

**ACTION REQUESTED BY
JANUARY 21, 2002**

Alternative Display Facility

**Rule Proposal
Regarding Nasdaq
Separation And The
Alternative Display
Facility. SEC Comment
Period Expires
January 21, 2002**

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

KEY TOPICS

- Alternative Display Facility

Executive Summary

On December 14, 2001, the Securities and Exchange Commission (SEC or Commission) published for comment a proposed rule change filed by the National Association of Securities Dealers, Inc. (NASD®)¹ that would (1) revise the NASD rules to reflect Nasdaq's anticipated approval as a national securities exchange and its resultant separation from the NASD and (2) establish the rules that would govern trading otherwise than on an exchange, including the implementation and operation of the NASD Alternative Display Facility (ADF).

The NASD is in the process of spinning off its Nasdaq® subsidiary as an independent, for-profit company. Once Nasdaq separates from the NASD, each corporate entity will have its own set of rules applicable to its respective members. The rule proposal deletes Nasdaq-specific rules and otherwise revises existing NASD rules to reflect Nasdaq's separation. The rule proposal also establishes the rules for the ADF, a quotation collection, trade comparison, and trade reporting facility that is being developed by the NASD. Generally, the proposed rules closely track Nasdaq's rules, and the NASD intends, where possible, to keep the rules the same.

The Commission seeks comment on whether the proposed ADF rules are sufficient to meet the NASD's obligations with respect to the over-the-counter market under Sections 15A(b)(11)² and 11A(c)(1)³ of the Securities Exchange Act of 1934 (the Act) and whether it provides market makers and electronic communication networks (ECNs) the ability to comply with the Commission's Order Handling Rules and Regulation ATS. The Commission

also specifically seeks comment on proposed Rule 4300, which would require ADF market participants to provide direct or indirect quote and order access to NASD members. As proposed, the NASD generally would not provide an order routing capability.

Members are encouraged to read the SEC's notice of the rule proposal, the text of which can be found on the NASD Regulation Web Site's Rule Filings Page at www.nasdr.com.

Comments

Persons wishing to make written comments should submit six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. All submissions should refer to the File No. SR-NASD-2001-90 and should be submitted to the SEC by January 21, 2002.

Questions/Further Information

Questions concerning this *Notice* may be directed to Philip Shaikun, Assistant General Counsel, Office of General Counsel, NASD Regulation, or Kathleen O'Mara, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8071.

Background

On December 14, 2001, the SEC published for notice and comment a comprehensive proposal filed by the NASD that would revise the NASD rules when Nasdaq receives approval as a national securities exchange and contemporaneously separates from the NASD. The proposal also establishes rules to implement and operate the ADF, a facility being developed by the NASD in accordance with the

Commission's SuperMontage Approval Order⁴ and in conjunction with Nasdaq's anticipated exchange registration. The ADF would provide members the ability to collect and view quotations and compare and report trades in exchange-listed securities.

Due to the size and scope of the rule filing, this *Notice* provides only an overview of the rule proposal and highlights those issues about which the SEC has specifically requested comment. As such, members are strongly encouraged to read carefully the entire rule filing and, to the extent members have comments on any of the proposed rule changes, to submit those comments to the SEC by January 21, 2002. Members should particularly read the "Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change" portion of the rule filing, which identifies and discusses in more detail the most substantive proposed rule changes.

Proposed Rule Change Relating To The Separation Of Nasdaq

The NASD is in the process of spinning off its Nasdaq subsidiary as an independent, for-profit company. Through a series of private placements, the NASD's ownership interest in Nasdaq has been reduced to a minority interest. Before Nasdaq can fully separate from the NASD, it must become registered as a national securities exchange with the SEC. Nasdaq has filed a Form 1 with the SEC requesting such registration. Notice and a request for comments on Nasdaq's completed application for exchange registration was published for comment in the *Federal Register* on June 13, 2001,⁵ and the comment period expired on August 29, 2001.

Upon Nasdaq's registration as a national securities exchange, the NASD will no longer control the voting rights in the common stock of Nasdaq. At that point, Nasdaq and the NASD will be unaffiliated corporate entities, and therefore each will need separate rules applicable to their respective members. The NASD rule proposal published by the SEC would modify existing NASD rules, effective upon Nasdaq's registration as an exchange, to reflect this corporate separation. Generally, the proposed changes are administrative: they would delete Nasdaq-specific rules, such as listing and qualification requirements; replace references to "Nasdaq" with "NASD" or "exchange," as applicable; and rename and renumber certain rules. The proposal also includes corrections of minor grammatical or typographical errors and other miscellaneous non-substantive changes.

In addition to the ADF rules discussed in more detail below, the rule proposal contains several substantive changes relating to the following rules: IM-2110, Trading Ahead of Customer Orders; IM-2310-2, SEEDS Transactions; Rule 2840, Trading in Index Warrants; Rules 2850 through 2885, Position Limits and Options Trading; proposed Rule 5100 and IM-5100, Short Sale Rule; Rule 4612, Primary Market Maker Standards; proposed Rule 5200, Trading Halts; Rule 4619, Withdrawal of Quotations and Passive Market Making; Rules 4614 and 4624, Stabilizing Bids and Penalty Bids; Rules 4613 and 6330, relating to market maker obligations; Rule 4620, Voluntary Termination of Registration; Rules 4633 and 6420, relating to transaction reporting; proposed Rule 6100, the TRACS Trade Comparison Service; and Rule

Series 6600 and 6700, relating to trading in non-exchange-listed securities. Members should refer to the rule filing for a more detailed discussion of the changes related to these rules.

Proposed Rule Change Relating To Trading Otherwise Than On An Exchange—The Alternative Display Facility

The rule proposal generally would clarify that NASD rules that relate to trading practices (*e.g.*, quotations, trade reporting, short selling, trading halts) apply only to transactions otherwise than on an exchange. The term "otherwise than on an exchange" is defined in the proposal to mean a trade effected by an NASD member otherwise than on or through a national securities exchange. The determination of what constitutes a trade "on or through" a national securities exchange would be left to the respective exchanges and applicable statutes, rules and regulations, as approved by the SEC.

The ADF is a facility that the NASD will build to facilitate trading otherwise than on an exchange in listed securities. As proposed, the facility would provide market participants—market makers, ECNs, and order entry firms—the ability to collect and view quotations, and to report transactions to the appropriate Securities Information Processor (SIP)⁶ for consolidation and dissemination of data to vendors and ADF market participants. The facility also would provide for trade comparison and for real-time data delivery to NASD Regulation for regulatory purposes. The NASD or a vendor (other than Nasdaq) would maintain and operate the facility. NASD Regulation would enforce the proposed rules and provide market surveillance.

For the most part, the proposed ADF rules closely track existing Nasdaq rules (or rules proposed by Nasdaq in its exchange registration) and existing rules that govern trading in the Consolidated Quotation Service (CQS).⁷ The ADF would provide trade comparison and trade reporting services that would be similar to Nasdaq's Automated Confirmation Transaction Service (ACT) system.⁸ However, the proposed ADF rules have been refined to reflect the more limited functionality of the ADF, most particularly the absence of an automatic execution or order routing system. Instead, the proposed rule change would require ADF market participants to provide direct or indirect access to their quotations, as described in more detail below.

As required by existing Nasdaq rules, ADF participants would be required to register as market makers or ECNs for each security in which they make a market or display orders. Additionally, the proposed rule change tracks Nasdaq requirements that market makers maintain continuous two-sided, firm quotations and prescribes market maker obligations when a bid or offer locks or crosses the market. However, the rule proposal does not provide for stabilizing or penalty bids, as existing Nasdaq rules do. The proposal generally adopts Nasdaq's anticipated approach to trade reporting: the seller reports both intramarket and intermarket trades between market makers, the market maker reports trades between it and a customer, and an NASD member reports trades between it and a non-member. ECNs would report all trades effected within the ECN.

Order Access Rule

The ADF rules differ from existing Nasdaq rules most significantly with respect to participants' ability to reach quotes displayed in the ADF. The NASD would not provide ADF market participants an order routing capability, other than the Intermarket Trading System (ITS). Rather, proposed Rule 4300 would require market participants to provide direct electronic access to other market participants and direct or "readily available" indirect electronic access to all other NASD members seeking access. This quote access rule would facilitate ADF and other market participants' compliance with their best execution obligations and would further provide the means by which the NASD would enforce compliance with firm quote obligations and locked and crossed quotation obligations.⁹

The NASD does not intend to provide an order routing capability other than one to the ITS because it believes it can better perform its core investor protection mission by focusing on regulation rather than market operations. The NASD also believes that market participants already do, and can continue to, establish and run order linkage facilities that are more efficient and innovative than a facility the NASD could provide. The ITS "exception" is based upon the fact that ITS is in place and is the current accepted mechanism for intermarket linkage for CQS securities. The use of ITS by ADF market participants would be voluntary under the rule proposal.

Proposed Rule 4300 defines "direct electronic access" as the ability to deliver an order for execution directly against an individual NASD market participant's best bid and offer without the need for voice communication, and with the equivalent speed, reliability,

availability and cost as are made available to the NASD market participant's own customer broker/dealers or other active customers or subscribers. The proposal would not preclude market participants from charging more for the access required by the rule—sometimes called "hit or take" access—than for full service access. However, the proposed rule would prohibit market participants from discriminatorily charging for hit or take access, *i.e.*, charging differently for one group of users (*e.g.*, subscribers) than for others (*e.g.*, non-subscribers). While "hit or take" is more limited functionally than full book access, it also is a liquidity taking function and some markets—including Nasdaq—charge more for taking liquidity than providing it.¹⁰

The proposed rule change defines "indirect electronic access" as the ability to route an order through customer broker/dealers of an NASD market participant for execution against the NASD market participant's best bid and offer, without the need for voice communication, and with equivalent speed, reliability, availability, and cost as are available to the market participant's customer broker/dealer providing the indirect access or other active customers or subscribers. Market participants would be prohibited from influencing the prices that customer broker/dealers impose for providing indirect access or in any way discouraging the provision of indirect access.

ADF market participants could satisfy these requirements either by providing their own bilateral linkages or by participating in multilateral linkage facilities provided by private vendors. In addition, with respect to links with exchanges, market participants could satisfy these requirements

either by linking with the exchange or by linking with market participants operating within those exchanges.

To allow NASD Regulation to monitor compliance with certain trading rules, such as the firm quote rule and “trade or move” rules, the proposed rule also requires that all NASD market participants that display quotations or orders in the ADF record specified items of information pertaining to orders they receive via direct or indirect electronic access, and report this information to NASD Regulation on a real-time basis. The proposed rule requires this information to be provided to NASD Regulation within 10 seconds of the receipt of an order and, if applicable, when an order is acted upon or responded to. As part of the subscriber agreement approval process, market participants would be required to provide the terms and methods by which they would comply with these rules. The NASD would review these terms prior to approving a subscriber agreement.

SEC Comment Request

In its SuperMontage Approval Order, the SEC mandated that the ADF facility “provide a market neutral linkage to the Nasdaq and other marketplaces, but not an execution service.”¹¹ The NASD believes that proposed Rule 4300 satisfies the Commission’s directive because it provides a market neutral linkage by requiring market participants to link, either directly or indirectly, to all those seeking access to the market participants’ quotations. The SEC has specifically requested comment on whether this rule

will provide potential users with adequate access to quotations displayed through the ADF and will allow the NASD to effectively enforce its access requirements. In particular, the Commission requests comment on what it means to make indirect electronic access “readily available” under proposed Rule 4300(a)(2).

The SEC has also requested comment on whether the proposed rules are sufficient to meet the NASD’s obligations under Sections 15A(b)(11) and 11A(c)(1) of the Act. Section 15A(b)(11) of the Act states that the rules of a registered securities association must include:

Provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be distributed or published by any member or person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

Section 11A(c)(1) of the Act generally sets forth the obligations of self-regulatory organizations with respect to trading securities over-the-counter. Among other things, the statute requires a self-regulatory organization to ensure that it, and its members, comply with rules to prevent fraud and deceit; assure accurate, reliable and fair collection and dissemination of quotations; and prohibit

discrimination in obtaining information related to quotations and transactions.

As noted above, comments on the proposed rule change must be submitted to the SEC by January 21, 2002.

Endnotes

- 1 Securities Exchange Act Release No. 45156 (December 14, 2001).
- 2 15 U.S.C. 78o-3(b)(11).
- 3 15 U.S.C. 78k-1(c)(1); *see also* Section 11A(c)(3)(A) of the Act.
- 4 Securities Exchange Release No. 43863 (Jan. 19, 2001), 66 FR 8020 (Jan. 26, 2001).
- 5 Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001) (File No.10-131).
- 6 Nasdaq initially will be the designated SIP for all transactions in Nasdaq securities, while the Securities Industry Automation Corporation will continue to function as the SIP for transactions in listed securities.
- 7 Should Nasdaq amend its exchange registration with respect to matters such as trade reporting, short selling, or quotation obligations, the NASD anticipates making similar amendments to the proposed NASD rules.
- 8 The rule proposal would require members that effect trades otherwise than on an exchange in non-exchange-listed securities to enter into contractual agreements to use Nasdaq's ACT system for trade comparison and trade reporting.
- 9 While this rule would require inter-market links with other market centers, as well as intra-ADF links, the proposed locked and crossed rule, Rule 4612(d), unlike other market center locked and crossed rules, is based on the ADF's own quotations. In the event that the markets agree on a locked and crossed rule approach that encompasses quotations in all markets, proposed Rule 4300 would still facilitate compliance.
- 10 Securities Exchange Act Release No. 44918 (Oct. 10, 2001), 66 FR 52814 (Oct. 17, 2001).
- 11 Securities Exchange Release No. 43863 (Jan. 19, 2001), 66 FR 8020 (Jan. 26, 2001).

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