

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54706; File No. SR-NASDAQ-2006-036)

November 3, 2006

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Exempt Certain Cross Transactions from NASDAQ Rule 3350(a)

Pursuant to Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 25, 2006, The NASDAQ Stock Market LLC (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I and II below, which Items have been prepared by Nasdaq. On October 31, 2006, Nasdaq filed Amendment No. 1 to the proposed rule change.³ Nasdaq has designated the proposed rule change, as amended, as constituting a non-controversial rule change under Rule 19b-4(f)(6) under the Act,⁴ which renders the proposal, as amended, effective upon filing with the Commission. 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

Nasdaq proposes to exempt all transactions executed in the Nasdaq Crossing Network pursuant to NASDAQ Rule 4770 from the price test set forth in NASDAQ Rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 was a partial amendment in which Nasdaq made certain technical changes following discussions with Commission staff.

⁴ 17 CFR. 240.19b-4(f)(6).

3350(a). Nasdaq plans to implement the proposed rule change, as amended, on November 6, 2006.

The text of the proposed rule change is below. Proposed new language is underlined; proposed deletions are in brackets.⁵

3350 Short Sale Rule

(a) – (b) No Change.

(c) (1) – (10) No Change.

(11) Short sales of securities in the Nasdaq Crossing Network pursuant to NASDAQ Rule 4770 provided that:

(a) Such short sales involve securities that comprise the S&P 500 Index;

(b) Such short sales involve securities that qualify as “actively-traded securities” under Regulation M; or

(c) Such short sales are part of a basket transaction of 20 or more securities in which the subject security does not comprise more than five percent of the value of the basket traded.

(d) – (l) No Change.

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

In its filing with the Commission, Nasdaq 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

⁵ Changes are marked to the rule text that appears in the electronic NASDAQ Manual found at www.nasdaqtrader.com.

the places specified in Item IV below. Nasdaq 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

Nasdaq is proposing to amend Rule 3350(c) to create an exemption from the short sale rule for transactions executed in the Nasdaq Crossing Network pursuant to NASDAQ Rule 4770. Nasdaq states that Rule 3350, voluntarily adopted by the NASD in 1994, is modeled closely on SEC Rule 10a-1.⁶ Nasdaq notes that in its January 13, 2006 order approving Nasdaq's registration as a national securities exchange, the Commission granted Nasdaq an exemption from Rule 10a-1 to permit the continued application of Rule 3350 to the trading of Nasdaq-listed securities on Nasdaq.⁷ Nasdaq notes, however, that Rule 10a-1 continues to apply to Nasdaq's trading of securities listed on other national securities exchanges.

Background. Nasdaq states that the Nasdaq Crossing Network will consist of a series of trading day and after hours Reference Price Crosses. Nasdaq states that Reference Price Crosses involve the execution of trades at an externally derived price and in accordance with a predetermined algorithm. Nasdaq asserts that the purpose of the Nasdaq Crossing Network is to provide market participants and investors with an accurate single trading price at specific times during and after the trading day, resulting in

⁶ Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

⁷ Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006). Nasdaq Rule 3350 will continue to apply to Nasdaq Global Market securities and not to Nasdaq Capital Market securities.

an enhanced ability to execute block trades quickly and anonymously, while minimizing market impact and associated price movements. Nasdaq states that it expects to launch the Nasdaq Crossing Network on November 6, 2006.

Nasdaq explains that during the regular trading hours session (i.e. 9:30 a.m. to 4:00 p.m.), a series of Nasdaq Reference Price Crosses would allow market participants to place orders that will be executed at the midpoint of the national best bid and offer (“NBBO”) during a designated trading window. An additional cross would be scheduled to take place after the close of the trading day and eligible orders would be executed at either the Nasdaq official closing price (“NOCP”) for Nasdaq-listed securities or the official closing price of the primary market (“Primary Market Close”) for non-Nasdaq securities. Nasdaq states that eligible orders can be either market or limit orders and must be designated for one or more Nasdaq Reference Price Crosses with time-in-force indicators.⁸ Nasdaq notes that eligible orders will not be displayed.

Nasdaq states that it will execute the cross through an automated and random matching mechanism at a randomly designated time during a predetermined one minute trading window. Nasdaq notes that initially, the Nasdaq Reference Price Crosses will

⁸ Orders may be submitted as existing market or limit order types and would be designated by the firm upon entry with a time-in-force indicator as follows: (i) participate in the next scheduled regular hours cross with unexecuted shares being immediately canceled back to the user after that cross (NXT), (ii) participate in all of the regular hours crosses (*i.e.*, 10:45 a.m., 12:45 p.m. or 2:45 p.m. ET) with unexecuted shares being immediately canceled back to the user following the last regular hours cross (REG) or (iii) participate in all crosses for the current day (*i.e.*, 10:45 a.m., 12:45 p.m., 2:45 p.m. and 4:30 p.m. ET) with unexecuted shares immediately canceled back to the user following the after hours cross (AHX).

commence during the trading day at 10:45 a.m., 12:45 p.m. and 2:45 p.m. ET. In addition, an after hours cross would take place at 4:30 p.m. ET.⁹

Nasdaq states that orders would be required to be entered in round lots with a minimum of one round lot and may designate a minimum acceptable quantity for execution. In addition, Nasdaq notes that orders may not be canceled or replaced during the time of the cross, but may at any other time, including periods when trading in the applicable security is halted. Nasdaq states that Reference Price Cross orders would be required to be available for automatic execution. All market participants would be able to enter automatically executable orders into the Nasdaq Market Center to participate in the Reference Price Cross. Orders that are not automatically executable would not be accommodated by the Reference Price Cross. Further, Nasdaq states that Reference Price Crosses would have no order delivery capability and no special orders would be accommodated.

Nasdaq states that upon initiation of a cross, available shares would be treated as if they were the same price and would be allocated on a pro-rata basis to eligible orders. Such shares would be allocated based on the original size of the order, not on the size of the remaining unexecuted portion of the order. If additional shares remain after the initial pro-rata allocation, those shares would continue to be allocated pro-rata to eligible orders until a number of round lots remain that is less than the number of eligible orders. Any remaining shares would be allocated to the oldest eligible order.

Nasdaq states that the executions would be reported to the market participants via Nasdaq Market Center execution reports as a single trade reflecting the aggregate shares

⁹ In the event that Nasdaq wishes to institute further Reference Price Crosses or alter the timing of the crosses, it will submit a rule change to the Commission.

executed. In addition, Nasdaq notes that in order to reduce information leakage that could lead to adverse price movements, executions would be reported as anonymous trades, without identifying a contra party. Nasdaq also states that each execution would be reported to the Nasdaq Market Center trade reporting service for trade reporting, clearance and settlement.

Rationale for Proposed Exemption. Nasdaq believes that exempting the Reference Price Cross transactions from Rule 3350 is consistent with the goals of short sale regulation. Nasdaq states that Congressional and Commission objectives included allowing relatively unrestricted short selling in an advancing market, preventing short selling at successively lower prices; and preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level. Nasdaq asserts that given the algorithmic nature of the Nasdaq crosses, the proposed exemption poses little risk to investors.

Nasdaq states that in proposing Regulation SHO, the Commission noted that, due to the passive nature of pricing and the lack of price discovery, passive pricing systems “generally do not appear to involve the types of abuses that Exchange Act Rule 10a-1 was designed to prevent.”¹⁰ Nasdaq states that the Commission also noted that one of the reasons for its proposed bid test was to “better accommodate the recent growth of matching systems that execute trades at an independently derived price above the consolidated best bid.”¹¹ In addition, Nasdaq states that in connection with the

¹⁰ See Securities Exchange Act Release No. 48709 (October 28, 2003), 68 Fed. Reg. 62972, 62982 (November 6, 2003).

¹¹ *Id.* Although the Commission decided to defer consideration on adopting a uniform bid test until the conclusion of the Pilot Program established under Rule 202T of

representations made by other parties requesting relief for similar matching systems, the Commission took the view that these trades would not appear to involve the types of abuses that Rule 10a-1 was designed to address.¹²

Nasdaq believes that, consistent with the Commission's articulated belief regarding passive pricing systems and its view with respect to similar matching systems, trades executed in the Nasdaq Crossing Network are not the types of abuses that Rule 3350 was designed to address. Nasdaq states that the purpose of the Reference Price Cross is to provide an accurate single trading price at specific times of the day, resulting in an enhanced ability to execute block trades quickly and anonymously, thereby minimizing market impact and associated price movements.

Nasdaq notes that the Reference Price Crosses are designed to occur at an externally derived price and in accordance with a predetermined algorithm. There would be no price discovery, as orders would not be displayed and prices of orders are not specified, providing minimal information to persons interested in engaging in abusive short sale practices. Nasdaq also states that because a customer cannot predict in advance the final execution price of the cross, which during the trading day will be the mid-point of the NBBO and, for post-close cross executions, the NOCP for Nasdaq-listed securities

Regulation SHO, this decision does not appear to be related to the Commission's views on passive pricing systems.

¹² See e.g., Letter from James A. Brigagliano, Assistant Director, SEC, to Anitra T. Cassas, Wilmer, Cutler & Pickering, LLP (April 22, 2005) (granting ITG an extension of modified exemptive relief from Rule 10a-1 for certain transactions executed through ITG's Portfolio System for Institutional Trading; *see also* Letter from James A. Brigagliano, Acting Associate Director, SEC, to Alan G. Reed, Instinet Group, LLC (June 15, 2006) (granting Instinet an extension of exemptive relief from Rule 10a-1 for transactions executed through Instinet's Intraday Crossing System).

or the Primary Market Close for non-Nasdaq-listed securities, the cross transactions will not exert downward pressure on a subject stock's price. In addition, Nasdaq notes that all short sale orders will be marked in accordance with Rule 200(g) of Regulation SHO.

Furthermore, Nasdaq states that each Reference Price Cross will occur through an automated and random matching mechanism at a randomly selected time during a predetermined one minute trading window so no participant will know precisely when a match will occur, and no participant will be assured of receiving a match. During each one-minute trading window of cross, there will not be solicitation of orders from customers, nor will there be any communication to customers that the match has not yet occurred.

Nasdaq notes that the exemption for the Crossing Network would apply to short sale transactions involving securities that comprise the S&P 500 Index or that qualify as "actively-traded securities" under Regulation M.¹³ If the Reported Security is not an S&P 500 Index security or an "actively-traded security," the exemption would apply only if the transaction is part of a basket transaction of 20 or more securities in which the subject security does not comprise more than five percent of the value of the basket traded.

Nasdaq states that it is working with NASD to develop procedures to monitor for signs of manipulation and suspicious activity, which systems will be in place by the

¹³ 17 CFR 242.101(c)(1). Under Rule 101(c)(1) of Regulation M, actively-traded securities have an average daily trading volume (ADTV) value of at least \$1 million and are issued by an issuer with a public float value of at least \$150 million. For purposes of this letter, the ADTV would be calculated in reference to the date on which the proposed Nasdaq Reference Price Cross is to take place.

launch date of the Crossing Network.¹⁴ Nasdaq states that in connection with these procedures, Nasdaq will advise persons relying on this exemption to participate in the Crossing Network that they may not be represented in the primary market offer or otherwise influence the NBBO at the time of the transaction. Furthermore, Nasdaq states that it will advise such persons that transactions effected on the Crossing Network shall not be made for the purpose of creating actual, or apparent, active trading in or depressing, or otherwise manipulating, the price of any security.

Nasdaq states that the proposed exemption will also remove the disparity in short sale regulation that Nasdaq believes currently exists between markets. Nasdaq asserts that as opposed to Nasdaq, which has voluntarily adopted a short sale rule for Nasdaq securities, several exchanges that trade Nasdaq securities do so with no short sale regulation, encouraging market participants to route short sale orders to their markets to avoid any regulatory restriction. As a result, Nasdaq believes that the level of regulatory protection an investor receives depends almost entirely on the market to which the investor's order is routed. Nasdaq states that this disparity harms customers on all markets by forcing traders to choose between bypassing limit orders posted on Nasdaq, delaying executing those orders, or declining to execute. Nasdaq states that the proposed exemption is designed to help to alleviate these issues.

¹⁴ The surveillance systems specifically designed for the Reference Price Crosses will be in place for the launch of the Reference Price Crosses, currently scheduled for November 6, 2006.

2. Statutory Basis

Nasdaq believes that the proposed rule change, as amended, is consistent with the provisions of Section 6 of the Act,¹⁵ in general, and with Section 6(b)(5) of the Act,¹⁶ in particular, 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.

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

Nasdaq does not believe that the proposed rule change, as amended, will 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

(a) This proposed rule change, as amended, is filed pursuant to paragraph (A) of section 19(b)(3) of the Act.

(b) Because the foregoing rule change does not: (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed,

¹⁵ 15 U.S.C. 78f.

¹⁶ 15 U.S.C. 78f(b)(5).

or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁷ and Rule 19b-4(f)(6) thereunder.¹⁸

At any time within 60 days of the filing of a rule change pursuant to Section 19(b)(3)(A) of the Act, the Commission may summarily abrogate the 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 Act.

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-NASDAQ-2006-036 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-NASDAQ-2006-036. This file number should be included on the subject line if e-mail is used. To help the Commission process

¹⁷ 15 U.S.C. 78s(b)(3)(A).

¹⁸ 17 CFR 240.19b-4(f)(6).

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 Section, 100 F Street, NE, Washington, DC 20549. 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 available

publicly. All submissions should refer to File Number SR-NASDAQ-2006-036 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.¹⁹

Nancy M. Morris
Secretary

¹⁹ 17 CFR 200.30-3(a)(12).