

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50218; File No. SR-NASD-2004-002)

August 18, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Require an NASD Market Participant to Provide Written Notice Before Denying any NASD Member Direct Electronic Access to its Quote in the ADF

I. Introduction

On January 8, 2004, the National Association of Securities Dealers, Inc. (“NASD”) submitted to the Securities and Exchange Commission (“Commission” or “SEC”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NASD Rule 4300A to require an NASD Market Participant to provide written notice before denying any NASD member direct electronic access to its quote on NASD’s Alternative Display Facility (“ADF”). NASD filed Amendment No. 1 to the proposed rule change on February 5, 2004.³ The proposed rule change and Amendment No. 1 were published for comment in the Federal Register on February 24, 2004.⁴ The Commission received no comment letters on the proposed rule change and Amendment No. 1. NASD filed Amendment

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation (“Division”), Commission, dated February 4, 2004 (“Amendment No. 1”).

⁴ See Securities Exchange Act Release No. 49252 (February 13, 2004), 69 FR 8505.

No. 2 to the proposed rule change on July 14, 2004.⁵ This order approves the proposed rule change and Amendment No. 1 and issues notice of filing of, and approves on an accelerated basis, Amendment No. 2.

II. Description of the Proposal

The ADF is a pilot system that NASD operates for its members that choose to quote or effect trades in Nasdaq securities otherwise than on the Nasdaq Stock Market or an exchange.⁶ The Commission conditioned its approval of the SuperMontage facility on NASD's establishment of the ADF.⁷ In the SuperMontage proposal, several commenters expressed concern that SuperMontage would become the only execution system through which substantially all displayed trading interest in the over-the-counter markets could be reached. In response to these concerns, NASD agreed to provide an alternative quotation and transaction reporting facility (now know as the ADF) that would, in effect, make participation in SuperMontage voluntary.⁸ The ADF permits NASD members to comply with their obligations under Commission and NASD rules (including Rule 11Ac1-1(c)(5) under the Exchange Act⁹ and

⁵ See letter from Patricia M. Albrecht, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated July 13, 2004 ("Amendment No. 2").

⁶ See Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49821 (July 31, 2002) (approving the ADF pilot).

⁷ See Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001) (approving SuperMontage).

⁸ See 66 FR at 8024.

⁹ 17 CFR 240.11Ac1-1(c)(5).

Regulation ATS¹⁰) without participating in SuperMontage. NASD's authority to operate the ADF pilot system extends until October 26, 2004.¹¹

The ADF does not have an order-routing capability. Instead, an NASD Market Participant must provide other NASD Market Participants with direct electronic access to its quote in the ADF.¹² In addition, an NASD Market Participant must provide NASD member broker-dealers that are not NASD Market Participants direct electronic access, if requested, and allow for indirect electronic access to its ADF quote.¹³ An NASD Market Participant is prohibited from in any way directly or indirectly influencing or prescribing the prices that its customer broker-dealer may choose to impose for providing indirect access and precluding or discouraging indirect electronic access, including through the imposition of discriminatory pricing or quality of service with regard to a broker-dealer that is providing indirect electronic access.¹⁴ However, an NASD Market Participant that is an electronic communication network

¹⁰ 17 CFR 242.300 *et seq.*

¹¹ See Securities Exchange Act Release No. 49131 (January 27, 2004), 69 FR 5229 (February 3, 2004) (extending the ADF pilot).

¹² See NASD Rule 4300A(a)(1). "Direct electronic access" is defined as the ability to deliver an order for execution directly against an individual NASD Market Participant's best bid and offer subject to quote and order access obligations without the need for voice communication, with the equivalent speed, reliability, availability, and cost (as permissible under the federal securities laws, the rules and regulations thereunder, and NASD Rules), as are made available to NASD Market Participant's own customer broker-dealers or other active customers or subscribers. See NASD Rule 4300A(d)(2).

¹³ See NASD Rule 4300(a)(2). "Indirect electronic access" is defined as the ability to route an order through customer broker-dealers of an NASD Market Participant that are not affiliates of the NASD Market Participant, for execution against NASD Market Participant's best bid and offer subject to quote and order access obligations, without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to the Market Participant's customer broker-dealer providing the indirect access or other active customers or subscribers. See NASD Rule 4300A(d)(3).

¹⁴ See NASD Rule 4300(a)(2).

(“ECN”) may lawfully deny access to its ADF quote in the limited circumstances where a broker-dealer fails to pay contractually obligated costs to the ECN.

NASD proposes to amend NASD Rule 4300A to require an NASD Market Participant to provide written notice before denying any NASD member direct electronic access to its ADF quotes. The NASD Market Participant would be required to provide this notice to ADF Market Operations via facsimile, personal delivery, courier, or overnight mail at least 14 calendar days in advance of denying access. The 14-day period would begin on the first business day that ADF Market Operations has receipt of the notice. In Amendment No. 1, NASD stated that, to ensure proper documentation of compliance with this rule, NASD members should maintain evidence of receipt of the notice (e.g., dated facsimile confirmation, receipt from a courier, etc.). ADF Market Operations would then post this notice on the ADF webpage to ensure that members have adequate time to make other routing or access arrangements, as necessary.

In Amendment No. 2, NASD added a provision that a notice provided under the proposed rule must be based on the good faith belief of an NASD Market Participant that its denial of access is appropriate and does not violate any NASD rules or the federal securities laws. NASD also added that the proposed notification and publication of an NASD Market Participant’s intent to deny access would have no bearing on the merits of any claim between the NASD Market Participant and any affected broker-dealers, nor would it insulate the NASD Market Participant from liability for violations of NASD rules or the federal securities laws, such as Rule 11Ac1-1 under the Act,¹⁵ should it be determined that the denial of access was inappropriate. In Amendment No. 2, NASD stated that, if NASD believes that an NASD Market Participant has improperly denied a broker-dealer access to its quotes, the NASD Market Participant would not

¹⁵ 17 CFR 240.11Ac1-1.

have met the terms of Rule 4300A and therefore would be in violation of that provision and would not be permitted to continue quoting on the ADF. Amendment No. 2 also clarified that ECNs are the only NASD Market Participants that may lawfully deny access to their quotes, and that an ECN may do so only in the limited circumstances where a broker-dealer fails to pay contractually obligated costs.

Finally, in Amendment No. 2, NASD revised the proposal to remove the requirement that an NASD Market Participant provide notice with respect to a denial of indirect access. An NASD Market Participant is not permitted to look through its order flow to identify or discriminate against a source of the order flow via indirect access; therefore, the revised proposal no longer contemplates provision of notice for denials of indirect access.

The text of the proposed rule change, as amended by Amendment Nos. 1 and 2, appears below. Proposed new language is in italics. Proposed deletions are in brackets.

4300A. Quote and Order Access Requirements

(a) To ensure that NASD Market Participants comply with their quote and order access obligations as defined below, for each security in which they elect to display a bid and offer (for Registered Reporting ADF Market Makers), or a bid and/or offer (for Registered Reporting ADF ECNs), in the Alternative Display Facility, NASD Market Participants must:

(1) through (2) No change.

(3) Provide at least 14 calendar days advance written notice, via facsimile, personal delivery, courier or overnight mail, to NASD Alternative Display Facility Operations before denying any NASD member direct electronic access as defined below. An ECN is the only Market Participant that may lawfully deny

access to its quotes, and an ECN may only do so in the limited circumstance where a broker-dealer fails to pay contractually obligated costs for access to the ECN's quotes. The notice provided hereunder must be based on the good faith belief of a Market Participant that such denial of access is appropriate and does not violate any of the Market Participant's obligations under NASD rules or the federal securities laws. Further, any notification or publication of a Market Participant's intent to deny access will have no bearing on the merits of any claim between the Market Participant and any affected broker-dealer, nor will it insulate the Market Participant from liability for violations of NASD rules or the federal securities laws, such as SEC Rule 11Ac1-1. The 14-day period begins on the first business day that NASD Alternative Display Facility Operations has receipt of the notice.

(4) [3] Share equally the costs of providing to each other the direct electronic access required pursuant to paragraph (a)(1), unless those Market Participants agree upon another cost-sharing arrangement.

(b) through (f) No change.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether it 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. Please include File Number SR-NASD-2004-002 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-2004-002. 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 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-2004-002 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national

securities association,¹⁶ particularly Section 15A(b)(6) of the Act.¹⁷ Section 15A(b)(6) requires, among other things, that a national securities association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

The proposed rule change should allow NASD to provide its members advance notice of when an NASD Market Participant intends to deny an NASD member access to its quotes so as to minimize any potential disruptions in the ADF market. NASD has indicated that an NASD Market Participant recently denied an NASD member access to the NASD Market Participant's quotes for allegedly failing to pay contractually obligated costs. NASD stated that this denial of access disrupted trading not only for the NASD member that was denied access, but also for other NASD members that indirectly accessed the NASD Market Participant's quote through the NASD member that was denied direct access. NASD believes that, although there were other means in place by which NASD members could have accessed the NASD Market Participant's quotes, the absence of any advance notice of the denial of access caused confusion in the marketplace as members considered how best to access the NASD Market Participant's quotes by other means. The Commission believes that the proposed rule change should help avert such disruption by providing NASD members advance notice of potential denials of direct access, thereby affording them an opportunity to make other routing or access arrangements.

The Commission further believes that it is reasonable and consistent with the Act for the new provisions of NASD Rule 4300A(a)(3) to state that any notification or publication of an

¹⁶ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁷ 15 U.S.C. 78q-3(b)(6).

NASD Market Participant's intent to deny access will have no bearing on the merits of any claim between the NASD Market Participant and any affected broker-dealer, nor will it insulate the NASD Market Participant from potential liability for violations of NASD rules or the federal securities laws. The Commission believes that the mere act of providing notice of a denial of access pursuant to this rule change should not insulate an NASD Market Participant from liability if that denial of access were illegal.

The Commission finds good cause for accelerating approval of Amendment No. 2 prior to the thirtieth day after publication in the Federal Register. The Commission notes that the proposed rule change and Amendment No. 1 thereto were noticed for the full comment period and that no comments were received. Amendment No. 2 clarifies the proposal and provides that compliance with the proposed rule would not bear on the merits of any claim between an NASD Market Participant and any affected broker-dealer, nor would it shield an NASD Market Participant from liability for a violation of NASD rules or federal securities laws. Furthermore, accelerated approval should permit NASD to promptly begin to receive notices for any potential denials of access, thereby enabling NASD to investigate any denial of access while providing notice of such denials to NASD members to minimize any potential disruptions in the ADF market that could result. For these reasons, the Commission finds good cause exists, consistent with Sections 15A(b)¹⁸ and 19(b)(2) of the Act,¹⁹ to approve Amendment No. 2 on an accelerated basis.

¹⁸ 15 U.S.C. 78q-3(b).

¹⁹ 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁰ that the proposed rule change (SR-NASD-2004-002) and Amendment No. 1 is hereby approved, and that Amendment No. 2 is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Margaret H. McFarland
Deputy Secretary

²⁰

Id.

²¹

17 CFR 200.30-3(a)(12).