

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50311)

Order Granting Application for a Temporary Conditional Exemption Pursuant to Section 36(a) of the Exchange Act by the National Association of Securities Dealers, Inc. Relating to the Acquisition of an ECN by The Nasdaq Stock Market, Inc.

September 3, 2004

I. Introduction

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”), pursuant to Rule 0-12¹ under the Securities Exchange Act of 1934 (“Exchange Act”), an application for an exemption under Section 36(a)(1) of the Exchange Act² from the rule filing requirements of Section 19(b) of the Exchange Act³ with respect to Nasdaq’s acquisition of Brut, LLC, operator of the Brut ECN (“Brut”), a registered broker-dealer, and electronic communications network (“ECN”), as a wholly-owned subsidiary of Nasdaq.⁴ This order temporarily grants the request for exemptive relief subject to NASD and Nasdaq satisfying certain conditions, which are outlined below.

II. Nasdaq’s Application for Temporary Conditional Exemption from Section 19(b) Rule Filing Requirements

On August 25, 2004, Nasdaq requested that the Commission grant temporary exemptive relief, subject to certain conditions, from the rule filing procedures of Section 19(b) of the

¹ 17 CFR 240.0-12.

² 15 U.S.C. 78mm(a)(1).

³ 15 U.S.C. 78s(b).

⁴ On August 6, 2004, the NASD Board of Governors approved Nasdaq’s proposal to seek the exemption. The obligation to file with the Commission proposed changes to the NASD rules concerning Nasdaq systems has been delegated to Nasdaq by the NASD, pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries (“Delegation Plan”). Nasdaq submitted this request for exemption pursuant the Delegation Plan.

Exchange Act⁵ with regard to Nasdaq's acquisition and operation of Brut as a wholly-owned subsidiary of Nasdaq.⁶ According to Nasdaq's Exemption Request, Nasdaq entered into a definitive agreement to purchase Brut on May 25, 2004. Brut is currently an NASD member and participates in the Nasdaq Market Center execution system (formerly know as the "Nasdaq National Market Execution System" or "SuperMontage") as a Nasdaq Order-Delivery ECN.⁷ Brut's current relationship with Nasdaq is limited to participating in the Nasdaq Market Center execution system in the same manner as other ECNs. Nasdaq currently has no ownership interest in Brut.⁸

Once acquired by Nasdaq, Brut would become a "facility" of a self-regulatory organization ("SRO") pursuant to Section 3(a)(2) of the Exchange Act⁹ because Brut would be property of Nasdaq used for the purpose of effecting or reporting securities transactions.¹⁰ As a result, NASD and, pursuant to the Delegation Plan, Nasdaq would be obligated, under Section 19(b) of the Exchange Act¹¹ to file with Commission proposed rules governing the operation of Brut's trading system and subscriber fees.

Until transfer of ownership, Nasdaq and Brut remain legally separate entities, each of which, among other things, are engaged in and competing for, the business of facilitating securities transactions. Because Nasdaq and Brut are competitors, Nasdaq represents that it and

⁵ Id.

⁶ See letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated August 25, 2004 ("Exemption Request").

⁷ See NASD Rule 4701(t).

⁸ See Exemption Request, supra note 6.

⁹ See 15 U.S.C. 78c3(a)(2).

¹⁰ See Exemption Request, supra note 6. See also, supra note 9.

¹¹ 15 U.S.C. 78s(b).

Brut are limited in the amount and type of information that can be exchanged between them prior to the acquisition's consummation (e.g., information about the technical specifications of Brut's execution algorithm, order types, and pricing).¹² Nasdaq represents that this information from Brut is a necessary and important component of any rule filing it may submit to the Commission related to Brut and that this information must be kept confidential by Brut, and cannot be shared with Nasdaq, prior to the closing of the transaction. Moreover, Nasdaq stated in its Exemption Request that without such information, it would be unable to prepare and submit rule filings regarding Brut's operation and fee structure prior to close of the transaction and the transfer of ownership of Brut to Nasdaq. In its Exemption Request, Nasdaq represented that upon assuming ownership of Brut, Nasdaq and Brut would be relieved of certain legal constraints in sharing information and would begin to share the previously restricted information so that, among other things, Nasdaq could draft rules governing Brut's functionality and fees ("Brut Filings").

In its Exemption Request, Nasdaq asserted that without Commission approval of rules governing Brut's operation, it would not be able to operate Brut, thereby causing Brut to cease operations until the Brut Filings were approved by the Commission. Because Brut presently accounts for a significant portion of the share volume for Nasdaq-listed securities, the summary termination of its services could potentially harm investors and disrupt the functioning of a fair and orderly market. The requested exemption would allow Brut to continue to operate, subject to certain conditions, after it is acquired by Nasdaq, while NASD and Nasdaq undertake to

¹² Nasdaq represents that, as legally distinct entities, the exchange of sensitive information between Nasdaq and Brut pre-closing would subject them to Section 1 of the Sherman Antitrust Act, 15 U.S.C. 1, as well as to the "gun jumping" provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, 15 U.S.C. 18a. See Section 1 of the Sherman Antitrust Act, 15 U.S.C. 1; Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. 18a. See Exemption Request, supra note 6.

comply with the procedures related to rule changes under Section 19(b) of the Exchange Act.¹³

In addition, Nasdaq asserted that the requested exemption would be consistent with the protection of investors and the public interest, because it would allow Brut to continue to operate its ECN trading system during the period immediately after its purchase by Nasdaq.

The exemption would also provide Nasdaq a reasonable opportunity to fully analyze Brut's systems, operations, and fee structure to ensure an orderly integration of Brut and Nasdaq and to make accurate filings based on such information. In addition, Nasdaq stated that the exemption would not diminish the Commission's ability to monitor Nasdaq and Brut. In this regard, Nasdaq noted that to the extent it would undertake to make changes to its non-Brut systems during the exemption period, or thereafter, NASD and Nasdaq would remain subject to Section 19(b) and thus obligated to file proposed rule changes with the Commission. Further, in its Exemption Request, NASD and Nasdaq committed to satisfying certain conditions, which are outlined below. For example, as a condition to the exemption, Nasdaq would be required to submit proposed rule changes with respect to any material changes to Brut's functions during the exemption period. In this regard, Nasdaq noted in its Exemption Request that it currently anticipates making no material changes to Brut's ECN functionality during the exemption period.¹⁴

III. Order Granting Temporary Conditional Section 36 Exemption

In 1996, Congress gave the Commission greater flexibility to regulate trading systems, such as Brut, by granting the Commission broad authority to exempt any person from any of the

¹³ 15 U.S.C. 78s(b).

¹⁴ If such changes become necessary as the result of continued competition, however, Nasdaq's commitment above to file proposed rule changes would provide the Commission the opportunity to review any such modifications. See Exemption Request, supra note 6.

provisions of the Exchange Act and to impose appropriate conditions on their operation.¹⁵ Specifically, NSMIA added Section 36(a)(1) to the Exchange Act, which provides that “the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Exchange Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”¹⁶ In enacting Section 36, Congress indicated that it expected that “the Commission will use this authority to promote efficiency, competition and capital formation.”¹⁷ It particularly intended to give the Commission sufficient flexibility to respond to changing market and competitive conditions:

The Committee recognizes that the rapidly changing marketplace dictates that effective regulation requires a certain amount of flexibility. Accordingly, the bill grants the SEC general exemptive authority under both the Securities Act and the Securities Exchange Act. This exemptive authority will allow the Commission the flexibility to explore and adopt new approaches to registration and disclosure. It will also enable the Commission to address issues relating to the securities markets more generally. For example, the SEC could deal with the regulatory concerns raised by the recent proliferation of electronic trading systems, which do not fit neatly into the existing regulatory framework.¹⁸

In recent years, the Commission has exercised its Section 36 exemptive authority to enhance competition as a means to meet the objectives of the Exchange Act.¹⁹

¹⁵ 15 U.S.C. 78mm(a). Section 36 of the Exchange Act was enacted as part of the National Securities Markets Improvements Act 1996, Pub. L. No. 104-290 (“NSMIA”).

¹⁶ 15 U.S.C. 78mm(a).

¹⁷ H.R. Rep. No. 104-622, 104th Cong., 2^d Sess. 38 (1996).

¹⁸ S. Rep. No. 104-293, 104th Cong., 2^d Sess. 15 (1996).

¹⁹ 15 U.S.C. 78mm. For example, the Commission issued an order pursuant to Section 36 of the Exchange Act, granting NASD a temporary exemption from Section 19(b), relating to the acquisition and operation by Nasdaq of a software development company. See Securities Exchange Act Release No. 42713 (April 24, 2000), 65 FR 25401 (May 1, 2000). See also Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR

Section 19(b)(1) of the Exchange Act requires an SRO, including NASD, to file with the Commission its proposed rule changes accompanied by a concise general statement of the basis and purpose of the proposed rule change.²⁰ Once a proposed rule change has been filed with the Commission, the Commission is required to publish notice of it and provide an opportunity for public comment. The proposed rule change may not take effect unless approved by the Commission by order, unless the rule change is within the class of rule changes that are effective upon filing pursuant to Section 19(b)(3)(A) of the Act.²¹

Section 19(b)(1) of the Exchange Act²² defines the term “proposed rule change” to mean “any proposed rule or rule change in, addition to, or deletion from the rules of [a] self-regulatory organization.” Pursuant to Section 3(a)(27) and 3(a)(28) of the Exchange Act, the term “rules of a self-regulatory organization” means (1) the constitution, articles of incorporation, bylaws and rules, or instruments corresponding to the foregoing, of an SRO, and (2) such stated policies, practices and interpretations of an SRO (other than the MSRB) as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules. Rule 19b-4(b) under the Exchange Act,²³ defines the term “stated policy, practice, or interpretation” to mean generally “any material aspect of the operation of the

8500 (February 24, 2004) (Order Granting Application for Exemptions Pursuant to Section 36(a) of the Exchange Act by the American Stock Exchange LLC, the International Securities Exchange, Inc., the Municipal Securities Rulemaking Board, the Pacific Exchange, Inc., the Philadelphia Stock Exchange, Inc., and the Boston Stock Exchange, Inc.).

²⁰ 15 U.S.C. 78s(b)(1). This obligation also applies to Nasdaq, because Nasdaq has been delegated specific responsibilities related to rule changes affecting Nasdaq filed with the Commission pursuant to the Delegation Plan. See also, supra note 4.

²¹ 15 U.S.C. 78s(b)(3)(A).

²² 15 U.S.C. 78s(b)(1).

²³ 17 CFR 240.19b-4.

facilities of the self-regulatory organization²⁴ or any statement made available to the membership, participants, or specified persons thereof that establishes or changes any standard, limit, or guideline with respect to rights and obligations of specified persons or the meaning, administration, or enforcement of an existing rule.”

The term “facility” is defined in Section 3(a)(2) of the Exchange Act, with respect to an exchange, to include “its premises, tangible or intangible property whether on the premises or not, any right to use such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.”

In its Exemption Request, Nasdaq acknowledges that upon closing of the purchase transaction, Brut would become a facility of Nasdaq because the Brut trading system would be property of Nasdaq that is used for the purpose of effecting or reporting securities transactions. Section 19(b) of the Exchange Act and Rule 19b-4 thereunder, absent an exemption, would require NASD to file proposed rules with the Commission to allow Nasdaq to operate Brut as a facility. Further, Nasdaq represented in its Exemption Request that, due to legal constraints regarding information sharing, it would be unable to submit the Brut filings prior to close of the transaction and the transfer of ownership of Brut to Nasdaq. In its Exemption Request, Nasdaq represented that upon assuming ownership of Brut, Nasdaq and Brut would be permitted to share

²⁴ The term “facilities of the self-regulatory organization” is not defined in the Exchange Act. The Commission, however, has found that Nasdaq generally performs the functions commonly performed by an exchange. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) at nn. 58-61 and accompanying text.

information so that Nasdaq could undertake to prepare and submit the Brut Filings in compliance with NASD's obligations under Section 19(b) of the Exchange Act and Rule 19b-4 thereunder.²⁵

The Commission believes that it is appropriate to issue an exemption, subject to the conditions described below, to allow Nasdaq to operate Brut as a facility without being subject to the rule filing requirements of Section 19(b) of the Exchange Act for a temporary period.

Accordingly, the Commission has determined to grant Nasdaq's request for an exemption, subject to certain conditions, not to exceed six months from the date Nasdaq acquires ownership of Brut. The Commission finds that the temporary conditional exemption from the provisions of Section 19(b) of the Exchange Act²⁶ is necessary and appropriate in the public interest and is consistent with the protection of investors. In particular, the Commission believes that this exemption provides a limited amount of time for NASD and Nasdaq to obtain the necessary information to undertake to comply with NASD's obligations under Section 19(b) of the Exchange Act relative to Nasdaq's acquisition of Brut. In addition, the Commission believes that the exemption should help promote efficiency and competition in the market by allowing Brut to continue to operate while the Brut filings are pending before the Commission. In this regard, the Commission believes that this exemption should help to avoid any potential negative consequences to investors that could result if Nasdaq was required to abruptly limit Brut's trading operations immediately upon consummation of its acquisition of Brut.

To provide the Commission the opportunity to review and act upon any proposal to change Brut's fees or to make material changes to Brut's operations as an ECN during the period covered by the exemption, as well as to ensure that the Commission's ability to monitor Nasdaq and Brut is not diminished by the exemption, the Commission is imposing the following

²⁵ See Exemption Request, *supra* note 6.

²⁶ 15 U.S.C. 78s(b).

conditions while the exemption is in effect.²⁷ The Commission believes such conditions are necessary and appropriate in the public interest for the protection of investors. Therefore, the Commission is granting to NASD a temporary exemption, pursuant to Section 36 of the Exchange Act, from the rule filing requirements imposed by Section 19(b) of the Exchange Act as set forth above provided that NASD and Nasdaq comply with the following conditions:

- (1) Brut remains a registered broker-dealer under Section 15 of the Exchange Act and continues to operate as an ECN;
- (2) Brut operates in compliance with the obligations set forth under Regulation ATS;
- (3) Brut operates as a separate subsidiary of Nasdaq;
- (4) Nasdaq files a proposed rule change under Section 19 of the Exchange Act if it seeks to make a material change to Brut's operations. A material change would include any changes to a stated policy, practice, or interpretation regarding the operation of Brut or any other event or action relating to Brut that would require the filing of a proposed rule change by an SRO or an SRO facility;²⁸
- (5) Nasdaq files a proposed rule change under Section 19 of the Exchange Act²⁹ if it seeks to modify Brut's fee schedule;
- (6) Nasdaq treats Brut the same as other ECNs that participate in the Nasdaq Market Center, and, in particular, Nasdaq does not accord Brut preferential treatment in how Brut

²⁷ See Exemption Request, *supra* note 6.

²⁸ See Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. The Commission notes that a material change would include, among other things, changes to Brut's operating platform; the types of securities traded on Brut; Brut's types of subscribers; or the reporting venue for trading that takes place on Brut. The Commission also notes that the rule filings must set forth the operation of the Brut facility and its integration with Nasdaq sufficiently so that the Commission and the public can evaluate the proposed change.

²⁹ 15 U.S.C. 78s(b).

submits orders to the Nasdaq Market Center execution system or in the way its orders are displayed or executed; and

(7) Nasdaq submits rule filings under Section 19(b) of the Exchange Act³⁰ fully articulating its operation of Brut and Brut's integration with Nasdaq within sixty days of the date Nasdaq assumes ownership of Brut.³¹

In addition, the Commission notes that NASD is currently the Designated Examining Authority ("DEA") for Brut. On August 6, Nasdaq applied for membership to the New York Stock Exchange ("NYSE") on behalf of Brut. In its Exemption Request, Nasdaq commits to seek the Commission's approval pursuant to Rule 17d-1 under the Exchange Act³² to have the NYSE appointed as Brut's DEA for financial responsibility rules upon approval of Brut's membership in the NYSE.

In granting the Commission broad exemptive authority in Section 36 of the Exchange Act,³³ Congress intended to incorporate flexibility into the Exchange Act's regulatory scheme to reflect a rapidly changing marketplace. Congress particularly intended for the Commission to use this flexibility to promote efficiency and competition. The Commission believes that the requested temporary conditional exemption will help achieve these goals, while upholding the regulatory objectives of the Exchange Act. In granting this relief, the Commission makes no finding regarding whether Nasdaq's operation of Brut as a facility would be consistent with the Exchange Act. Proposed rule changes regarding Nasdaq's operation of Brut will be evaluated

³⁰ 15 U.S.C. 78s(b).

³¹ See Exemption Request, supra note 6.

³² 17 CFR 240.17d-1.

³³ 15 U.S.C. 78mm(a).

by the Commission in accordance with the procedures set forth under Section 19(b) the Exchange Act.³⁴

The Commission notes that without its approval of rules governing the operation of Brut, Nasdaq would be unable to operate Brut, thereby causing Brut to cease operations until the Brut Filings are approved by the Commission. Should Brut be required to abruptly cease operations, a significant source of liquidity would be lost, which could potentially disrupt the functioning of an orderly market and harm investors. This exemptive relief should facilitate competition in the market by allowing Brut to continue to provide liquidity and compete with other market centers, while also providing NASD and Nasdaq with a reasonable opportunity to comply with their obligations under Section 19(b) of the Exchange Act. Therefore, the Commission believes that this exemption strikes an appropriate balance between the Commission's interest to encourage competition in the rapidly changing market place and to uphold the procedural requirements under Section 19(b) of the Exchange Act, and thus is necessary and appropriate in the public interest and is consistent with the protection of investors.

For the reasons discussed above, the Commission finds that the temporary conditional exemptive relief requested by NASD and Nasdaq is necessary and appropriate in the public interest and is consistent with the protection of investors.

³⁴ See supra notes 20-23.

IT IS ORDERED, pursuant to Section 36 of the Exchange Act,³⁵ that the application for a temporary conditional exemption is granted for a period of six months following Nasdaq's acquisition of Brut.

By the Commission.

Margaret H. McFarland
Deputy Secretary

³⁵ 15 U.S.C. 78mm.