

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50478; File No. SR-NASD-2004-107)

September 30, 2004

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of a Proposed Rule Change Relating to Computer Generated Quoting in Exchange-Listed Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 12, 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 eliminate NASD Rule 6330(d) (“Obligations of CQS Market Makers”) to allow market makers to engage in Computer Generated Quoting (“CGQ”) in exchange-listed securities. The text of the proposed rule change is below. New text is in italics. Deleted text is in brackets.

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6330. Obligations of CQS Market Makers

(a) – (c) No Change.

[(d) Computer-Generated Quotations]

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

[(1) General Prohibition--Except as provided below, this rule prohibits the automatic updating or tracking of inside quotations in CQS by computer-generated quote systems. This ban is necessary to offset the negative impact on the capacity and operation of Nasdaq systems regarding certain systems techniques that track changes to the inside quotation and automatically react by generating another quote to keep the market maker's quote away from the best market, without any cognizable human intervention.]

[(2) Exceptions to the General Prohibition

Automated updating of quotations is permitted when:

(A) the update is in response to an execution in the security by that firm (such as execution of an order that partially fills a market maker's quotation size);

(B) it requires a physical, cognizable entry (such as a manual entry to the market maker's internal system which then automatically forwards the update to a Nasdaq system);

(C) the update is to reflect the receipt, execution, or cancellation of a customer limit order;

(D) it is used to expose a customer's market or marketable limit order for price improvement opportunities; or

(E) it is used to equal or improve either or both sides of the national best bid or offer ("NBBO"), or add size to the NBBO.]

[(e)d] Minimum Price Variation for Decimal-based Quotations

(1) No Change.

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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

Background

Nasdaq proposes to eliminate NASD Rule 6330(d), which governs CGQ in exchange-listed securities. Currently, NASD Rule 6330 prohibits the practice of automatically, and without cognizable human intervention, updating a market maker's quote to keep the market maker away from the inside market. NASD Rule 6330(d)(2) contains five exceptions to the general prohibition, including exceptions for conduct that is consistent with the Commission's Order Handling Rules, and for CGQ that equals or improves either or both sides of the national best bid or offer ("NBBO") or adds size to the NBBO.

The limitations contained in NASD Rule 6330(d) were originally implemented because of capacity constraints that Nasdaq believes no longer persist. Under recent procedures implemented by the Consolidated Tape Association,³ Nasdaq now has the opportunity to request additional capacity to accommodate increased quoting. Since Nasdaq would bear the expense of the additional capacity under the new procedures, Nasdaq should be free to increase capacity

³ See Securities Exchange Act Release No. 47030 (December 18, 2002), 67 FR 78832 (December 26, 2002).

without objection from the other markets that quote and trade exchange-listed securities.

Nasdaq believes that the current restriction on CGQ in exchange-listed securities not only reduces transparency in the National Market System, but also places a burden on highly automated participants that may wish to add liquidity in Nasdaq on a proprietary basis. Firms posting bids and offers using the Nasdaq Market Center are disadvantaged relative to firms using the other market centers, such as the regional stock exchanges and electronic communications networks.

Under the proposal, market makers would be able to engage in CGQ without limitations. Broad use of CGQ has been permitted for two years in Nasdaq-listed securities⁴ and has benefited investors by improving liquidity, transparency, and order interaction in the Nasdaq Market Center. Market participants have developed sophisticated systems that generate quote updates through automated means. These market makers engage in trading strategies in which their quoted prices are based on several factors, such as the last sale, bids, offers, and sizes, where available, on stocks, futures and options, and certain statistically derived relationships among these instruments.

Compliance with ITS Plan

Nasdaq believes that the proposed rule change is consistent with the Act and with the Intermarket Trading System (“ITS”) Plan. Nasdaq has examined the language in the ITS Plan and believes that nothing in the ITS Plan prohibits auto-quoting in exchange-listed securities. Subsection 8(d)(ii) of the ITS Plan, titled “Adoption of Trade-Through Rules,” references, inter alia, the practice of furnishing bid-asked quotations that are generated by an automated quotation system (functionality Nasdaq refers to as CGQ). According to Nasdaq, the sole purpose of

⁴ See NASD IM-4613(c).

Subsection 8(d)(ii) of the ITS Plan was to implement the trade-through rule, and not to banish entirely the whole practice of CGQ in exchange-listed securities. Nasdaq states that Subsection 8(d)(ii) of the ITS Plan establishes that CGQ for more than 100 shares should be prohibited only inasmuch as CGQ might prevent the implementation of the trade-through rule. Nasdaq believes that, if CGQ does not prevent the implementation of the trade-through rule, then Subsection 8(d)(ii) of the ITS Plan, and the remaining sections of the ITS Plan, do not otherwise prohibit or restrict CGQ in exchange-listed securities.

Nasdaq believes that a contrary interpretation would be difficult to support both in the context of the ITS Plan as a whole and in the context of past experience. According to Nasdaq, it is hard to believe that if the signatories of the ITS Plan had actually intended to banish CGQ in exchange-listed securities entirely, they would have chosen to “bury” such a provision in Subsection 8(d)(ii) of the ITS Plan without any substantive discussion either in that Subsection or elsewhere within the document. Nasdaq notes that the ITS Plan runs for over a hundred pages, and that all of its important prohibitions and limitations on the ITS participants’ conduct are carefully explained. Yet, according to Nasdaq, there is no section or subsection with the words “computer generated quoting” or “auto-quoting” in its title, there is no discussion whatsoever of this practice, and no substantive explanation or justification for banishing it is offered anywhere.

Nasdaq believes that there have always been public policy reasons to permit CGQ in exchange-listed securities. For example, Nasdaq states that beginning in February 2000 and every year thereafter, the Commission has granted the NASD an exemption to allow CGQ in

ITS.⁵ According to Nasdaq, each time the exemption was granted or extended, the Commission stated that, at least within the restrictions contained in the exemption, CGQ “is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets and the removal of impediments to, and perfection of the mechanisms of, a national market system.” Given these benefits of CGQ, Nasdaq does not believe that the ITS Plan could fairly or reasonably be construed as summarily prohibiting CGQ without any discussion.

Nasdaq believes that since CGQ does not automatically prevent the implementation of the trade-through rule, a total ban is not needed in order to implement the trade-through rule. For example, Nasdaq states that the trade-through rule is being observed even though CGQ in exchange-listed securities is currently permitted by Nasdaq (consistent with the Commission-granted exemptive relief referenced above). Nasdaq believes that this fact lends further support to its view of Subsection 8(d)(ii) of the ITS Plan as only prohibiting CGQ if and when CGQ prevents trade-through rule implementation.

Over the past several years Nasdaq has advocated and supported amending the ITS Plan to clarify its language and put this issue to rest. Nasdaq proposed, and the ITS Operating Committee (“ITSOC”) discussed and voted on a set of specific exceptions to a CGQ prohibition to be incorporated into the Plan. To date, no consensus for an amendment has been found.⁶

Further, as time has passed and the markets have evolved, Nasdaq has come to believe, as it has

⁵ See e.g., letter from Alden S. Adkins, Commission, to Eugene A. Lopez, Nasdaq, dated December 31, 2002 (explaining Nasdaq’s need for the exemption by stating that “[c]ertain ITS Participants interpret this section [Subsection 8(d)(ii) of the ITS Plan] as preventing Participants from employing automated quotation tracking systems that auto-quote for more than 100 shares”). It is Nasdaq’s opinion that the Commission has viewed the exemption as a prophylactic measure needed to address the interpretations by certain unnamed participants.

⁶ A unanimous vote is required to amend the ITS Plan. See Subsection 4(c) of the ITS Plan.

mentioned at the last two ITSOC meetings, that there should be no restrictions on CGQ in the ITS Plan. It appears to Nasdaq that there are other exchanges participating in ITS that permit forms of CGQ without having requested an exemption from the Commission.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act⁷ in general, and Section 15A(b)(6) of the Act,⁸ which requires that the rules of the NASD foster cooperation and coordination with persons engaged in facilitating transactions in securities and remove impediments to and perfect the mechanism of a free and open market. Nasdaq believes that permitting market makers to use these systems should have several benefits. According to Nasdaq, market makers will be able to utilize existing computer models, or develop new models, to automatically generate and update their quotes, which should enhance the price discovery process and allow members to increase the number of stocks in which they are registered as market makers.

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

⁷ 15 U.S.C. 78o-3.

⁸ 15 U.S.C. 78o-3(b)(6).

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
- 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, as amended, 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-2004-107 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-2004-107. 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 Room. 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-2004-107 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.⁹

Margaret H. McFarland
Deputy Secretary

⁹ 17 CFR 200.30-3(a)(12).