniform order audit trails and uniform enforcement of marketplace rules, Nasdaq is forced to subsidize other markets' regulatory costs, creating a classic free-riding dilemma. Nasdaq funds NASD's OATS to collect trading information from all NASD members, whether or not the trades are reported to Nasdaq. For example, Nasdaq claims that Island ECN ("Island"), an NASD member, reports 15 percent of all Nasdaq trades to the CSE, and then, where Island is the reporting party, Island sends detailed information about those trades to OATS. Therefore, according to Nasdaq, although CSE receives the market data revenue attributable to those trades, the NASD and Nasdaq bear the costs of receiving and storing Island's OATS data as well as the costs of regulating Island's conduct as an NASD member.

Nasdaq believes that the fairest way to allocate the costs of supervising the trading of Nasdaq stocks is to aggregate the exchanges' costs of regulation, which include costs associated with surveillance and enforcement, and to deduct that amount from the market data revenue collected pursuant to the Nasdaq UTP Plan. Nasdaq believes that the Commission could apply this allocation method to today's regulatory environment, as well as in the future to the single regulator, ISG, and DEA regulatory models that Nasdaq has identified in its Regulation White Paper. Nasdaq believes that this means of funding aggregate regulatory costs will counter the existing economic incentives that are leading markets to reduce their regulatory costs to compete for order flow.

Request for Comments on the Allocation of Regulatory Costs

The Commission welcomes comment on all aspects of Nasdaq's petition

requesting the reallocation of regulatory costs, including the following matters:

Q1. Should proceeds from the Nasdaq UTP Plan be withheld to pay for regulatory costs?

Q2. Would Nasdaq's proposal to aggregate and deduct regulatory costs from market data revenue result in adequate regulation? If so, what costs would appropriately be considered regulatory costs and therefore, appropriately deducted from the market data revenue?

Q3. Should other methods of fairly allocating regulatory costs be considered?

Q4. Should the NASD be required, as suggested by the CSE, to alter its systems to include more data from inter-market trading to improve inter-market surveillance?²³ If so, who should pay for this enhancement?

Q5. Who would determine what are legitimate regulatory costs? On what basis should such a determination be made?

C. Prohibition of Trading in Nasdaq-Listed Securities

Finally, Nasdaq asks the Commission to identify the markets that trade Nasdaq-listed securities without approved rules, order audit trails, surveillance, and examination programs sufficient to protect investors that buy and sell Nasdaq-listed securities on those markets. Specifically, Nasdaq believes it is unclear whether SROs, other than the NASD, have comparable algorithmic systems and examinations focused on detecting violations of Commission and SRO investor protection and trading rules.²⁴ In addition, while trading on Nasdaq is subject to a short-sale price test (NASD Rule 3350), several exchanges trade Nasdaq-listed securities without being subject to a comparable price test.²⁵ As a result of such disparities, Nasdaq believes that the level of regulatory protection an investor receives depends almost entirely on the market to which the investor's order is routed. For those markets that in Nasdaq's view do not have adequate regulatory protections, Nasdaq asks the Commission to exercise its authority under section 12(f)(2) and

(f)(3) of the Act²⁶ to prohibit the launch or continuation of Nasdaq trading by any market that fails to protect investors as required under the Act.

IV. Exchange-Listed Securities and Exchange-Listed Options

In response to the Regulation White Paper, CSE asserted that Nasdaq ignored that "the same cross-market manipulation issues that form the predicate for the regulatory solution it advocates in the Nasdaq world apply equally to all other securities, including the NYSE-listed stocks in which Nasdaq trades over 10% of the volume."²⁷ The CSE noted that, contrary to its position on the regulation of Nasdaq securities, Nasdaq did not appear to be arguing that the same surveillance programs were inadequate as applied toward NYSE-listed securities.²⁸ Subsequently, in its Petition, Nasdaq expressly stated that it was not addressing the application of the principles expressed in its Petition to exchange-listed securities.²⁹

The Commission notes that exchange-listed securities and securities options may be traded on more than one market and, therefore, the same regulatory issues raised by Nasdaq could arise. At present, trading in exchange-listed securities is more concentrated than the trading in Nasdaq securities.³⁰ In addition, the options markets are in the process of implementing a consolidated options audit trail system that will enable the options exchanges to reconstruct markets promptly, effectively surveil them and enforce order handling, firm quote, trade reporting and other rules.³¹

Request for Comments on the Application of Nasdaq's Recommendations to Exchange Listed Securities

The Commission requests comment on whether the same regulatory concerns raised by Nasdaq for Nasdaq securities, such as regulatory

²⁶ 15 U.S.C. 78l.

²⁷ See CSE Letter, *supra* note 12, at 2.

²⁸ *Id.*

²⁹ See Nasdaq Petition at note 11.

³⁰ See Table 12, Share Volume by Exchanges, SEC Annual Report 2002 at 175. In 2001, the NYSE had 84.31 percent of the share volume for exchanges. Share volume for exchanges includes stocks, rights, and warrants.

³¹ See Exchange Act Release No. 43268 (September 11, 2000) (order requiring, in part, the options markets to design and implement a consolidated options audit trail system that provides an accurate, time-sequenced record of electronic orders, quotations, and transactions). The International Securities Exchange ("ISE") was not a respondent in the proceedings instituted by this order and therefore has not been ordered to comply with the undertaking. Nevertheless, the ISE has agreed to participate in the audit trail.

²³ See CSE Letter, *supra* note at note 4.

²⁴ Nasdaq represented that while the CSE has asserted that its Firm Order Submission system is an order audit system for the surveillance of trading on the CSE, it was Nasdaq's understanding that FOS is a voluntary system used primarily for settling commercial disputes between traders rather than an integrated, comprehensive means for surveilling trading on the CSE.

²⁵ The Commission notes, however, that short sales in Nasdaq securities would be subject to borrowing requirements, pursuant to an NASD or UTP exchange rule. See, e.g., NASD Rule 3370.