

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52902; File No. SR-NASD-2005-128)

December 7, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving a Proposed Rule Change to Establish Rules Governing the Operation of the INET System

I. Introduction

On November 1, 2004, the National Association of Securities Dealers, Inc. (“NASD”), through its subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to establish rules governing the operation of the INET ECN (“INET System” or “System”) and fees for System services.

The proposed rule change was published for comment in the Federal Register on November 7, 2005.<sup>3</sup> The Commission received no comments on the proposal. This order approves the proposed rule change.

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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> See Securities Exchange Act Release No. 52723 (November 2, 2005), 70 FR 67513 (“INET Notice”).

## II. Description

On April 22, 2005, Nasdaq entered into definitive agreements to purchase INET ATS, Inc. (“INET”), a registered broker-dealer and member of NASD,<sup>4</sup> and operator of the INET System. Once acquired by Nasdaq, the INET System would immediately become a “facility” of a national securities association subject to the standards set forth in Sections 15A<sup>5</sup> and 19(b)(1)<sup>6</sup> of the Act and would be required to operate pursuant to formal system rules approved by the Commission.<sup>7</sup> Accordingly, in order to ensure that such rules are in place at the time of closing, Nasdaq proposes to establish rules governing the operation of its INET System. Proposed NASD Rule 4950 Series addresses, among other things, the INET System’s order display and matching function, access standards, order types, time-in-force designations, out-bound order routing, order execution algorithm, clearly erroneous trade procedures, and other system features and standards.<sup>8</sup> Proposed NASD Rule 7010(w) sets forth the fees applicable to participants, which currently include both NASD members and non-NASD members, in the INET System for order execution services. According to Nasdaq, such fees reflect those currently charged by INET to its participants. This fee schedule would apply for a temporary period of time, not to exceed 60 days after INET becomes a facility of Nasdaq.

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<sup>4</sup> In the INET Notice, Nasdaq stated that, as a member of NASD, INET is, and remains, subject to all NASD Rules applicable to its activities as a broker-dealer. In addition, INET would continue to participate in market surveillance and audit trail programs conducted by Nasdaq, NASD, and other self-regulatory organizations. INET would continue to act as a counter-party to all trades taking place in its system, for anonymity as well as clearance and settlement purposes. INET would also continue to provide outbound order routing services to other market centers for its subscribers. See INET Notice at 67518.

<sup>5</sup> 15 U.S.C. 78o-3.

<sup>6</sup> 15 U.S.C. 78s(b)(1).

<sup>7</sup> See INET Notice at 67518.

<sup>8</sup> See INET Notice.

Under the proposal, Nasdaq would initially operate INET on a platform separate from its Nasdaq Market Center and Brut platforms. For a temporary period of time ending no later than September 30, 2006, the INET System would continue to post its top-of-file quotes through the facilities of the National Stock Exchange (“NSX”), as it does today, and would remain subject to all applicable rules and regulations of the NSX.<sup>9</sup> In the INET Notice, Nasdaq also stated that it anticipates that, soon after the formal close of the Nasdaq/INET transaction, it would merge the INET broker-dealer into Nasdaq’s Brut broker-dealer and that Brut, as a single broker-dealer, would operate both trading platforms as separate systems with separate order processing and execution. As such, the New York Stock Exchange, Inc. (“NYSE”) would continue to serve as the designated examining authority for financial responsibility purposes for Nasdaq’s broker-dealer, which would operate both the Brut and INET trading platforms.<sup>10</sup> Ultimately, Nasdaq intends to integrate all of its systems into a single technology platform and also combine all three of its system books into a single integrated book. In the INET Notice, Nasdaq stated that it expects to accomplish this process before the end of the third quarter of 2006.

Nasdaq proposes that these rules would be implemented immediately upon formal closing of the Nasdaq/INET transaction, and in no event more than two weeks after Commission approval. In the INET Notice, Nasdaq stated that it will provide to the Commission formal written notice of the closing date of the transaction. Such closing date, which must take place within two weeks of Commission approval, shall be the start date for the calculation of any temporary time period referred to in this filing. Nasdaq also stated that it would thereafter submit rule filings to include such closing date in its rules.

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<sup>9</sup> See INET Notice at 67518.

<sup>10</sup> See INET Notice at 67522.

### III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a self-regulatory organization<sup>11</sup> and, in particular, the requirements of Section 15A of the Act<sup>12</sup> and the rules and regulations thereunder. Specifically, the Commission finds that the proposed rule change is consistent with 15A(b)(6) of the Act,<sup>13</sup> in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, remove impediments to a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission notes that the INET System would become a facility of a national securities association subject to the standards set forth in Sections 15A<sup>14</sup> and 19(b)(1)<sup>15</sup> of the Act when Nasdaq completes its purchase of INET. As such, NASD and, pursuant to NASD's plan of allocation and delegation of function to its subsidiaries, Nasdaq are obligated to file rules governing the operation of the INET System with the Commission. In addition, the Commission notes that, as a broker-dealer, INET remains subject to the applicable NASD rules.

The Commission notes that the proposed rule change articulates Nasdaq's operation of INET and INET's integration with the Nasdaq Market Center and Brut. The rules that are the subject of this filing encompass a wide range of areas, including the INET System's order display and matching function, access standards, order types, time-in-force designations, out-

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<sup>11</sup> In approving this proposed rule change the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>12</sup> 15 U.S.C. 78o-3.

<sup>13</sup> 15 U.S.C. 78o-3(b)(6).

<sup>14</sup> 15 U.S.C. 78o-3.

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

bound order routing, order execution algorithm, clearly erroneous trade procedures, other system features and standards, and fees. The Commission believes that the proposed rules are reasonably designed to provide order interaction and price competition. Under the proposed rule change, INET will continue to participate in market surveillance and audit trail programs conducted by Nasdaq and NASD, and, for the temporary period during which it posts its top-of-file quotes through the facilities of the NSX, would also remain subject to all applicable rules and regulations of the NSX. In addition, the Commission notes that many of the proposed trading rules for the INET System are modeled on existing rules that apply to Nasdaq's Brut facility and the Nasdaq Market Center.<sup>16</sup> Accordingly, the Commission believes that granting approval to substantially similar rules for Nasdaq's INET facility is appropriate because such rules do not raise any novel or significant regulatory issues.

The Commission notes that, under this proposal, there is a temporary transition period during which INET would continue to operate in functionally the same manner in which it operates today; thus, the immediate transition to INET's operation as a Nasdaq facility should be seamless from a market structure perspective for market participants, in general, and INET

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<sup>16</sup> See Securities Exchange Act Release No. 51326 (March 7, 2005), 70 FR 12521 (March 14, 2005) ("Brut Approval Order"). On September 7, 2004, Nasdaq acquired Brut LLC, a registered broker-dealer and member of NASD, and operator of the Brut ECN ("Brut"). Once purchased by Nasdaq, Brut became a facility of a national securities association. Nasdaq initially operated Brut pursuant to a Temporary Conditional Exemption under Section 36 of the Act, which the Commission granted for a period of six months following Nasdaq's acquisition of Brut. See Exchange Act Release No. 50311 (September 3, 2004), 69 FR 54818 (September 10, 2004). On November 3, 2004, NASD, through Nasdaq, filed with the Commission a proposed rule change to establish rules governing the operation of its Brut trading facility. The proposed rule change, as amended by Amendment No. 1 thereto, was published for comment in the Federal Register on January 31, 2005. See Securities Exchange Act Release No. 51078 (January 25, 2005), 70 FR 4902 (January 31, 2005) (SR-NASD-2004-173) ("Brut Notice"). The Commission received no comments on the Brut Notice, as amended by Amendment Nos. 1 and 2 thereto, and approved the proposed rule change, as amended, on March 7, 2005. See Brut Approval Order.

subscribers, in particular. The Commission also emphasizes that INET, as a Nasdaq facility, will now be subject to Section 19 of the Act<sup>17</sup> and, to the extent that proposed rule changes are required to effectuate the Nasdaq/INET integration as described above, such proposed rule changes must be submitted to, and reviewed by, the Commission.

In addition, the Commission notes that several of Nasdaq's proposed rules would apply for a temporary period, allowing INET to continue certain of its current practices during a limited transition period immediately following the closing of the Nasdaq/INET transaction. For example, INET's proposed rules relating to the registration of all INET system participants as members of NASD,<sup>18</sup> clearly erroneous transactions,<sup>19</sup> limitation of liability,<sup>20</sup> and system service charges<sup>21</sup> only apply for a period of time not to exceed 60 days after INET becomes a facility of Nasdaq. Likewise, INET's display of its best priced orders through the facilities of the NSX may continue on a temporary basis until September 30, 2006.<sup>22</sup> The Commission notes that this proposal represents an interim step toward Nasdaq's ultimate plan to unify INET, the Nasdaq Market Center, and Brut into a single technology platform, which Nasdaq has committed to complete before the end of the third quarter of 2006. Finally, the Commission expects that, as Nasdaq has stated, soon after the formal close of the Nasdaq/INET transaction, Nasdaq will merge the INET broker-dealer into Nasdaq's Brut broker-dealer and that Brut as a single broker-dealer would operate both ECNs as separate systems, with separate order processing and execution, which would permit the NYSE to continue to serve as the designated examining

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<sup>17</sup> 15 U.S.C. 78s(b).

<sup>18</sup> Proposed NASD Rule 4952.

<sup>19</sup> Proposed NASD Rule 4961.

<sup>20</sup> Proposed NASD Rule 4964.

<sup>21</sup> Proposed NASD Rule 7010(w).

<sup>22</sup> Proposed NASD Rule 4954(b)(2).

authority for financial responsibility purposes for Nasdaq's wholly-owned broker-dealer. The Commission believes that this arrangement should help to eliminate actual, or the appearance of any, conflicts of interest between NASD and INET's broker-dealer operation.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>23</sup> that the proposed rule change (File No. SR-NASD-2005-128) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>24</sup>

Jonathan G. Katz  
Secretary

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<sup>23</sup> 15 U.S.C. 78s(b)(2).

<sup>24</sup> 17 CFR 200.30-3(a)(12).