EDWARD KNIGHT
EXECUTIVE VICE PRESIDENT

#1

NASDAQ

October 30,2003

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OFFICE OF THE SECRETARY

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549

Re: Comments of The Nasdaq Stock Market, Inc. Regarding SR-AMEX-2003-81 and Certain Un-Filed Rule Proposals Regarding Closing Procedures on the American Stock Exchange

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") respectfully submits its comments to SR-AMEX-2003-81, which modifies the closing procedures that the American Stock Exchange ("Amex") employs to trade Nasdaq-listed securities. Nasdaq's comments are also directed at Amex's un-filed rule proposal to engage in a joint venture with Standard and Poor's ("S&P") to set the closing price for Nasdaq securities that are included in the S&P 500 Index. SR-AMEX-2003-81, along with the un-filed S&P Proposal, attempts to transform radically how closing prices are set for millions of investors and billions of dollars of investments. Nasdaq strongly believes that the public must have a complete opportunity to comment on SR-AMEX-2003-81 and the un-filed S&P Proposal because they pose potentially serious threats to the protection of investors and the public interest.

Amex's New Closing Procedures for Nasdaq Securities

On April 10,2003, the Commission approved an Amex proposal to establish a single-price closing for Nasdaq securities that are traded on Amex pursuant to unlisted trading privileges.[1] The proposal applied Amex's closing market procedures for Amex-listed equities to

[1] **Exchange Act Release 47658 (Apr. 10,2003) (order granting accelerated approval** of **SR-AMEX-2003-18 regarding closing procedures** for **Amex trading** of **Nasdaq securities).**

Nasdaq-listed issues that Amex members trade. Amex Rule 109 requires Amex specialists to execute any imbalance of buy and sell at-the-close orders against the Amex best bid (for sell orders) or best offer (for buy orders). The Amex member then "stops" the remaining buy and sell orders at the price of the imbalance trade and pairs them off against each other at or as near to the close as practicable. Amex filed the proposal on March 21,2003, and the Commission approved it on an accelerated basis on April 10,2003, with no prior opportunity for public comment.

On September 8,2003, Amex filed SR-AMEX-2003-81, a proposal to change the manner in which the "pair off' transactions are reported to the consolidated tape for Nasdaq securities and then disseminated to the public. The Amex rule permits the specialists to execute the closing print and the pair off transactions either at the close or at an indeterminate time after the close, giving specialists a potential opportunity to trade in other venues after the close and before setting an official closing price. The pair off transactions will be reported to the consolidated tape as "stopped stock," and Amex separately will disseminate an official closing price with no volume associated. Amex designated the filing as a non-controversial proposal susceptible to immediate effectiveness under SEC Rule 19b-4(f)(6) stating that it "does not significantly affect the protection of investors or the public interest.', As a result, the public had no prior opportunity to comment on this rule proposal.

On October 8,2003 (*after* submitting SR-AMEX-2003-81 for immediate effectiveness), Amex announced a pilot program with S&P to provide closing prices for Nasdaq securities in the S&P 500 Index. According to S&P's calculations, over $840 billion was invested in S&P 500 products at the end of 2002. As a result, Amex specialists that today collectively account for less than one-tenth of one percent of Nasdaq trading volume will potentially set the daily closing value of billions of dollars of investors' S&P-linked assets. This pilot is scheduled to commence on December I, 2003, just four business days after Amex first disseminates its official closing price under the procedures established by SR-AMEX-2003-81. The public has had no . .opportunity to comment on this rule proposal because Amex has not filed it yet.

The Amex Proposal Is Vague And Raises Serious Investor Protection Concerns

SR-AMEX-2003-81 offers scant detail on when Amex specialists will close their markets and how they will determine Amex closing prices in Nasdaq securities. Today, the exclusive securities information processor for Nasdaq-listed securities disseminates as the Amex closing price the last regular-way trade reported to the Amex prior to 4:01:30 p.m. EST. Under the new procedures, the Amex specialist can select a closing price seconds or even minutes after the close and disseminate that price to the public. The new proposal does not describe how Amex specialists will select that price. Amex rules permit specialists to execute closing trades at the Amex best bid and offer, rather than relative to the national best bid and offer ("NBBO"). Since Amex **rules** do not require that the Amex best bid or offer be related to the NBBO, specialists have complete discretion to set the Amex best bid and offer quotation at the close and complete discretion to set a closing price anywhere within that quotation.

That discretion also permits Amex specialists to set closing prices after the close of trading on Amex and other markets. Using the new "stopped stock" modifier described in SR-**AMEX-2003-81,** Amex specialists may report pair off transactions after the close, potentially substantially after the close. Amex Vendor Alert **2003-27,** dated October **22, 2003,** states that closing prices can be set after **4:01:30** pm, and that Amex will not scan for specialists' closing prices within Amex systems until **4:15** pm. Since the Amex rules do not address how specialists will determine when to close their markets or what criteria the specialists must consider, it appears that specialists have unlimited discretion in this area.

In light of the specialists' broad discretion to set closing times and prices, it is incumbent upon Amex to explain how it will regulate specialists at the close. It failed to do so. The proposal fails to explain how Amex will prevent specialists from engaging in "front-running" which is a serious investor protection concern on certain exchanges.[2] Amex's proposed closing procedures present that concern in stark relief, Amex specialists will publish imbalance indicators at **3:40** pm, and then have exclusive access to on-close orders on their books before and after the close. Armed with that informational advantage, specialists will be able to buy or sell ahead of an imbalance (using other markets that trade Nasdaq securities) and then fill the on-close orders at a guaranteed profit. This concern is particularly acute where, as here, specialists have the opportunity to trade on other markets ***after*** the specialist himself closes trading on Amex.

At a minimum, Amex must explain how it will surveil for misconduct by its specialists, how it will assess the specialists' exercise of their wide discretion to set closing prices, and how it will enforce potential violations. These concerns are acute because Amex specialists currently account for less than one-tenth of one percent of total volume in Nasdaq securities but may see significantly increased trading volume under the new procedures and pilot.[3] In addition, since Amex will only begin disseminating its new official closing price procedures on November **24, 2003,** it will be virtually untested on December 1, when the S&P pilot program is scheduled to begin. These dramatic changes come at a time of great uncertainty about whether Amex can

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[2] The Commission considered the potential for specialist front-running when it first approved Amex's proposal to trade Nasdaq securities. ***See*** Exchange Act Release 46305 (Aug. 2, 2002), fn. 11. Specifically, the Commission noted that Nasdaq trading on Amex is exempt from Amex Rule 24. which is designed to prevent front-running. The Commission believed that such exemption was appropriate, in part, because Amex is not the primary market for Nasdaq securities and, implicitly because Amex specialists executed few trades, . Amex's current proposals clearly increase the potential for front-running and the difficulty of detecting and addressing it.

Exchanges must improve their surveillance and disciplinary capabilities when their trading volume increases. The Chicago Stock Exchange recently settled an action brought by the SEC Department of Enforcement for failing to "adequately improve and increase its surveillance and disciplinary capabilities to match [Chicago's] increase in trading volume" in Nasdaq securities. In the Matter of the Chicago Stock Exchange, Exchange Act Release 48566 (Sept. 30, 2003).

effectively detect, control, and accurately report to regulators about manipulation and fraud on its market.

SR-AMEX-2003-81 May Cause Serious Market Disruption

Today, Amex specialists execute less than one-tenth of one percent of the total volume in Nasdaq securities, although they have been trading Nasdaq securities for over a year. Several factors account for Amex's inability to attract Nasdaq order flow. First, Amex and its specialists offer few connectivity options and thus are less accessible than other markets and market makers that trade Nasdaq securities. Second, Amex is one of the few markets, and the only one trading Nasdaq securities, that does not offer automatic execution of orders. These pitfalls weigh particularly heavily on retail investors that tend to rely upon rapid, inexpensive automatic executions that Nasdaq and other automated venues provide.

In addition, Amex reports poor execution quality statistics under SEC Rule 11Ac1-5. For example, Amex execution speeds are ten times slower and its effective spreads are twice as wide for Amex stocks that are included in the S&P 500 Index when compared to Nasdaq execution speeds and effective spreads for Nasdaq stocks in the S&P 500 Index.[4] Likewise, for Nasdaq stocks in the S&P 500 Index, Amex's execution speed is almost eight times slower and its effective spread is over 60 percent wider than Nasdaq's execution speed **and** effective spread for that group of securities.[5]

As a result of these factors, and perhaps other well-publicized problems with the specialist system, market participants have been unwilling to send Nasdaq orders to Amex. If the Amex proposals take effect, it is possible that market participants will believe themselves compelled to send orders to Amex and that Amex will experience an unmanageable flow of orders during a brief but critical period of the trading day. Nasdaq questions whether and, if so, how Amex has prepared its systems and its specialists for this unusual order flow. If Amex systems are not adequately prepared, the market will experience significantly increased levels of locks and crosses and trades that are not reasonably related to the market or to each other. Given Amex's relative isolation as a market, it is virtually certain that Amex will be unable to provide equal and fair access to all investors that may wish to participate in the close that affects the S&P 500 Index. Additionally, since Amex specialists may post closing prices after **4:00** prn, many investors will be unable to obtain the Amex closing price. Additionally, because stopped stock transactions that Amex specialists report after **4:01:30** are excluded from the consolidated last-

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[4] **These figures are based upon SEC Rule** 11Ac1-5 **reports submitted by the American Stock Exchange for the month of August** 2003, **and analyzed by Market System Inc., an independent service provider to reporting market centers.** Two **Amex stocks are included in the S&P 500 Index, Devon Energy Corp. and Nabors Industries, Ltd. Although they ranked** 190th **and** 341st **among S&P 500 stocks by market value during that period, they ranked** 461st **and** 480th **for quoted spreads,** 471st **and** 475th **for effective spread, and** 497th **and** 500th **for execution speed.**

[5] *Id.* **Nasdaq notes that the statistics for Amex specialists trading Nasdaq securities are based upon small sample sizes due to Amex's** small **order** flow **in Nasdaq securities.**

sale calculation, average investors may be unaware of them and their potential impact on the S&P 500 Index.

Nasdaq believes that it would be inconsistent with the Exchange Act and poor public policy for the Commission to permit Amex to undertake this transformation without first ensuring that Amex and the public have considered and addressed the above market structure issues.

The Public Has Had No Effective Opportunity To Comment On Amex's New Closing Procedures, Both The Filed And Un-Filed Proposals

Over the past six months, Amex has radically transformed its closing procedure for Nasdaq securities with remarkably little opportunity for-meaningful public comment:

- On March 21,2003, Amex submitted SR-AMEX-2003-18, which adopted certain Amex closing procedures for Nasdaq stocks. That proposal was simultaneously published in the Federal Register and approved on an accelerated basis on April 10, 2003.

- On September 8,2003, Amex submitted SR-AMEX-2003-81 to modify the determination and reporting of its closing price as an immediately effective filing with no prior opportunity for comment.

- On October 8,2003, Amex announced its pilot program with S&P without submitting a rule proposal to the Commission.

- On October 22,2003, Amex announced that on November 24,2003, Amex will begin disseminating the .M modifier to designate the Amex Official Closing Price. Again, Amex submitted no rule proposal to the Commission.

Taken together, these proposals completely transform the closing price process for Amex and for other markets. By submitting proposals piecemeal and subsequently announcing its full intent, Amex avoided meaningful scrutiny of any of its individual proposals. For example, when the Commission approved Amex's single price close on an accelerated basis, neither the Commission nor investors were aware that a major index provider would adopt that closing price upon implementation. Had the Commission been aware, Nasdaq hopes that it would have given investors the opportunity to comment on the market structure implications of permitting a non-primary market to set such an important price indicator.

Given the impending announcement of Amex's joint venture with S&P, Nasdaq respectfully submits that it was inappropriate for Amex to designate SR-AMEX-2003-81 as a non-controversial proposal susceptible to immediate effectiveness under SEC Rule 19b-4(f)(6). Nasdaq is troubled that Amex would represent that that proposal "does not significantly affect the protection of investors or the public interest" and puzzled that the Commission would accept that representation once made. Nasdaq requests that the Commission abrogate SR-AMEX-2003-81 and provide an opportunity for notice and comment rulemaking pursuant to Section 19(b)(2) of the Securities Exchange Act of 1934 (the "Act").

In addition, the Amex proposal to change the closing price calculation of the S&P 500 is a major market structure change that demands the opportunity for public notice-and-comment under subsection (b)(2) of Section **19** and that must be filed in accordance with the requirements of Rule 19b-4. As Ms. Nazareth stated in her March 27,2003, letter to the markets, under Rule 19b-4 a stated policy, practice, or interpretation of an SRO is deemed to be a proposed rule change and therefore subject to the notice and comment process. The letter also stated that "proposed rule change" is broadly defined and that "stated policy, practice, or interpretation" is defined to include "any material aspect of the operation of the facilities of the self regulatory organization" as well as any general statement that "establishes or changes any standard, limit or guideline with respect to ... the meaning, administration or enforcement of an existing rule." There is no doubt that the Amex proposal to set S&P 500 closing prices is such a stated practice.

Amex specialists with little experience trading Nasdaq securities could potentially determine the value of billions of dollars of S&P-linked assets. Those specialists will operate with virtually unbridled discretion to set prices in after-hours trades, at a time when there is great uncertainty regarding the soundness of the Amex regulatory program. Without the benefit of a public rule filing and comment process, investors and the Commission cannot be certain how this pilot will operate, whether investors are protected against specialist misconduct and if so how the proposal complies with the substantive requirements of the Act.

The Division of Market Regulation asked these questions about Nasdaq's rule proposal to modify its closing price process and to utilize a trade report modifier to disseminate that closing price to the investing public. On October 30,2002, Nasdaq filed SR-NASD-2002-158 to establish the Nasdaq Official Closing Price ("NOCP") and to establish the ".M" trade report modifier with which to identify the NOCP to market data vendors and to the public. The NOCP proposal was published in the Federal Register and received numerous comments from market participants and national securities exchanges, including Amex. Nasdaq twice responded to those comments, addressing all procedural and substantive contentions, before the proposal was approved effective April 15,2003. The public deserves the same level of scrutiny of Amex's proposals.

If the Commission determines that a comment period is not necessary for SR-AMEX-2003-81 and that a filing is not required for Amex's joint venture with S&P, to avoid any suggestion of arbitrariness, this decision should serve as a precedent for other markets. Specifically, based upon this precedent Nasdaq must expect equal treatment of its upcoming filing to establish a closing auction.

Nasdaq believes that consistent regulation of all broker dealers and all markets that trade the same securities is a critical component of an effective national market system because disparities in the Commission's regulation will, ultimately, lead to unequal protection of public investors. That is precisely the issue presented by Amex's attempts to transform closing prices for millions of investors with no opportunity for effective public consideration. Nasdaq requests that the Commission abrogate SR-AMEX-2003-81 and provide an opportunity for notice and comment rulemaking on Amex's proposals pursuant to Section 19(b)(2) of the Securities Exchange Act of **1934.**

Sincerely,

Edward S. Knight

Edward **S.** Knight

cc: The Hon. William Donaldson, Chairman
The Hon. Cynthia Glassman, Commissioner
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Harvey Goldschmid, Commissioner
Giovanni Prezioso, General Counsel
Annette Nazareth, Director, Division of Market Regulation
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