

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-70159; File No. SR-NASDAQ-2013-102)

August 12, 2013

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of a Proposed Rule Change to Assume Operational Responsibility for Certain Surveillance Activity Currently Performed by FINRA under the Exchange's Authority and Supervision

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 July 31, 2013, The NASDAQ Stock Market LLC ("NASDAQ" or the "Exchange") filed with the Securities and Exchange Commission ("Commission") a proposed rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. 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 Substance of the Proposed Rule Change

NASDAQ is proposing to assume operational responsibility for certain surveillance activity currently performed by the Financial Industry Regulatory Authority ("FINRA") under the Exchange's authority and supervision.

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 those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below,

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

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

of the most significant parts of such statements.

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

1. Purpose

Section 6 of the Act requires that national securities exchanges enforce their members' compliance with federal securities laws and rules as well as the exchanges' own rules.<sup>3</sup> As a self-regulatory organization ("SRO"), NASDAQ must conduct surveillance of trading on the Exchange as part of a comprehensive regulatory program that also includes member examinations and investigation and prosecution of suspicious activity. Since it became a national securities exchange, NASDAQ has contracted with FINRA through various regulatory services agreements to perform certain surveillance and other regulatory functions on its behalf. However, as the Commission has made clear, "the Nasdaq Exchange bears the responsibility for self-regulatory conduct and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf."<sup>4</sup>

Notwithstanding its use of FINRA, the Exchange has also retained operational responsibility for a number of surveillance and other regulatory functions including real-time surveillance, qualification of companies listed on NASDAQ and most surveillance related to its affiliated options markets. Historically NASDAQ retained operational responsibility in areas where NASDAQ's expertise regarding its own markets, technology and listed companies enhanced regulation. For the reasons outlined below, NASDAQ now proposes to reallocate

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<sup>3</sup> 15 U.S.C. 78f.

<sup>4</sup> Securities Exchange Act Release No. 53128 at 28 (January 13, 2006), 71 FR 3550, 3556 (January 23, 2006).

operational responsibility from FINRA to NASDAQ Regulation for a limited number of equities surveillance patterns and related review functions focused on:

- manipulation patterns that monitor solely NASDAQ activity, including patterns that monitor the Exchange's opening and closing crosses and compliance with minimum bid listing requirements, and
- monitoring of compliance by member firms with elements of Regulation M and NASDAQ Rule 4619 compliance.

FINRA operates a full suite of equities surveillance patterns on behalf of NASDAQ that covers many types of potential misconduct. In recent years FINRA, with NASDAQ's oversight and approval, modified a number of these NASDAQ patterns to incorporate data from markets operated by NYSE Euronext. NASDAQ plans to continue to participate in this cross-market surveillance performed by FINRA, some of which focuses on identifying similar violative activity, which will not be impacted by this proposal. However, a limited number of FINRA's patterns only review NASDAQ market data and detect conduct occurring only on the Exchange. These patterns incorporate unique elements of NASDAQ's market structure and focus on trading activity in the NASDAQ opening and closing cross process, as well as NASDAQ minimum bid listing standards, an area already regulated by NASDAQ. An additional pattern monitors attempts to manipulate NASDAQ using small orders to advantage larger orders placed on the opposite side of the NASDAQ market at an improved price (often referred to as "odd lot manipulation" or "mini-manipulation").

NASDAQ believes that its expertise in its own market structure coupled with its continued monitoring of these activities in real-time will enable it to enhance existing patterns to better detect improper activity on its market. In addition, these patterns, the underlying rules, and

analytical requirements are similar to patterns NASDAQ regulatory personnel already operate for affiliated options markets. For example, NASDAQ regulatory personnel routinely monitor affiliated options markets for market closing activity and other patterns designed to detect various types of price influence.

NASDAQ also proposes to assume operational responsibility for real-time monitoring of compliance by market makers that are members of an underwriting syndicate with the quoting and trading restrictions in Rules 101 and 103 under the Act<sup>5</sup> and NASDAQ Rule 4619. Lead underwriters affected by the rules file a Regulation M Commencement Notification at the beginning of a secondary offering and subsequent Underwriter Activity Report for the offering. The surveillance pattern monitors quoting and trading of firms that are designated as participants in the secondary offering and alerts regulatory staff if a firm that has requested passive market making exceeds its trading thresholds or an excused withdrawal has traded in a way that could lead to violations of the rules. The activity is monitored in real-time and firms are called upon receipt of regulatory alerts to prevent potential or further violations. This is the only real-time surveillance function performed by FINRA and NASDAQ believes that this responsibility is more properly handled by NASDAQ's MarketWatch group that handles all other real-time surveillance of the NASDAQ market. MarketWatch already has responsibility for monitoring similar activity on NASDAQ OMX BX by market makers participating in secondary offerings, although this surveillance is not currently active as BX does not have any registered market makers.

NASDAQ plans to operate the surveillance patterns referenced above in the SMARTS surveillance system. SMARTS is a state-of-the-art surveillance platform used in 26 markets and

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<sup>5</sup> 17 CFR 242.101 and 17 CFR 242.103.

by 9 government regulators around the world. NASDAQ plans to use SMARTS for both real-time monitoring and the limited non-real time surveillance covered by this proposal. Running the patterns in real-time will permit an expedited review of critical alerts that previously would not have been completed the same day. It will now be easier to quickly compare unusual activity noted as part of NASDAQ's operations monitoring of market activity with surveillance alerts. NASDAQ anticipates being able to refer a broader cross section of problematic activity to FINRA for expedited review than was previously the case.

NASDAQ Regulation intends to leverage its existing staff of experienced analysts, lawyers, programmers and market structure experts to perform the new functions covered by this proposal. This group is working with NASDAQ's regulatory technology group to develop and test the surveillance patterns that will run in the SMARTS system. This distribution of responsibilities was the result of detailed discussions between NASDAQ and FINRA that focused on reallocating responsibilities based on the core competencies of each organization. NASDAQ Regulation and FINRA have developed comprehensive plans covering the transition and the groups have met regularly over more than nine months to ensure a smooth transition of the work and prevent any gaps in surveillance coverage. NASDAQ and FINRA anticipate a phased transition of patterns, with NASDAQ formally relieving FINRA of operational responsibility for each pattern once testing, training, procedures and other preparations are completed. FINRA will retire each pattern once relieved of responsibility. After the transition, NASDAQ Regulation will review surveillance alerts and refer potentially violative conduct to FINRA using existing processes and systems. FINRA will continue to have operational responsibility for the vast majority of surveillances involving NASDAQ's equity market as well

as examination and enforcement matters, subject to NASDAQ's supervision and ultimate responsibility.

The provisions of NASDAQ Rule 0150 require that NASDAQ obtain Commission approval if regulatory functions subject to the regulatory services agreement in effect at the time NASDAQ became a national securities exchange are no longer performed by FINRA or another independent self-regulatory organization. For the reasons stated above, NASDAQ believes that the reassignment of operational responsibility for a limited number of equities surveillance patterns will further its regulatory program and benefit investors and the markets. Commission approval of the proposal would allow NASDAQ OMX to better leverage data and systems across its three equities exchanges, including NASDAQ OMX PHLX, an affiliate of NASDAQ, that does not have an equivalent to Rule 0150 requiring Commission approval for this reallocation.

In addition, NASDAQ notes that its proposal is consistent with, but more limited than, surveillance work performed by other national securities exchanges. The SEC has previously approved several applications for registration as national securities exchanges in which the SRO proposed to perform its own surveillance function. For example, the SEC approved BATS Exchange's application where BATS performed most surveillance for its markets, finding in its approval order that it was consistent with the Act for BATS Exchange to contract with FINRA to perform regulatory functions limited to "examination, enforcement, and disciplinary functions."<sup>6</sup> Similarly, NASDAQ understands that Miami International Securities Exchange ("MIAX") performs the majority of its surveillance operations in-house. This is consistent with MIAX's Form 1, which states that the new exchange entered into a regulatory services agreement with CBOE that is limited to "conducting certain market surveillances" in addition to other regulatory

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<sup>6</sup> Securities Exchange Act Release No. 34-58375 (August 18, 2008), 73 FR 49498 (August 21, 2008).

work.<sup>7</sup>

## 2. Statutory Basis

NASDAQ believes that the proposed rule change is consistent with the provisions of Section 6 of the Act,<sup>8</sup> in general and with Sections 6(b)(5) of the Act,<sup>9</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 foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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. The Exchange believes that this proposal is in keeping with those principles by leveraging the SMARTS technology system that has the ability to operate in real-time and, as a consequence, will permit NASDAQ to react more quickly to potential manipulation in the applicable regulatory areas covered by this proposal. The surveillance patterns to be reallocated to NASDAQ involve solely activity on NASDAQ's own market. NASDAQ believes that its expertise in its own market structure, coupled with its existing monitoring of these activities in real-time, will enable it to enhance current patterns to better detect improper activity on its market. In addition, NASDAQ will be able to leverage the knowledge and the regulatory staff that already perform similar work for affiliated options markets.

NASDAQ will continue to refer potentially violative conduct to FINRA for further review. Moreover, FINRA will continue to perform the vast majority of surveillance activity for

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<sup>7</sup> Securities Exchange Act Release No. 34-68341 (December 3, 2012), 77 FR 73065 (December 7, 2012) (emphasis added).

<sup>8</sup> 15 U.S.C. 78f.

<sup>9</sup> 15 U.S.C. 78f(b)(5).

NASDAQ's equities markets, in many cases using patterns that incorporate data from other market centers. FINRA will also perform examination and enforcement work, subject to NASDAQ's supervision and ultimate responsibility.

NASDAQ also believes the proposal is consistent with the Act because, as the Commission has made clear on many occasions, an SRO cannot delegate its ultimate responsibility for surveillance in the absence of an SEC-approved agreement under Section 17(d)(2) of the Act, and therefore must remain involved and responsible for its regulatory program. In addition, NASDAQ notes that its proposal is consistent with, but more limited than, surveillance work performed by other national securities exchanges. As noted above, the SEC has previously approved several applications for registration as national securities exchanges in which the SRO proposed to perform its own surveillance function.<sup>10</sup> NASDAQ believes it would therefore be consistent with the Act for NASDAQ to perform a much more limited surveillance function than has been approved for other exchanges and, in fact, more limited than surveillance functions NASDAQ already performs for non-cash equities markets.

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

The Exchange 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, as amended.

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.

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<sup>10</sup> See supra notes 6 and 7, and accompanying text discussing the surveillance work by BATS and MIAX.



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

Within 45 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 Exchange consents, the Commission shall: (a) by order approve or disapprove 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 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-NASDAQ-2013-102 on the subject line.

#### Paper comments:

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

All submissions should refer to File Number SR-NASDAQ-2013-102. 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 website (<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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, D.C. 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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-NASDAQ-2013-102, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>11</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>11</sup> 17 CFR 200.30-3(a)(12).