

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52141; File No. SR-NASD-2004-009)

July 27, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 2, 3, 4, and 5 Thereto to Modify Nasdaq's Clearly Erroneous Rule

I. Introduction

On January 21, 2004, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² to modify the Nasdaq's clearly erroneous rule. On August 23, 2004, Nasdaq submitted Amendment No. 1 to the proposed rule change.³ On May 5, 2005, Nasdaq submitted Amendment No. 2 to the proposed rule change.⁴ On May 11, 2005, Nasdaq submitted Amendment No. 3 to the proposed rule change.⁵ On May 16, 2005, Nasdaq submitted Amendment No. 4 to the proposed rule change.⁶ The proposed rule change, as amended by Amendment Nos. 1, 2, 3, and 4, was published for comment in the Federal Register on May 26,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated August 20, 2004 ("Amendment No. 1"). Amendment No. 1 replaced the original rule filing in its entirety.

⁴ Amendment No. 2 replaced Amendment No. 1 in its entirety.

⁵ Amendment No. 3 revised incorrect cross-references in the rule text.

⁶ Amendment No. 4 revised an incorrect paragraph designation in the rule text.

2005.⁷ On June 16, 2005, Nasdaq submitted Amendment No. 5 to the proposed rule change.⁸

The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.⁹

II. Description of the Proposed Rule Change

NASD Rule 11890 governs the review and resolution of clearly erroneous transactions. The NASD Rule permits Nasdaq to review, at the request of a market participant, any transaction arising out of the use or operation of any execution or communication system owned or operated by Nasdaq to determine if such transaction is clearly erroneous. NASD Rule 11890 also permits Nasdaq to review transactions on Nasdaq's own motion under specific circumstances. The NASD Rule provides Nasdaq officials with the authority to nullify a transaction or modify one or more terms of the transaction. In addition, NASD Rule 11890 sets forth the procedures for review of a transaction to determine whether it is clearly erroneous and for appeal of a determination to the Market Operations Review Committee ("MORC").

The NASD proposes to amend NASD Rule 11890 to: (1) specify the supporting information that must be submitted in connection with a complaint requesting review of a transaction to determine whether it is clearly erroneous; (2) establish minimum price deviation thresholds that would provide a "bright line" standard for determining whether a transaction is eligible for review; (3) provide that complaints failing to meet minimum price deviation

⁷ See Securities Exchange Act Release No. 51722 (May 20, 2005), 70 FR 30508.

⁸ See Amendment No. 5, which made technical corrections to the rule text, is a technical amendment that is not subject to notice and comment. The amended rule text proposed in Amendment No. 5 is available on the NASD's Web site (<http://www.nasd.com>), at the NASD's Office of the Secretary, and at the Commission's Public Reference Room.

⁹ Nasdaq has represented that the proposed rule change would take effect on a date specified in a Head Trader Alert to its members, which date would be no later than three weeks after Commission approval of the proposal. Telephone call on July 27, 2005, between John Yetter, Senior Associate General Counsel, Nasdaq, and Terri Evans, Special Counsel, Division, Commission.

thresholds or documentation requirements would be rejected, and limit the grounds for review of such rejections by the MORC; and (4) make several clarifying changes to the rule text. These changes are described in more detail below.

Specify the Supporting Information To Be Submitted by a Complainant

The proposed rule change would amend NASD Rule 11890 to require that a complaint, to be eligible for review, must include the following information: approximate time of transaction(s), security symbol, number of shares, price(s), contra broker(s) if transactions are not anonymous, the Nasdaq system used to execute the transactions, and the reason that the review is being sought.

Establish Minimum Price Deviation Thresholds

The proposed rule change also would establish minimum price deviation thresholds that would provide a standard for determining whether transactions are considered eligible for review. A transaction price that meets the minimum price threshold would not automatically trigger a clearly erroneous determination; however, if the transaction price does not meet the minimum price threshold, the transaction would not be considered as a clearly erroneous transaction. Thus, there would be a conclusive presumption that a transaction to buy (sell) is not clearly erroneous unless its price is greater than (less than) the best offer (best bid) by an amount that equals or exceeds the minimum threshold set forth below:

<u>Inside Price</u>	<u>Minimum Threshold</u>
\$0 - \$0.99	$\$0.02 + (0.10 \times \text{Inside Price})$
\$1.00 - \$4.99	$\$0.12 + (0.07 \times (\text{Inside Price} - \$1.00))$
\$5.00 - \$14.99	$\$0.40 + (0.06 \times (\text{Inside Price} - \$5.00))$
\$15 or more	\$1.00

For a transaction to buy (sell) a Nasdaq listed security, the inside price would be the best offer (best bid) in Nasdaq at the time that the first share of the order that resulted in the disputed transaction was executed, and for a transaction to buy (sell) an exchange-listed security, the inside price shall be the national best offer (best bid) at the time that the first share of the order that resulted in the disputed transaction was executed.¹⁰ Nasdaq also proposes to adopt IM-11890-3 to assist market participants in understanding the minimum price deviation thresholds by providing an example of their application.

Reject, As Ineligible, Non-Conforming Clearly Erroneous Complaints

In addition, in conjunction with providing standards as to required minimum documentation and minimum price deviation thresholds, the proposed rule would set forth clearly defined consequences for failing to meet the minimum documentation requirements. Members failing to meet the minimum documentation requirements within the initial 30-minute time frame for complainants to submit any supporting written information or failing to meet the minimum price deviation parameters would not be eligible to maintain an action under NASD Rule 11890, unless the member alleges a mistake of material fact. Nasdaq staff would notify the complainant immediately of any deficiencies in the filing so that the complainant can revise and resubmit the documentation, if possible, within the 30-minute time frame.

In cases where a claim is not eligible for review because the transaction does not meet the minimum price deviation thresholds or because the complaint does not include the supporting documentation required by the proposed amendment to the rule, the party appealing to the MORC must allege a mistake of material fact upon which it believes the Nasdaq officer's

¹⁰ Trades in exchange-listed securities are reviewed under NASD Rule 5265, which incorporates Rule 11890 by reference.

determination was based.¹¹ The MORC would not substantively review an appeal of a determination that does not allege a mistake of material fact. Accordingly, if the MORC finds that a mistake has not been alleged in an appeal, Nasdaq is not required to notify the counterparty to the trade concerning the appeal or to submit the decision for further review by the MORC. If the MORC concludes that the appeal alleges a mistake of material fact, the counterparty would be notified and the determination would be reviewed by the same panel. If the MORC then finds that the determination was based on a mistake of material fact, the MORC would remand the matter to the Nasdaq officer for adjudication; otherwise, the determination would become final and binding. If the matter is remanded to the Nasdaq officer, the right of appeal to the MORC would be preserved.

Other Proposed Changes

Finally, in order to clarify the Rule's text and expedite procedures under the Rule, Nasdaq is proposing the following additional changes:

- The text of IM-11890-2 would be amended to reflect the proposed use of panels of one or more members of the MORC for purposes of reviewing determinations that a transaction is not eligible for review because the complainant failed to provide all the supporting information or the transaction price does not meet or exceed the applicable minimum deviation thresholds.

¹¹ For purposes of NASD Rule 11890, a decision of the MORC may be rendered by a panel of the MORC. In the case of a determination by a Nasdaq officer under Rule 11890(a)(2)(C) that a transaction is not eligible for review (including a review of the sufficiency of allegations contained in an appeal regarding such a determination), the panel may consist of one or more members of the MORC, provided that no more than 50 percent of the members of any panel are directly engaged in market making activity or employed by a member whose revenues from market making activity exceed ten percent of its total revenues. In all other cases, the panel shall consist of three or more members of the MORC, provided that no more than 50 percent of the members of any panel are directly engaged in market making activity or employed by a member firm whose revenues from market making activity exceed ten percent of its total revenues.

- NASD Rule 11890 would be amended to provide that adjudication of a complaint or an appeal is not required if the party submitting the complaint or appeal withdraws it prior to the notification of counterparties.
- NASD Rule 11890 would be amended to provide that appeals are focused solely on trades to which the party submitting the appeal is a party. Thus, for example, if Broker A submits a complaint regarding two separate trades with Broker B and Broker C, the trades are broken, and Broker B appeals but Broker C does not, the appeal would focus solely on the trade between Broker A and Broker B.
- NASD Rule 11890 currently provides that facsimile machines are the preferred method for submitting materials regarding clearly erroneous adjudications. Nasdaq proposes to amend the rule to provide that parties should use such telecommunications methods as are announced from time to time through an NASD Notice to Members or a Nasdaq Head Trader Alert.
- In light of the upcoming retirement of the Nasdaq Workstation II Service, Nasdaq also is proposing to replace a reference to that service with a more general reference to Nasdaq telecommunications protocols.
- Cross references in NASD Rule 111890 would be amended to reflect preferred NASD style, and references to the “Committee” would be replaced with references to the “MORC.”

III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national

securities association,¹² and, in particular, with the requirements of Section 15A of the Act.¹³ Specifically, the Commission finds that the proposal is consistent with Section 15A(b)(6)¹⁴ of the Act in that the proposal is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission believes that the amendments to NASD Rule 11890 to establish minimum price deviation thresholds and to specify the information necessary to support a complaint are designed to provide greater specificity and clarity with respect to the procedures Nasdaq must follow in determining whether a transaction is clearly erroneous. The amendments also would provide Nasdaq with objective bases for rejecting clearly erroneous petitions that fail to provide complete information or that relate to a transaction at a price sufficiently close to the inside market that it should not be considered for review as a clearly erroneous transaction. The Commission believes that it is proper for Nasdaq's trade adjustment and nullification provisions to provide for objective standards in determining whether a transaction is eligible for clearly erroneous review and clear procedures in conducting such a review or an appeal of such review, because they would provide greater certainty to Nasdaq market participants who are parties to trades that are claimed to be clearly erroneous. In addition, Nasdaq officers who are called upon to review such trades would be provided with transparent standards and procedures when determining whether a transaction is clearly erroneous.

¹² In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹³ 15 U.S.C. 78q-3.

¹⁴ 15 U.S.C. 78q-3(b)(6).

The amendments to NASD Rule 11890 also would require a Nasdaq market participant to allege a mistake of material fact in order to appeal a determination of a Nasdaq officer that a transaction is not eligible for review and would permit the use of panels of one or more members of the MORC for the purpose of reviewing such determinations. If the MORC panel concludes that a mistake of material fact has not been alleged in an appeal, the determination shall become final and binding and Nasdaq would not be required to notify the counterparty to the trade about the appeal. The Commission notes that, if the MORC concludes that an appeal alleges a mistake of material fact, the counterparty would be notified and a determination as to whether the appeal alleges a mistake of material fact would be reviewed by the MORC panel. In the event that the panel then determines that the appeal alleges a mistake of material fact, the complaint would be remanded to the Nasdaq officer and the right of either party to appeal would be preserved. The Commission believes that these procedures, particularly the requirement that the complaint be remanded to the Nasdaq officer and the preservation of the appeal right in the event the MORC panel determines that the appeal alleges a mistake of material fact, are designed so that NASD Rule 11890 is exercised in an efficient manner, while the rights of the parties to an appeals process are preserved.

Finally, the amendments to NASD Rule 11890 would eliminate the requirement for an adjudication of a complaint or an appeal if the party submitting the complaint or appeal withdraws it prior to the notification of counterparties and would provide that appeals be focused solely on trades to which the party submitting the appeal is a party. The Commission believes that these features of the amendments are designed to provide additional certainty to Nasdaq market participants that their trades would not be adjusted or nullified if they decide not to appeal a particular trade or trades.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁵ that the proposed rule change (SR-NASD-2004-009), as amended by Amendments Nos. 1, 2, 3, 4, and 5, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland
Deputy Secretary

¹⁵ 15 U.S.C. 78s(b)(2).

¹⁶ 17 CFR 200.30-3(a)(12).