

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54798; File No. SR-NASD-2006-104)

November 21, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Reflect Nasdaq's Complete Separation from the NASD Upon The NASDAQ Stock Market LLC's Operation as a National Securities Exchange For Non-Nasdaq Exchange-Listed Securities

I. Introduction

On September 5, 2006, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend various NASD rules to reflect the complete separation of the NASD from The Nasdaq Stock Market, Inc. ("Nasdaq"), which would permit the Nasdaq Stock Market LLC ("Nasdaq Exchange") to begin operations as a national securities exchange for securities reported to the Consolidated Transaction Association Plan ("CTA Plan Securities"). NASD also proposes to amend its NASD/Nasdaq Trade Reporting Facility ("TRF") rules to allow members to report over-the-counter ("OTC") trades in CTA Plan Securities. On September 14, 2006, the NASD submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for comment in the Federal Register on September 21, 2006.<sup>4</sup> The

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

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

<sup>3</sup> In Amendment No. 1, NASD clarified that (1) the effective date of the proposed rule change would be the date upon which the Nasdaq Exchange commences operation as an exchange for CTA Plan Securities; (2) the NASD's Market Regulation Committee would perform substantially the same functions as performed by the Nasdaq's Quality of Markets Committee; and (3) the proposed rule change would reflect NASD's continued participation in the Intermarket Trading System ("ITS") Plan.

<sup>4</sup> See Securities Exchange Act Release No. 54451 (September 15, 2006), 71 FR 55243.

Commission received no comments on the proposed rule change. On November 3, 2006, the NASD submitted Amendment No. 2 to the proposed rule change.<sup>5</sup>

## II. Background

Prior to 2000, Nasdaq was wholly-owned by the NASD. The NASD and Nasdaq began restructuring their relationship in 2000 with the goal of completely separating Nasdaq from the NASD. As part of this restructuring, Nasdaq filed with the Commission an application to register one of its subsidiaries, the Nasdaq Exchange, as a national securities exchange.<sup>6</sup> The Commission approved the Nasdaq Exchange's registration as a national securities exchange on January 13, 2006.<sup>7</sup>

In the Nasdaq Exchange Order, the Commission conditioned the Nasdaq Exchange's operation as a national securities exchange on the satisfaction of certain enumerated requirements. The Nasdaq Exchange Order and the conditions therein reflected the Nasdaq Exchange's original intent to begin trading at the same time CTA Plan Securities and Nasdaq securities reported to 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 Privileges Basis ("Nasdaq UTP Plan

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<sup>5</sup> In Amendment No. 2, the NASD (i) amended the definition of Consolidated Quotation Service in NASD Rule 6320 to clarify that CQS Market Makers will send their quotations to the ITS/CAES System; (ii) conformed NASD Rule 6420(d)(3)(B), which relates to riskless principal transactions in the proposed ITS/CAES System to NASD Rule 4632(d)(3)(B), which relates to the same transactions in the NASD/Nasdaq TRF; and (iii) amended NASD Rule 11890(b)(2) to provide that an officers designated by an Executive Vice President of NASD's Market Regulation Committee or NASD's Transparency Services Department could also take action under that rule.

<sup>6</sup> In connection with the Nasdaq Exchange registration, Nasdaq became a holding company with the Nasdaq Exchange as its wholly-owned subsidiary.

<sup>7</sup> See Securities Exchange Act Release No. 53128, 71 FR 3350 (January 23, 2006) ("Nasdaq Exchange Order").

Securities”). In March 2006, however, the Nasdaq Exchange requested that the Commission modify the conditions in the Nasdaq Exchange Order so that it could begin operations as a national securities exchange for Nasdaq UTP Plan Securities before all the conditions were satisfied. In response to the request, this Commission modified the conditions in the Nasdaq Exchange Order.<sup>8</sup> All conditions for the Nasdaq Exchange to begin trading Nasdaq UTP Plan Securities were fulfilled,<sup>9</sup> and the Nasdaq Exchange commenced operations with respect to these securities on August 1, 2006.<sup>10</sup>

The condition remaining to be satisfied before the Nasdaq Exchange may commence trading CTA Plan Securities is that “the NASD must represent to the Commission that control of Nasdaq through the Preferred D share is no longer necessary because the NASD can fulfill through other means its obligations with respect to securities reported to the CTA Plan under Section 15A(b)(11) of the Exchange Act, Rules 602 and 603 of Regulation NMS, and the national market system plans in which the NASD participates.” NASD currently has delegated to Nasdaq authority to perform obligations under the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries (the “Delegation Plan”) with respect to NASD members’ OTC activities, including quoting, trading, and trade reporting of CTA Plan Securities. Because Nasdaq continues to operate pursuant to the Delegation Plan, the NASD retains control of

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<sup>8</sup> See Securities Exchange Act Release No. 54085 (June 30, 2006), 71 FR 38910 (July 10, 2006) (“Order Modifying Nasdaq Exchange Conditions”).

<sup>9</sup> See e.g., Securities Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006) (File No. SR-NASD-2005-087) (amending the Delegation Plan to eliminate Nasdaq’s authority over NASD members’ over-the-counter (“OTC”) activities in Nasdaq UTP Plan Securities). The NASD also established the NASD/Nasdaq Trade Reporting Facility.

<sup>10</sup> Id.

Nasdaq through the outstanding share of Nasdaq Series D preferred stock.<sup>11</sup> In this proposed rule change, the NASD proposes to complete its separation from Nasdaq by, among other things, amending its Delegation Plan to completely eliminate its delegation of authority to Nasdaq.

In addition to amending the Delegation Plan, the NASD proposes to: (1) delete the By-laws of Nasdaq and amend the By-laws of the NASD, NASD Regulation, Inc. (“NASDR”), and NASD Dispute Resolution, Inc. to reflect that Nasdaq will no longer be a subsidiary of the NASD; (2) delete NASD rules that are specific to Nasdaq and its operating systems and amend NASD rules to reflect Nasdaq’s complete separation from the NASD; (3) modify certain NASD rules to clarify the NASD’s continued regulation of the OTC market in CTA Plan Securities and to reflect the NASD’s continued participation in the ITS Plan; and (4) expand the scope of the NASD/Nasdaq TRF rules to allow NASD members to report OTC transactions in CTA Plan Securities.<sup>12</sup>

### III. Discussion

#### A. Condition with Regard to CTA Plan Securities

As noted above, before the Nasdaq Exchange can commence operations as a national securities exchange for CTA Plan Securities, “the NASD must represent to the Commission that

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<sup>11</sup> The share of Series D preferred stock gives the NASD the right to cast one vote more than one-half of all votes entitled to be cast at an election by all holders of capital stock of Nasdaq. The voting right of the NASD immediately terminates upon the date on which Nasdaq no longer operates pursuant to authority delegated by NASD under the NASD’s Delegation Plan. See Nasdaq Certificate of Incorporation, Certificate of Designation of Series D Preferred Stock of Nasdaq, Section 4.

<sup>12</sup> The proposed rule change also includes corrections of minor grammatical or typographical errors as well as the renaming and renumbering of certain rules, including redesignation of Commission rules adopted under Section 11A of the Exchange Act with the appropriate Regulation NMS references.

control of Nasdaq through the Preferred D share is no longer necessary because the NASD can fulfill through other means its obligations with respect to securities reported to the CTA Plan under Section 15A(b)(11) of the Exchange Act, Rules 602 and 603 of Regulation NMS, and the national market system plans in which the NASD participates.”

#### 1. OTC Quotations and Transaction Reports

Section 15A(b)(11) of the Exchange Act requires the NASD to have rules that govern the form and content of quotations relating to securities sold otherwise than on a national securities exchange . . . .<sup>13</sup> These rules also must be designed to produce fair and informative quotations and to promote orderly procedures for collecting, distributing, and publishing quotations.<sup>14</sup>

Rule 602 of Regulation NMS also requires the NASD to collect bids, offers, quotation sizes, and aggregate quotation sizes from those members who are responsible broker or dealers.<sup>15</sup> The NASD must then make available to vendors, at all times when last sale information is reported, information about the best bids, best offers, and quotation sizes communicated otherwise than on an exchange by its members that act as OTC market makers, and their identity.

The NASD has retained its rules that allow its members to register as CQS Market Makers<sup>16</sup> and ITS/CAES Market Makers.<sup>17</sup> These rules are essential to the NASD's ability to

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<sup>13</sup> 15 U.S.C. 78o-3(b)(11).

<sup>14</sup> Id.

<sup>15</sup> 17 CFR 242.602.

<sup>16</sup> See NASD Rule 6300 Series. NASD members that submit quotes in CQS securities must be registered as CQS market makers. See NASD Rule 6320(a). CQS market makers must also register as ITS/CAES market makers. See NASD Rule 6320(e).

<sup>17</sup> See NASD Rule 5200 Series. NASD members that participate in ITS must register as ITS/CAES market makers. See NASD Rule 5220. ITS/CAES market makers must also register as CQS market makers. See NASD Rule 5220(a). See also NASD Rule 6320(e).

fulfill its statutory and regulatory obligations, and to NASD members' ability to fulfill their regulatory obligations to submit their OTC quotes to the NASD.<sup>18</sup> These rules provide that members communicating quotations in CTA Plan Securities off an exchange must register as CQS Market Makers and ITS/CAES Market Makers.

Rule 601 of Regulation NMS<sup>19</sup> requires the NASD to file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities that are executed by its members otherwise than on a national securities exchange.<sup>20</sup> Under Rule 603 of Regulation NMS,<sup>21</sup> national securities exchanges and national securities associations act jointly pursuant to an effective national market system plan to disseminate consolidated information, including a national best bid and offer, and quotations for and transactions in NMS stocks.

Currently, the NASD satisfies these requirements with regard to CTA Plan Securities by participating in the Consolidated Quotation System Plan ("CQ Plan") and CTA Plan and by operating the SuperIntermarket<sup>22</sup> pursuant to authority delegated to Nasdaq under the Delegation Plan.<sup>23</sup>

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<sup>18</sup> See Rule 602(b) of Regulation NMS under the Exchange Act, 17 CFR 242.602.

<sup>19</sup> 17 CFR 242.601.

<sup>20</sup> Under Rule 601(b) of Regulation NMS, broker-dealers are prohibited from executing a transaction otherwise than on a national securities exchange unless there is an effective transaction reporting plan. NASD Rule 5000 requires NASD members to report transactions in exchange-listed securities effected otherwise than on an exchange to the NASD.

<sup>21</sup> 17 CFR 242.603.

<sup>22</sup> The SuperIntermarket is referred to as the ITS/CAES System under NASD rules. See NASD Rule 4700 Series.

<sup>23</sup> Through its delegation to Nasdaq, the NASD currently uses technology owned by Nasdaq, as its facility to collect quotes and transaction reports in CTA Plan Securities.

The NASD intends to continue to participate in the CQ Plan and CTA Plan. To satisfy its obligations under these plans, the NASD proposes to continue to use the ITS/CAES System for quote collection and trade reporting.<sup>24</sup> Quotes that are submitted to the ITS/CAES System will continue to be reported to the CQ Plan for dissemination. Transactions that are effected in the ITS/CAES System would be locked in by the system and reported to the CTA Plan for dissemination.<sup>25</sup> For transactions that are not effected in the ITS/CAES System, the NASD will allow members to report their trades to the ITS/CAES System for dissemination to the CTA Plan.<sup>26</sup> The NASD proposes to amend its Rule 4720 and Rule 6400 to provide that NASD members may report trades in CTA Plan Securities that are not effected in the ITS/CAES System to ITS/CAES System.

## 2. ITS Plan

Rule 608 of Regulation NMS requires the NASD to comply with and enforce compliance with the terms of each national market system plan of which it is a sponsor or participant.<sup>27</sup> In addition to the CQ Plan and CTA Plan, the NASD is a participant in the ITS Plan. The ITS Plan establishes the rules under which ITS Participants interact with regard to CTA Plan Securities and contains a trade-through rule. The NASD currently satisfies its obligations under the ITS Plan through the ITS/CAES System, which, as noted above, is currently operated by Nasdaq pursuant to the Delegation Plan. The NASD also enforces compliance by its members with the

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<sup>24</sup> The NASD will contract with Nasdaq for the use of the ITS/CAES System for these purposes. The ITS/CAES System will remain a facility of the NASD.

<sup>25</sup> The ITS/CAES System would also provide the necessary clearing information regarding the transaction to the National Securities Clearing Corporation.

<sup>26</sup> Non-ITS/CAES market makers that wish to use this trade reporting functionality must register as “Trade Reporting Only Participants” pursuant to proposed NASD Rule 4705(a).

<sup>27</sup> 17 CFR 242.608(c).

terms of the ITS Plan. The NASD intends to remain a participant in the ITS Plan until the termination of the ITS Plan, which is expected to take place on the Trading Phase Date.<sup>28</sup>

Accordingly, it must comply with, and enforce compliance by its members with, the provisions of the ITS Plan.<sup>29</sup>

The NASD proposes to continue to use the ITS/CAES System to support its participation in the ITS Plan.<sup>30</sup> Members, including electronic communication networks (“ECNs”) that wish to become ITS/CAES Market Makers, must register with the NASD.<sup>31</sup> Registration and compliance requirements for NASD members continue to be provided in amended NASD Rules 4705, 5220, 6320, and 6330. All ITS/CAES Market Makers must continue to display and maintain continuous two-sided quotes.<sup>32</sup>

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<sup>28</sup> The Trade Phase Date is the required date for full operation of Regulation NMS-compliant trading systems of all automated trading centers that intend to qualify their quotations for trade-through protection under Rule 611 of Regulation NMS. The Commission previously extended compliance dates for Rule 610 (Access Rule) and Rule 611 (The Order Protection Rule) of Regulation NMS. The Commission established the Trading Phase Date as February 5, 2007. See Securities Exchange Act Release No. 34-53829 (May 18, 2006), 71 FR 30038 (May 24, 2006). The termination of the ITS Plan will be subject to a separate filing.

<sup>29</sup> On September 29, 2006, the Commission issued an exemption to the ITS Plan participants from certain provisions of the ITS Plan. Because the NASD is not participating in The Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 (“Linkage Plan”), see Securities Exchange Act Release No. 54551 (September 29, 2006), 71 FR 59148 (October 6, 2006), it was not granted the same exemptions as were granted to the Linkage Plan participants. See letter to Robert Hill, Chairman, ITS Operating Committee, from David Shillman, Associate Director, Division of Market Regulation, Commission, dated September 29, 2006 (“ITS Exemption Letter”).

<sup>30</sup> See supra note 24.

<sup>31</sup> See NASD Rule 5210(e).

<sup>32</sup> See NASD Rule 5220(e).



The rules that govern the ITS/CAES System are found in NASD Rule 4700 and 5200 Series. The NASD proposes to amend its Rule 4700 Series to eliminate certain functionalities that are not necessary for compliance with the ITS Plan. For example, the NASD proposes to eliminate the automatic execution functionality of the ITS/CAES System.<sup>33</sup> Therefore, all references to automatic executions and execution algorithms have been deleted. In addition, the NASD proposes to eliminate reserve size and certain order types such as “discretionary,” “non-directed,” “sweep,” “fill or return,” “good-till-cancelled,” and “total good-till-cancelled” orders.<sup>34</sup> The Commission finds that the deletion of these rules is consistent with the Exchange Act because they are not required for compliance with the ITS Plan.

In the proposed rule change, the NASD also proposes to delete NASD Rules 5240 and 5250 relating to the ITS Pre-Opening Application functionality. The Commission believes that eliminating these rules is consistent with the Exchange Act because the other ITS participants are exempt from Section 7 Pre-Opening Application and Exhibit A Pre-Opening Application Rule under the ITS Plan.<sup>35</sup>

ITS/CAES Market Makers will continue to access other ITS/CAES Market Makers’ bids and offers by entering “Preferred Orders,”<sup>36</sup> but the proposed rule change requires that the

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<sup>33</sup> The ITS/CAES System will be an order delivery system, which will require a market maker’s response to execute an order delivered in response to its quote. See NASD Rule 4710(b)(1).

<sup>34</sup> NASD Rules 4701 (nn), (p), (rr), (ll), (ii) and (tt), respectively, have been deleted. Under the proposed ITS/CAES System, an order must be either a market or limit orders, must indicate whether it is a buy, short sale, short-sale exempt or long sale and may be designated “immediate or cancel,” “day,” “total day,” “total immediate or cancel” or “summary.” See NASD Rule 4706(a)(1).

<sup>35</sup> See ITS Exemption Letter, supra note 29.

<sup>36</sup> Preferred Orders may be designated to be delivered to a particular ITS/CAES Market Maker or a particular ITS exchange. See NASD Rule 4701(aa).

Preferred Order be entered using the immediate or cancel designation (i.e., IOC or IOX).<sup>37</sup>

Under the proposed rules, Preferred Orders may only be sent to another ITS/CAES Market Maker when that ITS/CAES Market Maker is at the best bid/offer in the proposed ITS/CAES System and only in an amount equal to or less than the ITS/CAES Market Maker's displayed quote.<sup>38</sup> The proposed system would reject a Preferred Order sent to an ITS/CAES Market Maker that is not at the best bid/offer in the system, or where the execution of the Preferred Order would result in the violation of the trade through rule set forth in NASD Rule 5262.<sup>39</sup>

ITS/CAES Market Makers may interact with other ITS exchanges' bids and offers via inbound and outbound ITS Commitments.<sup>40</sup> Inbound ITS Commitments would have a uniform time-in-force ("TIF") of 5 seconds.<sup>41</sup> Since the proposed ITS/CAES System would not provide automatic executions, ITS Commitments received by ITS/CAES Market Makers must be responded to or executed by an affirmative response within 5 seconds. If the ITS Commitment is not responded to within that time period, it would be returned to the sending exchange. Similarly, ITS/CAES Market Makers would be able to send outbound ITS Commitments to access quotes displayed by other ITS exchanges. All outbound ITS Commitments entered by ITS/CAES Market Makers would be treated as "immediate or cancel" and would have a TIF of 5 seconds.<sup>42</sup> Once an ITS Commitment is entered, it cannot be cancelled by the ITS/CAES Market

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<sup>37</sup> See NASD Rule 4701(aa).

<sup>38</sup> See NASD Rule 4710(b)(1)(B).

<sup>39</sup> Id.

<sup>40</sup> See NASD Rule 5230 for requirements regarding ITS Commitments.

<sup>41</sup> See NASD Rule 4708(b)(3).

<sup>42</sup> The TIF would be 30 seconds in the limited circumstance where the ITS Commitment is sent to an ITS exchange that is unable to accept a TIF of 5 seconds. See NASD Rule 4708(c). See also NASD Rule 5230 (NASD Rule 4708 states that outbound ITS

Maker.<sup>43</sup>

The proposed ITS/CAES System will reject all quotes that lock or cross the NASD best bid or offer (“BBO”) or the National BBO.<sup>44</sup> Since the system will no longer permit ITS/CAES Market Makers to initiate a locking or crossing quote, the NASD is proposing to replace the current NASD Rule 5263, which provides procedures relating to locking and crossing markets, with a new NASD Rule 5263 that prohibits such quoting activities altogether.

The Commission finds that the NASD’s proposed changes to its ITS/CAES System is consistent with Section 15A(b)(6) of the Exchange Act.<sup>45</sup> In addition, the Commission believes that it will allow the NASD to continue to fulfill its statutory and regulatory obligations and will enable NASD members to fulfill their regulatory obligation to submit their OTC quotations to the NASD and to continue to comply with the requirements of the ITS Plan. Further, the NASD’s rules are designed to produce fair and informative quotations and promote orderly procedures for collecting, distributing and publishing quotations as required by Section 15A(b)(11) of the Exchange Act.<sup>46</sup> The Commission finds that the modifications to the proposed ITS/CAES System are consistent with Section 15A(b)(6) of the Exchange Act and that under the proposed ITS/CAES System rules the NASD will be able to continue to satisfy its obligations under Rules 601, 602, and 603 of Regulation NMS.

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Commitments must be consistent with the applicable provisions of NASD Rule 5200 Series and the ITS Plan).

<sup>43</sup>

Id.

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See NASD Rule 4708(a)(2) and NASD Rule 4710(b)(1)(C)(2). In addition, market and limit orders designated as IOC and limit orders designated as “total IOC,” whose displayed price would lock or cross another quote/order if they were displayed shall be rejected. See NASD Rule 4706(a)(1)(E).

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15 U.S.C. 78o-3(b)(6).

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15 U.S.C. 78o-3(b)(11).

### 3. Changes to Governing Documents

The NASD proposes to amend the Delegation Plan to eliminate its delegation of authority to Nasdaq. The removal of Nasdaq from the Delegation Plan terminates the NASD's control of Nasdaq pursuant to the share of Series D preferred stock. Specifically, the NASD will lose its voting right and Nasdaq will be able to redeem the share for \$1.00.<sup>47</sup> Because the NASD has represented that it is able to fulfill its obligations with regard to CTA Plan Securities, the Commission believes that it is consistent with Section 15A(b)(6) of the Exchange Act to approve the NASD's proposal to eliminate its delegation of functions to Nasdaq from the NASD's Delegation Plan.

Because the NASD proposes to eliminate the delegation to Nasdaq, the NASD also proposes to eliminate the Quality of Markets Committee, which was a committee appointed by the Nasdaq Board. The NASD represents that its existing Market Regulation Committee will perform substantially the same functions as those performed by the Quality of Markets Committee.<sup>48</sup>

Furthermore, the NASD proposes to delete references to the Market Operations Review Committee ('MORC'), which was appointed by the Nasdaq Board and which reviewed transactions under the clearly erroneous procedures of NASD Rule 11890 and related NASD Rule 5626.<sup>49</sup> The NASD proposes to amend the Delegation Plan to reflect that the authority of the Uniform Practice Code ('UPC') Committee has been expanded to enable it to the review

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<sup>47</sup> See supra note 11.

<sup>48</sup> See In the Matter of National Association of Securities Dealers, Inc., Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act Release No. 37538 (August 8, 1996), Administrative Proceeding File No. 3-9056.

<sup>49</sup> See Delegation Plan, Section III.C.2.

appeals under NASD Rule 11890 of determinations relating to all transactions (including those in CTA Plan Securities), not only those involving Nasdaq UTP Plan Securities and OTC Equity Securities.<sup>50</sup>

In addition, the NASD proposes to remove all references in the Delegation Plan to Nasdaq as a subsidiary of the NASD. For example, the Delegation Plan has been amended to reflect that the NASDR will no longer, in conjunction with Nasdaq, develop and adopt rules to establish trading practices with respect to OTC Equity Securities, including OTC Bulletin Board securities.<sup>51</sup> In the proposal, the NASD also revises the By-laws of the NASD, NASDR and NASD Dispute Resolution, Inc. to remove references to Nasdaq as a subsidiary of the NASD. In addition, the NASD proposes to delete the Nasdaq By-Laws.

The NASD also proposes to eliminate its delegation of authority to Stockwatch, which handles the trading halt functions for CTA Plan Securities traded in the OTC market because this function will now be performed by the NASD.<sup>52</sup>

The Commission finds that these changes to the NASD's governing documents are consistent with the Exchange Act because they will accurately reflect the complete separation of Nasdaq from the NASD once the Nasdaq Exchange begins to operate as a national securities exchange for CTA Plan Securities.

#### 4. Other Deleted Rules to Reflect Nasdaq's Separation

The NASD also proposes to delete several rules in their entirety because the NASD will no longer require these rules after the Nasdaq Exchange commences operations as a national

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<sup>50</sup> Id. See NASD Rule 6610(d) (defining OTC Equity Security).

<sup>51</sup> See Delegation Plan, Section II.A.1(t).

<sup>52</sup> See Delegation Plan, Sections II and IV.

securities exchange for CTA Plan Securities. For example, the NASD proposes to delete the rules that govern member activities in BRUT and the Inet. These trading systems are Nasdaq trading systems and when the Nasdaq Exchange begins operations as an exchange for CTA Plan Securities, they will be facilities of the Nasdaq Exchange.<sup>53</sup> Because these systems will cease to be NASD facilities, the Commission finds that deletion of these rules is consistent with Section 15A(b)(6) of the Exchange Act.<sup>54</sup>

The NASD also proposes to delete NASD Rule 4400, which describes the treatment of securities that are dually-listed on the New York Stock Exchange, Inc. and the Nasdaq Exchange.<sup>55</sup> These dually-listed securities are considered CTA Plan Securities, and thus are not currently trading on the Nasdaq Exchange. Upon approval of this proposed rule change, these dually-listed securities will be eligible to trade on the Nasdaq Exchange along with the other CTA Plan Securities, and thus NASD Rule 4400 will no longer be necessary. The Nasdaq Exchange currently has the same rule in its rules, which continues to describe these securities as CTA Plan Securities for purposes of quoting and trade reporting.<sup>56</sup> Accordingly, the

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<sup>53</sup> BRUT and Inet are already facilities of the Nasdaq Exchange for the purposes of trading Nasdaq UTP Plan Securities. See also Securities Exchange Act Release No. 54155 (July 14, 2006), 71 FR 41291 (July 20, 2006).

<sup>54</sup> 15 U.S.C. 78q-3(b)(6).

<sup>55</sup> Under current NASD Rule 4400, these securities are subject to the CTA and CQ Plans and are treated as CTA Plan Securities under the NASD rules.

<sup>56</sup> See Nasdaq Exchange Rule IM-4390. Like the NASD Rule 4400, Nasdaq Exchange Rule IM-4390 provides that the Nasdaq Exchange will send all quotes and trade reports in dually-listed securities to the processor of the CTA Plan. In addition, the Nasdaq Exchange Rule IM-4390 states that market makers in the dually-listed securities will be subject to the obligations set forth in Nasdaq Exchange Rule 5200 regarding quoting, trading, and transaction reporting of CTA Plan Securities and that the Nasdaq Exchange will honor the trade halt authority of the primary market under the CQ and CTA Plans.

Commission finds the deletion of this rule to be consistent with Section 15A(b)(6) of the Exchange Act.

In addition, the NASD proposes to delete NASD Rule 0140, which provides procedures for fingerprint-based background checks of Nasdaq employees and independent contractors for purposes of enhancing the physical security of Nasdaq facilities, systems and data. Once Nasdaq separates from the NASD, these procedures will no longer be governed by NASD rules.<sup>57</sup> The Commission finds that the deletion of this rule is consistent with Section 15A(b)(6) of the Exchange Act because it relates solely to the operation of the Nasdaq Exchange.

**B. Proposed Changes to NASD/Nasdaq Trade Reporting Facility Rules**

Currently, the NASD/Nasdaq Trade Reporting Facility only accepts trade reports in Nasdaq UTP Plan Securities.<sup>58</sup> The NASD proposes to redefine “designated securities” in NASD Rule 4100 to include any NMS stock as defined in Rule 600(b)(47) of Regulation NMS.<sup>59</sup> This change will permit NASD members to report OTC transactions in CTA Plan Securities to the NASD/Nasdaq Trade Reporting Facility.<sup>60</sup> In addition, to accommodate transaction reports in CTA Plan Securities, the NASD proposes to incorporate the trade reporting requirements for CTA Plan Securities currently set forth in the NASD Rule 6400 Series into NASD Rules 4100, 4200, 4600, and 6100 Series, which are rules relating to the NASD/Nasdaq TRF. Specifically, the NASD proposes to incorporate the exclusions set forth in current NASD Rules 6420(e)(6) and (7) into proposed NASD Rule 4632(e). Current NASD Rules 6420(e)(6) and (7) provide that the following transactions are not to be reported to the NASD: (i) acquisitions of securities

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<sup>57</sup> The Nasdaq Exchange has a similar rule. See Nasdaq Exchange Rule 0140.

<sup>58</sup> See supra note 9.

<sup>59</sup> 17 CFR 242.600(b)(47).

<sup>60</sup> See also proposed NASD Rule 4200(a)(2).

by a members as a principal in anticipation of making an immediate distribution or offering on an exchange; and (ii) purchase of securities off the floor of an exchange pursuant to a tender offer. These exclusions are specific to exchange trading and, therefore, did not apply to reporting of transactions in Nasdaq UTP Plan Securities. However, now that the NASD/Nasdaq Trade Reporting Facility will accept transaction reports in all exchange-listed securities, the NASD proposes that these exclusions be applied to trade reporting to the NASD/Nasdaq Trade Reporting Facility. The Commission finds that including these exclusions in NASD Rule 4632(e) is consistent with Section 15A(b)(6) of the Exchange Act.

Members that report to the NASD/Nasdaq Trade Reporting Facility currently can enter into “give-up” arrangements<sup>61</sup> whereby one member reports transactions to the NASD/Nasdaq Trade Reporting Facility on behalf of another member. Proposed NASD Rule 4632(h) codifies this process and provides that the member with the reporting obligation will remain responsible for the transaction report submitted on its behalf. Further, under the proposed rule, both the member with the reporting obligation and the member submitting the trade to the NASD/Nasdaq Trade Reporting Facility will be responsible for ensuring that the information submitted is in compliance with all applicable rules and regulations. The Commission finds that codifying this existing practice, which is currently being applied in the ITS/CAES System, is consistent with Section 15A(b)(6) of the Exchange Act since it should clarify the reporting obligations of market participants and promote coordination in trade reporting.

The NASD also proposes to amend NASD Rule 4632(d)(3)(B) relating to requirements

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<sup>61</sup> These arrangements are similar to those currently in place in the ITS/CAES System. See NASD Rule 4720.



for reporting “riskless principal” transactions to the NASD/Nasdaq Trade Reporting Facility.<sup>62</sup> The proposed rule change will clarify that where the initial leg of a riskless principal transaction (media leg) has been reported to the NASD/Nasdaq Trade Reporting Facility, the second leg (non-media leg) must also be reported to the NASD/Nasdaq Trade Reporting Facility. However, where the initial leg of the riskless principal transaction has been executed on an exchange and thus reported by the exchange, the NASD member will be permitted, but not required, to report the second leg to the NASD/Nasdaq Trade Reporting Facility. NASD members that choose to report such second leg transactions to the NASD/Nasdaq Trade Reporting Facility must include all data required under NASD Rule 4632. NASD members should not submit the principal transaction (media leg) to the NASD/Nasdaq Trade Reporting Facility for a transaction that was executed on and reported by an exchange, because that would result in double reporting of the same transaction.<sup>63</sup> The Commission finds that this proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act since it codifies an existing practice and clarifies the rules relating to riskless principal transaction reporting.

Finally, the NASD proposes to amend the definition of “Reporting ECN” in NASD Rule 6110(i) to clarify that the term includes alternative trading systems, as well as ECNs, as those terms are defined in Rule 600 of Regulation NMS, for purposes of reporting transactions to the

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<sup>62</sup> A riskless principal transaction is a transaction in which a member, after having received a customer order, executes an offsetting transaction, as principal, with another customer or broker-dealer to fill that customer order and both transactions are executed at the same price. Such transactions are reported to the NASD/Nasdaq Trade Reporting Facility as one transaction in the same manner as an agency transaction (excluding the mark-up or mark-down, commission equivalent or other fee) or otherwise, as specified in NASD Rule 4632. See NASD 4632(d)(3)(B).

<sup>63</sup> See also NASD Rule 4632(e)(6). In the proposed rule change, the NASD proposes a similar amendment to NASD Rule 6420(d)(3)(B) with regard to riskless principal transactions in CTA Plan Securities reported to the NASD via the ITS/CAES System.

NASD/Nasdaq Trade Reporting Facility.<sup>64</sup> The Commission believes that this proposed change to NASD Rule 6110(i) is consistent with Section 15A(b)(6) of the Exchange Act because it will ensure that ECNs and ATs are subject to the same clearing and comparison rules of the NASD and should promote consistency in the NASD's treatment of market participants

In its filing, the NASD represented that it will have an integrated audit trail of CTA Plan Securities transactions that are reported to the ITS/CAES System and the NASD/Nasdaq Trade Reporting Facility. The NASD also represented that it will have integrated surveillance capabilities. Until the implementation of a comprehensive automated audit trail and surveillance is complete, the NASD has represented that its staff will create an integrated audit trail on a manual basis as needed for regulatory purposes.<sup>65</sup>

C. Other Changes

The NASD proposes to move certain trading practice requirements relating to exchange-listed securities currently found in NASD Rule 6440 to NASD Rule 5120, thus making them applicable to OTC trading of all exchange-listed securities. Currently, NASD Rule 6440 only applies to CTA Plan Securities. The NASD proposes to extend these rules prohibiting certain manipulative practices with respect to Nasdaq UTP Plan Securities. The Commission believes that proposed NASD Rule 5120 is consistent with the Section 15A(b)(6) of the Exchange Act because it extends the NASD's rules that prohibit manipulative trading practices to Nasdaq UTP Plan Securities. The Commission believes that this change will promote uniformity in NASD's rules.

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<sup>64</sup> The amended definition of "Reporting ECN" shall also apply to the trade reporting service of the ITS/CAES System. See NASD Rule 6110(m).

<sup>65</sup> In its filing, the NASD stated that it expects that an automated comprehensive audit trail and integrated surveillance will be completed by the end of fourth quarter 2006.

In addition, the NASD proposes to add a new NASD Rule 5130 to explicitly require that NASD members participating in any NASD system or facility must provide information to the staff of the NASD when the NASD staff requests information relating to a specific NASD rule, Commission rule, or provision of a joint industry plan (e.g., UTP, CTA, CQ and ITS). A failure to comply in a timely, truthful and/or complete manner with such request may be deemed conduct inconsistent with just and equitable principles of trade. This rule is substantially similar to former NASD Rule 4625, which imposed obligations on NASD members to respond to requests from the staff of Nasdaq MarketWatch and Nasdaq Market Operations and which was inadvertently deleted from NASD rules.<sup>66</sup> The Commission finds that proposed NASD Rule 5130 is consistent with Section 15A(b)(6) of the Exchange Act, and with Section 15A(b)(2) of the Exchange Act because it is designed to allow the NASD to conduct more efficient surveillance and investigation of its members' activities for potential violations of NASD rules and the federal securities laws.

Finally, the NASD proposes to amend NASD Rule 11890 Series (Clearly Erroneous Transactions). Specifically, the NASD proposes to delete those provisions that provide Nasdaq with the authority to break trades as a result of a complaint. The proposed rule change also reallocates to the NASD authority previously allocated to Nasdaq to break trades in CTA Plan Securities on its own motion, which is consistent with the NASD's current authority with respect to Nasdaq UTP Plan Securities and OTC Equity Securities. The Commission finds that these changes are consistent with Section 15A of the Exchange Act because it updates the NASD's rules to reflect the separation of Nasdaq.

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<sup>66</sup> NASD Rule 4625 was inadvertently deleted as part of File No. SR-NASD-2005-087, supra note 9.

The NASD also proposes to amend NASD Rule 11890(c) to delete references to the MORC, which currently reviews appeals of erroneous transactions in CTA Plan Securities. Instead, proposed NASD Rule 11890(b) and (c) will provide that the NASD's UPC Committee will have its authority expanded so that it may review appeals relating to all transactions (including transactions in CTA Plan Securities), and not just transactions relating to Nasdaq UTP Plan Securities and OTC Equity Securities as provided in the current rule.<sup>67</sup> The Commission finds that these proposed changes are consistent with Section 15A(b)(6) of the Exchange Act as they adequately reflect the structure and obligations of the NASD's committee with respect to NASD Rule 11890 upon Nasdaq's complete separation from the NASD.

In Amendment No. 2, the NASD clarified that the Consolidated Quotation Service referred to in NASD Rule 6320 is the ITS/CAES System. The Commission finds that this proposed change is consistent with Section 15A(b)(6) of the Exchange Act<sup>68</sup> because it clarifies NASD's rule and reflects the fact that CQS Market Makers, who are required to be registered as ITS/CAES Market Makers, will send their quotations to the ITS/CAES System. In Amendment No. 2, the NASD also amended NASD Rule 6420(d)(3)(B), which relates to riskless principal transactions in the proposed ITS/CAES System so that it would conform to NASD Rule 4632(d)(3)(B), which relates to the same transactions in the NASD/Nasdaq TRF. The NASD also amended NASD Rule 11890(b)(2), which relates to clearly erroneous transactions to provide that an officers designated by an Executive Vice President of NASD's Market Regulation Committee or NASD's Transparency Services Department could also take action under that rule.

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<sup>67</sup> See supra notes 50-51 and accompanying text. In contrast to the MORC's decisions, decisions by UPC Committee may be submitted by the parties to arbitration. See NASD Rule 11890(c)

<sup>68</sup> 15 U.S.C. 78q-3(b)(6).

The Commission finds that these proposed changes are consistent with the Section 15A(b)(6) of the Exchange Act since they clarify the NASD's rules and accurately reflect NASD's proposed ITS/CAES System and its review of clearly erroneous transactions. For these reasons, the Commission finds good cause for approving Amendment No. 2 to the proposal prior to the 30<sup>th</sup> day after the date of publication of filing thereof in the Federal Register. Accordingly, the Commission finds that it is consistent with Section 15A(b)(6) and Rule 19(b)(2) of the Exchange Act<sup>69</sup> to approve Amendment No. 2 on an accelerated basis.

D. Effective Date of Proposed Rule Change

The NASD proposes that the changes to its governing documents, including the Delegation Plan, and its rules become effective on the date on which the Nasdaq Exchange commences operation as a national securities exchange for CTA Plan Securities. The Commission finds that this effective date is consistent with Section 15A of the Exchange Act because until the Nasdaq Exchange begins operations, the NASD must maintain its current rules to fulfill its statutory and regulatory obligations.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Exchange 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 No. SR-NASD-2006-104 on the subject line.

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<sup>69</sup> 15 U.S.C. 78o-3(b)(6) and 15 U.S.C. 78s(b)(2).

Paper comments:

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

All submissions should refer to File No. SR-NASD-2006-104. 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 the 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 publicly available. All submissions should refer to File No. SR-NASD-2006-104 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act, that the proposed rule change (SR-NASD-2006-104), as amended by Amendment No. 1, is approved and that Amendment No. 2 is approved on an accelerated basis.<sup>70</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>71</sup>

Nancy M. Morris  
Secretary

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<sup>70</sup> In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>71</sup> 17 CFR 200.30-3(a)(12).