

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54537; File No. SR-NASD-2006-091)

September 28, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving a Proposed Rule Change and Amendment No. 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto to Align NASD Rules with Regulation NMS

I. Introduction

On July 28, 2006, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission”), 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> a proposed rule change to align its rules, including those governing the Alternative Display Facility (“ADF”), with Regulation NMS under the Act (“Regulation NMS”).<sup>3</sup> On August 4, 2006, NASD filed Amendment No. 1 to the proposed rule change. Also on August 4, 2006, NASD withdrew Amendment No. 1 and filed Amendment No. 2 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on August 14, 2006.<sup>4</sup> The Commission received no comments on the proposal.

On September 27, 2006, NASD filed Amendment No. 3 to the proposed rule change.<sup>5</sup> This order approves the proposed rule change, as amended by Amendment No. 2, grants accelerated

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

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

<sup>3</sup> 17 CFR 242.600 *et seq.* See also Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“Regulation NMS Adopting Release”).

<sup>4</sup> See Securities Exchange Act Release No. 54277 (August 4, 2006), 71 FR 46527 (“Notice”).

<sup>5</sup> In Amendment No. 3, NASD: (1) added language to NASD Rule 4611A(a) stating that the priority for determining the bid and offer to be designated the protected quotation on the ADF would be price, size, and time and clarified in its Form 19b-4 submission that the protected quotation would be associated with a single market participant identifier

approval to Amendment No. 3 to the proposed rule change, and solicits comments from interested persons on Amendment No. 3.

## II. Description

NASD proposes to amend its rules to comply with Rules 610 and 611 of Regulation NMS (“Access Rule” and “Order Protection Rule,” respectively).<sup>6</sup> Additionally, NASD proposes to revise its Certification Record, which each ADF Trading Center is required to complete prior to being permitted to post quotations through the ADF, and thereafter, to recertify on an annual basis. NASD also proposes to amend its rules that govern quoting, trade reporting, and clearing through the ADF to extend this functionality to all NMS stocks, as defined in Rule 600(b)(47) of Regulation NMS.<sup>7</sup> Finally, NASD proposes to reorganize the ADF trade reporting rules and make certain technical changes to enhance the clarity of the ADF rules.

NASD stated in Amendment No. 3 that the changes to the Certification Record and certification procedures will become effective upon approval of the proposal by the Commission.

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(“MPID”); (2) modified Item 4 of the proposed Certification Record to make clear that an ADF Trading Center must respond to orders immediately and automatically and must respond to intermarket sweep orders (“ISOs”) consistent with Regulation NMS; (3) modified Item 10 of the proposed Certification Record to make clear that an ADF Trading Center must post its relevant connectivity and access technical specifications on its Web site; (4) added new Item 13 to the proposed Certification Record regarding the self-help exception to Rule 611 of Regulation NMS; (5) clarified the definition of “system outage” in proposed NASD Rule 4300A(e)(2); (6) revised proposed NASD Rule 4619A to track more closely proposed NASD Rule 4300A(e)(2); (7) indicated that the Certification Record and certification procedures will be effective upon approval of the proposal; (8) stated that NASD would make its approved connectivity provider list available prior to October 16, 2006; (9) clarified that current ADF Trading Centers would be required to publish appropriate technical specifications, consistent with the proposed Certification Record, no later than October 16, 2006; (10) stated that NASD would provide a link to each such ADF Trading Center’s specifications on its Web site; and (11) made minor technical changes to the proposal.

<sup>6</sup> 17 CFR 242.610 and 242.611.

<sup>7</sup> 17 CFR 242.600(b)(47).

All other rule changes in the proposal will become effective on the Regulation NMS Trading Phase Date – February 5, 2007.

#### Automated Quotations

NASD proposes to amend its Rule 4300A(e) to require that an ADF Trading Center submit only automated quotations, as defined in Rule 600(b)(3) of Regulation NMS,<sup>8</sup> to the ADF, and to specifically state that manual quotations, as defined in Rule 600(b)(37) of Regulation NMS,<sup>9</sup> shall not be submitted to the ADF. Pursuant to proposed NASD Rule 4300A(a)(4), each ADF Trading Center must demonstrate to NASD that it has sufficient technology to automatically update its quotations and immediately respond to orders for execution directly against the individual ADF Trading Center's best bid or offer (i.e., sufficient technology to display automated quotations). In addition, NASD Rule 4300A(e) would require each ADF Trading Center to adopt policies and procedures to ensure that only automated quotations are submitted to the ADF, and each ADF Trading Center would be required to monitor its systems on a real-time basis to assess whether they are functioning properly.

NASD also proposes to amend the system outage procedures in its Rule 4300A. A system outage would now be defined in NASD Rule 4300A(e)(2) as an inability to post automated quotations or an inability to respond to orders immediately and automatically.<sup>10</sup> Pursuant to proposed NASD Rule 4619A, if an ADF Trading Center were unable to submit automated quotations or were unable to respond immediately and automatically to orders, it would have to withdraw its quotations from the ADF and notify ADF Operations. NASD

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<sup>8</sup> 17 CFR 242.600(b)(3).

<sup>9</sup> 17 CFR 242.600(b)(37).

<sup>10</sup> NASD also proposes to delete existing NASD IM-4613A that bans the automated update of certain quotations through the ADF. NASD originally adopted this IM to address capacity and operation concerns, but it no longer believes such a prohibition is necessary.

proposes that, pursuant to these rules, ADF Operations would determine: (1) when three unexcused outages during a five-day period should result in the suspension of an ADF Trading Center from quoting in the ADF for a period of 20 days; and (2) in its discretion, whether an outage should be excused without limitation. NASD could suspend, condition, limit, prohibit, or terminate an ADF Trading Center's authority to enter quotations in one or more ADF-eligible securities for violations of applicable requirements or prohibitions, pursuant to proposed NASD Rule 4621A.<sup>11</sup>

Only a single quotation of a single ADF Trading Center would be the source of a protected bid or a protected offer, as defined in Rule 600(b)(57) of Regulation NMS.<sup>12</sup> Among the bids and offers of all ADF Trading Centers, the protected bid and protected offer would be identified by NASD based upon price, size, and time priority.<sup>13</sup>

#### Access Rule

NASD proposes to amend its Rule 4300A to promote compliance by ADF Trading Centers with the access standards set forth in Rule 610 of Regulation NMS. Specifically, pursuant to amended NASD Rules 4300A(a)(3) and 4300A(a)(5), each ADF Trading Center must: (1) provide a level and cost of access to its quotations in an NMS stock displayed in the ADF that is substantially equivalent to the level and cost of access to quotations in that NMS stock displayed by SRO trading facilities; and (2) ensure that it does not impose unfairly

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<sup>11</sup> The Commission notes that this remedy is in addition to any remedy NASD may pursue against an ADF Trading Center for inadequate policies and procedures to ensure that only automated quotations are submitted to the ADF. The ADF Trading Center would still have an obligation to post only automated quotations, pursuant to NASD Rule 4300A(e).

<sup>12</sup> 17 CFR 242.600(b)(57).

<sup>13</sup> As revised in Amendment No. 3, NASD Rule 4611A(a) would provide that the ADF's protected quotation will be identified by NASD based upon price, size, and time priority. In addition, NASD clarified that the protected quotation would be submitted through and associated with a single MPID. See also Notice, 71 FR at 46528, n.10.

discriminatory terms that prevent or inhibit any person from obtaining, through a registered broker-dealer, efficient access to such quotations. In addition, NASD proposes to amend its Rule 4300A to require an ADF Trading Center to provide direct electronic access to registered broker-dealers, and its Rule 4400A to provide standing for any registered broker-dealer, not just an NASD member, to file a complaint with NASD alleging a denial of direct or indirect access.

Amended Rule 4300A(d)(1) would require each ADF Trading Center to use communication services that are deemed sufficient by NASD.<sup>14</sup> To facilitate this effort, NASD staff would develop and post on the NASD Web site a list of NASD-approved private sector connectivity providers (e.g., financial extranet services and direct market access firms).<sup>15</sup> Each ADF Trading Center would be required to be accessible through at least two approved connectivity providers. Also, each ADF Trading Center would be required to provide a certification regarding its ability to make available to market participants a substantially equivalent level and cost of access to that offered by SRO trading facilities, consistent with the Access Rule.<sup>16</sup>

In addition, NASD proposes to adopt new Rule 4130A that would require each member to reasonably avoid displaying any quotation that locks or crosses a protected quotation in an NMS stock during regular trading hours, unless it meets a specified exception. In light of this new rule, NASD would delete certain provisions in existing NASD Rule 4613A that address locked or crossed intra-market quotations during regular trading hours. NASD Rule 4613A

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<sup>14</sup> As stated in the Notice, NASD staff would not necessarily review the technical functionality of the various connectivity providers, but would assess the reliability, cost effectiveness, and the extent to which the service is sufficiently prevalent among firms that require the ability to route orders to an ADF Trading Center to meet their obligations under the Order Protection Rule.

<sup>15</sup> See Amendment No. 3, Changes to Form 19b-4, Item 4.

<sup>16</sup> See infra note 23 and accompanying text.

would continue to address locked or crossed quotation conditions in the ADF prior to market opening (i.e., 9:30 a.m. Eastern Time).

### Certification Record

NASD proposes certain changes to its Certification Record and certification process to ensure that each ADF Trading Center has the capability to comply with the Order Protection Rule and Access Rule.<sup>17</sup> Proposed NASD Rule 4200A(a)(5) provides that an ADF Trading Center must execute and continue to comply with its Certification Record to be eligible to display quotations through the ADF.

The Certification Record would require each ADF Trading Center to certify, among other things, that it:

- monitors in real-time away market protected quotations;<sup>18</sup>
- will submit only automated quotations for display on the ADF;<sup>19</sup>
- offers immediate-or-cancel order and ISO<sup>20</sup> execution functionality for execution against its protected quotations to those required to be granted access to protected quotations consistent with Regulation NMS;<sup>21</sup>
- offers fair and non-discriminatory access;<sup>22</sup>
- provides a level and cost of access to quotations displayed through the ADF that is substantially equivalent to the level and cost of access offered by SRO trading

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<sup>17</sup> NASD's proposed Certification Record was filed as Exhibit 3 to its proposal and was published on the Commission's Web site (<http://www.sec.gov/rules/sro.shtml>). The Certification Record is described in detail in the Notice.

<sup>18</sup> See Certification Record, Item 2 (also requiring a clock synchronization protocol).

<sup>19</sup> See Certification Record, Item 3.

<sup>20</sup> See 17 CFR 242.600(b)(30).

<sup>21</sup> See Certification Record, Item 4.

<sup>22</sup> See Certification Record, Item 5.

facilities generally;<sup>23</sup>

- will make publicly available on its Internet Web site relevant connectivity and access technical specifications;<sup>24</sup> and
- will transmit to ADF Operations any notification received or transmitted by it regarding use of the self-help exception to the Order Protection Rule (i.e., Rule 611(b)(1)).

Documentation would have to be filed with NASD to demonstrate that the certifications are reasonably supported. In addition, each enumerated item would have to be certified by a duly authorized representative of the ADF Trading Center at the time of the initial application.<sup>25</sup> Recertification would be required within 30 days of the end of each ADF Trading Center's fiscal year. As provided in proposed NASD Rule 4300A(c), NASD's acceptance of an ADF Trading Center's Certification Record would not relieve the ADF Trading Center of any of its ongoing

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<sup>23</sup> See Certification Record, Item 7. An ADF Trading Center would also certify that, to the extent that NASD deems such ADF Trading Center not to be granting the requisite level and cost of access, that ADF Trading Center would be required by NASD to defray the connectivity costs of those persons entitled to access the ADF Trading Center. See Certification Record, Item 8. Moreover, if an ADF Trading Center charges a fee in excess of the fee cap for accessing orders other than protected quotations, it must certify that it will provide functionality that prevents market participants from inadvertently accessing a non-protected quotation and being charged a fee in excess of the fee cap. See Certification Record, Item 6.

<sup>24</sup> See Certification Record, Item 10. Consistent with Regulation NMS, NASD will require current ADF Trading Centers to publish such technical specifications no later than October 16, 2006. See Amendment No. 3, Changes to Form 19b-4, Item 6. NASD will identify each ADF Trading Center on NASD's Web site and provide a link to the final technical specifications. Id.

<sup>25</sup> Current ADF Trading Centers also would be required to be re-certified prior to the implementation of Regulation NMS and comply with applicable Regulation NMS requirements prior to the Specifications Date – October 16, 2006 – and Trading Phase Date – February 5, 2007. Accordingly, there will be no “grandfather” allowance for current ADF Trading Centers.

obligations and would not constitute an estoppel as to NASD or bind NASD in any subsequent administrative, civil, or disciplinary proceeding.

#### Extending ADF Functionality to All NMS Stocks

NASD proposes to extend the ADF's quoting, trade reporting, and clearing functionality by changing the definition of "ADF-eligible security" to include all NMS stocks, not just Nasdaq stocks. In addition, NASD proposes to amend the ADF rules to adopt uniform rules governing quoting and trade reporting for NMS stocks, and amend certain other rules to reflect the inclusion of all NMS stocks in the ADF.<sup>26</sup> Correspondingly, NASD also proposes to delete the NASD Rule 5200 series relating to the Intermarket Trading System Plan ("ITS Plan"), reflecting the fact that subsequent to the Trading Phase Date – February 5, 2007 – it is expected that the ITS Plan will cease to be operative.<sup>27</sup>

#### Changes to ADF Trade Reporting Rules

NASD proposes to clarify the ADF trade reporting rules by, among other things, amending: (1) NASD Rule 4630A, to provide that a transaction executed otherwise than on an exchange would have to be reported to the Trade Reporting and Comparison Service ("TRACS"), in accordance with NASD Rule 4632A or another pertinent NASD rule, unless it were reported to another facility designated by the Commission as being authorized to accept trade reports for trades executed otherwise than on an exchange;<sup>28</sup> (2) NASD Rule 4632A(f), to

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<sup>26</sup> NASD would delete the existing NASD Rule 6300 and 6400 series, relevant portions of which are being incorporated into the NASD Rule 4000A series, which governs the ADF.

<sup>27</sup> See Securities Exchange Act Release No. 53829 (May 18, 2006), 71 FR 30038, 30039 (May 24, 2006) ("Regulation NMS Compliance Release").

<sup>28</sup> See, e.g., Securities Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006) (File No. SR-NASD-2005-087) (establishing, among other things, rules for the trade reporting of transactions otherwise than on an exchange through the Trade Reporting Facility).



expressly prohibit aggregation of individual executions of orders in a security at the same price into a single transaction report; and (3) NASD Rule 4632A(l), to clarify a member's obligation under ADF rules to report cancelled trades in a timely manner.<sup>29</sup>

In addition, proposed NASD Rule 4632A(a)(4) would expressly require reporting members to append certain new trade report modifiers to a last sale report. In particular, NASD would adopt a new modifier (.X) for reporting a trade-through of a protected quotation that qualifies for one of certain exceptions or exemptions from the Order Protection Rule. The reporting member would also be required to append a separate unique modifier, if applicable, to identify the specific applicable exception or exemption upon which the member is relying.<sup>30</sup>

Proposed NASD Rule 4632A(a)(4) further provides that, to ensure consistency in the usage of such modifiers, trades will be identified in accordance with the specifications approved by the Operating Committee of the relevant national market system plan ("NMS Plan").<sup>31</sup> NASD has represented that it would provide a comprehensive list of all required modifiers when it publishes the ADF technical specifications on or before October 16, 2006.<sup>32</sup>

### III. Discussion and Commission Findings

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

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<sup>29</sup> Corresponding changes are being proposed to NASD's Rule 6100A series governing the use of TRACS to reflect the inclusion of all NMS stocks in the ADF.

<sup>30</sup> In its proposal, NASD stated that a firm is responsible for ensuring that the specific transaction falls expressly into an exception set forth in the Order Protection Rule.

<sup>31</sup> NASD would require reporting members, including ADF Trading Centers, to append additional NASD-specific trade report modifiers in certain situations.

<sup>32</sup> See Notice, 71 FR at 46529; Amendment No. 2, Changes to Form 19b-4, Item 6.

a national securities association.<sup>33</sup> In particular, the Commission finds that the proposal is consistent with Section 15A(b)(6) of the Act<sup>34</sup> in that it is 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. In addition, the Commission finds that the proposal is consistent with Section 15A(b)(11) of the Act<sup>35</sup> in that it is designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations. Finally, as discussed in more detail below, the Commission believes that the proposal is reasonably designed to conform NASD's rules to, and promote ADF Trading Centers' compliance with, the requirements of Regulation NMS.

A. Rule Changes Related to Regulation NMS

Rule 611 of Regulation NMS requires every trading center to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of "protected quotations" in NMS stocks (unless an exception or exemption applies). A protected quotation is a bid or offer displayed by an "automated trading center" pursuant to an effective national market system plan that, with respect to NASD, is the best bid or offer displayed on the ADF.<sup>36</sup> An automated trading center is a trading center that has implemented such systems, procedures, and rules as are necessary to render it capable of

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<sup>33</sup> 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).

<sup>34</sup> 15 U.S.C. 78o-3(b)(6).

<sup>35</sup> 15 U.S.C. 78o-3(b)(11).

<sup>36</sup> See 17 CFR 242.600(b)(57).

displaying quotations that meet the requirements for “automated quotations.”<sup>37</sup> An automated quotation is a quotation displayed by a trading center that, among other things, permits an incoming order to be marked immediate-or-cancel, immediately and automatically executes an order so marked against the displayed quotation, or cancels without routing elsewhere, immediately transmits a response, and immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms.<sup>38</sup>

The ADF was established as a facility of NASD in connection with NASD’s severing its affiliation with Nasdaq,<sup>39</sup> which is now registered as a national securities exchange.<sup>40</sup> In approving a major market structure change to Nasdaq – the establishment of its SuperMontage trading platform – the Commission took the view that market participants should not be forced to participate in SuperMontage. Therefore, the Commission conditioned its approval of SuperMontage on NASD, having a statutory obligation under Section 15A(b)(11) to regulate quoting in the over-the-counter (“OTC”) market, establishing an “alternative display facility.”<sup>41</sup> In its initial approval of the ADF pilot, the Commission found that this condition to the SuperMontage approval had been met and stated that the ADF “furthers the public interest by ensuring that continuity in the [OTC] market is maintained and that the NASD satisfies its statutory obligation to regulate the [OTC] market.”<sup>42</sup> The Commission’s adoption of Regulation

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<sup>37</sup> See 17 CFR 242.600(b)(4).

<sup>38</sup> See 17 CFR 242.600(b)(3).

<sup>39</sup> See generally Securities Exchange Act Release Nos. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001) (“SuperMontage Approval Order”); and 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (“ADF Pilot Approval Order”).

<sup>40</sup> See Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006); and 54085 (June 30, 2006), 71 FR 38910 (July 10, 2006).

<sup>41</sup> See SuperMontage Approval Order, 66 FR at 8053-54.

<sup>42</sup> ADF Pilot Approval Order, 67 FR at 49848.

NMS imposes certain new duties on NASD as operator of the ADF, which currently is the only “SRO display-only facility” in the national market system.

First, NASD must identify the ADF’s protected quotation so that all other market participants can readily see what Rule 611 requires them to protect. Unlike with an exchange, where the quotations of two or more exchange members can be aggregated to constitute a single protected quotation, the best bid of the ADF must reflect a single quotation of a single ADF Trading Center, and the best offer of the ADF must reflect a single quotation of a single ADF Trading Center.<sup>43</sup> Because the ADF does not provide execution functionality, market participants must use private linkages to route orders to individual ADF Trading Centers. The Commission’s approach prevents market participants from having to route orders to multiple ADF Trading Centers to fulfill their obligations under Rule 611 to satisfy the ADF’s protected quotation. This approach treats exchange markets comparably with the ADF, as market participants need route only a single order to an exchange to fulfill any obligations under Rule 611.<sup>44</sup>

The Commission believes that NASD Rule 4611A(a) is reasonably designed to identify the ADF protected quotation in a manner consistent with Regulation NMS and the Act generally. NASD clarified that the best bid of the ADF will reflect a single quotation of a single ADF Trading Center, and the best offer of the ADF will reflect a single quotation of a single ADF Trading Center, in each case represented through a single MPID.<sup>45</sup> The Commission further believes that NASD’s assignment of priority based on price, size, and then time is reasonable and

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<sup>43</sup> See Regulation NMS Adopting Release, 70 FR at 37534 (“A best bid and best offer must be accessible by routing an order to a single market destination....”)

<sup>44</sup> See *id.*, 70 FR at 37529.

<sup>45</sup> See Amendment No. 3, Changes to Form 19b-4, Item 2.

consistent with the Act. Furthermore, as directed by the Commission in the Regulation NMS Compliance Release, NASD must provide on its Web site, on or before the Specifications Date – October 16, 2006 – a hyperlink to the Web site of each ADF Trading Center that will set forth the required technical specifications, with respect to each such ADF Trading Center, that are required to be posted by that date.<sup>46</sup> NASD has stated that a link to ADF Trading Centers' technical specifications will be posted on NASD's Web site.<sup>47</sup>

Second, as the regulator of quotations in the OTC market, NASD must promote compliance by ADF Trading Centers with the requirements relating to automated quotations, which Rule 611 requires market participants to protect. NASD has determined to carry out that responsibility by permitting ADF Trading Centers to submit only automated quotations to the ADF. NASD Rule 4300A(e)(1) prohibits manual quotations from being submitted to the ADF and requires every ADF Trading Center to establish policies and procedures to ensure that it submits only automated quotations to the ADF. In addition, NASD Rule 4300A(a)(4) requires each ADF Trading Center to demonstrate to NASD that it has sufficient technology to automatically update its quotations and immediately respond to orders for execution directly against its best bid or offer. Furthermore, Items 3 and 4 of the Certification Record require an ADF Trading Center to certify that it will post only automated quotations to the ADF and that it will be able to respond appropriately to incoming orders in accordance with Regulation NMS.

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<sup>46</sup> See Regulation NMS Compliance Release, 71 FR at 30039.

<sup>47</sup> See Amendment No. 3, Changes to Form 19b-4, Item 6. NASD will separately require each ADF Trading Center to post its final technical specifications on its own Web site setting out, among other things, how market participants may link to it, and how orders must be coded to enable access to quotations published on the ADF, consistent with the Regulation NMS Compliance Release. In this regard, NASD will require current ADF Trading Centers to certify that they will comply with this requirement and, as appropriate, provide ADF Operations with relevant related information.

The inability to post automated quotations in the ADF or the inability to immediately and automatically respond to orders would constitute a “system outage” under NASD Rule 4300A(e)(2). An ADF Trading Center experiencing a system outage must immediately withdraw its quotations and contact ADF Operations, pursuant to NASD Rule 4619A. NASD Rule 4621A allows NASD to suspend, condition, or terminate an ADF Trading Center’s authority to enter quotations for violating this requirement.

The Commission believes that NASD’s rules relating to the provision of automated quotations to the ADF are reasonable and consistent with the Act, and with Regulation NMS in particular. The requirements that an ADF Trading Center post only automated quotations to the ADF and, in the event of a systems problem, withdraw its quotations immediately should minimize the extent to which the systems problems of a particular ADF Trading Center interfere with efficient trading throughout the national market system. The affirmative duty of each automated trading center to identify its quotations appropriately is a vitally important element of Regulation NMS. It will help promote the smooth and efficient functioning of intermarket price priority and trading in general. Timely and accurate identification of quotations will give investors, broker-dealers, and other trading centers essential information concerning the status of quotations in NMS stocks, thereby minimizing the extent to which the systems problems of a particular trading center can interfere with efficient trading throughout the national market system. For example, when a trading center experiencing systems problems promptly fulfills its duty to identify its quotations as manual or pulls its quotation altogether, and thereby removes them from trade-through protection, it will not be necessary for other trading centers or order-routers to invoke the self-help exception.

Third, for the goals of Regulation NMS to be met, NASD must help promote efficient access to ADF Trading Centers that wish to be eligible for protected quotation status without displaying their quotations in an SRO trading center.<sup>48</sup> In the process leading to the Commission’s adoption of Regulation NMS, various commenters expressed concern that it could be inefficient to establish linkages to numerous individual ADF Trading Centers whose quotations are protected under Rule 611.<sup>49</sup> As the Commission itself noted, “the greater the number of ADF Trading Centers, the greater the number of separate connectivity points that market participants will need to access to comply with the Order Protection Rule.”<sup>50</sup> To address these concerns, the Commission ultimately determined that the cost of such access passed on to users, and the level of access generally, must be “substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.”<sup>51</sup> The Commission further stated that “effective NASD oversight of NASD participants’ compliance with [Rule 610] is critical to the viability of the access standards . . . given that these participants are not accessible through an SRO trading facility.”<sup>52</sup>

The Commission believes that NASD has reasonably designed the ADF rules, Certification Record, and related materials to promote compliance by ADF Trading Centers with the requirements of the Access Rule. NASD Rule 4300A(a)(3) requires each ADF Trading Center to provide a level and cost of access to its quotations in an NMS stock displayed in the

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<sup>48</sup> See Regulation NMS Adopting Release, 70 FR at 37543 (“As the self-regulatory authority responsible for the OTC market, the NASD must act as the ‘gatekeeper’ for the ADF, and, as such, will need to closely assess the extent to which ADF Trading Centers meet the access standards of Rule 610.”)

<sup>49</sup> See Regulation NMS Adopting Release, 70 FR at 37540, nn. 370, 381.

<sup>50</sup> Id., 70 FR at 37541.

<sup>51</sup> Id., 70 FR at 37542.

<sup>52</sup> Id., 70 FR at 37543.

ADF that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities in that NMS stock. NASD Rule 4300A(a)(5) prohibits an ADF Trading Center from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining, through a registered broker-dealer, efficient access to such quotations. Items 5 and 7 of the Certification Record require an ADF Trading Center to certify that it is in compliance with the requirements of NASD Rules 4300A(a)(5) and 4300A(a)(3). NASD Rule 4400A(a) allows any registered broker-dealer to file a claim for denial of direct or indirect access and, if applicable, authorizes NASD to withdraw an ADF Trading Center's quotations until appropriate access is provided.

NASD Rule 4300A(d)(1) requires an ADF Trading Center to provide direct electronic access through the use of at least two providers from the list of NASD-approved connectivity providers. The Commission believes that this is a reasonable approach to promote compliance by ADF Trading Centers with the Access Rule and is, therefore, consistent with the Act. NASD also has stated that it would review the list periodically and update it on an as-needed basis. Therefore, the Commission believes that the maintenance of this list does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act, as required by Section 15A(b)(9) of the Act.<sup>53</sup>

Each ADF Trading Center must demonstrate its compliance with the Access Rule, and in particular that it will provide a level and cost of access substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities. NASD, as the regulator of quotations in the OTC market, must evaluate "substantially equivalent cost of access" on a per-

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<sup>53</sup> 15 U.S.C. 78q-3(b)(9).



transaction basis.<sup>54</sup> In its proposal, NASD has indicated that it will consider costs related to directly accessing SRO trading facilities generally, and more specifically, ADF Trading Center and SRO connectivity costs such as line costs and port charges. In addition, NASD stated that it would consider costs associated with SRO membership in evaluating substantially equivalent costs. The Commission expects NASD to provide appropriate guidance in accordance with these principles to ADF Trading Centers, as necessary, in connection with their demonstration of substantially equivalent access.

Furthermore, the Commission has stated that NASD must make an affirmative determination that existing ADF Trading Centers are in compliance with the requirements of the Access Rule, and that, if an ADF Trading Center were not so complying, NASD would have a responsibility to stop publishing its quotations until it comes into compliance.<sup>55</sup> In the Notice, NASD represented that it will comply with this directive.

Fourth, paragraph (d) of the Access Rule<sup>56</sup> requires each national securities exchange and national securities association to establish, maintain, and enforce written rules that require its members reasonably to avoid displaying quotations that lock or cross any protected quotation in an NMS stock and are reasonably designed to assure the reconciliation of locked or crossed quotations in an NMS stock. NASD Rule 4130A requires every NASD member to reasonably avoid displaying, or engaging in a pattern or practice of displaying, any quotations that lock or cross a protected quotation and any manual quotations that lock or cross a quotation previously

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<sup>54</sup> The Commission has previously stated that, in evaluating access, a \$1,000 port charge for an ECN participating in the ADF that trades one million shares per day would not be substantially equivalent to a \$1,000 port fee charged by an SRO trading facility trading 100 million shares per day. See Regulation NMS Adopting Release, 70 FR at 37543.

<sup>55</sup> See Regulation NMS Adopting Release, 70 FR at 37543.

<sup>56</sup> 17 CFR 242.610(d).

disseminated pursuant to an effective NMS Plan, subject to certain exceptions.<sup>57</sup> In addition, the rule would require a member displaying a manual quotation in an NASD facility other than the ADF<sup>58</sup> that locks or crosses a quotation previously disseminated pursuant to an effective NMS Plan to promptly withdraw the quotation or route an ISO to execute against the full displayed size of the locked or crossed quotation. The Commission believes that NASD Rule 4130A is reasonably designed to fulfill NASD's obligations under Rule 610(d) of Regulation NMS and is, therefore, consistent with the Act.

B. Other Rule Changes

Currently, the ADF accommodates the quoting, trade reporting, and clearing of only Nasdaq securities. NASD proposes to amend its Rule 4200A(a)(2) to define "ADF-eligible security" to include any NMS stock, thereby extending the ADF quoting, trade reporting, and clearing functionality to NMS stocks other than those listed on Nasdaq. Correspondingly, NASD is deleting the existing Rule 6300 and 6400 series, which govern the quoting and trade reporting of exchange-listed securities, because these rules would no longer be necessary. NASD also will update certain other rules to reflect the inclusion of all NMS stocks in the ADF.

As originally conceived, the ADF would have accommodated the quoting, trade reporting, and clearing of exchange-listed securities as well as Nasdaq securities, and would have made participation in the ITS Plan voluntary for OTC market makers.<sup>59</sup> At the time of the proposal, commenters expressed concern with allowing OTC market makers for exchange-listed

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<sup>57</sup> The Commission notes that existing NASD Rule 4613A will continue to address locked or crossed quotation conditions in the ADF prior to market opening.

<sup>58</sup> As described above, manual quotations shall not be submitted to the ADF. See proposed NASD Rule 4300A(e)(1).

<sup>59</sup> See Securities Exchange Act Release No. 45156 (December 14, 2001), 67 FR 388 (January 3, 2002).

securities to participate in the ITS Plan on a voluntary basis.<sup>60</sup> Subsequently, NASD revised the ADF proposal to eliminate the quoting of exchange-listed securities, and proposed operating the ADF on a pilot basis for Nasdaq securities only.<sup>61</sup> With the Access Rule of Regulation NMS, however, the Commission adopted a private linkage approach to promote efficient interaction among market participants. This approach is expected to replace the ITS linkage, thus eliminating the concern originally expressed by commenters. Therefore, the Commission believes that it is reasonable and consistent with the Act to eliminate the restriction on quoting non-Nasdaq NMS stocks in the ADF.

NASD has proposed to delete its Rule 5200 series relating to the ITS Plan effective upon the Trading Phase Date. On the Trading Phase Date, it is expected that the ITS Plan will cease to be operative, and NASD's rules related to the ITS Plan will thus no longer be necessary.

NASD also proposes to amend ADF transaction reporting requirements. Among other things, NASD Rule 4632A(a)(4) expressly requires reporting members to append certain new trade report modifiers to a last sale report to more closely align NASD modifiers with the exceptions and exemptions from the Order Protection Rule. The Commission believes that these rules are consistent with the Act and should enhance consistency for trades that are executed in reliance on an exception or exemption from Rule 611. The use of identical modifiers across all markets should facilitate surveillance and promote transparency in the marketplace.<sup>62</sup>

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<sup>60</sup> See Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) at 49848, n.26.

<sup>61</sup> See Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002).

<sup>62</sup> See Regulation NMS Adopting Release, 71 FR at 37507, n.73 (“Such modifiers would greatly enhance transparency and minimize the potential for false appearances of violations of Rule 611.”)

NASD also has proposed other changes to the ADF trade reporting rules, including Rules 4300A, 4630A, and 4632A, to enhance their clarity. In addition, NASD is correcting cites to the Commission's national market system rules that were renumbered by Regulation NMS. These changes are reasonable and consistent with the Act.

#### IV. Accelerated Approval of Amendment No. 3

Pursuant to Section 19(b)(2) of the Act,<sup>63</sup> the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30<sup>th</sup> day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding.

In Amendment No. 3, the NASD added language to its NASD Rule 4611A(a) stating that the priority for determining the bid and offer to be designated the protected quotation on the ADF would be price, size, and time, and clarified in its Form 19b-4 submission that the best bid and best offer would be determined based on quotations submitted through individual MPIDs. NASD also modified Item 4 of the proposed Certification Record to make clear that an ADF Trading Center must respond to orders immediately and automatically and must respond to ISOs consistent with Regulation NMS, modified Item 10 of the proposed Certification Record to make clear that an ADF Trading Center must post its relevant connectivity and access technical specifications on its Web site, and added new Item 13 to the proposed Certification Record that requires an ADF Trading Center to certify that it will transmit to ADF Operations any notification received or transmitted by it regarding use of the self-help exception to the Order Protection Rule. In addition, NASD clarified the definition of system outage in proposed NASD Rule 4300A(e)(2), revised proposed NASD Rule 4619A to track more closely that definition,

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<sup>63</sup> 15 U.S.C. 78s(b)(2).

and made minor technical changes to the proposal. Finally, NASD clarified that the Certification Record and process for certifying ADF Trading Centers will be effective upon Commission approval of the proposal, that the NASD-approved list of connectivity providers will be made available prior to October 16, 2006, that current ADF Trading Centers would be required to publish appropriate technical specifications no later than October 16, 2006, that it would provide a link to each such ADF Trading Center's specifications on its Web site and that effectiveness of the other proposed rules will be the Trading Phase Date – February 5, 2007. The Commission believes that these changes clarify the proposed rules and Certification Record and do not raise any significant or novel regulatory issues. Accordingly, the Commission hereby finds good cause for approving Amendment No. 3 to the proposed rule change prior to the 30<sup>th</sup> day after publishing notice of Amendment No. 3 in the Federal Register.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 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-2006-091 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-091. 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 the 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-2006-091 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>64</sup> that the proposed rule change (File No. SR-NASD-2006-091), as amended by Amendment No. 2, be, and hereby is approved, and that Amendment No. 3 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>65</sup>

Nancy M. Morris  
Secretary

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<sup>64</sup> 15 U.S.C. 78s(b)(2).

<sup>65</sup> 17 CFR 200.30-3(a)(12).