archipelago

November 10, 2005

VIA ELECTRONIC TRANSMISSION;
CONFIRMATION BY OVERNIGHT MAIL

Mr. Jonathan G. Katz
Secretary, Office of the Secretary
Mail Stop 0609
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Re: Comments of Archipelago Holdings, Inc. (ArcaEx) In Response to:
(1) Release No. 34-52049, File No. SR-NASD-2005-087; and
(2)Release No. 34-52559, File No. 10-131

Dear Mr. Katz:

This letter sets forth the comments of Archipelago Holdings, Inc., which wholly owns the Archipelago Exchange, ("ArcaEx") in response to: (1) Release No. 34-52049 filed with the Securities and Exchange Commission ("SEC" or "Commission") by the National Association of Securities Dealers, Inc. ("NASD") to reflect Nasdaq's separation from the NASD upon approval of Nasdaq's exchange registration; and (2) Release No. 34-52559 filed by the Nasdaq Stock Market Inc. ("Nasdaq") regarding its application for registration as a national securities exchange (hereinafter referred to as the "Proposals").[1] As an exchange and a significant market participant in the trading of Nasdaq-listed securities, ArcaEx has a profound interest in the Proposals.[2]

[1] *See* Exchange Act Release No. 34-52049 (July 15, 2005), 70 FR 42398 (July 22, 2005) and Exchange Act Release No. 34-52559 (October 4, 2005), 70 FR 59097 (October 11, 2005).

[2] ArcaEx is available to execute trades in over 8,000 Listed- and OTC-securities and, as of October 31, 2005, handled approximately 24% of total trading volume in OTC securities, 34% of total trading volume in Amex-listed securities, and approximately 5% of total trading volume in NYSE-listed securities. On September 26, 2005, ArcaEx completed the acquisition of PCX Holdings, Inc. and its subsidiaries, which included the acquisition of the PCX options trading business. The PCX share of total monthly equity option contract volume in October 2005 was approximately 8%. See ArcaEx October 2005 Transaction Volume Data, dated November 10, 2005.

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I. Executive Summary

In our view, the Proposals create a market structure that enables an exchange to benefit from a print facility that encourages internalization. ArcaEx respectfully, but strongly, disagrees with the creation of such an arrangement. We believe the Proposals are in conflict with what constitutes an exchange and undermine the value that an exchange provides in bringing together orders for interaction and execution. Moreover, the Proposals weaken investor protection and the national securities markets as a whole.

II. Analysis of the Proposals

A. Current Nasdaq Market Structure

The Nasdaq Stock Market is a decentralized dealer market supported by two distinct execution businesses. The first, the Nasdaq Market Center system (formerly SuperMontage), is an electronic order book where limit orders are displayed and automatically executed. The second, ACT, is a trade reporting facility where internalized dealer prints are reported. [3] This type of trade reporting facility is often referred to as a "print facility" because such executions are printed to the tape without exposure to other orders prior to execution. The ACT facility is unique to Nasdaq's market structure because Section 11A of the Securities Exchange Act requires that dealers report last sale information for executions otherwise than on an exchange through an association. [4] Such ACT prints currently comprise a significant portion of Nasdaq's execution business. [5] Accordingly, Nasdaq has enjoyed an economic benefit and competitive advantage over exchange markets because of the substantial market data revenue generated by such prints.

B. Future Nasdaq Market Structure under the Proposals

The Proposals create a contract between NASD and Nasdaq to form a shell company that merely serves to allow Nasdaq as an exchange to continue to benefit financially from a print facility business. Under the Proposals, the ACT prints that were formerly reported through Nasdaq would be printed through the NASD's Trade Reporting Facility in order for such internalized prints to continue to be reported via an association. However, we believe that the Trade Reporting Facility is a facility of Nasdaq because Nasdaq controls the board, directs all business decisions, provides the technology, and reaps the economic benefits of the facility. NASD merely provides regulatory services, which are paid for by Nasdaq. Accordingly, the Trade Reporting Facility is in fact a business facility of Nasdaq.

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[3] Internalized prints are those where the dealer executes customer order flow on a proprietary basis without exposing the customer order to competing market participants for execution.

[4] *See* §§ 240.11Ac1-1(b)(1)(B)(ii).

[5] Nasdaq no longer separately reports its Nasdaq Market Center and ACT market share. The last segment reporting was provided in a February 2004 Bear, Stearns & Co., Inc. analyst report which indicated that Nasdaq Market Center market share was 16.4%. ACT market share for that period was approximately 33% based upon the difference between the Nasdaq Stock Market total market share and the Nasdaq Market Center market share.

C. Exchange Print Facility

Creating the appearance of a separate NASD facility is not an effective way to circumvent the conflict created by an exchange print facility. In fact, a marketplace with a print facility is inconsistent with the definition of an exchange. As referenced above, not only does Section 11A of the Securities Exchange Act suggest that it is inappropriate for an exchange to report internalized trades, the SEC clarified the definition of an exchange in its approval of Regulation ATS. [6] In Regulation ATS, the Commission modified the definition of an exchange to "more closely reflect the statutory concept of "bringing together" buying and selling interests." [7] Specifically, Regulation ATS stated that a system "brings together orders when orders entered in the system for a given security have the opportunity to interact with other orders entered into the system for the same security."

Applying this analysis to Nasdaq, the Nasdaq Market Center system seeks to "bring together" buy and sell interests by offering a system where such orders electronically interact with each other. Accordingly, Nasdaq Market Center executions are consistent with the exchange definition as set forth in Regulation ATS.

In contrast, Nasdaq's internalized prints reported to the Trade Reporting Facility, do not interact with other orders in the Nasdaq system. The lack of order interaction precludes such executions from being classified as exchange prints. To the contrary, Nasdaq has proposed that the internalized prints be reported as Nasdaq prints with a separate identifier. [8] Further, Nasdaq claims that marking such trades with a separate identifier makes "their regulatory status abundantly clear to all investors." [9] Nasdaq fails to acknowledge that despite the allocation of regulatory responsibilities for the Trade Reporting Facility to the NASD, Nasdaq as an exchange would still control the Trade Reporting Facility business and receive a substantial economic benefit from its executions. Given that federal securities law states that an exchange provides an opportunity for order interaction, approving a market structure with a Trade Reporting Facility in which there is no order interaction will undermine the value and purpose of an exchange.

D. The Proposals weaken investor protection and the national securities markets

The Nasdaq Trade Reporting Facility encourages internalization. The SEC expressed concerns about internalization and the fact that it "discourag[es] the display of aggressively priced quotes" in the Office of Compliance Inspections and Examinations and the Office of Economic Analysis December 2000 Special Study on Payment for Order Flow and Internalization in the Options

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[6] *See* Exchange Act Release No. 34-40760 (December 8, 1998), 63 FR 70844 (December 22, 1998).

[7] *See id* at Section II.A and Rule 3b-16.

[8] Nasdaq has requested that the CTA and UTP Committees implement an additional trade reporting modifier to indicate Trade Reporting Facility executions.

[9] *See* Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq Stock Market to Mr. Jonathan G. Katz dated October 13, 2005.

Markets.[10] Internalization is in contrast with the principle of transparency, which is a hallmark of the securities markets. By discouraging public display of limit orders, internalized trades deter price discovery. Reduced price competition results in wider bid/ask spreads, higher implicit transaction costs, reduced depth of liquidity and an associated increased vulnerability to short term price swings.

In addition, internalization promotes the isolation of limit orders. For example, a customer may enter a limit order that improves the current quote. Dealers that match displayed prices rather than executing against displayed orders may leave the displayed order unexecuted. Ultimately this possibility that limit orders remain unexecuted provides a disincentive for customers to enter better-priced orders. Clearly, internalization has a deleterious effect on investors by discouraging transparency, reducing price competition, and increasing trading costs.

Taking this argument one step further, the Proposals weaken the national securities markets. Nasdaq's competing dealer structure and associated Trade Reporting Facility lack an important element that all national securities exchanges currently must abide by—centralized price, time priority across all orders presented to the exchange. In the approval order to rescind NYSE Rule 390, the Commission states that "price/time priority rules of limit order markets also can enhance depth and liquidity by providing an incentive for trading interest to stack up at prices that are at or around the best bid and offer…[r]educed order interaction may hamper price competition, interfere with the process of public price discovery, and detract from the depth and stability of the markets." [11]

If the Commission were to approve the Proposals that support exchange control of a print facility structure, it would ultimately have to extend this same capability to other exchanges in order to maintain an even playing field and comply with Section 11A(a)(1)(c)(ii) of the Securities Exchange Act. [12] In fact, the National Stock Exchange ("NSX") is establishing a similar arrangement with the NASD. [13] To be certain, other exchanges will be forced to follow suit to remain competitive. The scenario in which there is a proliferation of print facilities across the securities markets results in less order interaction, reduced assurance that investors receive executions at the best available prices, and an overall weakening of the national securities markets.

III. Conclusion

ArcaEx respectfully requests that the Commission not approve the NASD/Nasdaq Trade Reporting Facility and limit Nasdaq's exchange registration to Nasdaq Market Center executions.

[10] http://www.sec.gov/news/studies/ordpay.htm

[11] SEC Release No. 34-42758; File No. SR-NYSE-99-48

[12] Section 11A(a)(1)(c)(ii) states 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 brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."

[13] NSX submitted a memo to the CTA Committee, dated November 3, 2005, regarding its intentions to develop a Trade Reporting Facility.

ArcaEx believes the Proposals seek to mask Nasdaq's intentions of running an exchange print facility, which violates the definition of an exchange and seriously undermines investor protection.

We thank the Commission for providing us this opportunity to comment on the Proposals. If you have any questions concerning our views, please contact me at 312-442-7146.

Very truly yours,

Kevin J. P. O'Hara

Kevin J. P. O'Hara
Chief Administrative Officer &
General Counsel

cc: Christopher Cox, Chairman
Paul S. Atkins, Commissioner
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