

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54277; File No. SR-NASD-2006-091)

August 4, 2006

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 28, 2006, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. NASD filed Amendment No. 1 to the proposed rule change on August 4, 2006 but subsequently withdrew it. NASD filed Amendment No. 2 to the proposed rule change on August 4, 2006.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend its rules, including the rules governing the Alternative Display Facility (“ADF”), to align them with Regulation NMS.⁴ In addition, NASD is proposing to amend rules that govern quoting, trade reporting, and clearing through the ADF to extend this functionality to all NMS stocks, as defined in Commission Rule 600(b)(47), including stocks listed on the New York Stock Exchange (“NYSE”), American Stock Exchange (“Amex”), and

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 2, NASD made certain revisions to its proposed rules and Certification Record for ADF Trading Centers. NASD also clarified certain sections of its Form 19b-4 description of the proposal.

⁴ 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 Approval Order”).

certain other exchanges. Further, this rule proposal would reorganize ADF trade reporting rules and make changes to the ADF rules to enhance the clarity of the rules.

The text of the proposed rule change is available on NASD's Web site (www.nasd.com), at NASD's principal office, and at the Commission's Public Reference Room. The text of Exhibits 3 and 5 to the proposed rule change are also available on the Commission's Web site (www.sec.gov/rules/sro.shtml).⁵

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

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

The ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the Commission's SuperMontage Approval Order⁶ and in conjunction with Nasdaq's registration as a national securities exchange. The ADF, which currently is operating on a pilot basis, provides ADF market participants (market makers and

⁵ The Commission recently approved SR-NASD-2005-087, which establishes the Trade Reporting Facility ("TRF"). See Securities Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006). Here, NASD proposes to amend NASD rules to implement Regulation NMS and amend certain ADF rules to reflect that all NMS stocks can be quoted and trade reported through the ADF. Any amendments that are needed to implement Regulation NMS for the TRF will be addressed in a separate filing.

⁶ Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001) (File No. SR-NASD-99-53).

Electronic Communications Networks (“ECNs”)⁷ the ability to post quotations in Nasdaq securities and provides all members that participate in the ADF the ability to view quotations and report transactions in Nasdaq securities to the exclusive securities information processor (“SIP”) for Nasdaq-listed issues for consolidation and dissemination of data to vendors and ADF market participants. The facility provides for trade comparison through the Trade Reporting and Comparison Service (“TRACS”) and further provides for real-time data delivery to NASD for regulatory purposes, including enforcement of firm quote and related rules.

On June 29, 2005, the Commission published its release adopting Regulation NMS.⁸ Regulation NMS established new substantive rules designed to modernize and strengthen the regulatory structure of the U.S. equities markets. Among other things, Regulation NMS adopted an Order Protection Rule (SEC Rule 611) that requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by automated trading centers, subject to applicable exceptions. To be protected, a quotation must be immediately and automatically accessible. Regulation NMS also adopted an Access Rule (SEC Rule 610), which requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires NASD and the exchanges to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying any quotation that locks or crosses a protected quotation, or a manual

⁷ ECNs are defined under Regulation NMS in SEC Rule 600(b)(23).

⁸ See supra note 4.

quotation that locks or crosses a quotation disseminated pursuant to an effective National Market System Plan (“NMS Plan”).⁹

The primary purpose of this filing is two-fold: (1) to amend NASD rules (primarily ADF rules) to align them with Regulation NMS; and (2) to amend rules that govern quoting, trade reporting, and clearing through the ADF to extend this functionality to all NMS stocks, as defined in SEC Rule 600(b)(47). Previously, the ADF could accommodate only the quoting, trade reporting and clearing of Nasdaq securities, but this proposal also would allow for the quoting, trade reporting, and clearing of NMS stocks listed on NYSE, Amex, and certain other exchanges. Further, this rule proposal would amend and reorganize ADF trade reporting rules to enhance the clarity of these rules. Below is a brief summary of the substantive changes NASD is proposing.

(1) Align NASD Rules with Regulation NMS

Today, NASD is proposing to amend its rules to align them with Regulation NMS, specifically, the Order Protection Rule and the Access Rule. NASD also is proposing conforming changes to certain NASD rules to reflect the new numbering of SEC rules in Regulation NMS. Lastly, NASD is filing its proposed ADF Certification Record to, among other things, allow for public notice and comment on the certifications to which new incoming ADF

⁹ In addition, Regulation NMS adopted a sub-penny rule that, in general, prohibits market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than \$1.00 per share. Further, Regulation NMS adopted amendments to the market data rules to update the requirements for consolidating, distributing, and displaying market information, as well as amendments to the joint industry plans for disseminating market information that modify the formulas for allocating plan revenue and broadening participation in plan governance. This rule proposal primarily addresses implementation of the Order Protection Rule and the Access Rule. It does not address Regulation NMS issues related to the sub-penny rule or market data rules.

Trading Centers would be required to certify prior to being permitted to post quotations through the ADF.

a. Implementing the Order Protection Rule

The Order Protection Rule reinforces the fundamental principle of obtaining the best price for an investor when such price is represented by an automated quotation that is immediately accessible.¹⁰ In general, the Order Protection Rule requires a 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 that do not fall within an enumerated exception (as well as ensure compliance with such exceptions) and to surveil regularly to ascertain the effectiveness of the policies and procedures adopted pursuant to SEC Rule 611 and take prompt action to remedy deficiencies in such policies and procedures. To be a protected quotation, such quotation must be an “automated quotation,” as defined in SEC Rule 600(b)(3).

Consistent with many of the goals articulated by the Commission in adopting SEC Rule 611, NASD is proposing to amend Rule 4300A(e) to specify that an ADF Trading Center must submit automated quotations, as defined in SEC Rule 600(b)(3). (Under NASD’s proposed rules, manual quotations, as defined in SEC Rule 600(b)(37), could not be submitted to the ADF.) In furtherance of that provision, Rule 4300A(e) would require that each ADF Trading

¹⁰ ADF’s protected quotation will be transparent in the National Market System. As discussed in the Division of Market Regulation: Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, available at <http://www.sec.gov/spotlight/regnms.htm>, Question and Answer No. 7, the best bid of the ADF will reflect the quotation of a single ADF Trading Center. Accordingly, when two or more ADF participants are quoting at the best price for an NMS stock, the ADF must identify a single participant quotation for its best bid and size and a single participant for its best offer and size. Currently, this single participant would be identified by NASD based upon price, size, and time priority. Further, the identity of such ADF participant would be included in the network quotation streams that are disseminated to the public.

Center adopt policies and procedures to ensure only automated quotations are submitted to the ADF. Moreover, an ADF Trading Center would be required to monitor its systems on a real-time basis to assess whether they are functioning properly.

NASD also is proposing to amend its system outage procedures found in Rule 4300A. A system outage would now be defined in Rule 4300A(e)(2) as the posting of quotations in the ADF that are not automated quotations,¹¹ and in that regard, failing to immediately and on an automated basis respond to orders. In light of the time frames that are pertinent in a Regulation NMS environment, NASD also is proposing to amend Rule 4300A to address ADF Trading Center system outages. 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.¹² It should be noted, however, that ADF Operations would strictly interpret the requirement under Rule 4300A that an ADF Trading Center submit only automated quotations. Accordingly, if an ADF Trading Center were to experience technical problems and was unable to submit automated quotations, it would have to withdraw its quotations from the ADF and notify ADF Operations.¹³ As noted above, ADF Trading Centers would be strictly prohibited from displaying manual quotations in the ADF.

¹¹ NASD also is proposing to delete 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.

¹² Currently, Rule 4300A(e)(4) permits only five excused system outages to be granted in a 30-day period.

¹³ See proposed Rule 4619A (requiring an ADF Trading Center to immediately withdraw its quotations and promptly contact ADF Operations if it cannot submit automated quotations). See also proposed Rule 4621A (allowing NASD to 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).

NASD also is proposing to amend ADF transaction reporting requirements to expressly require reporting members to append certain new identifiers to enhance regulation of the Order Protection Rule and to facilitate transparency to the marketplace. There are nine exceptions to the Order Protection Rule.¹⁴ NASD is proposing to revise its transaction reporting requirements found in Rule 4632A to more closely align NASD modifiers with SEC Rule 611 exceptions.¹⁵ Specifically, NASD is proposing to adopt a new modifier (.X) that would be appended to a last sale report if the trade would be a trade-through of a protected quotation, but for the trade being qualified for an exception from SEC Rule 611. Further, reporting members also would be required, in addition to using this new identifier (.X), to append a separate unique modifier, specified by NASD, which would identify the specific applicable exception or exemption from SEC Rule 611 upon which the member is relying.¹⁶ Moreover, NASD is proposing to amend Rule 4632A to ensure that certain individual modifiers that currently can be used to report multiple trading situations would be more narrowly configured. In addition, NASD is proposing the creation of several new trade modifiers to supplement the proposed modifiers which are now more narrowly configured. For example, an NASD member can currently use the .PRP modifier to report market-on-open, market-on-close, and missed executions. In this filing, NASD is proposing to limit the use of the .PRP modifier to reflect a price different from the current market when the execution price is based on a prior point in time. Accordingly, .PRP would be used

¹⁴ See 17 CFR 242.611(b).

¹⁵ However, a firm would be responsible for ensuring that the specific transaction falls expressly into the exception as set forth in SEC Rule 611. Accordingly, a firm could not rely on the identification of a transaction pursuant to NASD rules as a type of trade that is excepted from Regulation NMS without ensuring the specific trade meets all of the criteria set forth in SEC Rule 611.

¹⁶ In order to ensure consistency in the usage of Rule 611 related modifiers, including the .X and separate unique modifier for specific applicable exceptions or exemptions, NASD would adopt such modifiers in conformity with the specifications approved by the Operating Committee of the relevant National Market System Plans.

primarily to reflect missed execution scenarios. A new modifier (.4) would be used when a transaction is based upon a single-priced opening, re-opening, or closing transaction by a trading center.¹⁷ Further, NASD also is proposing amendments to ADF order reporting requirements in Rule 4300A(b)(1)(N) and transaction reporting requirements in Rule 4632A(a)(4)(L) to expressly require the reporting of “[a]ny other modifier as specified by NASD or the Securities and Exchange Commission.” NASD would provide a comprehensive list of all required modifiers when it publishes ADF technical specifications on or before October 16, 2006.

Consistent with NASD’s responsibilities under the Order Protection Rule, NASD would review the activities of ADF Trading Centers and other NASD member trading centers.¹⁸ To complement NASD’s automated surveillance for member compliance with the Order Protection Rule, NASD’s Trading and Market Making Surveillance (“TMMS”) examination program would examine relevant NASD members for adequate supervisory procedures applicable to Regulation NMS and to determine whether trading centers are in fact conducting internal surveillance for trade-throughs. NASD also would examine for continued compliance with the real-time monitoring requirements and for potentially excessive use of certain trade-through exceptions. Annual compliance questionnaires would be used for this same regulatory purpose for firms not subject to a TMMS examination.

b. Implementing the Access Rule

¹⁷ NASD also is proposing to amend Rule 4632A to create a new stop stock modifier (.1). Previously, member firms used the .W modifier to identify stop stock, exchange-for-physicals, and volume-weighted average-price trades.

¹⁸ The regulatory processes discussed in this rule proposal relate solely to NASD’s responsibilities under Regulation NMS as an SRO. This rule proposal does not address NASD’s regulatory responsibilities to other SROs that have contracted with NASD to provide regulatory services.

The Access Rule promotes fair and non-discriminatory access to quotations displayed by trading centers through a private linkage approach. In general, the Access Rule: (1) requires that self-regulatory organizations (“SROs”) not impose unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member to the quotations in an NMS stock displayed through its SRO trading facility; (2) requires that each trading center that displays quotations in an NMS stock through an SRO display-only facility (such as the ADF) provide a level and cost of access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities in that stock and ensure that it does not impose unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access to such quotations through a member, subscriber, or customer of the trading center; (3) adopts limits on fees for accessing quotations; and (4) requires SROs to establish, maintain, and enforce written rules that: (a) require their members to reasonably avoid displaying quotations that lock or cross any protected quotation in an NMS stock; (b) require their members to avoid displaying manual quotations that lock or cross a quotation in an NMS stock that was previously disseminated pursuant to an NMS Plan; (c) assure the reconciliation of locked or crossed quotations in an NMS stock; and (d) prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quotations in an NMS stock, or displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an NMS Plan, other than quotations permitted by an exception contained in its rules.

In approving Regulation NMS, the Commission articulated the expectation that NASD, as the SRO responsible for the OTC market, will act as “gatekeeper” of the ADF.¹⁹ In that

¹⁹ See Regulation NMS Approval Order, 70 FR at 37543.

regard, NASD will be required to make an “affirmative determination” as to whether ADF Trading Centers are complying with the SEC Rule 610 access standard.²⁰ NASD will fulfill this obligation in several ways. First, NASD is expressly incorporating the Regulation NMS access standard into proposed Rule 4300A. An ADF Trading Center would be expressly required to: (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 displayed by SRO trading facilities in that NMS stock; (2) demonstrate 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); and (3) ensure that it does not impose unfairly discriminatory terms that prevent or inhibit any person, through a registered broker-dealer, from obtaining efficient access to such quotations. Further, NASD is proposing to amend Rule 4300A to require ADF Trading Centers to provide direct electronic access to any registered broker-dealer that requests it.²¹

At the request of Commission staff, NASD also is proposing to amend Rule 4300A(d)(1), to require each ADF Trading Center to use a communication service(s) that is deemed sufficient by NASD. 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). To remain current with industry practice, the list would be reviewed periodically and updated on an as needed basis. NASD staff would not necessarily review the

²⁰ See id.

²¹ NASD also is proposing to amend 4300A to add a new section (g) to require each Registered Reporting ADF ECN to post at least one marketable quote/order through the ADF on each side of the market each 30 calendar days or lose its ADF certification.

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 its Order Protection Rule obligations. In addition, while NASD staff would evaluate the level and cost of accessing an ADF Trading Center on a case-by-case basis, each ADF Trading Center would be required to be accessible through at least two approved connectivity providers.²² Also, in conformity with the guidance provided by the Commission in the Regulation NMS Approval Order, NASD would expect an ADF Trading Center to defray connectivity costs to the extent that the level and cost of access offered by the ADF Trading Center is not substantially equivalent to the level and cost of access offered generally by SRO trading facilities.²³

Second, NASD is proposing changes to its Certification Record process to address the standards set forth in SEC Rule 610, including requiring documentation that demonstrates that ADF Trading Center costs are substantially equivalent with costs of accessing SRO trading facilities generally.²⁴ The Certification Record process would specifically require each ADF

²² It is important to note that the approved private sector connectivity provider list would not serve as an exclusive list of connectivity options for accessing an ADF Trading Center. For instance, to the extent a market participant deems it necessary, it could choose to connect to an ADF Trading Center via a dedicated telecommunications line. However, an ADF Trading Center would not be obligated to provide such dedicated access if it were accessible through at least two providers on the approved list.

²³ See Regulation NMS Approval Order, 70 FR at 37543 (“Under Rule 610(b)(1) . . . ADF participants will be required to bear the costs of the necessary connectivity to facilitate efficient access to their quotations”).

²⁴ In this regard, NASD is required to evaluate “substantially equivalent” cost of access on a per-transaction basis. As the Commission noted in the Regulation NMS Approval Order, this cannot be evaluated in terms of absolute dollars. For example, in evaluating access a \$1,000 port charge for an ECN participating in 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 Approval Order, 70 FR at 37543. In evaluating “substantially equivalent” cost of access, NASD will look at cost related to directly accessing SRO trading facilities generally. Specifically, NASD will

Trading Center to make representations that it is able to comply with the various requirements of SEC Rule 610. To that end, one of the goals of NASD's amended Certification Record process is to make certain that each ADF Trading Center possesses technology capable of offering automated quotations (i.e., that each ADF Trading Center is capable of immediate internal order turnaround times not to equal or exceed one second). As noted above, the Commission has tasked NASD with making an affirmative determination as to the extent to which each ADF Trading Center offers substantially equivalent level and cost of access relative to SRO trading facilities. This will require NASD staff to consider the ADF Trading Center's system functionality robustness, the ability of market participants to interface efficiently with the ADF Trading Center's system, and the fee structure of the ADF Trading Center. The Certification Record process would be used to inform NASD in these areas and is discussed in greater detail later in this document.

Third, NASD is proposing to amend Rule 4400A to provide standing for all registered broker-dealers, not just members, to file a direct or indirect access complaint with NASD. This would ensure that there is a process in place for promptly addressing claims that an ADF Trading Center is preventing or inhibiting efficient access to its quotations.²⁵ Further, NASD would allow such complaints to be filed via facsimile, e-mail, personal delivery, courier, or overnight mail. It is NASD's belief in amending Rule 4400A that NASD would be notified when issues concerning a limitation or denial of access arise. Moreover, the process specified in Rule 4400A

look at ADF Trading Center and SRO connectivity costs such as line costs and port charges. In addition, NASD will also consider costs associated with SRO membership in evaluating "substantially equivalent" costs.

²⁵ Proposed Rule 4400A would allow any registered broker-dealer to file a direct or indirect access complaint against an ADF Trading Center with NASD to allege a denial of or limitation on access. It should be noted, however, that the filing of a frivolous direct or indirect access complaint by an NASD member could constitute a violation of Rule 2110.

would allow NASD to promptly address such issues and, if it were determined that there had been or there were an ongoing limitation or denial of access, NASD would limit, as appropriate and necessary, an ADF Trading Center's participation in ADF, including the withdrawal of its quotations from ADF, until access is provided.²⁶

Fourth, through the examination process and annual compliance questionnaires, NASD would review the activities of ADF Trading Centers. With respect to the Access Rule, NASD's automated surveillance for certain aspects of the Access Rule would again be complemented through the review of relevant NASD members' supervisory procedures through the TMMS examination program. NASD also plans to use annual compliance questionnaires to determine ongoing compliance with requirements such as "substantially equivalent" access, access fees, and conditions on access.

Lastly, NASD is proposing to adopt a 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, and to avoid displaying a manual quotation that locks or crosses any quotation in an NMS stock previously disseminated pursuant to an effective NMS Plan. This new Rule 4130A would be adopted in conformity with the SRO requirements set forth in the Access Rule.

Commission staff asked each of the SROs to ensure that its locking or crossing quotation rules are generally consistent among the SROs. NASD is replacing this Rule in the 4000A series because the ADF is the only facility NASD currently provides that allows its members to display

²⁶ The Commission noted in the Regulation NMS Approval Order that, if an ADF participant were not complying with these access standards, NASD would have a responsibility to stop publishing the participant's quotations until the participant comes into compliance. See Regulation NMS Approval Order, 70 FR at 37543. Rule 4400A would be amended to expressly incorporate this authority.

quotations in NMS stocks. Further, Rule 4613A would be amended to delete provisions that currently prohibit locked or crossed intra-market quotations during regular trading hours. This is being proposed because new Rule 4130A would be applied during regular trading hours, rather than Rule 4613A. The provisions in Rule 4613A, however, that address locked or crossed quotation conditions in the ADF prior to opening the market would remain. Rule 4613A also would be modified to clarify the application of this rule in a Regulation NMS environment.

c. Making Conforming Changes to Reflect New Numbering of SEC Rules in Regulation NMS

NASD also is proposing conforming changes to certain NASD rules to reflect the new numbering of SEC rules in Regulation NMS. To simplify the structure of the rules adopted under Section 11A of the Exchange Act (“NMS rules”), the Commission renumbered previously adopted NMS rules, incorporated such rules into Regulation NMS and established a new definitional rule, Rule 600. Accordingly, NASD is proposing to update all references to the NMS rules to reflect the new SEC rule numbers.²⁷

d. Overview of NASD Certification Record Process

Also, critical to NASD’s Regulation NMS compliance effort is the establishment of an enhanced Certification Record process for ADF Trading Centers.²⁸ In light of the importance of the Certification Record process to NASD’s Regulation NMS program, NASD is filing with the

²⁷ NASD also is proposing to delete the requirement currently found in Rule 4613A(e) that requires a member that uses an ADF terminal or other electronic interface to have available in close proximity to the ADF terminal or interface a service that disseminates the bid price and offer price from all markets trading that security. NASD is proposing this change to reflect changes that the Commission made to the Vendor Display Rule when adopting SEC Rule 603.

²⁸ NASD is proposing to amend Rule 4200A to define the term “Certification Record.” In addition, Rule 4300A would be amended to expressly require compliance with the “terms agreed to in the Certification Record.”

Commission a copy of its proposed Certification Record with this rule filing.²⁹ Each enumerated item on the ADF Trading Center Certification Record would have to be certified to by a duly authorized representative³⁰ of the ADF Trading Center at the time of initial application to become an ADF participant. Moreover, recertification of the ADF Trading Center Certification Record must be required within 30 days of the end of each ADF Trading Center fiscal year.³¹

The ADF Trading Center Certification Record would include, at a minimum, the specific certifications listed below (in substantially the form described below) and would require that supporting documentation be filed with NASD to demonstrate that the certifications are reasonably supported.³² However, as noted in proposed Rule 4300A(c), acceptance of an ADF Trading Center's Certification Record would not relieve an ADF Trading Center of any of its ongoing obligations and would not constitute an estoppel as to NASD or bind NASD in any subsequent administrative, civil, or disciplinary proceeding.

i. Order Protection Rule Certification

²⁹ NASD's proposed Certification Record was filed as Exhibit 3 to its proposal and is available on the Commission's Web site (<http://www.sec.gov/rules/sro.shtml>).

³⁰ This representative typically should be the Chief Compliance Officer or other principal with appropriate oversight responsibilities.

³¹ Current ADF Trading Centers also would be required to be re-certified prior to the implementation of Regulation NMS. Accordingly, there will be no "grandfather" allowance for current ADF Trading Centers.

³² For example, as part of the certification process NASD staff would require each ADF Trading Center to certify and demonstrate that it offers fair and non-discriminatory access to any person as required by Regulation NMS. NASD staff generally anticipates that an ADF Trading Center would demonstrate offering the requisite fair and non-discriminatory access by providing NASD staff with relevant documentation, including: (i) subscriber criteria (including types of subscriber classes, if applicable); (ii) subscriber agreement (or relevant contractual agreement language related to subscriber rights and restrictions of use); (iii) fee schedules (including relevant rebates, discounts, capacity charges, etc.); (iv) compatible data interface protocols; and (v) connectivity options.

Consistent with the Order Protection Rule, an ADF Trading Center would be required to certify that it monitors in real time protected quotations, including the protected quotations of other ADF Trading Centers and SRO trading facilities, and that it has implemented a clock synchronization protocol such that the ADF Trading Center's internal clock used for Regulation NMS compliance purposes is set to Eastern Standard Time and is corrected to the NIST Atomic Clock, and in no event would the ADF Trading Center's internal clock be more than one second away from the NIST Atomic Clock. As noted above, and required by proposed Rule 4300A(e), each ADF Trading Center also would be required to certify that it will submit only "automated quotations"³³ for display on the ADF and that under no circumstances would a manual quotation be submitted (including a quotation that otherwise would be an automated quotation, but for an ADF Trading Center system error, malfunction, latency, etc.). Moreover, each ADF Trading Center would be required to certify that it offers immediate-or-cancel order execution functionality for execution against its protected quotations and that such functionality is offered to those required to be granted access to protected quotations. Each ADF Trading Center also would be required to certify that its order response time would at least meet the response time required for its quotations to qualify as automated quotations under Regulation NMS. In addition, each ADF Trading Center would be required to further certify that in no event would its order response time be equal to or greater than 1.00 elapsed second and in no event would its immediate response to orders require any human discretion for completion.

ii. Access Rule Certifications

NASD is proposing significant revisions to its ADF Trading Center Certification Record process to ensure compliance with the Access Rule. In addition to access and order reporting

³³ See 17 CFR 242.600(b)(3).

requirements expressly set forth in proposed Rule 4300A, many of the certifications seek to further ensure that each ADF Trading Center would “provide a level and cost of access” to quotations displayed through the ADF “that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.”³⁴ Each ADF Trading Center would be required to certify that it offers fair and non-discriminatory access. Moreover, each ADF Trading Center would be required to provide documentation demonstrating that it is complying with these requirements. Further, each ADF Trading Center would be required to certify its acknowledgment that, to the extent that NASD deems an 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. In addition, each ADF Trading Center would be required to certify that, if it charged a fee in excess of the fee cap for accessing orders other than protected quotations, it would provide functionality that prevents market participants from inadvertently accessing a non-protected quotation and being charged a fee in excess of the fee cap.

An ADF Trading Center also would acknowledge through the Certification Record process that NASD would not permit an ADF Trading Center’s quotations to be displayed through the ADF, unless NASD determined that sufficient public notice had been provided of the ADF Trading Center’s intention to display quotations through the ADF at least 60 days in advance of such activity and, at least initially, in conformity with the standard set forth by the Commission in its order extending certain Regulation NMS compliance dates.³⁵ With regard to an ADF Trading Center that displays quotations in the ADF prior to the implementation of

³⁴ 17 CFR 242.610.

³⁵ See Securities Exchange Act Release No. 53829 (May 18, 2006), 71 FR 30038 (May 24, 2006) (requiring ADF participants to meet the new automation requirements discussed above to qualify).

Regulation NMS and seeks to continue uninterrupted quoting on the ADF after Regulation NMS implementation, such ADF Trading Center also would have to comply with this 60-day public notice period in advance of Regulation NMS implementation.

NASD would require that such advance notice be given through reasonable means (e.g., through press releases, the NASD Web site, and the ADF Trading Center's Web site). Further, each ADF Trading Center also would be required to certify as part of the pre-quotation notice period that it had made publicly available through reasonable means relevant connectivity and access technical specifications, including: (i) technical interface specifications (e.g., compatible system protocols, etc.); (ii) testing schedules; (iii) connectivity providers (e.g., extranet providers and direct market access firms) through which the ADF Trading Center's quotations may be accessed; and (iv) all relevant subscriber and non-subscriber fees, access fees, port fees, connectivity fees, and rebates.

(2) Extend ADF Quoting, Trade Reporting and Clearing Functionality to All NMS Stocks

NASD is amending rules that govern quoting, trade reporting, and clearing through the ADF to extend this functionality to all NMS stocks, as defined in SEC Rule 600(b)(47). Currently, the ADF accommodates the quoting, trade reporting, and clearing of only Nasdaq securities, but this proposal would allow for the quoting, trade reporting, and clearing of stocks listed on NYSE, Amex, and certain other exchanges. Specifically, NASD is proposing to change the definition of "ADF-eligible security" to include all NMS stocks, as defined in SEC Rule 600(b)(47). In addition, NASD is proposing to amend ADF rules to adopt uniform rules governing quoting and trade reporting of Nasdaq, NYSE, Amex, and certain other regionally listed securities.

Since NASD would incorporate the requirements to quote and trade-report for all NMS stocks directly into the ADF rules, NASD would no longer need a separate set of rules (currently found in the Rule 6300 and 6400 Series) governing the quoting and trade reporting of NYSE, Amex, and certain other regionally listed securities.³⁶ Therefore, NASD is proposing to delete the rules currently found in the Rule 6300 and 6400 series.³⁷ Further, in conformity with the new standards articulated in Regulation NMS, NASD does not intend to be a participant of the Intermarket Trading System Plan (“ITS Plan”) or the new National Market System Linkage Plan (“NMS Linkage Plan”). Instead, ADF quotes in all NMS stocks would be accessible through private connectivity providers in accordance with the proposed quote and order access requirements set forth in proposed Rule 4300A. As discussed previously, this would require, among other things, that each ADF Trading Center provide direct electronic access to other ADF market participants and direct or indirect electronic access to all other registered broker-dealers seeking such access. Accordingly, because NASD does not intend to participate in the ITS Plan or the new NMS Linkage Plan, the Rule 5200 Series (containing ITS Rules) would be deleted in its entirety. Lastly, corresponding changes are being proposed to the Rule 6100A Series that governs the use of the TRACS Trade Comparison Service to reflect the inclusion of all NMS stocks in the ADF.

³⁶ While ADF rules would be applied in a uniform manner to all NMS stocks to the extent possible, NMS stocks are subject to two separate transaction reporting plans. Nasdaq securities are governed by the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation, and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis (UTP Plan); and NYSE, Amex, and certain other regionally listed securities are governed by the Consolidated Quotation Plan (CQ Plan) and the Consolidated Tape Association Plan (CTA Plan).

³⁷ While the NASD is proposing to delete the Rule 6300 and 6400 series, many of the same requirements set forth in the Rule 6300 and 6400 series would be incorporated expressly into the amended ADF rules.

(3) Reorganize ADF Trade Reporting Rules to Enhance the Clarity of the Rules

NASD is proposing to amend the ADF trade reporting rules to enhance their clarity. Specifically, NASD is proposing to amend Rule 4630A to clarify that a transaction executed otherwise than on an exchange would have to be reported to TRACS, in accordance with 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.³⁸ In addition, NASD is proposing to amend Rule 4632A to reorganize the ADF trade reporting rules and to require members to report execution time in hours, minutes, and seconds based on Eastern Time in military format, unless another provision of NASD rules requires that a different time be included on the report.³⁹

In general, NASD is inserting in Rule 4632A(a) the same requirements that were previously found in Rule 5430(a). NASD would, however, rearrange the order of certain requirements and change the headings (or adopt additional headings) to provide clarity. In addition, NASD is proposing to use consistent terms, whenever appropriate, throughout this rule. For example, NASD is referring to “member” obligations whenever possible, rather than listing all the different types of members that are subject to the particular rule.

NASD also is proposing to amend Rule 4632A(b) to set forth which party is responsible for reporting transactions to NASD. These proposed rules would be simplified to delineate

³⁸ 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 new TRF).

³⁹ As described previously in the Order Protection Rule discussion, NASD also is proposing to change the required modifiers set forth in Rule 4632A(a) to more closely align them with Regulation NMS and would insert a general provision that would require a member to report “[a]ny other modifier as specified by NASD or the Securities and Exchange Commission.”

reporting responsibility between registered reporting members, non-registered reporting members, and customers or non-members. In general, Rule 4632A(b) would require the following: (1) in transactions between two registered reporting members, the sell side shall report the trade; (2) in transactions between a registered reporting member and non-registered reporting member, the registered reporting member is required to report the trade; (3) in transactions between two non-registered reporting members, the sell side shall report the trade; (4) in transactions between a member and a customer or non-member, the member shall report the trade.⁴⁰

NASD also is proposing to amend Rule 4632A(f). Currently, Rule 4632A(f) allows for the aggregation of transaction reports under certain circumstances. NASD is proposing to amend Rule 4632A(f) to expressly prohibit aggregation of individual execution of orders in a security at the same price into a single transaction report. NASD has determined that it no longer should allow members to bunch transactions for reporting purposes. By prohibiting bunching, the NASD would ensure greater transparency of individual transactions. NASD also is proposing to amend Rule 4632A(l) to clarify a member's obligation under ADF rules to report cancelled trades in a timely manner. Lastly, NASD is proposing to amend the Rule 6100A series concerning the TRACS Trade Comparison Service to use terminology consistent with the ADF rules found in the Rule 4000A series.

As noted in Item 2 of this filing, NASD would announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following

⁴⁰ Rule 4200A definitions also would be amended to ensure the terms “registered reporting member” and “non-registered reporting member” used in the transaction reporting rules are defined terms.

Commission approval, if the Commission approves this proposal. The effective date of the proposed rule change will be on or before February 5, 2007.

2. Statutory Basis

NASD believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A(b)(6) of the Act,⁴¹ which requires, among other things, that NASD rules be 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. As noted above, NASD is filing this proposal to align its rules with Regulation NMS and to allow for the quoting, trade reporting, and clearing of all NMS stocks through the ADF. NASD believes these goals are consistent with Section 15A(b)(6) and that this proposal facilitates the goals articulated in Regulation NMS, including providing an effective mechanism and regulatory framework for the over-the-counter market.

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

NASD does not believe that the proposed rule change would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

⁴¹ 15 U.S.C. 78q-3(b)(6).

- (A) by order approve such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-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 such 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].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴²

Nancy M. Morris
Secretary

⁴² 17 CFR 200.30-3(a)(12).