



March 30, 2004

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: SR-NASD-2004-06: NASD Proposed Rule Change Related to the  
Entry of Locking or Crossing Bids or Offers by ECNs Participating  
in Nasdaq's SuperMontage System

Dear Mr. Katz:

The Securities Industry Association ("SIA")<sup>1</sup> Trading Committee ("Committee") appreciates the opportunity to comment on the above-referenced rule filing.<sup>2</sup> Our comments are limited due to the fact that the rule change has become effective and the period for abrogation by the Securities and Exchange Commission ("SEC" or "Commission") has expired.<sup>3</sup> Nevertheless, we believe it is important to communicate our concerns to the Commission so that in the future the Commission will consider whether similar changes should be afforded full notice and comment before becoming effective. The NASD filed this rule change with the Commission pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 ("Exchange Act"), which provides for immediate effectiveness.<sup>4</sup>

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<sup>1</sup> The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in domestic revenue and \$278 billion in global revenues. (More information about SIA is available on its home page: <http://www.sia.com>.)

<sup>2</sup> Securities Exchange Act Release No. 49106 (January 20, 2004), 69 FR 3970.

<sup>3</sup> The comment period for this proposal ended on February 17, 2004 and the abrogation period ended on or about March 13, 2004.

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A).

In the filing, the NASD, through its subsidiary, The Nasdaq Stock Market (“Nasdaq”), proposed to allow Electronic Communication Networks (“ECNs”) voluntarily participating in SuperMontage to post locking or crossing bids, or locking or crossing offers, for Nasdaq securities in other display venues operated by self-regulatory organizations (“SROs”). The Committee believes that the rule change could effect significant changes in Nasdaq’s operations that will impact all markets. Although industry participants ultimately may determine that the rule change is consistent with the Exchange Act, the process did not provide firms with an adequate opportunity to evaluate the impact or to challenge the appropriateness of the rule change. Particularly in light of the Commission’s sweeping changes proposed in Regulation NMS,<sup>5</sup> the Committee recommends that any such SRO rule proposals with potential market structure implications should be considered in conjunction with or after action has been taken on the Regulation NMS proposals. At a minimum, such proposals should be filed under Section 19(b)(2) of the Exchange Act, which provides for notice and comment before a proposal becomes effective.

## **I. Commission Review of Proposed Rule Changes**

Section 19(b) of the Exchange Act requires that every SRO file with the Commission copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such SRO, accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Commission is required to publish notice of the filing of a proposed rule change and to give interested persons an opportunity to submit written data, views, and arguments. Section 19(b) provides that the Commission shall approve an SRO’s proposed rule change if it is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO.

A proposed rule change may take effect when approved by the Commission by order, unless the rule change is within the class of rule changes that are effective upon filing pursuant to Section 19(b)(3)(A). Under Section 19(b)(3)(A) of the Exchange Act and Rule 19b-4(f) thereunder, a proposed rule change may take effect upon filing with the Commission, without the notice and approval procedures required by Section 19(b)(2), if *properly* [emphasis added] designated by the SRO as:

- (1) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO;
- (2) establishing or changing a due, fee, or other charge imposed by the SRO;
- (3) concerned solely with the administration of the SRO;
- (4) effecting a change in an existing service of a registered clearing agency;

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<sup>5</sup> Securities Exchange Act Release No. 49325 (February 27, 2004), 69 FR 11125.

- (5) effecting a change in an existing order-entry or trading system of a SRO; or
- (6) effecting a change that (i) does not significantly affect the protection of investors or the public interest, (ii) does not impose any significant burden on competition, and (iii) does not become operative for thirty days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, provided that the SRO has given the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing, or such shorter time as designated by the Commission.

At any time within 60 days of the filing of a proposed rule change under any of these subsections, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

Nasdaq filed its rule change under the last subsection above, Rule 19b-4(f)(6), which was adopted by the Commission in 1994 to allow for the submission of “noncontroversial” filings.<sup>6</sup> In amending Rule 19b-4 to expand the category of proposed rule changes that may become effective on filing to include noncontroversial filings, the Commission did not intend to preclude meaningful public comment where necessary. The Commission noted in the adopting release that this procedure was designed to expedite those SRO filings that are inherently simple and concise, and that generally are less likely to engender adverse comment or require an extended review or analysis by the Commission.

The Committee respectfully disagrees with the Commission’s conclusion regarding the appropriateness of filing this proposed rule change under Rule 19b-4(f)(6). In fact, it is not apparent that the Commission considered the appropriateness at all as it waived the required pre-filing notice requirement.

## **II. Substance of the Rule Change**

The rule change amended NASD Rule 4623, which previously required ECNs quoting a security in Nasdaq to provide to Nasdaq their best-priced buy and sell prices in

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<sup>6</sup> In 1994, the Commission amended Rule 19b-4 to expedite the rule filing process by expanding the category of proposed rule changes that may become effective on filing pursuant to Section 19(b)(3)(A) of the Exchange Act to include certain systems changes and other noncontroversial filings. *See* Securities Exchange Act Release No. 35123 (December 28, 1994), 59 FR 66692. At that time, subsection (f) of Rule 19b-4 was subsection (e); this subsection was changed to subsection (f) in 1998 with the adoption of new Rule 19b-4(e) relating to new derivatives securities products. *See* Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952.

that security for dissemination to data vendors. This obligation, according to Nasdaq, created issues for ECNs when those best prices would lock or cross either the inside bid or inside offer then being displayed in Nasdaq. Nasdaq stated that, in that situation, an ECN's re-entry of the locking or crossing quote/order would subject it to special SuperMontage processing that made the ECN's quote/order eligible for automatic execution, unlike the NNMS normal method of interacting with ECNs in which Nasdaq delivers orders to the ECN for execution. Nasdaq noted that the change in order processing to automatic execution from order delivery also impacts access fee and rebate arrangements between the submitting ECN and its subscribers, and complicates the ECN's ability to avoid dual liability for executions simultaneously taking place in Nasdaq and the ECN's internal systems.

Because Nasdaq believed the rule provided a disincentive to non-NNMS ECNs or ATSS to participate in the system and restricted the ability of participating ECNs to manage their most aggressively priced subscriber orders, Nasdaq proposed a modification to its best-price rule requirement to provide ECNs with a limited exception that gives ECNs the option of posting locking or crossing trading interest (individual bids or offers) in other display trading venues operated by either a national securities association or a national securities exchange. According to Nasdaq, this modification is designed to provide ECNs greater flexibility and choice in managing subscriber orders and to enhance the voluntary nature of the SuperMontage system, while ensuring that the system continues to operate without locked or crossed markets. Nasdaq also stated that this limited exception to the best price requirement is consistent with other SuperMontage participants' ability to place locking or crossing quotes/orders in other display venues and Nasdaq's planned approach to linkage agreements with other markets that trade Nasdaq securities. As such, Nasdaq believes the rule change will increase competition among association and exchange quote display venues. Finally, Nasdaq noted that the requirement to display any locking or crossing bid or offer in a display venue for Nasdaq securities operated by an association or exchange will ensure that such bids or offers continue to be widely disseminated to data vendors.

### **III. SIA Trading Committee Concerns**

Although this rule change may ultimately prove to be consistent with Section 15A(b)(6) of the Exchange Act,<sup>7</sup> the Committee believes the industry should have been given an opportunity to participate in the process before the changes became effective. The rule change will impact different market participants in various ways and the overall functioning of the U.S. securities markets. For example, SIA member firms have raised the following significant regulatory issues:

- (1) The rule change is likely to result in more locked and crossed markets (which Regulation NMS is trying to prevent) and regulatory arbitrage (*e.g.*, splitting

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<sup>7</sup> 15 U.S.C. 78o-3(b)(6).

quotes and directing them to whichever SRO is more favorable for the particular type of quote or trade they want to do at that time).

(2) The rule change could be confusing to the marketplace, because ECNs will constantly switch the SRO they are using to post the top of their book (*e.g.*, depending on whether or not they are locking the market). Therefore, a firm may at times be able to hit the ECN through SuperMontage and other times they may not be able to do so.

(3) The rule change may make it more difficult to deal with regulatory issues like the Firm Quote Rule, when it is unclear which SRO has oversight responsibility.

(4) The rule change could cause confusion to investors and the market since there will be two quotes displayed under the same market center identifier (or MPID) but at different prices. As such, this rule change may be inconsistent with long-standing policies that have existed for OTC market makers in NYSE and Amex listed issues. Specifically, in the early 1990s, the NASD adopted a rule that requires CQS market makers that maintain quotes in more than one market center to maintain the identical quote (*see* NASD Rule 6350 - formerly NASD Rules, Schedule D, Part VI, Section 2). The intent of the CQS rule is presumably to ensure market quality and prevent investor confusion. Therefore, the rule change may be inconsistent with long-standing rules applicable to the trading of listed securities, and contrary to the goals of the Commission's move to harmonize regulation across markets.

Notably, in proposed Regulation NMS, the Commission is seeking comment on substantial changes for the U.S. equity markets, particularly regarding the trade-through rule, access standards, subpenny quoting and market data issues. Included in the Commission's access proposals are proposed prohibitions against locking and crossing the market, proposals that could ultimately conflict with the recent rule change. Given the comprehensive changes proposed in Regulation NMS, and the controversial nature of this rule change, the Committee strongly believes that it should not have become effective immediately.

Other recent SRO rule proposals also address issues covered by Regulation NMS and also may conflict with this rule change.<sup>8</sup> We believe that, although they may not

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<sup>8</sup> *See, e.g.*, Securities Exchange Act Release No. 49152 (January 27, 2004), 69 FR 5632 regarding a NASD proposal to repeal Rule 4613A(e) requiring same-priced quotations on multiple markets. The Commission approved this NASD rule change on March 12, 2004. Securities Exchange Act Release No. 49413 (March 12, 2004), 69 FR 12882. Several SIA member firms believe that this NASD rule change raises concerns similar to those raised by the Nasdaq rule change, particularly those expressed in Item 4 above in the text. These firms believe that this NASD rule change – to eliminate the requirement for ADF market participants to maintain the same-priced quotations across all markets in which they display a priced quotation – is similarly inconsistent with long-standing rules applicable to the trading of listed securities, and contrary to the goals of the Commission's move to harmonize regulation across markets.

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have been filed on an immediately effective basis, such proposed rule changes should be considered in the context of the changes proposed in Regulation NMS.

#### **IV. Conclusion**

The Committee appreciates the opportunity to provide comments on this rule change and, more importantly, on the process for considering SRO rule changes. The SIA Trading Committee urges the Commission to narrowly construe the scope of rule changes that can be filed pursuant to Section 19(b)(3) of the Exchange Act to ensure that all proposals that raise substantive issues, such as the recent Nasdaq rule change, are filed under Section 19(b)(2), thus allowing for full notice and comment prior to effectiveness.

If we can provide further information or clarification of the points in this letter, please contact me or Ann Vlcek, Associate General Counsel, SIA, at 202.216.2000.

Sincerely,

Andrew Madoff  
Chairman  
SIA Trading Committee

cc: Annette L. Nazareth, Director, Division of Market Regulation, SEC  
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC

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