

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49604; File No. SR-NASD-2004-066)

April 22, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Related to Direct ECN Connection to SuperMontage

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on April 19, 2004, the National Association of Securities Dealers, Inc. (“NASD”), through its subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq proposes to require “Order-Delivery” Electronic Communications Networks (“ECNs”) that participate in the Nasdaq National Market Execution System (“NNMS” or “SuperMontage”) to access the system using solely direct, dedicated point-to-point communication linkages. Nasdaq will implement the proposed rule change 90 days after approval by the Commission. The exact date will be provided to market participants via a Head Trader Alert on [www.nasdaqtrader.com](http://www.nasdaqtrader.com).

The text of the proposed rule change is below. Proposed new language is in italics; proposed deletions are in brackets.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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### **4623. Alternative Trading Systems**

(a) **No Change.**

(b) An ATS or ECN that seeks to utilize the Nasdaq-provided means to comply with SEC Rule 301(b)(3), the ECN display alternatives, or to provide orders to Nasdaq voluntarily shall:

(1) through (6) **No Change.**

(7) provide orders to Nasdaq only through a dedicated communications linkage as prescribed by Nasdaq.

(c) **No Change.**

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### **4710. Participant Obligations in NNMS**

(a) **No Change.**

(b) Non-Directed Orders

(1) General Provisions--A Quoting Market Participant in an NNMS Security, as well as NNMS Order Entry Firms, shall be subject to the following requirements for Non-Directed Orders:

(A) – (B) **No Change.**

(C) Decrementation Procedures--The size of a Quote/Order displayed in the Nasdaq Order Display Facility and/or the Nasdaq Quotation Montage will be decremented upon the delivery of a Liability Order or the delivery of an execution of a Non-Directed Order or Preferred Order in an amount equal to the system-delivered order or execution.

(i) through (iii) **No Change.**

(iv) If an NNMS ECN regularly fails to meet a 5-second response time [(as measured by the ECN's Service Delivery Platform)] over a period of orders, such that the failure endangers the maintenance of a fair and orderly market, Nasdaq will place that ECN's quote in a closed-quote state. Nasdaq will lift the closed-quote state when the NNMS ECN certifies that it can meet the 5-second response time requirement with regularity sufficient to maintain a fair and orderly market. The 5-second response time shall be measured by timestamps generated by NNMS.

(v) **No Change.**

(D) **No Change.**

(2) – (8) **No Change.**

(c) through (e) **No Change.**

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

ECNs have two options when participating in Nasdaq's SuperMontage system. They can be "Auto-Ex" ECNs, in which case their quotes/orders are subject to automatic execution, or they can elect to be Order-Delivery where the system instead the delivers a buy or sell trading message to the ECN that, in response, either executes or rejects the message. Today, all ECNs in Nasdaq's SuperMontage system participate as Order-Delivery ECNs.

Under current SuperMontage rules, Order-Delivery ECNs must respond to messages sent to them by the system within 5 seconds on average, and in no event later than 30 seconds for any one message. The 5-second average response standard is measured by timestamps generated at the ECN's Service Delivery Platform ("SDP") at the ECN's trading location.

Recently, Nasdaq has experienced several instances of ECN response times materially slower than other market participants. While reasons for these delays can vary between issues related to ECN internal message processing capacity and delivery queuing in SuperMontage, the result is a disruption in trading - particularly during the crucial period immediately before the Nasdaq close. In response, Nasdaq is proposing the creation of mandatory dedicated "point-to-point" linkages between the SuperMontage host computer and individual Order-Delivery ECNs. These linkages will connect directly to a participating ECN's host computers, bypassing the ECN's SDP. By creating these dedicated linkages, Nasdaq expects to significantly reduce response delays that can be encountered in the current environment where order delivery messages directed to ECNs

use existing SuperMontage application programming interfaces (“APIs”) to reach their destination and are commingled, and compete with, other SuperMontage messaging (Executions, Cancels, etc.) for bandwidth to reach the ECN’s SDP. Nasdaq notes that the proposed linkage would only speed delivery and receipt of messages between the SuperMontage host computer and the ECN, it would not give such messages any special priority in the SuperMontage execution process. Nasdaq believes that the new linkages will enhance the speed and efficiency of the SuperMontage system as a whole and provide a more accurate understanding of whether Nasdaq or an ECN’s own internal system is at fault when ECN order processing is unduly delayed.

Since Nasdaq’s current rules governing ECN responsiveness are based on timestamps generated by the SDP, Nasdaq is also proposing modifying its rules to reflect that in the new environment the 5-second time period will be measure by data generated by Nasdaq’s host computer. In short, Nasdaq will calculate and monitor, on a real-time basis, the difference between the following time stamps: (1) the time the SuperMontage host dispatched a message to the ECN using the dedicated linkage, and (2) the time the SuperMontage host received a response back from the ECN over the dedicated link. On an ongoing basis, Nasdaq will monitor individual ECN response times and provide each ECN with its own order responsiveness time statistics, which will not be made public. Like the current rule, if an ECN regularly fails to meet the 5-second response time over a number of orders, Nasdaq will place that ECN’s quote in a closed quote state. Also like the current rule, the closed quote state will be lifted when the ECN can certify that it can meet the 5-second response time requirement.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,<sup>3</sup> in general and with Section 15A(b)(6) of the Act,<sup>4</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

### B. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

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<sup>3</sup> 15 U.S.C. 78o-3.

<sup>4</sup> 15 U.S.C. 78o-3(b)(6).

B. institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-066 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-066. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for

inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-066 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>5</sup> 17 CFR 200.30-3(a)(12).