

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-53128; File No. 10-131]

### In the Matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission

January 13, 2006.

#### I. Introduction

On March 15, 2001, The Nasdaq Stock Market, Inc. ("Nasdaq"), a subsidiary of the National Association of Securities Dealers, Inc. ("NASD"), submitted to the Securities and Exchange Commission ("Commission") a Form 1 application ("Form 1") under the Securities Exchange Act of 1934 ("Exchange Act"), seeking registration as a national securities exchange pursuant to section 6 of the Exchange Act.<sup>1</sup> Notice of the application was published for comment in the **Federal Register** on June 13, 2001.<sup>2</sup> On November 13, 2001, December 5, 2001, and January 8, 2002, Nasdaq submitted Amendment Nos. 1,<sup>3</sup> 2,<sup>4</sup> and 3,<sup>5</sup> respectively, to its Form 1. The Commission received 82 comment letters in response to the Original Notice and Amendment Nos. 1, 2, and 3.

On August 15, 2005, and September 23, 2005, Nasdaq submitted Amendment Nos. 4<sup>6</sup> and 5<sup>7</sup> respectively, to its Form 1. In Amendment Nos. 4 and 5, Nasdaq proposed, among other things, a new corporate structure whereby Nasdaq would become a holding company with

two subsidiaries. Nasdaq requested that the Commission grant registration as a national securities exchange to one of its proposed subsidiaries—The Nasdaq Stock Market LLC ("Nasdaq Exchange" or "Exchange").<sup>8</sup> The Commission published notice of Amendment Nos. 4 and 5 on October 11, 2005.<sup>9</sup> In response to the October 2005 Notice, the Commission received 15 comment letters.<sup>10</sup> On December 13, 2005, Nasdaq submitted a response to comment letters received on Amendment Nos. 4 and 5.<sup>11</sup> On January 13, 2006, Nasdaq submitted Amendment No. 6 to its Form 1.<sup>12</sup>

<sup>8</sup> The other subsidiary of Nasdaq would be The Trade Reporting Facility LLC, which would operate the proposed NASD Trade Reporting Facility ("TRF"), which the NASD submitted to the Commission for approval. See Exchange Act Release No. 52049 (July 15, 2005), 70 FR 42398 (July 22, 2005) ("NASD Proposal"). As described in the NASD Proposal, the TRF would be available to NASD members for the reporting of trades executed in the internal systems of NASD members.

<sup>9</sup> See Exchange Act Release No. 52559 (October 4, 2005), 70 FR 59097 ("October 2005 Notice"). Complete copies of Nasdaq's Amendment Nos. 4 and 5 to its Form 1 are available in the Commission's Public Reference Room, File No. 10-131. Portions of Nasdaq's Form 1, as amended by Amendment Nos. 4 and 5, including the Nasdaq Exchange's proposed rules, are available on the Commission's Internet Web site (<http://www.sec.gov>).

<sup>10</sup> See letters from Steven I. Weissman, P.A., dated October 9, 2005 and December 18, 2005 ("Weissman Letters"); Brad Smith et al., International Association of Small Broker Dealers and Advisors, received October 12, 2005 ("SBDA Letter"); Representative Ginny Brown-Waite et al., House Financial Services Committee, Members of Congress, dated October 31, 2005 ("House Financial Services Committee Letter"); Michael J. Simon, International Securities Exchange, Inc., dated November 3, 2005 ("ISE Letter"); Carolyn McCarthy, Member of Congress, dated November 3, 2005 ("Carolyn McCarthy Letter"); James T. Brett, Managing Director, J.P. Morgan Securities, Inc., dated November 4, 2005 ("J.P. Morgan Letter"); Michael Santucci, President, Kimberly Unger, Executive Director, and Stephen J. Nelson, Co-Chair STANY Trading Issues Committee, The Security Traders Association of New York, Inc., dated November 8, 2005 ("STANY Letter"); Vito Fossella, Member of Congress, dated November 8, 2005 ("Vito Fossella Letter"); Jeffrey W. Rubin, Partner, Hogan & Hartson L.L.P., dated November 9, 2005 ("Nissan Letter"); Senator Chuck Hagel et al., United States Senate, dated November 9, 2005 ("Senator Chuck Hagel et al. Letter"); Kevin J.P. O'Hara, Chief Administrative Officer and General Counsel, Archipelago Holdings, Inc., dated November 10, 2005 ("Arca Letter"); Mary Yeager, Assistant Secretary, New York Stock Exchange, Inc., dated November 10, 2005 ("NYSE Letter"); Kim Bang, Bloomberg L.P., dated November 17, 2005 ("Bloomberg Letter"); and James A. Duncan, Chairman, and John C. Giesea, President/CEO, Security Traders Association, dated November 17, 2005 ("STA Letter").

<sup>11</sup> See letter to Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated December 13, 2005 ("Nasdaq Response Letter").

<sup>12</sup> See letter to Robert L.D. Colby, Deputy Director, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 13, 2006 ("Amendment No. 6"). Amendment No. 6, among other things, revises the proposed rules of the

Nasdaq's original proposal raised significant regulatory concerns. As originally proposed, Nasdaq's exchange would have expanded what has traditionally been recognized as an exchange. In particular, commenters noted that Nasdaq's original application proposed to operate an exchange without intra-market priority rules.<sup>13</sup> Intra-market priority rules require orders in the same securities directed to an exchange to interact with each other. By contrast, Nasdaq had proposed to permit members to report transactions on the Nasdaq exchange without providing price protection to orders displayed in Nasdaq. Commenters argued that if the Commission approved these rules, it would have to reverse its longstanding position that exchanges have a central limit order book with priority over dealer trades on the exchange, and permit other exchanges to adopt similar rules.<sup>14</sup> Commenters also took issue with Nasdaq's broad definition of what it proposed to be a

Nasdaq Exchange to reflect the NASD rule changes filed and approved by the Commission since Nasdaq filed Amendment No. 4, including, for example, the rules that govern executions on the INET system and Rule 2111, which would prohibit Nasdaq Exchange members and persons associated with Nasdaq Exchange members from trading ahead of a customer's market order. See Exchange Act Release No. 52226 (August 9, 2005), 70 FR 48219 (August 16, 2005). See Nasdaq Exchange Rule 4950 Series. See Exchange Act Release No. 52902 (December 7, 2005), 70 FR 73810 (December 13, 2005) ("INET Order"). In addition, in Amendment No. 6, Nasdaq proposes: (1) A new Rule 4305, which is a transitional listing rule for securities included on Nasdaq, as a facility of the NASD, the day prior to the Nasdaq Exchange commencing operations as a national securities exchange; (2) a new Rule 4720 that sets forth the timing on consolidating the Nasdaq Exchange's three trading systems; (3) a new Rule 4121, regarding trading halts; (4) amendments to Exchange By-Law Article III, section 5(e) to clarify the responsibilities of the Regulatory Oversight Committee; (5) a new Rule 0150 requiring the Nasdaq Exchange to contract out those regulatory functions subject to the Regulatory Contract, *supra* notes 107—112 and accompanying text, to the NASD, an affiliate of NASD, or an independent self-regulatory organization, unless Nasdaq Exchange obtains prior Commission approval to do otherwise; and (6) to amend Rules 1002(e) and 1014(a)(15) to require that members maintain membership in another registered securities association that is not registered solely under section 15A(k) of the Exchange Act or another registered exchange that is not registered solely under section 6(g) of the Exchange Act.

<sup>13</sup> See letters from Cameron Smith, General Counsel, The Island ECN, Inc., dated August 26, 2001 ("Island Letter"); Jeffrey T. Brown, Vice President, Regulation and General Counsel, Cincinnati Stock Exchange, dated August 28, 2001 ("CSE Letter"); James E. Buck, Senior Vice President, New York Stock Exchange, dated August 27, 2001 ("NYSE August 2001 Letter"); and Darla C. Stuckey, Corporate Secretary, New York Stock Exchange, dated February 14, 2002 ("NYSE February 2002 Letter").

<sup>14</sup> See CSE Letter and Island Letter, *supra* note 13; and letter from Edward J. Joyce, President, Chief Operating Officer, Chicago Board Options Exchange, dated August 27, 2001 ("CBOE Letter").

<sup>1</sup> 15 U.S.C. 78f.

<sup>2</sup> See Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 ("Original Notice"). The Commission extended the comment period for the Original Notice for 30 days. See Exchange Act Release No. 44625 (July 31, 2001), 66 FR 41056 (August 6, 2001).

<sup>3</sup> See letter to Annette Nazareth, Director, Division of Market Regulation ("Division"), Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated November 13, 2001 ("Amendment No. 1").

<sup>4</sup> See letter to Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated December 5, 2001 ("Amendment No. 2").

<sup>5</sup> See letter to Annette Nazareth, Director, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 8, 2002 ("Amendment No. 3").

<sup>6</sup> See letter to Robert L.D. Colby, Deputy Director, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated August 15, 2005 ("Amendment No. 4"). Amendment No. 4 supersedes and replaces the Original Notice and Amendment Nos. 1, 2, and 3.

<sup>7</sup> See letter to Robert L.D. Colby, Deputy Director, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated September 23, 2005 ("Amendment No. 5").

“Nasdaq transaction.”<sup>15</sup> In particular, Nasdaq proposed to include as a “Nasdaq transaction” certain transactions reported to Nasdaq that were executed otherwise than by using the systems of the Nasdaq exchange. In addition, Nasdaq members not required to report such transactions to Nasdaq would be permitted to do so. A number of commenters expressed significant concern about Nasdaq’s proposal to permit Nasdaq members to report, to the Nasdaq exchange, trades that had always been considered over-the-counter (“OTC”) market trades.<sup>16</sup>

Nasdaq proposes in Amendment Nos. 4 and 5 to address these concerns by limiting Nasdaq Exchange transactions to only those trades that are executed in the Exchange’s systems and to amend its Exchange systems to require executions to occur pursuant to price priority rules. Trades that are executed otherwise than on the Nasdaq Exchange or any other national securities exchange would continue to be reported to the NASD either to its Alternative Display Facility (“ADF”) or its proposed TRF.<sup>17</sup>

In response to the October 2005 Notice, the Commission received several comments in support of Nasdaq’s amended application to register the Nasdaq Exchange as a national securities exchange.<sup>18</sup> Specific concerns raised by other commenters are discussed below.<sup>19</sup>

<sup>15</sup> See CSE Letter, Island Letter, NYSE August 2001 Letter, and NYSE February 2002 Letter, *supra* note 13; and letters from George W. Mann, Jr., Senior Vice President and General Counsel, Boston Stock Exchange, dated July 20, 2001; Sol Reicher, Co-Chairman, Amex Specialists Associations, John Hawkey, Chairman, Amex Floor Brokers Association, and Ross Moore, Chairman, Amex Options Market Maker Association, writing on behalf of the Member Associations of the American Stock Exchange, dated July 30, 2001 (“Member Associations of the American Stock Exchange Letter”); Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, dated August 30, 2001 (representing the interests of some of its members) (“SIA Letter”); Douglas M. Atkin, President, Chief Executive Officer, Instinet, dated August 28, 2001 (“Instinet Letter”); Kevin M. Foley, Bloomberg L.P. and Bloomberg Tradebook LLC, dated August 28, 2001 (“Bloomberg 2001 Letter”); and Meyer S. Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, dated September 4, 2001 and February 25, 2002 (“Phlx Letters”).

<sup>16</sup> See NYSE August 2001 Letter and NYSE February 2002 Letter, *supra* note 13; and Instinet Letter, Member Associations of the American Stock Exchange Letter, Phlx Letters, SIA Letter, *supra* note 15.

<sup>17</sup> See NASD Proposal, *supra* note 8.

<sup>18</sup> See Carolyn McCarthy Letter, House Financial Services Committee Letter, ISE Letter, J.P. Morgan Hagel, NYSE Letter (with proviso), Senator Chuck Hagel et al. Letter, STA Letter, STANY Letter, Vito Fossella Letter, *supra* note 10.

<sup>19</sup> The Commission received two comments not directly related to the Nasdaq Exchange’s registration. One commenter voiced concern about the NASD’s responsibility over the Over-the-

## II. Statutory Standards

Under sections 6(b) and 19(a) of the Exchange Act,<sup>20</sup> the Commission shall by order grant a registration as a national securities exchange if it finds that the exchange is so organized and has the capacity to carry out the purposes of the Exchange Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange. The rules of the exchange, among other things, must be adequate to insure fair dealing and to protect investors, and may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

As discussed in greater detail below, the Commission finds that Nasdaq’s application for exchange registration meets the requirements of the Exchange Act and the rules and regulations thereunder. Further, the Commission finds that the proposed rules of the Nasdaq Exchange as proposed in Amendment Nos. 4 and 5<sup>21</sup> and further amended by Amendment No. 6<sup>22</sup> are consistent with section 6 of the Exchange Act in that, among other things, they are designed to: (1) Assure fair representation of an exchange’s members in the selection of its directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer; (2) prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanisms of a free and open market and a national market system; and (3) protect investors and the public interest. The Commission also believes that the rules of the Nasdaq Exchange are consistent with 11A of the

Counter Bulletin Board. See SBDA Letter, *supra* note 10. In response, Nasdaq noted that the issue of the NASD’s regulatory responsibility over the Over-the-Counter Bulletin Board has already been addressed by the Commission. See Nasdaq Response Letter, *supra* note 11. Another commenter alleged that Nasdaq violated Section 17(b) of the Securities Act of 1933 by allegedly “touting” Nasdaq-listed companies. See Weissman Letters, *supra* note 10. Nasdaq responded by noting that this issue is currently in litigation. See Nasdaq Response Letter, *supra* note 11.

<sup>20</sup> 15 U.S.C. 78f(b) and 78s(a).

<sup>21</sup> See Amendment No. 4 and Amendment No. 5, *supra* notes 6 and 7.

<sup>22</sup> See Amendment No. 6, *supra* note 12.

Exchange Act. Finally, the Commission finds that the proposed rules of the Nasdaq Exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>23</sup>

## III. Discussion

### A. Corporate Structure

Prior to 2000, Nasdaq was a wholly-owned subsidiary of the NASD. In 2000, the NASD began restructuring its relationship with Nasdaq. As the result of a two-phase private placement of Nasdaq shares, a public offering completed in January 2005, and other dispositions by the NASD of Nasdaq shares, the NASD’s ownership interest in Nasdaq has been reduced to about 26%.<sup>24</sup> Notwithstanding its minority ownership interest in Nasdaq, the NASD has retained control of Nasdaq through its ownership of one outstanding share of Series D preferred stock, which 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. This share of Series D preferred stock allows the NASD to continue to retain control over Nasdaq.<sup>25</sup> The Series D preferred share will expire when Nasdaq ceases to operate pursuant to the NASD’s Plan of Allocation and Delegation of Functions by the NASD to Subsidiaries (“Delegation Plan”).

As noted above, Nasdaq proposes to convert to a holding company (“Nasdaq Holding Company”),<sup>26</sup> which would have two subsidiaries: (1) The Nasdaq Exchange; and (2) The Trade Reporting Facility LLC, which would operate the proposed new NASD TRF. Nasdaq filed its corporate documents for the proposed Nasdaq Holding Company and proposed Exchange. According to Nasdaq, it plans to transfer all or

<sup>23</sup> 15 U.S.C. 78f(b)(8).

<sup>24</sup> As of December 6, 2005, the NASD had beneficial ownership of 22,138,996 shares of the common stock of Nasdaq. This includes 17,590,968 shares of common stock underlying warrants and 4,548,028 shares of common stock held by the NASD. Of the 17,590,968 shares underlying warrants, 6,849,849 of the shares of common stock underlying warrants have been exercised by the holders of such warrants. The NASD, however, retains the right to vote these shares pursuant to a voting trust agreement. Upon approval of the application to register the Nasdaq Exchange as a national securities exchange, the NASD’s beneficial ownership of shares underlying the exercised warrants will terminate. See Amendment No. 4, Exhibit K, *supra* note 6.

<sup>25</sup> See Exchange Act Release No. 53022 (December 23, 2005), 70 FR 77433 (December 30, 2005). In this filing, Nasdaq replaced a Preferred B share that had provided the NASD with control over Nasdaq with the Preferred D share.

<sup>26</sup> Current Nasdaq shareholders will receive shares in the holding company, making it the publicly-traded company.

substantially all of its assets and liabilities to the subsidiaries of the Nasdaq Holding Company.

#### 1. Self-Regulatory Function of the Exchange; Relationship between Nasdaq Holding Company and the Nasdaq Exchange; Jurisdiction Over Nasdaq Holding Company

Although Nasdaq Holding Company will not itself carry out regulatory functions, its activities with respect to the operation of the Exchange must be consistent with, and not interfere with, the Exchange's self-regulatory obligations. The proposed Nasdaq Holding Company corporate documents include certain provisions that are designed to maintain the independence of the Nasdaq Exchange's self-regulatory function from the Nasdaq Holding Company, enable the Exchange to operate in a manner that complies with the federal securities laws, including the objectives of sections 6(b) and 19(g) of the Exchange Act, and facilitate the ability of the Exchange and the Commission to fulfill their regulatory and oversight obligations under the Exchange Act.<sup>27</sup> For example, the Nasdaq Holding Company submitted to the Commission's jurisdiction with respect to activities relating to the Nasdaq Exchange,<sup>28</sup> and agreed to provide the Commission with access to its books and records.<sup>29</sup> Nasdaq Holding Company also agreed to keep confidential non-public information relating to the self-regulatory function<sup>30</sup> of the Exchange and not to use such information for any non-regulatory purpose.<sup>31</sup> In addition, the board of directors of the Nasdaq Holding Company, as well as its officers, employees, and agents are required to give due regard to the preservation of the independence of the Exchange's self-regulatory function.<sup>32</sup> Finally, the Nasdaq Holding Company By-Laws require that any changes to the Nasdaq Holding Company Certificate of

Incorporation and By-Laws be submitted to the Board of Directors of the Nasdaq Exchange ("Exchange Board"), and, if the Exchange Board determines that such amendment is required to be filed with the Commission pursuant to section 19(b) of the Exchange Act, such change shall not be effective until filed with, or filed with and approved by, the Commission.<sup>33</sup> The Commission believes that these provisions are consistent with the Exchange Act.<sup>34</sup>

The Commission also believes that under section 20(a) of the Exchange Act<sup>35</sup> any person with a controlling interest in the Nasdaq Holding Company would be jointly and severally liable with and to the same extent that Nasdaq Holding Company is liable under any provision of the Exchange Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, section 20(e) of the Exchange Act<sup>36</sup> creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Exchange Act or rule thereunder. Further, section 21C of the Exchange Act<sup>37</sup> authorizes the Commission to enter a cease-and-desist order against any person who has been "a cause of" a violation of any provision of the Exchange Act through an act or omission that the person knew or should have known would contribute to the violation.

#### 2. Changes in Control of the Nasdaq Exchange; Ownership and Voting Limitations

The Nasdaq Holding Company's Restated Certificate of Incorporation imposes limits on direct and indirect changes in control, which are designed to prevent any shareholder from exercising undue control over the operation of the Exchange and to ensure that the Exchange and the Commission are able to carry out their regulatory obligations under the Exchange Act.

Specifically, no person who beneficially owns shares of common stock, preferred stock, or notes in excess of five percent of the securities generally entitled to vote may vote the shares in excess of five percent.<sup>38</sup> This five percent voting limitation does not apply, however, to the NASD or its affiliates until such time as the NASD beneficially owns five percent or less of Nasdaq's outstanding stock or notes. In addition, the Nasdaq Holding Company Board may approve exemptions from the five percent voting limitation for any person that is not a broker-dealer, an affiliate of a broker-dealer, or a person subject to a statutory disqualification under section 3(a)(39) of the Exchange Act.<sup>39</sup> Any such exemption from the five percent voting limitation would not be effective until approved by the Commission pursuant to section 19 of the Exchange Act.<sup>40</sup>

The Nasdaq Exchange's proposed rules also prohibit Exchange members and persons associated with Exchange members from beneficially owning more than 20 percent of the then-outstanding voting securities of the Nasdaq Holding Company.<sup>41</sup> Members that trade on an exchange traditionally have ownership interests in such exchange. As the Commission has noted in the past, however, a member's interest in an exchange could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member.<sup>42</sup> A member that is a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the Federal securities laws with respect to conduct by the member that violates such provisions.

The Commission believes that these ownership and voting restrictions are consistent with the Exchange Act. These ownership limitations should minimize the potential that a person could improperly interfere with or restrict the ability of the Commission or the

<sup>27</sup> See Nasdaq Holding Company By-Laws Article XI, section 11.3; Article XII, sections 12.1, 12.2, 12.3, 12.4, and 12.5.

<sup>28</sup> See Nasdaq Holding Company By-Laws Article XII, section 12.3.

<sup>29</sup> See Nasdaq Holding Company By-Laws Article XII, section 12.1(b).

<sup>30</sup> This requirement to keep confidential non-public information relating to the self-regulatory function shall not limit the Commission's ability to access and examine such information or limit the ability of directors, officers, or employees of the Nasdaq Holding Company from disclosing such information to the Commission. See Nasdaq Holding Company By-Laws Article XII, section 12.1(b).

<sup>31</sup> See Nasdaq Holding Company By-Laws Article XII, section 12.1(b).

<sup>32</sup> See Nasdaq Holding Company By-Laws Article XII, section 12.1(a).

<sup>33</sup> See Nasdaq Holding Company Restated Certificate of Incorporation Article Eighth.B. and Nasdaq Holding Company By-Laws Article XI, section 11.3.

<sup>34</sup> The Commission notes that it is in the process of reviewing issues related to new ownership structures of SROs and has proposed rules relating to the governance and ownership of SROs, including limiting the restrictions on ownership and voting to members of an SRO or a facility of an SRO. See Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 18, 2004).

<sup>35</sup> 15 U.S.C. 78t(a).

<sup>36</sup> 15 U.S.C. 78t(e).

<sup>37</sup> 15 U.S.C. 78u-3.

<sup>38</sup> See Nasdaq Holding Company Restated Certificate of Incorporation Article Fourth.C.

<sup>39</sup> 15 U.S.C. 78c(a)(39). See Nasdaq Holding Company Restated Certificate of Incorporation Article Fourth.C.6.

<sup>40</sup> See Nasdaq Holding Company By-Laws Article XII, Section 12.5.

<sup>41</sup> See Nasdaq Exchange Rule 2130.

<sup>42</sup> See Exchange Act Release Nos. 51149 (February 8, 2005), 70 FR 7531 (February 14, 2005) (SR-CHX-2004-26); 49718 (May 17, 2004), 69 FR 29611 (May 24, 2004) (SR-PCX-2004-08); 49098 (January 16, 2004), 69 FR 3974 (January 27, 2004) (SR-Phlx-2003-73); and 49067 (January 13, 2004), 69 FR 2761 (January 20, 2004) (SR-BSE-2003-19).

Exchange to effectively carry out their regulatory oversight responsibilities under the Exchange Act.

### 3. The Nasdaq Exchange

Nasdaq has applied to the Commission to register its wholly-owned subsidiary, the Nasdaq Exchange, as a national securities exchange. As part of its exchange application, Nasdaq has filed the proposed Nasdaq Exchange Limited Liability Company Agreement ("Exchange LLC Agreement") and Exchange By-Laws. In these documents, among other things, Nasdaq establishes the composition of the Exchange Board and the Exchange committees.

#### a. The Nasdaq Exchange Board of Directors

The Exchange Board will be the governing body of the Nasdaq Exchange and possess all of the powers necessary for the management of the business and affairs of the Nasdaq Exchange and the execution of its responsibilities as an SRO. Under the Exchange By-Laws:

- Twenty percent of the directors on the Exchange Board will be "Member Representative Directors;"<sup>43</sup>
- The number of "Non-Industry Directors"<sup>44</sup> will equal or exceed the sum of the number of "Industry Directors"<sup>45</sup> and "Member Representative Directors;"<sup>46</sup>
- The Exchange Board will include at least one "Public Director;"<sup>47</sup>

<sup>43</sup> See Exchange LLC Agreement, Section 9(a). "Member Representative Director" means a Director "who has been elected or appointed after having been nominated by the Member Nominating Committee or by a Nasdaq [Exchange] Member \* \* \*." See Exchange By-Laws Article I(q).

<sup>44</sup> "Non-Industry Director" means a "Director (excluding Staff Directors) who is (i) a Public Director; (ii) an officer or employee of an issuer of securities listed on the national securities exchange operated by the [Exchange]; or (iii) any other individual who would not be an Industry Director." See Exchange By-Laws Article I(v).

<sup>45</sup> Generally, an "Industry Director" is, among other things, a Director that is or has been an officer, director, employee, or owner of a broker-dealer. In addition, persons who have a consulting or employment relationship with the Exchange, its affiliates, or the NASD are considered "Industry." See Exchange By-Laws Article I(l).

<sup>46</sup> See Exchange By-Laws Article III, section 2(a).

<sup>47</sup> See *id.* Nasdaq proposes that the Audit Committee would include at least two Public Directors and the Regulatory Oversight Committee ("ROC") would include at least three Public Directors. Accordingly, the Exchange Board would also have to include at least three Public Directors. See Exchange By-Laws Article III, section 5(e) and (d). "Public Director" means a "Director who has no material business relationship with a broker or dealer, the [Exchange] or its affiliates, or the NASD." See Exchange By-Laws Article I(y). Public Directors that serve on the ROC must also satisfy independence requirements applicable to Nasdaq Exchange issuers set forth in Exchange Rule 4200. See Nasdaq Exchange By-Laws Article III, section 5(e).

• The Exchange Board will include at least one issuer representative (or at least two if the Exchange Board consists of ten or more members);<sup>48</sup> and

• Up to two officers of the Nasdaq Exchange ("Staff Directors") may be elected to the Exchange Board.<sup>49</sup>

On December 14, 2005, Nasdaq Holding Company elected the initial directors of the Exchange Board pursuant to the Exchange LLC Agreement.<sup>50</sup> The initial Exchange Board is the current Board of Directors of the Nasdaq Holding Company who were elected pursuant to the procedures set forth in the current Nasdaq By-Laws. The initial Exchange Board is balanced: the number of Non-Industry Directors exceeds the number of Industry Directors and there are four Public Directors and four issuer representatives. These Directors were selected by the Nasdaq Nominating Committee, and elected by a majority vote of the Board of Governors of the NASD, which includes representatives of NASD members. No Nasdaq Exchange members participated in the selection of directors for the initial board because the Exchange does not yet have members. In light of these circumstances, and Nasdaq's representation that it expects to elect a new Exchange Board at the same time the Nasdaq Holding Company holds its annual meeting in Spring 2006, the Commission believes that the initial Exchange Board is consistent with the Exchange Act.

For subsequent boards, the Exchange Board will appoint a Nominating Committee and a Member Nominating Committee. The Member Nominating Committee will nominate candidates for each Member Representative Director position on the Exchange Board, as well as nominate candidates for appointment by the Exchange Board for each vacant or new position on a committee that is to be filled with a Member Representative under the Exchange By-Laws. Additional candidates may be added to the list of candidates for the Member Representative Director positions if a Nasdaq Exchange Member submits a timely and duly executed written nomination to the Secretary of

<sup>48</sup> See Exchange By-Laws Article III, section 2(a).

<sup>49</sup> These Staff Directors will be considered "neutral" and not as either Industry or Non-Industry Directors. See Exchange By-Laws Article I(l). See also Exchange Act Release No. 44280 (May 8, 2001), 66 FR 26892 (May 15, 2001) (SR-NASD-2001-06) (approving amendment to NASD By-Laws to allow for the treatment of staff Governors as "neutral" for purposes of Industry/Non-Industry balancing on the NASD Board of Governors).

<sup>50</sup> See Exchange LLC Agreement, section 9 and Schedule C.

the Nasdaq Exchange.<sup>51</sup> These candidates, together with those nominated by the Member Nominating Committee, will then be presented to Exchange members for election.<sup>52</sup> The Nominating Committee will nominate candidates for all other vacant or new Director positions on the Exchange Board, the Nasdaq Listing and Hearing Review Council, and the Nasdaq Review Council.

The Commission believes that the requirement in the Exchange By-Laws that twenty percent of the directors be "Member Representative Directors" and the means by which they are elected by members provides for the fair representation of members in the selection of directors and the administration of the Exchange consistent with the requirement in section 6(b)(3) of the Exchange Act.<sup>53</sup> This requirement helps to ensure that members have a voice in the use of self-regulatory authority, and that an exchange is administered in a way that is equitable to all those who trade on its market or through its facilities.

The Commission has previously stated its belief that the inclusion of public, non-industry representatives on exchange oversight bodies is critical to an exchange's ability to protect the public interest.<sup>54</sup> Further, public representatives help to ensure that no single group of market participants has the ability to systematically disadvantage other market participants through the exchange governance process. The Commission believes that public directors can provide unique, unbiased perspectives, which should enhance the ability of the Exchange Board to address issues in a non-discriminatory fashion and foster the integrity of the Nasdaq Exchange. The Commission believes that the Nasdaq Exchange Board satisfies the requirements in section 6(b)(3) of the Exchange Act,<sup>55</sup> which requires that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer.<sup>56</sup>

<sup>51</sup> See Exchange By-Laws Article II, section 1(c).

<sup>52</sup> See Exchange By-Laws Article II.

<sup>53</sup> 15 U.S.C. 78f(b)(3).

<sup>54</sup> See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release").

<sup>55</sup> 15 U.S.C. 78f(b)(3).

<sup>56</sup> See also *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, Exchange Act Release No. 37538 (August 8, 1996), Administrative Proceeding File No. 3-9056 ("1996 Settlement

## b. The Nasdaq Exchange Committees

In the Exchange By-Laws, the Nasdaq Exchange has proposed to establish several committees. Specifically, the Exchange has proposed to establish the following committees that would be composed solely of directors: An Executive Committee,<sup>57</sup> a Finance Committee,<sup>58</sup> a Management Compensation Committee,<sup>59</sup> an Audit Committee,<sup>60</sup> and a ROC.<sup>61</sup> In addition, the Exchange has proposed to establish these other committees that are not required to be composed solely of directors: a Nasdaq Listing and Hearing Review Committee,<sup>62</sup> a Nasdaq Review Council ("NRC"),<sup>63</sup> a Nominating Committee,<sup>64</sup> a Member Nominating Committee,<sup>65</sup> a Quality of Markets Committee,<sup>66</sup> a Market Operations Review Committee,<sup>67</sup> an Arbitration and Mediation Committee,<sup>68</sup> and a Market Regulation Committee.<sup>69</sup> The Commission believes that the Exchange's proposed committees should enable it to carry out its responsibilities under the Exchange Act.

The Exchange has proposed that the composition of certain committees be consistent with the 1996 Settlement Order. These committees include the Nominating Committee, the Quality of Markets Committee, the Arbitration and Mediation Committee,<sup>70</sup> the Market

Order"). Simultaneously with issuing this Order, the Commission also published a Report pursuant to section 21(a) of the Exchange Act regarding the NASD and the Nasdaq market. See Report and Appendix to Report Pursuant to section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market (August 8, 1996). As a subsidiary of the NASD, Nasdaq is currently bound by the 1996 Settlement Order settling an enforcement action against the NASD. In conjunction with the Nasdaq Exchange's application to register as an exchange, Nasdaq submitted a letter to the Commission affirming that the Nasdaq Exchange will comply with the 1996 Settlement Order except as specified. See letter to Robert L.D. Colby, Deputy Director, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 11, 2006. Consistent with the 1996 Settlement Order, the Exchange Board structure has at least fifty percent independent public and non-industry membership.

<sup>57</sup> See Exchange By-Laws Article III, section 5(a).

<sup>58</sup> See Exchange By-Laws Article III, section 5(b).

<sup>59</sup> See Exchange By-Laws Article III, section 5(c).

<sup>60</sup> See Exchange By-Laws Article III, section 5(d).

<sup>61</sup> See Exchange By-Laws Article III, section 5(e).

<sup>62</sup> See Exchange By-Laws Article V.

<sup>63</sup> See Exchange By-Laws Article VI.

<sup>64</sup> See Exchange By-Laws Article III, section 6(b).

<sup>65</sup> *Id.*

<sup>66</sup> See Exchange By-Laws Article III, section 6(c).

<sup>67</sup> See Exchange By-Laws Article III, section 6(d).

<sup>68</sup> See Exchange By-Laws Article III, section 6(e).

<sup>69</sup> See Exchange By-Laws Article III, section 6(f).

<sup>70</sup> The Exchange By-Laws provide that the Arbitration and Mediation Committee shall consist of no fewer than 10 and no more than 25 members, and shall have at least 50 percent Non-Industry members. See Exchange By-Laws Article III, section

Regulation Committee,<sup>71</sup> the NRC,<sup>72</sup> the Management Compensation Committee, and the Audit Committee.<sup>73</sup> Each of these committees is compositionally balanced as they each must be composed of at least 50 percent Non-Industry members. The Commission believes that these committees' compositional balance is consistent with the 1996 Settlement Order.

## B. Regulation of the Nasdaq Exchange

As a prerequisite for the Commission's approval of an exchange's application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Exchange Act.<sup>74</sup> Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the federal securities laws and the rules of the exchange.<sup>75</sup>

### 1. Membership

Nasdaq proposes that the criteria for membership in the Nasdaq Exchange be substantially the same as the criteria currently applicable to firms applying for membership in the NASD.<sup>76</sup> Unlike

5(e)(ii). The Arbitration and Mediation Committee may be maintained on the Exchange's behalf by a regulatory services provider (e.g., the NASD). See Exchange By-Laws Article III, section 5(e). ("The Board shall appoint an Arbitration and Mediation Committee, or shall cause the [Exchange] to enter into an agreement with a self-regulatory organization that provides regulatory services pursuant to which such self-regulatory organization shall appoint an Arbitration and Mediation Committee on the Company's behalf."). In the event that a regulatory services provider appoints an Arbitration and Mediation Committee on the Nasdaq Exchange's behalf, it must comply with the compositional and other requirements set forth in the Exchange By-Laws with respect to such committee.

<sup>71</sup> The Market Regulation Committee is the successor to the Market Surveillance Committee. See Exchange Act Release Nos. 38545 (April 24, 1997), 62 FR 25226 (May 8, 1997); and 38908 (August 7, 1997), 62 FR 43385 (August 13, 1997).

<sup>72</sup> The Nasdaq Exchange will not maintain a National Business Conduct Committee. Its appellate level disciplinary body, the NRC, however, is composed of a majority of Non-Industry Directors consistent with the 1996 Settlement Order. See Exchange By-Laws Article VI, section 2. The NRC will be appointed by the Exchange Board and will, among other things, preside over appeals or reviews of disciplinary proceedings, statutory disqualification proceedings, and membership proceedings. See Exchange By-Laws Article VI, section 1.

<sup>73</sup> Consistent with the 1996 Settlement Order, the Audit Committee is composed of a majority of Non-Industry Directors and is chaired by a Public Director. See Exchange By-Laws Article III, section 5(d).

<sup>74</sup> See section 6(b)(1) of the Exchange Act; 15 U.S.C. 78f(b)(1).

<sup>75</sup> *Id.* See also section 19(g) of the Exchange Act; 15 U.S.C. 78s(g).

<sup>76</sup> See Nasdaq Exchange Rule 1010 Series. The Nasdaq Exchange's proposed membership By-Laws and rules essentially mirror the NASD's By-Laws

the NASD rules, however, the Nasdaq Exchange's proposed rules require a broker-dealer to be a member of at least one other SRO before applying for membership in the Exchange and to remain a member of another SRO.<sup>77</sup>

Current NASD members will be able to apply through an expedited process to become a Nasdaq Exchange member, and to register with the Exchange all of their associated persons whose registrations were approved with the NASD, by submitting a Waive-in Membership Application Form and a Membership Agreement.<sup>78</sup> All of the firm's associated persons who are registered in categories recognized by Exchange rules would become registered persons of a Nasdaq Exchange member firm.

Broker-dealers that are not members of the NASD and new broker-dealers that are not yet members of another SRO may apply for membership in the Nasdaq Exchange and comply with the Exchange Rule 1010 Series. Firms that apply to become both NASD and Exchange members simultaneously may file one full membership application with the NASD in compliance with the NASD Rule 1010 Series.<sup>79</sup> New broker-dealers that wish to become members of the Nasdaq Exchange and an SRO other than the NASD must submit a complete application form with all of the information required of new applicants in Exchange Rule 1013(a)(2).<sup>80</sup> The Nasdaq Exchange will consider the application for membership in the Exchange after its membership in the other SRO has been approved.

The Exchange has contracted with NASD Regulation ("NASDR"), the NASD's wholly-owned subsidiary, to which the NASD has delegated the performance of certain of its regulatory obligations,<sup>81</sup> to perform certain

and Rule 1010 series. In Amendment No. 6, Nasdaq updated proposed Nasdaq Exchange Rule IM-1000-2 to reflect a proposed rule change, which clarified the scope of the relief provided to registered representatives called into active military duty. See Exchange Act Release No. 52980 (December 19, 2005), 70 FR 76477 (December 27, 2005).

<sup>77</sup> See Nasdaq Exchange Rules 1002(e) and 1014(a)(15). In Amendment No. 6, Nasdaq amended these rules to amend Rules 1002(e) and 1014(a)(15) to require that members maintain membership in another registered securities association that is not registered solely under section 15A(k) of the Exchange Act or another registered exchange that is not registered solely under section 6(g) of the Exchange Act. See *supra* note 12. NASD membership is required, in particular, for applicants that will transact business with the public. See also section 15(b)(8) of the Exchange Act and Rule 15b9-1 thereunder. 15 U.S.C. 78o(b)(8); 17 CFR 240.15b9-1.

<sup>78</sup> See Nasdaq Exchange Rule 1013(a)(6)(C).

<sup>79</sup> See Nasdaq Exchange Rule 1013(a)(6)(A).

<sup>80</sup> See Nasdaq Exchange Rule 1013(a)(6)(B).

<sup>81</sup> See Delegation Plan.

regulatory functions on its behalf (the "Regulatory Contract").<sup>82</sup> Under the Regulatory Contract, NASDR will perform certain membership functions for the Nasdaq Exchange. Specifically, NASDR will accept and review all applications for membership in the Exchange, and receive and process membership applications through the Central Registration Depository ("CRD") system pursuant to the Exchange's membership rules.<sup>83</sup> NASDR will evaluate the applications and make recommendations to the Exchange about whether they should be approved or denied. The Nasdaq Exchange will make the ultimate decision on whether to accept a broker-dealer as a member.<sup>84</sup>

Appeals of staff denials of membership will be heard by the NRC.<sup>85</sup> Decisions of this committee will be final, but may be called for review by the Exchange Board.<sup>86</sup> This process is consistent with the current process by which the NASD Board of Directors may call for review membership decisions made by the NASD's National Adjudicatory Council.

The Nasdaq Exchange also proposes to require that all broker-dealer applicants include an original Nasdaq Exchange-approved fingerprint card for each associated person of the applicant subject to section 17(f)(2) of the Exchange Act and Rule 17f-2 thereunder<sup>87</sup> for whom a fingerprint card has not been filed with another SRO.<sup>88</sup> The Nasdaq Exchange's rules also permit the Exchange to make the registration of a person effective pending receipt of a fingerprint card.<sup>89</sup> Section 17(f)(2) of the Exchange Act and Rule 17f-2(a) thereunder<sup>90</sup> states that every member of a national securities exchange shall require that each of its partners, directors, officers and employees be fingerprinted, and shall submit such fingerprints, or cause the

fingerprints, to be submitted to the Attorney General of the United States for identification and appropriate processing. Exchange Act Rule 17f-2(c)<sup>91</sup> permits a national securities exchange to file a fingerprint plan with the Commission that will facilitate the submission of fingerprints to the Attorney General. Because the Exchange's rules contemplate that the Exchange will facilitate the submission of fingerprints to the Attorney General on behalf of its members as permitted by Exchange Act Rule 17f-2(c), as a condition to the operation of the Nasdaq Exchange, a fingerprint plan must be filed by the Nasdaq Exchange under Exchange Act Rule 17f-2 and declared effective by the Commission.

The Commission finds that the Nasdaq Exchange's membership rules are consistent with section 6 of the Exchange Act,<sup>92</sup> specifically section 6(b)(2) of the Exchange Act,<sup>93</sup> which requires that a national securities exchange have rules that provide that any registered broker or dealer may become a member and any person may become associated with an exchange member. The Commission notes that pursuant to section 6(c) of the Exchange Act, an exchange must deny membership to non-registered broker-dealers and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity. As a registered exchange, the Nasdaq Exchange must independently determine if an applicant satisfies the standards set forth in the Exchange Act, regardless of whether an applicant is a member of another SRO.<sup>94</sup>

## 2. Regulatory Independence—the Chief Regulatory Officer and Regulatory Oversight Committee

Nasdaq proposes to create an Exchange Board committee, the ROC, that would be composed of independent directors. The ROC would consist of three members, each of whom must be a Public Director and "independent director" as defined by Nasdaq Exchange Rule 4200.<sup>95</sup> The ROC would be responsible for monitoring the

adequacy and effectiveness of the Exchange's regulatory program, assessing the Exchange's regulatory performance, assisting the Exchange Board in reviewing the Exchange's regulatory plan and the overall effectiveness of the Exchange's regulatory functions.<sup>96</sup>

The ROC would also meet with the Chief Regulatory Officer ("CRO") in executive session at regularly scheduled meetings and at any time upon request of the CRO or any member of the ROC.<sup>97</sup> The ROC would also be informed about the CRO's compensation, promotion, or termination (including reasons).<sup>98</sup> Finally, the regulatory budget would be presented to the ROC so that its members may inquire as to the adequacy of resources available for the Nasdaq Exchange's regulatory program.<sup>99</sup>

Nasdaq proposes that its CRO have general supervision of the regulatory operations of the Exchange, including overseeing surveillance, examination, and enforcement functions.<sup>100</sup> The CRO also would administer any regulatory services agreement with another SRO to which the Nasdaq Exchange is a party.<sup>101</sup> The CRO would be an Executive Vice President or Senior Vice President that reports directly to the Chief Executive Officer.<sup>102</sup> The CRO may also serve as the Nasdaq Exchange's General Counsel.<sup>103</sup>

In addition, the Nasdaq Exchange has created an independent regulatory department, Nasdaq Regulation, for the purpose of functionally separating its regulatory functions from its business lines. Nasdaq Regulation will carry out many of the Nasdaq Exchange's regulatory functions, including administering its membership and disciplinary rules.<sup>104</sup>

<sup>82</sup> The Nasdaq Exchange and NASDR have requested confidential treatment for their contractual agreement pursuant to section 24(b)(2) of the Exchange Act and Rule 24b-2 thereunder. 15 U.S.C. 78x(b)(2); and 17 CFR 240.24b-2. Nasdaq has represented to the Commission that it will assign the Regulatory Contract to the Nasdaq Exchange.

<sup>83</sup> See Nasdaq Exchange Rule 1013. See also Exchange By-Laws Article VI, Section 2.

<sup>84</sup> In Amendment No. 6, Nasdaq proposed to modify Nasdaq Exchange Rule 3230(h) to reflect an NASD proposed rule change relating to reporting requirements for members that are clearing firms. See Exchange Act Release No. 52352 (August 26, 2005), 70 FR 52460 (September 2, 2005).

<sup>85</sup> See Nasdaq Exchange Rule 1015. See also Exchange By-Laws Article VI, Section 2.

<sup>86</sup> See Nasdaq Exchange Rules 1015(j)(3) and 1016.

<sup>87</sup> 15 U.S.C. 78q(f)(2); and 17 CFR 240.17f-2.

<sup>88</sup> See Nasdaq Exchange Rule 1013(a)(2)(B).

<sup>89</sup> See Nasdaq Exchange Rule 1140(c)(2).

<sup>90</sup> 15 U.S.C. 78q(f)(2); and 17 CFR 240.17f-2(a).

<sup>91</sup> 17 CFR 240.17f-2(c).

<sup>92</sup> 15 U.S.C. 78f. The Commission notes that it is not approving the Nasdaq NTS Access Order Form and Nasdaq Services Agreement.

<sup>93</sup> 15 U.S.C. 78f(b)(2).

<sup>94</sup> In response to the Original Notice, the Securities Industry Association submitted a comment noting that the Nasdaq Exchange should be clear about its membership application process and the process for the registration of associated persons of Nasdaq Exchange members. See SIA Letter, *supra* note 15.

<sup>95</sup> Nasdaq Exchange Rule 4200(a)(15) sets forth the director independence listing standards applicable to Nasdaq-listed issuers. See also Amendment No. 6, *supra* note 12.

<sup>96</sup> See Exchange By-Laws Article III, section 5(e).

<sup>97</sup> See Exchange By-Laws Article IV, section 7.

<sup>98</sup> See Exchange By-Laws Article III, section 5(e).

<sup>99</sup> *Id.*

<sup>100</sup> See Exchange By-Laws Article IV, section 7.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> See Exchange Rules 1011(c) and 9120(w). See also Report of Investigation Pursuant to section 21(a) of the Securities Exchange Act of 1934 Regarding the Nasdaq Stock Market Inc., as Overseen By Its Parent, The National Association of Securities Dealers, Inc., Exchange Act Release No. 51163 (February 9, 2005). The Commission issued this report as a result of an investigation that uncovered a regulatory failure between the NASD and Nasdaq. In this report, the Commission stated that "[i]n carrying out their regulatory responsibilities, SROs must ensure that they effectively manage the inherent conflicts between their role as a market and their role as a regulator." *Id.* In response, the NASD and Nasdaq took several remedial steps, including the creation of the Nasdaq Regulation.

In the October 2005 Notice, the Commission requested comment on whether the Nasdaq Exchange's proposed regulatory structure, including the ROC and CRO, insulate its regulatory functions from its market and other commercial interests so that it could carry out its regulatory obligations. In response, the Commission received two comment letters.<sup>105</sup> Both commenters supported the Exchange's proposed regulatory structure.

The Commission believes that, in this context, the Exchange's proposal is consistent with the statutory requirements. In addition, the Commission believes that the Nasdaq Exchange's proposal is consistent with the 1996 Settlement Order.<sup>106</sup>

### 3. The Regulatory Contract

Although the Exchange will be an SRO with all of the attendant regulatory obligations under the Exchange Act, it has entered into the Regulatory Contract with NASDR, under which NASDR will perform certain regulatory functions on its behalf.<sup>107</sup> Notwithstanding the Regulatory Contract, the Exchange will retain ultimate legal responsibility for the regulation of its members and its market. This contract is intended to reflect the current relationship that Nasdaq and NASDR have and accordingly, NASDR will be performing for the Nasdaq Exchange the same regulatory functions it currently performs for Nasdaq as a facility of the NASD.

In addition to performing certain membership functions for the Nasdaq Exchange,<sup>108</sup> NASDR will perform certain disciplinary and enforcement functions for the Exchange. Generally, NASDR will investigate members, issue complaints, and conduct hearings pursuant to the Exchange's rules. Appeals of disciplinary hearings, however, will be handled by the NRC.<sup>109</sup>

The Commission has previously stated that it would consider whether it would be consistent with the public interest for an exchange to contract with another SRO to perform certain regulatory functions.<sup>110</sup> In this case, the

Commission believes that it is consistent with the Exchange Act and the public interest to allow the Exchange to contract with NASDR to perform membership, disciplinary, and enforcement functions. Membership, discipline, and enforcement are fundamental elements to a regulatory program, and constitute core self-regulatory functions. It is essential to the public interest and the protection of investors that these functions are carried out in an exemplary manner, and the Commission believes that NASDR has the expertise and experience to perform these functions on behalf of the Nasdaq Exchange.<sup>111</sup>

At the same time, the Commission believes that, unless relieved by the Commission of its responsibility,<sup>112</sup> the Nasdaq Exchange bears the responsibility for self-regulatory conduct and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the

29, 2004), 69 FR 47962 (August 6, 2004) ("Amex Order").

<sup>111</sup> In response to the Original Notice, some commenters raised general concerns over the ability of NASDR to be a fair and impartial regulator of the Nasdaq Exchange given the historical relationship between Nasdaq and NASDR and the fact that the Nasdaq Exchange is a "customer" of the NASD's for regulatory services. See *Instinet Letter*; *Member Associations of the American Stock Exchange Letter*; and *SIA Letter*, *supra* note 15; and letters from William O'Brien, Senior Vice President & General Counsel, The Brut ECN, L.L.C., dated July 30, 2001; and W. Hardy Callcott, Senior Vice President and General Counsel, Charles Schwab, dated August 30, 2001. Other commenters, however, believed that exchange status for Nasdaq would permit the NASD to provide regulatory services without the perception or potential for a conflict of interest. See letters from Robert M. Funk, Executive Director, American Shareholders Association, dated July 17, 2001; Grover G. Norquist, President, Americans for Tax Reform, dated July 17, 2001; Congressman Patrick J. Tiberi, Ohio, dated July 20, 2001; Congressman Steven C. LaTourette, Ohio, dated July 25, 2001; Congressman E. Clay Shaw, Florida, dated July 25, 2001; Senator Richard J. Durbin, Illinois, dated July 27, 2001; Barry S. Porter, Chairman, The Nasdaq Stock Market Issuer Affairs Committee and 22 representatives of the Nasdaq Issuer Affairs Committee, dated August 8, 2001; Glenn R. Oxner, Executive Vice President, Scott & Stringfellow, Inc., dated August 14, 2001; Congressional Delegation from Maryland, including Constance A. Morella, Roscoe Bartlett, Wayne Gilchrest, and Robert L. Ehrlich, Jr., dated August 15, 2001; Congressman Charles A. Gonzalez, Texas, dated August 21, 2001; Congressman Chip Pickering, Mississippi, dated August 21, 2001; Congressman Jerry Weller, Illinois, letters dated August 23, 2001 and August 31, 2001; Mathew Ng, Assistant General Counsel & Assistant Secretary, Oracle Corporation, dated August 29, 2001; Congressional Delegation from Connecticut, including Nancy Johnson, James Maloney and Christopher Shays, dated September 18, 2001; and Congressman Mark Foley, Florida, dated September 21, 2001.

<sup>112</sup> See section 17(d)(1) of the Exchange Act and Rule 17d-2 thereunder. 15 U.S.C. 78q(d)(1); and 17 CFR 240.17d-2. See also *infra* notes 114-117 and accompanying text. The Commission is not approving the Regulatory Contract.

Exchange's behalf. In performing these functions, however, NASDR may nonetheless bear liability, in appropriate circumstances, for causing or aiding and abetting the failure of the Exchange to perform its regulatory functions.<sup>113</sup> Accordingly, although NASDR will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for the Nasdaq Exchange, NASDR also may have secondary liability if, for example, the Commission finds that the contracted functions are being performed so inadequately as to cause a violation of the Federal securities laws by the Nasdaq Exchange.

### 4. Rule 17d-2 Agreements

Section 19(g)(1) of the Exchange Act<sup>114</sup> requires every SRO to examine its members and persons associated with its members and to enforce compliance with the federal securities laws and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to section 17(d) of the Exchange Act.<sup>115</sup> Section 17(d) was intended, in part, to eliminate unnecessary multiple examinations and regulatory duplication with respect to members of more than one SRO ("common members"). Rule 17d-2 of the Exchange Act<sup>116</sup> permits SROs to propose joint plans allocating regulatory responsibilities concerning common members. These agreements, which must be filed with and approved by the Commission, generally cover such regulatory functions as personnel registration, branch office examinations, and sales practices. Commission approval of a 17d-2 plan relieves the specified SRO of those regulatory responsibilities allocated by the plan to another SRO. Many existing SROs have entered into such agreements.<sup>117</sup>

Nasdaq has represented to the Commission that the Nasdaq Exchange

<sup>113</sup> For example, if failings by NASDR have the effect of leaving the Exchange in violation of any aspect of the Exchange's self-regulatory obligations, the Exchange would bear direct liability for the violation, while NASDR may bear liability for causing or aiding and abetting the violation.

<sup>114</sup> 15 U.S.C. 78s(g)(1).

<sup>115</sup> 15 U.S.C. 78q(d).

<sup>116</sup> 17 CFR 240.17d-2.

<sup>117</sup> See, e.g., Exchange Act Release Nos. 13326 (Mar. 3, 1977), 42 FR 13878 (Mar. 14, 1977) (NYSE/Amex); 13536 (May 12, 1977), 42 FR 26264 (May 23, 1977) (NYSE/BSE); 14152 (Nov. 9, 1977), 42 FR 59339 (Nov. 16, 1977) (NYSE/CSE); 13535 (May 12, 1977), 42 FR 26269 (May 23, 1977) (NYSE/CHX); 13531 (May 12, 1977), 42 FR 26273 (May 23, 1977) (NYSE/PSE); 14093 (Oct. 25, 1977), 42 FR 57199 (Nov. 1, 1977) (NYSE/Phlx); 15191 (Sep. 26, 1978), 43 FR 46093 (Oct. 5, 1978) (NASD/BSE, CSE, CHX and PSE); 16858 (May 30, 1980), 45 FR 37927 (June 5, 1980) (NASD/BSE, CSE, CHX and PSE); and 42815 (May 23, 2000), 65 FR 34762 (May 31, 2000) (NASD/ISE).

<sup>105</sup> ISE Letter and STA Letter, *supra* note 10.

<sup>106</sup> See 1996 Settlement Order, *supra* note 56.

<sup>107</sup> In Amendment No. 6, Nasdaq proposed Rule 0150, which provides that the regulatory functions performed by NASD will continue to be performed by NASD, an affiliate of NASD, or an independent self-regulatory organization, unless Nasdaq Exchange obtains prior Commission approval to do otherwise.

<sup>108</sup> See *supra* text accompanying note 82.

<sup>109</sup> See Exchange By-Laws Article VI, section 1.

<sup>110</sup> See, e.g., Regulation ATS Release, *supra* note 54. See also Exchange Act Release No. 50122 (July

and the NASD intend to file a Rule 17d-2 agreement with the Commission covering common members of the Nasdaq Exchange and the NASD. The Nasdaq Exchange represented that this agreement would allocate to the NASD regulatory responsibility, with respect to common members, the following:

(1) The NASD will receive and process in the CRD applications, reports, information, filings, fingerprint cards, and notices generally relating to the status of an associated person of a common member, and registration as a principle or representative of any type, or any other type of employee of a common member required to register or pass a qualification examination under the Nasdaq Exchange rules.

(2) The NASD will receive and process notices, filings, or registrations for the branch offices of common members of the Nasdaq Exchange and the NASD, including notices, filings, or registrations to designate offices of supervisory jurisdiction.

(3) The NASD will examine common members of the Nasdaq Exchange and the NASD for compliance with Federal securities laws, rules and regulations, and rules of the Nasdaq Exchange that have been certified by the Nasdaq Exchange as identical or substantially similar to the NASD rules.

(4) The NASD will investigate common members of the Nasdaq Exchange and the NASD for apparent violations of Federal securities laws, rules or regulations, or Nasdaq Exchange rules that has been certified by the Nasdaq Exchange as identical or substantially identical to an NASD rule.

(5) The NASD will enforce compliance with Federal securities laws, rules and regulations, and rules of the Nasdaq Exchange that have been certified by Nasdaq as identical or substantially similar to the NASD rules.

Because the Nasdaq Exchange anticipates entering into this 17d-2 agreement, it has not made provisions to fulfill the regulatory obligations that would be undertaken by the NASD under this agreement with respect to common members of the Nasdaq Exchange and the NASD. Accordingly, the Commission is conditioning the operation of the Nasdaq Exchange on approval by the Commission of a 17d-2 agreement between the Nasdaq Exchange and the NASD that allocates the above specified matters to the NASD.<sup>118</sup>

<sup>118</sup> Alternatively, the Nasdaq Exchange could demonstrate that it has the ability to fulfill its regulatory obligations.

## 5. Discipline and Oversight of Members

As a prerequisite for the Commission approval of an exchange's application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Exchange Act. Specifically, an exchange must be able to enforce compliance by its members and persons associated with its members with Federal securities laws and the rules of the exchange.<sup>119</sup> As noted above, pursuant to the Regulatory Contract, NASDR will perform many of the initial disciplinary processes on behalf of the Exchange.<sup>120</sup> For example, NASDR will investigate claims of securities laws violations, issue complaints, and conduct hearings pursuant to Nasdaq Exchange rules.<sup>121</sup> Appeals from disciplinary decisions will be heard by the NRC. Thereafter, the NRC may affirm, reverse, or otherwise modify the decision of the Hearing Panel, and must submit a proposed written decision to the Exchange Board, which will become final unless the matter is called for review by any Director.<sup>122</sup> After review, the Exchange Board may affirm, reverse, modify, and increase or reduce any sanction, or impose any other fitting sanction.<sup>123</sup>

The Nasdaq Exchange's By-Laws and rules provide that it has disciplinary jurisdiction over its members so that it can enforce its members' compliance with its rules and the Federal securities laws.<sup>124</sup> The Exchange's rules also permit it to sanction members for violations of its rules and violations of the Federal securities laws by, among other things, expelling or suspending members, limiting members' activities,

<sup>119</sup> 15 U.S.C. 78f(b)(1).

<sup>120</sup> In response to the Original Notice, the Securities Industry Association submitted a comment generally supporting this arrangement for the regulation of Nasdaq Exchange members. See SIA Letter, *supra* note 15.

<sup>121</sup> NASDR will appoint Hearing Panels pursuant to Nasdaq Exchange rules. In Amendment No. 6, Nasdaq proposed a new transitional rule, 9231(b)(1)(D), allowing persons who served on the NASD National Adjudicatory Council, or a disciplinary subcommittee thereof, prior to the date that Nasdaq commenced operating as a national securities exchange to sit on Hearing Panels. The Commission believes that proposed Nasdaq Exchange Rule 9231(b)(1)(D) is consistent with the Exchange Act. Allowing persons who previously served on the NASD National Adjudicatory Council, or a disciplinary subcommittee thereof, to act as Panelists in the Nasdaq Exchange disciplinary hearings will facilitate a seamless transition from the current NASD disciplinary process to the Nasdaq Exchange disciplinary process.

<sup>122</sup> Nasdaq Exchange Rules 9349 and 9351(a).

<sup>123</sup> Nasdaq Exchange Rule 9351.

<sup>124</sup> See generally Nasdaq Exchange By-Laws Article IX; Nasdaq Exchange Rule Series, 0100, 1000, 9000.

functions, or operations, fining or censuring members, or suspending or barring a person from being associated with a member.<sup>125</sup> The Nasdaq Exchange's rules also provide for the imposition of fines for minor rule violations in lieu of commencing disciplinary proceedings.<sup>126</sup> Accordingly, as a condition to the operation of the Nasdaq Exchange, a Minor Rule Violation Plan ("MRVP") filed by the Nasdaq Exchange under Exchange Act Rule 19d-1(c)(2) must be declared effective by the Commission.<sup>127</sup>

The Nasdaq Exchange will operate MarketWatch, a real-time surveillance department.<sup>128</sup> MarketWatch will perform this real-time intraday surveillance over all Nasdaq Exchange-listed companies and all Nasdaq Exchange market participants. More specifically, MarketWatch will oversee the complete and timely disclosure of Nasdaq Exchange issuers' material information to determine if a trading halt is necessary to maintain an orderly market for the release of material news. In addition, MarketWatch, through its automated detection system, will monitor the trading activity of each security and will generate a price and volume alert to aid in the assessment of unusual market activity. MarketWatch will also coordinate and execute the release of initial public offerings; administer market participants' excused withdrawals and passive market making requests; and handle the clearly

<sup>125</sup> See Nasdaq Exchange Rule 8300.

<sup>126</sup> See Nasdaq Exchange Rule 9216 and IM-9216. Minor Nasdaq Exchange rule violations include, for example, failing to file timely reports of short positions, failure to timely submit amendments to Forms BD or U-4, failing to submit trading data as requested, or failing to have a principal approve advertisements or sales literature prior to its use. See Nasdaq Exchange Rule IM-9216. In Amendment No. 6, Nasdaq updated proposed Nasdaq Exchange Rule IM-9216 to reflect a NASD proposed rule change, which expanded the list of violations appropriate for disposition as minor rule violations. See Exchange Act Release No. 52294 (August 18, 2005), 70 FR 49700 (August 24, 2005). The Commission finds that this proposed rule change is consistent with section 6(b)(5), (b)(6) and (b)(7) of the Exchange Act for the same reasons that the Commission approved these rule changes under section 15A(b)(6), (b)(7) and (b)(8).

<sup>127</sup> 17 CFR 240.19d-1(c)(2).

<sup>128</sup> See Amendment No. 5, Exhibit E, *supra* note 7. Nasdaq currently operates MarketWatch pursuant to the Delegation Plan, and MarketWatch will continue to operate in the same manner upon the Nasdaq Exchange's operation as an exchange. In Amendment No. 6, Nasdaq proposed to add Nasdaq Exchange Rule 4121, which provided that, in accordance with the standing request of the Commissions, the Nasdaq Exchange would halt domestic trading if other major securities markets initiated market-wide trading halts in response to extraordinary market conditions.



erroneous trade adjudication process.<sup>129</sup> If MarketWatch observes any activity that may involve a violation of Commission or Nasdaq Exchange rules, MarketWatch will immediately refer the activity to NASDR's Market Regulation Department for further investigation and potential disciplinary action.<sup>130</sup>

The Commission finds that the Nasdaq Exchange's By-Laws and rules concerning its disciplinary and oversight programs are consistent with the requirements of sections 6(b)(6) and 6(b)(7)<sup>131</sup> of the Exchange Act in that they provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the rules of the Exchange provide it with the ability to comply, and with the authority to enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the Nasdaq Exchange.<sup>132</sup>

#### 6. Order Audit Trail System

Under the Nasdaq Exchange rules, Nasdaq Exchange members will be required to comply with the NASD's Order Audit Trail System ("OATS") requirements. Because Exchange members will report order information to OATS pursuant to the Nasdaq Exchange rules, the Exchange will have the right of access to OATS data for regulatory purposes. In the October 2005 Notice, the Commission specifically requested comment on the extent to which the Nasdaq Exchange should be able to use OATS data for non-regulatory purposes and whether it

should have access to OATS data regarding: (1) All orders its members receive, including those orders that are routed to markets other than the Exchange; and (2) reports of executions by its members that are reported to the new TRF.

The Commission received two comment letters addressing these issues.<sup>133</sup> One commenter stated that it was its understanding that the Nasdaq Exchange's sole use of OATS information would be for regulatory purposes and if that understanding were incorrect, it objects to the Exchange's access to such information for non-regulatory purposes.<sup>134</sup> A second commenter argued that the Nasdaq Exchange should not have access to OATS data regarding orders and executions by its members that are executed off the Exchange and that the Exchange should not be permitted to use OATS data for non-regulatory purposes.<sup>135</sup> This commenter, however, said that if the Exchange is permitted to use OATS data for non-regulatory purposes, access to such data for non-regulatory purposes should be granted to other markets or any other person who requests the data.<sup>136</sup>

The Commission shares commenters' concerns about the use by the Nasdaq Exchange of OATS information for non-regulatory purposes, particularly since it includes information about members' trading activities on competitors of the Exchange. The Nasdaq Exchange's OATS rules would require Exchange members to report, on a daily basis, extensive information with respect to the handling of orders for Nasdaq securities, including when all or portions of orders are executed on markets other than the Nasdaq Exchange. A member's failure to provide this information could give rise to disciplinary action by the Exchange pursuant to its authority as a self-regulatory organization under the Exchange Act. Because this information is obtained from members through the exercise of the Exchange's regulatory powers, the Commission does not believe it should be used for non-

regulatory purposes, unless the NASD makes available such OATS data to other market participants on the same terms as it is provided to the Nasdaq Exchange.

#### C. Trading System

##### 1. Trading Rules

In Amendment No. 4, Nasdaq proposed that only trades executed on the Nasdaq Exchange systems would be considered exchange trades. Currently, the Nasdaq systems that would be the Exchange's systems are the Nasdaq Market Center, formerly known as SuperMontage, Brut, and INET.<sup>137</sup>

The Nasdaq Exchange's proposed Nasdaq Market Center rules require price priority.<sup>138</sup> The rules, with limited exceptions, also require time priority.<sup>139</sup> Accordingly, the Nasdaq Exchange's proposed Nasdaq Market Center rules differ from current NASD rules governing the Nasdaq Market Center as follows:

(1) The Exchange's rules do not include the priority rule that first executes an incoming order against the submitting member's own interest reflected in the Nasdaq Market Center at

<sup>137</sup> Nasdaq acquired Brut in September 2004 and the rules governing the execution of transactions on Brut were approved by the Commission in March 2005. Brut is a price/time priority system. See Exchange Act Release No. 51326 (March 7, 2005), 70 FR 12521 (March 14, 2005) ("Brut Order"). In addition, on December 8, 2005, Nasdaq purchased INET ECN, and the rules governing the trading on INET were approved by the Commission in December 2005. See INET Order, *supra* note 12. In Amendment No. 6, Nasdaq proposed to add Nasdaq Exchange Rules 4950 *et seq.*, governing the operation of INET, including its rules requiring orders to be executed in price/time priority.

<sup>138</sup> In Amendment No. 6, Nasdaq proposed to add two order types that are consistent with its priority rules and were previously approved by the Commission for the NASD: proactive limit orders and reverse pegged orders. See *respectively*, Exchange Act Release Nos. 52511 (September 27, 2005), 70 FR 57636 (October 3, 2005) (relating to proactive limit orders) and 52449 (September 15, 2005), 70 FR 55647 (September 22, 2005) (relating to reverse pegged orders).

<sup>139</sup> Because ERISA may restrict the ability of a Nasdaq Quoting Market Participant or Order Entry Firm that is trading for a managed account, pursuant to Exchange rules, these members may append an anti-internalization qualifier ("AIQ") to its quote or order to prevent an order from trading with the entering firms' own trading interest.

In addition, Nasdaq Market Center Participants may submit "Auto-Ex Orders," which would only trade with the quotes and orders of automatic execution participants that do not charge a separate quote-access fee. An Auto-Ex Order would cancel instead of locking or trading through the price of an order-delivery or quote-access fee charging participant's quote or order. Order delivery and quote-access charging participants would not retain time priority over the quotes and orders of automatic execution participants that do not charge a separate quote-access fee when such quotes and orders trade with Auto-Ex Orders.

<sup>129</sup> In Amendment No. 6, Nasdaq proposed to modify Nasdaq Exchange Rule 11890(b) to reflect a proposed rule change approved by the Commission for the NASD. The proposed rule change clarified the time frames under which an officer of the NASD must initiate action to declare a transaction null and void. See Exchange Act Release No. 52508 (September 26, 2005), 70 FR 57346 (September 30, 2005).

<sup>130</sup> The INET ECN currently operates as a facility of the NASD. See *infra* note 137 and accompanying text. Nasdaq represents that until September 30, 2006, INET will report its trading activity to the National Stock Exchange ("NSX"). As a result, surveillance and disciplinary actions are currently handled by INET and NSX. Trading activity on INET will become subject to Nasdaq Exchange Rule 11890 on or before February 6, 2006, and clearly erroneous matters will be administered by MarketWatch pursuant to the same rules and processes as trading activity through The Nasdaq Market Center and Brut. INET will cease reporting its trading activity to NSX at or prior to the end of September 2006, when Nasdaq's trading systems are integrated onto a single platform. See *infra* note 144 and accompanying text. At that time, Nasdaq MarketWatch will assume the same functions for INET trading as for the Nasdaq Market Center and Brut.

<sup>131</sup> 15 U.S.C. 78f(b)(6) and (7).

<sup>132</sup> 15 U.S.C. 78f(b)(1).

<sup>133</sup> See Bloomberg Letter and STA Letter, *supra* note 10.

<sup>134</sup> See STA Letter, *supra* note 10.

<sup>135</sup> See Bloomberg Letter, *supra* note 10.

<sup>136</sup> See Bloomberg Letter, *supra* note 10. Nasdaq responded to commenters' concerns by reaffirming its commitment not to use OATS data for commercial purposes. Nasdaq, however, believes that its use of OATS data by Nasdaq's Department of Economic Research to study public policy issues, such as sub-penny trading and decimalization, does not constitute a commercial use of the data. The Commission believes that any non-regulatory use of the data would have a commercial benefit. See Nasdaq Response Letter, *supra* note 11.

the best price, irrespective of whether the member has time priority;<sup>140</sup> and

(2) The Exchange's rules do not permit preferenced orders by members, which permit trades to occur outside of time priority.<sup>141</sup>

In addition to the Nasdaq Market Center, Nasdaq currently owns and operates two other trading systems—the Brut Facility<sup>142</sup> and the INET Facility.<sup>143</sup> Nasdaq proposes to integrate its three execution systems into a single trading platform with an integrated quote/order book operated in accordance with a unified price priority execution algorithm prior to the end of September 2006.<sup>144</sup> Nasdaq has also represented that upon completion of this systems integration there will be a single integrated book where all orders interact with each other. If the Nasdaq Exchange satisfies each of the conditions required for it to begin operating as an exchange set forth in this Order prior to completing integration of the three systems, the Nasdaq Exchange may temporarily operate as many as three separate trading facilities, each of which trades the same securities, but do not fully interact with each other.<sup>145</sup>

The Commission believes that it is beneficial for orders in the same securities directed to an exchange to interact with each other. Such interaction promotes efficient exchange trading and protects investors by assuring that orders are executed pursuant to a single set of priority rules that are consistently and fairly applied. For example, consolidating the limit orders received by an exchange within a single trading facility affords an opportunity for such orders to be executed in accordance with price

priority, which may not be available when an exchange's orders are directed among multiple trading facilities.

Nasdaq's operation of three trading facilities is due to recent acquisitions by Nasdaq. Nasdaq has represented that it is in the process of combining these three trading systems into one system, which Nasdaq proposes to complete by September 30, 2006.<sup>146</sup> Both Brut and INET were operating as alternative trading systems prior to Nasdaq's acquisition, and are important trading markets with participants that rely on their continuing availability. The Commission believes that it is in the public interest for Brut and INET to be available while Nasdaq is integrating them together with its Nasdaq Market Center and, thus, for this limited period of time it is consistent with the Exchange Act for the Nasdaq Exchange to operate as many as three separate trading system until September 30, 2006.<sup>147</sup>

## 2. Trade Reporting Facility

In a separate filing with the Commission, the NASD proposes to establish a new Trade Reporting Facility to provide NASD members with a mechanism for reporting transactions in all exchange-listed securities executed otherwise than on an exchange.<sup>148</sup> In commenting on Nasdaq's application for exchange registration, several commenters criticized this NASD proposal.<sup>149</sup> These commenters contend, among other things, that because of the affiliation between the Nasdaq Exchange and the limited liability company that will operate the TRF, the Trade Reporting Facility would not really be a facility of the NASD, but instead would be a facility of the Nasdaq Exchange. At such time as the Commission considers the TRF proposal, it will take these comments into account.

## 3. Market Maker Obligations

Nasdaq Exchange members may register as Nasdaq Market Makers or ITS/CAES Market Makers.<sup>150</sup> As market makers, these members must engage in a course of dealings for their own

account to assist in the maintenance, insofar as reasonably practicable, of fair and orderly markets.<sup>151</sup> In addition, Nasdaq Market Makers and ITS/CAES Market Makers, among other things, must maintain continuous two-sided quotes, that are firm, with a minimum quotation increment of \$0.01. The Commission believes that these requirements are consistent with the Exchange Act because they should help to ensure that Nasdaq Market Makers and ITS/CAES Market Makers perform their obligations in a manner that promotes just and equitable principles of trade.

## 4. Section 11 of the Exchange Act

Section 11(a)(1) of the Exchange Act<sup>152</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T)<sup>153</sup> under the Exchange Act, known as the "effect versus execute" rule, provides exchange members with an exemption from the section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>154</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission,<sup>155</sup> Nasdaq requested that the Commission concur with Nasdaq's conclusion that Nasdaq Exchange members that enter orders into Nasdaq Market Center, Brut, and INET (collectively "Nasdaq

<sup>140</sup> See NASD Rule 4710(b)(1)(B)(ii)(a).

<sup>141</sup> Currently, NASD rules permit the use of preferenced orders, which permit NASD members to direct orders to a particular contra party for execution. If the contra party is at the best price, the system executes the order against the preferenced party, irrespective of whether the preferenced party has time priority. See NASD Rule 4701(aa).

<sup>142</sup> See Brut Order, *supra* note 137.

<sup>143</sup> See INET Order, *supra* note 137.

<sup>144</sup> See Amendment No. 6, Nasdaq Exchange Rule 4720.

<sup>145</sup> As of the date of this Order, the Nasdaq INET Facility is a wholly-separate platform that posts its top-of-file quotes through the facilities of the National Stock Exchange ("NSX"). Nasdaq and Brut are partially integrated. Brut displays its entire book in the Nasdaq Market Center. Accordingly, all quotes and orders resident in the Nasdaq Market Center, including Brut's entire depth of the book, interact with incoming orders based on the Nasdaq Market Center's order execution algorithm. Orders sent directly to the Brut system, however, do not interact with quotes and orders resident in the Nasdaq Market Center; they interact solely with quotes and orders displayed in Brut.

<sup>146</sup> See Nasdaq Exchange Rule 4720.

<sup>147</sup> Pursuant to the Brut Order and the INET Order, Brut and INET are subject to all NASD rules applicable to their broker-dealer activities, including those requiring participation in market surveillance and audit trail programs conducted by the NASD and Nasdaq. Similarly, Brut and INET will be subject to all applicable Nasdaq Exchange broker-dealer rules as of the operation date of the Exchange.

<sup>148</sup> See NASD Proposal, *supra* note 8.

<sup>149</sup> See Arca Letter and NYSE Letter, *supra* note 10.

<sup>150</sup> See Nasdaq Exchange Rules 4611 and 5220.

<sup>151</sup> See Amendment No. 6, *supra* note 12 and Nasdaq Exchange Rules 4613 and 5221.

<sup>152</sup> 15 U.S.C. 78k(a)(1).

<sup>153</sup> 17 CFR 240.11a2-2(T).

<sup>154</sup> The member may, however, participate in clearing and settling the transaction.

<sup>155</sup> See letter to Nancy Morris, Secretary, Commission, and Elizabeth King, Associate Director, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 12, 2006 ("Nasdaq 11(a) Letter").

Execution Systems'') satisfy the requirements of Exchange Act Rule 11a2-2(T). For reasons set forth below, the Commission believes that Nasdaq Exchange members entering orders into the Nasdaq Execution Systems would satisfy the conditions of the Rule.

The Rule's first condition is that orders for covered accounts be transmitted from off the exchange floor. The Nasdaq Execution Systems receive orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.<sup>156</sup> Since the Nasdaq Execution Systems receive orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the Nasdaq Execution Systems satisfy the off-floor transmission requirement.

Second, the rule requires that the member not participate in the execution of its order. Nasdaq represented that at no time following the submission of an order is a member able to acquire control or influence over the result or timing of an order's execution.<sup>157</sup> According to Nasdaq, the execution of a

member's order is determined solely by what orders, bids, or offers are present in the system at the time the member submits the order. Accordingly, the Commission believes that a Nasdaq Exchange member does not participate in the execution of an order submitted into the Nasdaq Execution Systems.

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that the requirement is satisfied when automated exchange facilities, such as the Nasdaq Execution Systems, are used.<sup>158</sup>

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to section 11(a) of the Exchange Act and Rule 11a2-2(T).<sup>159</sup> Nasdaq represented that Nasdaq Exchange members trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.<sup>160</sup>

## 5. Short Sale Rule

### a. Background

Section 10(a) of the Exchange Act<sup>161</sup> gives the Commission plenary authority

<sup>158</sup> In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, *supra* note 156.

<sup>159</sup> 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated person thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, *supra* note 156 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

<sup>160</sup> See Nasdaq 11(a) Letter, *supra* note 155.

<sup>161</sup> 15 U.S.C. 78j(a).

over short sales<sup>162</sup> of securities registered on a national securities exchange as necessary or appropriate in the public interest or for the protection of investors. The Commission adopted Rule 10a-1 in 1938 in order to restrict short selling in a declining market.<sup>163</sup> Paragraph (a) of Rule 10a-1 generally covers short sales in securities registered on, or admitted to unlisted trading privileges on, a national securities exchange if trades of the securities are reported pursuant to an "effective transaction reporting plan" and information as to such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information.<sup>164</sup> Paragraph (b) applies to short sales on national exchanges in securities that are not covered by paragraph (a).

Rule 10a-1(a)(1) provides that, subject to certain exceptions, an exchange-registered security may only be sold short: (1) At a price above the price at which the immediately preceding sale was effected (plus tick), or (2) at the last sale price if it is higher than the last different price (zero-plus tick). Conversely, short sales are not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. The operation of these provisions is commonly described as the "tick test."

<sup>162</sup> A "short sale" is defined in Rule 200(a) of Regulation SHO as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." 17 CFR 242.200(a).

<sup>163</sup> See Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938). In addition to section 10(a) of the Exchange Act, and Rule 10a-1 thereunder, Regulation SHO, which became effective on September 7, 2004, also governs the regulation of short sales. See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) ("Adopting Release"). Regulation SHO adopted the following provisions: (i) Rule 200—Definitions and Marking Requirements; (ii) Rule 202T—Pilot Program; and (iii) Rule 203—Locate and Delivery Requirements. Pursuant to the terms of Regulation SHO, the Commission approved an order establishing a one-year pilot program ("Pilot Program") suspending the provisions of Rule 10a-1(a) under the Exchange Act and any short sale price test of any exchange or national securities association for short sales of certain securities for certain time periods. See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004). The Commission decided to defer consideration of proposed Rule 201, which would have replaced the current "tick" test of Rule 10a-1(a) with a new uniform bid test. See Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) ("Proposing Release"). The Commission will consider any further action on the price test after the completion of the Pilot Program. Therefore, Rule 10a-1's tick test currently applies to short sales of securities registered on, or admitted to unlisted trading privileges on, a national securities exchange.

<sup>164</sup> Rule 10a-1 uses the term "effective transaction reporting plan" as defined in Rule 600 of Regulation NMS under the Exchange Act, 17 CFR 242.600. 17 CFR 240.10a-1(a)(1)(i).

<sup>156</sup> See, e.g., Exchange Act Release Nos. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving the Boston Options Exchange as an options trading facility of the Boston Stock Exchange); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (order approving Archipelago Exchange ("ArcaEx") as an electronic trading facility of the Pacific Exchange ("PCX") ("ArcaEx Order")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's ("Phlx") Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

<sup>157</sup> See Nasdaq 11(a) Letter, *supra* note 155. The member may only cancel or modify the order, or modify the instructions for executing the order, but only from off the Exchange floor. *Id.* The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

### b. Nasdaq Securities

Current short sale regulations apply different price tests to securities trading in different markets. Rule 10a-1's "tick test," which is based on the sale price reported pursuant to an effective transaction reporting plan, applies to short sales of securities registered on, or admitted to unlisted trading privileges on, a national securities exchange. In 1994, the Commission granted temporary approval to the NASD to apply its own short sale rule to Nasdaq National Market securities on a pilot basis.<sup>165</sup> Specifically, NASD Rule 3350 prohibits short sales at or below the current best (inside) bid when the current best (inside) bid is below the previous best (inside) bid in a security. Once Nasdaq operates as an exchange, Nasdaq National Market securities and Nasdaq Capital Market securities<sup>166</sup> will be exchange-registered securities reported pursuant to an effective transaction reporting plan and therefore subject to Rule 10a-1.<sup>167</sup>

In the Regulation SHO Proposing Release,<sup>168</sup> the Commission considered Nasdaq's request for an exemption from Rule 10a-1 in conjunction with its exchange registration to allow Nasdaq to apply Rule 3350 to Nasdaq exchange-listed securities, as well as other market developments<sup>169</sup> in proposing a uniform bid test using the consolidated best bid as the reference point for permissible short sales.<sup>170</sup> After considering comments to the Regulation SHO Proposing Release regarding the proposed uniform bid test, the Commission decided to defer consideration of a new uniform bid test

<sup>165</sup> See Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994). The NASD's short sale rule was originally approved on an eighteen-month pilot basis. The NASD has proposed and the Commission has approved, extensions of NASD Rule 3350 several times, most recently, until December 15, 2006. See Exchange Act Release No. 53093 (January 10, 2006). In Amendment No. 6, Nasdaq proposed to modify Nasdaq Exchange Rules 3350(k)(2) and 3350(l) to reflect the changes made to NASD Rule 3350.

<sup>166</sup> Nasdaq Capital Market securities were formerly known as "Nasdaq SmallCap Market securities." See Exchange Act Release No. 52489 (September 21, 2005), 70 FR 56948 (September 29, 2005).

<sup>167</sup> Nasdaq plans to request relief from the registration requirements of section 12(b) of the Exchange Act for certain issuers who are currently exempt grandfathered foreign private issuers (Rule 12g3-2(b) of the Exchange Act) and insurance companies (section 12(g)(2)(G) of the Exchange Act). If granted, such securities would trade on Nasdaq even though they would not be registered pursuant to section 12(b) of the Exchange Act. However, such securities would remain subject to Nasdaq Exchange Rule 3350.

<sup>168</sup> See Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003).

<sup>169</sup> 68 FR at 62979.

<sup>170</sup> *Id.*

and instead adopted Rule 202T of Regulation SHO.<sup>171</sup> Rule 202T is a temporary rule that excludes designated securities from the operation of the "tick" test of Rule 10a-1(a) and any short sale price test rule of any exchange or national securities association for a designated period of time.<sup>172</sup> The Commission believes that conducting a Pilot Program pursuant to Rule 202T of Regulation SHO is an important component of evaluating the overall effectiveness of price test restrictions on short sales.<sup>173</sup> The empirical data obtained from the Pilot Program will help the Commission assess whether it is necessary or appropriate to amend, or possibly remove, the short sale price tests for some population of securities.<sup>174</sup> The Commission will consider any further action on the adoption of a price test after the completion of the Pilot Program. In order to promote efficient regulation and to avoid unnecessarily burdening markets with the imposition of costs associated with implementing a price test that may be temporary, the Commission believes that, as discussed below, it is necessary and appropriate in the public interest and consistent with the protection of investors to maintain the status quo for the price test to apply to short sales in Nasdaq National Market securities, and to continue to not apply to short sales in Nasdaq Capital Market securities.

### c. Request for exemption from Rule 10a-1

Nasdaq has requested<sup>175</sup> an exemption from Rule 10a-1 to continue regulating short sales of Nasdaq National Market securities under the bid test of Nasdaq Exchange Rule 3350.<sup>176</sup> Nasdaq has also requested an exemption from Rule 10a-1 for Nasdaq Capital Market securities, as current NASD Rule 3350 is inapplicable to such securities. The requested exemption would therefore allow Nasdaq Capital Market securities to continue to trade without being subject to a price test. Nasdaq proposes to continue all current exemptions to NASD Rule 3350 in its Rule 3350, including the exemption for

<sup>171</sup> 17 CFR 242.202T.

<sup>172</sup> See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004). See also Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004).

<sup>173</sup> See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004).

<sup>174</sup> *Id.*

<sup>175</sup> See letter to James A. Brigagliano, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 4, 2006 ("Short Sale Letter").

<sup>176</sup> The Nasdaq Exchange's short sale rule is identical to the NASD's short sale rule.

qualified market makers in connection with bona fide market making.<sup>177</sup>

Nasdaq represents that its requested exemption would serve the public interest and protect investors by enabling Nasdaq to continue regulating short sales under Nasdaq Rule 3350 as it does today under NASD Rule 3350.<sup>178</sup> In addition, Nasdaq represents, among other things, that (i) its short sale rule would continue to prohibit the same conduct as Commission Rule 10a-1; (ii) Nasdaq would continue to vigorously and effectively enforce those prohibitions; and (iii) it is imperative that Nasdaq preserve its current structure to the greatest extent possible to avoid needless confusion during Nasdaq's transition to exchange status.<sup>179</sup>

Commenters generally supported the Commission granting an exemption to Nasdaq from Rule 10a-1 to allow the Nasdaq Exchange to apply its own bid test once it becomes a national securities exchange.<sup>180</sup> One commenter in particular noted that it is important for Nasdaq to retain the NASD short sale rule when it becomes an exchange for the following reasons, among others: (i) Because depriving market makers of the market maker exception would significantly hinder their ability to quickly adjust inventory risk positions; and (ii) because options market makers and block facilitators widely use the NASD short sale rule's options hedge exceptions as a risk management tool, the unavailability of the NASD short sale rule's exception may result in less

<sup>177</sup> Nasdaq's request states that, unlike exchange specialists, dealers in Nasdaq securities have no monopoly-like position in the securities they trade, nor do they have an inherent informational advantage over any other dealer. Additionally, they have no ability to close their market because of sudden volatility or an order imbalance. Given these differences, it believes that treating market makers and exchange specialists identically is not appropriate. See letter to James A. Brigagliano, Division, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 4, 2006. Allowing Nasdaq to maintain the market maker exemption would also be consistent with the CBOE's position expressed in its comment letter. The CBOE stated that there is a critical need to maintain an exemption for options market makers until, at a minimum, the Commission makes a final determination concerning the future framework and provision of Rule 10a-1. See CBOE Letter, *supra* note 14.

<sup>178</sup> See Short Sale Letter, *supra* note 175.

<sup>179</sup> *Id.*

<sup>180</sup> See letter from Thomas N. McManus, Executive Director and Counsel, Morgan Stanley Dean Witter, dated September 4, 2001 ("Morgan Stanley Letter"). See also SIA Letter, *supra* note 15; and letters from Robert M. Funk, Executive Director, American Shareholders Association, dated July 17, 2001; Grover G. Norquist, President, Americans for Tax Reform, dated July 17, 2001; Congressman Patrick J. Tiberi, Ohio, dated July 20, 2001; and Congressman Jerry Weller, Illinois, dated August 23, 2001 and August 31, 2001.

willingness to commit capital to customer orders.<sup>181</sup>

A few commenters, on the other hand, believed that Nasdaq should not be granted an exemption from Rule 10a-1, noting, among other things, that from a regulatory, fairness and competitive perspective, Nasdaq should be required to comply with all Commission rules applicable to a national securities exchange, including the Commission's short sale rule.<sup>182</sup> One commenter, in particular, stated that the Commission should either propose amendments to Rule 10a-1 to apply to all exchanges equally, including Nasdaq, or require Nasdaq to amend its proposed rules to be consistent with the short sale regulatory regime applied to all other exchanges.<sup>183</sup>

#### d. Response

The Commission appreciates the concerns expressed by such commenters; however, as discussed above, the Commission believes that it is important to maintain the status quo of short sale regulation during the Pilot Program in order to avoid unnecessarily burdening the markets. Moreover, it is important to maintain the integrity of the data obtained by the Commission during this period on the impact of short selling in the absence of a price test. This data will, among other things, assist in (i) determining the extent to which a price test is necessary to further the objectives of short sale regulation; (ii) the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity; and (iii) whether a short sale price test should be removed, in part or in whole, for some or all securities, or if retained, should be applied to additional securities. Investor protection will be enhanced because the Commission's determination with respect to the short sale price test will be based on sound empirical data obtained from the Pilot Program.

Based upon the representations and facts Nasdaq has presented in its request for exemption, as discussed above, and as necessary and appropriate in the public interest and consistent with the protection of investors, in particular the necessity and importance of maintaining the status quo during the Pilot Program, pursuant to section 36 of the Exchange Act,<sup>184</sup> the Commission hereby grants a temporary exemption<sup>185</sup>

from Rule 10a-1 to permit the Nasdaq Exchange to apply Nasdaq Exchange Rule 3350 to short sales in Nasdaq National Market securities occurring on the Nasdaq Exchange and to allow Nasdaq Capital Market securities to be exempt from the application of the tick test.<sup>186</sup> The exemptions from Rule 10a-1 will expire upon termination of the Pilot Program or at such other time the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.<sup>187</sup>

Because Nasdaq proposes to continue to maintain the exemption from its Rule 3350 for qualified market makers in connection with bona fide market making, the exemptions from Rule 10a-1 are subject to the following conditions:<sup>188</sup>

comments received on the Nasdaq Exchange Application. See SIA Letter, *supra* note 15.

<sup>186</sup> As exchange-registered securities reported pursuant to an effective transaction reporting plan, Rule 10a-1 applies to Nasdaq securities, as defined in Rule 600 of Regulation NMS, wherever they are traded. See 17 CFR 240.10a-1(a)(1)(i). Therefore, short sales in Nasdaq securities effected on any national securities exchange that trades Nasdaq securities on a unlisted trading privileges ("UTP") basis or in the OTC market are subject to Rule 10a-1 unless exempted. It may be appropriate for the Nasdaq short sale rule to apply uniformly to all Nasdaq National Market securities, wherever they are traded. 15 U.S.C. 78mm(a)(1). The Commission is therefore prepared to consider an appropriate exemptive request from Rule 10a-1 for any exchange trading Nasdaq National Market securities UTP to apply an analogue of Nasdaq Exchange Rule 3350, so that short sales in Nasdaq National Market securities would be treated consistently whether they occurred on Nasdaq or in another venue. Likewise, the Commission is prepared to consider an appropriate exemption from Rule 10a-1 for any exchange trading Nasdaq Capital Market securities UTP so that such securities would be exempt from the tick test wherever traded. This would be consistent with at least one commenter's position that if Nasdaq is granted an exemption from Rule 10a-1, other registered exchanges must equally be granted such an exemption. See CSE Letter, *supra* note 13.

<sup>187</sup> The Pilot Program is currently scheduled to end on April 28, 2006. See Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004). However, the Commission may from time to time approve further orders affecting the Pilot Program, including extension of the duration of the Pilot Program.

<sup>188</sup> This exemption from Rule 10a-1 is strictly limited to the application of Rule 10a-1 to transactions in Nasdaq securities. The exemption does not affect any other provisions of the Federal securities laws, and is subject to modification or revocation at any time the Commission determines that such action is necessary or appropriate in furtherance of the purposes of the Federal securities laws. Further, this exemption is subject to modification or revocation should the Commission amend Rule 10a-1 in such a manner as to render the exemption unnecessary or in conflict with any adopted amendments. In addition, Nasdaq is directed to the anti-fraud and anti-manipulation provisions of the Federal securities laws, including sections 9(a) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Responsibility for these and

(1) The Nasdaq Exchange is required to surveil member firms in order to monitor whether firms claiming the bona fide market maker exception in Nasdaq Exchange Rule 3350 are engaged in bona fide market making activity; and

(2) The Nasdaq Exchange will issue a Notice to Members or other appropriate communication to its members to provide further clarification to Nasdaq market makers regarding what activity would not be deemed "bona fide market making activity" for purposes of claiming the exception to Nasdaq Exchange Rule 3350's bid test.

#### D. Section 11A of the Exchange Act

Section 11A of the Exchange Act and the rules thereunder form the basis of our national market system and impose requirements on exchanges to implement its objectives. Specifically, national securities exchanges are required, under Rule 601 of Regulation NMS,<sup>189</sup> to file transaction reporting plans regarding transactions in listed equity and Nasdaq securities that are executed on its facilities. Currently registered exchanges satisfy this requirement by participating in the Consolidated Transaction Association Plan ("CTA Plan"), for listed equities and 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") for Nasdaq securities.<sup>190</sup> Before the Nasdaq Exchange can begin operating as an exchange, it must join these plans as a participant in its own right. Currently, the transactions executed in Nasdaq trading facilities are reported to these plans as OTC trades pursuant to the NASD's participation in the plans. The NASD's continued participation in these plans is necessary for it to fulfill its obligations under section 11A of the Exchange Act and Rules 601 and 603.

National securities exchanges are required, under Rule 602 of Regulation NMS,<sup>191</sup> to collect bids, offers, quotation sizes and aggregate quotation sizes from those members who are responsible broker or dealers. National securities

any other applicable provisions of the federal securities laws must rest with those relying on the relief granted herein.

<sup>189</sup> 17 CFR 242.601.

<sup>190</sup> These plans also satisfy the requirement in Rule 603 that 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. See 17 CFR 242.603.

<sup>191</sup> 17 CFR 242.602.

<sup>181</sup> See Morgan Stanley Letter, *supra* note 180.

<sup>182</sup> See NYSE August 2001 Letter, *supra* note 13. See also CSE Letter, *supra* note 13; SIA Letter, *supra* note 15.

<sup>183</sup> See CSE Letter, *supra* note 13.

<sup>184</sup> 15 U.S.C. 78mm(a)(1).

<sup>185</sup> Granting a temporary exemption to Nasdaq from Rule 10a-1 is consistent with certain

exchanges must then make this information available to vendors at all times when the exchange is open for trading. The current exchanges satisfy this requirement by participating in the Consolidated Quotation System Plan ("CQ Plan") for listed equity securities and the Nasdaq UTP Plan for Nasdaq securities. Before the Nasdaq Exchange can begin operating as an exchange it also must join the CQ Plan as a participant in its own right. As with transaction reports, quotations posted in Nasdaq trading facilities are currently provided to the CQ Plan and Nasdaq UTP Plan pursuant to the NASD's participation in the plans. The NASD must remain a member of these plans for OTC quotations in exchange-listed and Nasdaq securities so that it can continue to fulfill its obligations under sections 15A(b)(11)<sup>192</sup> and 11A of the Exchange Act and Rules 602 and 603.

An integral part of our national market system is the means by which quotations are accessible across the competing exchanges and the NASD.<sup>193</sup> Currently, the registered exchanges and the NASD are linked for the purpose of accessing quotations in exchange-listed securities via the Intermarket Trading System ("ITS"). The ITS Plan contains the rules pursuant to which its participants interact and contains the current trade-through rule.<sup>194</sup> Currently, the NASD is a member of the ITS Plan and as a participant complies with, and enforces compliance by its members, with the terms of the ITS Plan.<sup>195</sup> Accordingly, most OTC transactions in non-Nasdaq exchange-listed securities regulated by the NASD are subject to the requirements of the ITS Plan. The NASD plans to remain a member of the ITS Plan for the purpose of providing access to OTC quotations communicated by its members through NASD facilities and to provide its members access to exchanges' quotations. The NASD's Nasdaq facility currently is the means

by which the NASD and its members comply with obligations under the ITS Plan. Accordingly, the NASD must have the means to satisfy these obligations prior to completing the spin-off of its subsidiary as an independent national securities exchange. For this reason, the Commission is conditioning the operation of the Nasdaq Exchange, which will automatically terminate the NASD's control of Nasdaq,<sup>196</sup> on the NASD representing to the Commission that control of Nasdaq through the Preferred D share is no longer necessary.

To provide access to quotes and orders in non-Nasdaq exchange-listed securities displayed on the Nasdaq Exchange, the Nasdaq Exchange must become a member of the ITS Plan prior to its operation as a national securities exchange for trading such securities. Although required participation in the ITS Plan is of limited duration,<sup>197</sup> the Commission believes that it is necessary until the full implementation of Rule 611 that the Nasdaq Exchange join the ITS Plan to ensure that the Commission's policy of protecting limit orders and providing price protection across markets is maintained. Further, the Nasdaq Exchange participation in the ITS Plan should ensure that regulatory requirements are consistent across the markets for exchange-listed securities.<sup>198</sup> Nasdaq has proposed to adopt ITS rules that are similar to the current NASD ITS Rules. The Commission notes that the Nasdaq Exchange may have to amend its ITS rules to reflect its participation in the ITS Plan. Any changes to its rules to implement its participation in the ITS Plan must be filed with and approved by the Commission prior to its commencement of operations as a national securities exchange.

The NASD currently fulfills its obligations under Rules 602 and 603, the CTA Plan, CQ Plan, Nasdaq UTP Plan, and section 15A(b)(11) of the Exchange Act<sup>199</sup> through NASD facilities that are owned by the NASD's subsidiary, Nasdaq. The NASD also operates the ADF for collecting quotations and trade reports in Nasdaq securities but not exchange-listed securities. With respect to non-Nasdaq exchange-listed securities, the only

means currently available to the NASD to fulfill these statutory and regulatory obligations is through NASD facilities owned by Nasdaq. Accordingly, the Commission believes that, until the NASD has alternative means to satisfy these obligations, it cannot complete its separation from Nasdaq and Nasdaq cannot cease to operate as a facility of the NASD. For this reason, the Commission is conditioning the operation of the Nasdaq Exchange, which will automatically terminate the NASD's control of Nasdaq,<sup>200</sup> on the NASD representing to the Commission that control of Nasdaq through the Preferred D share is no longer necessary.

In the Original Notice, the Commission noted that the registration of the Nasdaq Exchange has implications for the NASD and its ability to satisfy its statutory and regulatory obligations.<sup>201</sup> The Commission further stated that the NASD must have an operational quotation and transaction reporting facility upon the registration of the Nasdaq Exchange. The Commission received comments on the Original Notice and Amendment Nos. 1, 2, and 3 that raised significant concerns about how the NASD would continue to satisfy its statutory and regulatory obligations.<sup>202</sup> In particular, one commenter expressed concern about Nasdaq's registration as an exchange because it "will eliminate the only non-exchange facilities that exist for trading NMS securities."<sup>203</sup> Therefore, this commenter believed that the Commission should withhold approval of Nasdaq's exchange registration until a viable NASD quotation display and trade reporting facility is in place because, without such a facility, market makers and electronic communication networks would essentially be mandated to become a member of the Nasdaq Exchange to meet their regulatory obligations. Similarly, another commenter noted that for several decades, Nasdaq has been the arm of the NASD through which broker-dealers satisfy their regulatory obligations for OTC transactions in NMS stocks. This commenter believed that Nasdaq's exchange application could not be reconciled with the requirements of the Exchange Act until after the NASD has in place operational facilities

<sup>192</sup> 15 U.S.C. 78o-3(b)(11).

<sup>193</sup> See section 11A(a)(1)(D) of the Exchange Act; 15 U.S.C. 78k-1(a)(1)(D). In this section, Congress found that the "[t]he linking of all markets for qualified securities through communications and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders."

<sup>194</sup> In June 2005, the Commission adopted Regulation NMS, which included the new Rule 611 that will supersede the trade-through rule found in the ITS Plan. Rule 611 requires a trading center to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations in NMS stocks. Rule 611 became effective on August 29, 2005; compliance with this rule shall begin starting on June 29, 2006. 17 CFR 242.611.

<sup>195</sup> 17 CFR 242.608(c).

<sup>196</sup> See *supra* note 25 and accompanying text.

<sup>197</sup> See *supra* note 194.

<sup>198</sup> See section 11A(a)(1)(ii) of the Exchange Act; 15 U.S.C. 78k-1(a)(1)(ii).

<sup>199</sup> 15 U.S.C. 78o-3(b)(11). Section 15A(b)(11) requires the rules of the NASD to include provisions governing the form and content of quotations relating to securities sold OTC that may be distributed or published by any NASD member or person associated with such member, and the persons to whom such quotations may be supplied.

<sup>200</sup> See *supra* note 25 and accompanying text.

<sup>201</sup> See Original Notice, *supra* note 2.

<sup>202</sup> See e.g., Bloomberg 2001 Letter, Instinet Letter, Phlx Letters, SIA Letter, *supra* note 15; and letters from Barry S. Porter, Chairman, The Nasdaq Stock Market Issuer Affairs Committee, dated August 8, 2001; and Senator Zell Miller, U.S. Senate, dated August 16, 2001.

<sup>203</sup> See SIA Letter, *supra* note 15.

to permit OTC trading to continue to flourish in the U.S.<sup>204</sup>

The Commission agrees with these commenters and is conditioning the operation of the Nasdaq Exchange upon the ability of the NASD to satisfy its statutory and regulatory obligations. The Commission does not believe that it would be consistent with the Exchange Act to allow the NASD to separate from the facilities by which it satisfies its regulatory obligations without having alternative means to do what the Exchange Act and the rules thereunder require. Accordingly, the Nasdaq Exchange may not begin operating as a national securities exchange and cease to operate as a facility of the NASD until NASD has the means to fulfill its regulatory obligations.

Finally, national securities exchanges must make available certain order execution information pursuant to Rule 605 of Regulation NMS.<sup>205</sup> Current exchanges have standardized the required disclosure mechanisms by participating in the Order Execution Quality Disclosure Plan.<sup>206</sup> The Nasdaq Exchange must join this plan before it begins operations as an exchange.

#### E. Listing Requirements

##### 1. Registration Under Section 12(b) of the Exchange Act

Once the Nasdaq Exchange begins operations as a national securities exchange, a security will be considered for listing on the Nasdaq Exchange only if such security is registered pursuant to section 12(b) of the Exchange Act<sup>207</sup> or such security is subject to an exemption.<sup>208</sup> An issuer may register a

<sup>204</sup> See Instinet Letter, *supra* note 15.

<sup>205</sup> 17 CFR 242.605.

<sup>206</sup> See Exchange Act Release No. 44177 (April 12, 2001), 66 FR 19814 (April 17, 2001).

<sup>207</sup> 15 U.S.C. 78l(b). Nasdaq has notified Commission staff of its intent to request appropriate regulatory relief to facilitate the efficient registration of its issuers' securities under section 12(b) of the Exchange Act. The Commission expects that any such process would include a notice by Nasdaq to the general public and an appropriate notice to issuers, and an opportunity for issuers to opt out of the process.

<sup>208</sup> 15 U.S.C. 78l(c); Nasdaq Exchange Rules 4310(a) and 4320(a). Certain issuers currently listed on Nasdaq are not required to register under section 12(g) of the Exchange Act because of exemptions provided to foreign private issuers, Rule 12(g)(3)-2(b), and insurance companies, section 12(g)(2)(G). These issuers, however, are not similarly exempt from section 12(b) of the Exchange Act. The Commission received one comment letter submitted on behalf of Nissan Motor Co., Ltd., whose shares (in the form of American Depositary Shares) are listed on Nasdaq but are exempt from registration under section 12(g). See Nissan Letter, *supra* note 10. Nissan requests that its current exemption from registration be continued, or alternatively that it and other similarly situated foreign private issuers be given a transition period after Nasdaq begins operating as an exchange within which to evaluate

security pursuant to section 12(b) by submitting to the Nasdaq Exchange a listing application that provides certain required information.<sup>209</sup> The Exchange will review the listing application and, if the listing application is approved, will certify to the Commission that it has approved the security for listing and registration.<sup>210</sup> Registration of the security will become effective thirty days after the receipt of such certification by the Commission or within a shorter period of time as the Commission may determine.<sup>211</sup> Once registration is effective the security is eligible for listing on the Nasdaq Exchange.<sup>212</sup>

##### 2. Initial and Continuing Listing Standards

Nasdaq proposes that its initial and continuing listing standards be largely the same as current NASD listing rules.<sup>213</sup> Nasdaq also proposes a transitional listing rule that would automatically qualify for initial listing any security trading on the Nasdaq facility of the NASD on the day prior to the Nasdaq Exchange's first day of operation as an independent exchange.<sup>214</sup> The Commission believes

whether to register under section 12(b). In its response to this comment, Nasdaq stated that it expects to submit a formal request to the Commission pursuant to which Nasdaq will seek a three-year exemption period for issuers such as Nissan.

<sup>209</sup> 15 U.S.C. 78l(b); Nasdaq Exchange Rules 4310(b) and 4320(b).

<sup>210</sup> See Nasdaq Exchange Rules 4310(b), 4320(b), and 4410(b); 15 U.S.C. 78l(d).

<sup>211</sup> 15 U.S.C. 78l(d).

<sup>212</sup> See Nasdaq Exchange Rules 4310(b), 4320(b), and 4410(b); 15 U.S.C. 78l(d).

<sup>213</sup> In Amendment No. 6, Nasdaq proposed to modify their listing standards to reflect proposed rule changes approved by the Commission for the NASD as follows: SR-NASD-2004-125 clarifies and increases the transparency of the procedures associated with denying companies initial or continued listing on Nasdaq, see Exchange Act Release No. 52342 (August 26, 2005), 70 FR 52456 (September 2, 2005); SR-NASD-2005-153 amends the procedures for review of listing determinations to allow for electronic delivery of documents, see Exchange Act Release No. 53067 (January 6, 2006); SR-NASD-2004-162 establishes a fee and notice requirements for substitution listing events for all Nasdaq issuers, except dual listed companies, see Exchange Act Release No. 52712 (November 1, 2005), 70 FR 67511 (November 7, 2005); SR-NASD-2005-136 permits Nasdaq to issue public reprimand letters to listed companies for certain rule violations when a determination is made that delisting is not an appropriate sanction, see Exchange Act Release No. 52899 (December 6, 2005), 70 FR 74392 (December 15, 2005); and SR-NASD-2005-082 clarifies the listing standards applicable to companies in bankruptcy proceedings, see Exchange Act Release No. 52603 (October 13, 2005), 70 FR 61163 (October 20, 2005). The Commission finds that these changes are consistent with section 6(b)(5) of the Exchange Act for the same reasons that the Commission approved them under section 15A(b)(6) of the Exchange Act.

<sup>214</sup> See Amendment No. 6, *supra* note 12 and Nasdaq Exchange Rule 4305.

that these rules are consistent with the requirements of the Exchange Act because they would enable current Nasdaq securities to continue trading once the Nasdaq Exchange begins operations as a national securities exchange thus providing a continuous market for investors for these securities.

##### 3. Corporate Governance Standards

In 2003, the Commission approved a proposal to revise the NASD rules by adding new corporate governance standards for listed issuers, as contained in NASD Rules 4200 and 4350.<sup>215</sup> These changes, which were applied to Nasdaq-listed issuers through the NASD as a national securities association, established enhanced requirements for audit committees of Nasdaq-listed issuers, as mandated by the Sarbanes-Oxley Act of 2002.<sup>216</sup> In addition, these changes established new requirements relating to the independence of the listed issuer's board of directors and key board committees and required issuers to adopt codes of conduct for directors, officers and employees. The corporate governance listing standards proposed for the Nasdaq Exchange are the same as those previously approved by the Commission for the NASD pursuant to section 10A(m) of the Exchange Act and Rule 10A-3 and pursuant to section 15A(b)(6) of the Exchange Act.<sup>217</sup>

<sup>215</sup> See Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003) (approving changes to the corporate governance listing standards of the Nasdaq Stock Market, Inc. and the NYSE).

<sup>216</sup> The Sarbanes Oxley Act, Public Law 107-204, 116 Stat. 745 (2002), established, among other provisions, section 10A(m) of the Exchange Act, 15 U.S.C. 78j-1(m), which relates to standards for audit committees. Rule 10A-3 under the Exchange Act, which was adopted pursuant to section 10A(m) of the Exchange Act, directed each national securities exchange and national securities association to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements specified in the Rule. 17 CFR 240.10A-3.

<sup>217</sup> 15 U.S.C. 78f(b)(5). Subsequent to the Commission's approval of changes to the corporate governance listing standards for Nasdaq-listed issuers, the NASD refined those standards. See Exchange Act Release Nos. 49060 (January 12, 2004), 69 FR 2954 (January 21, 2004); 49901 (June 22, 2004), 69 FR 38944 (June 29, 2004); 49903 (June 22, 2004), 69 FR 38941 (June 29, 2004); 50573 (October 20, 2004), 69 FR 62493 (October 26, 2004); 51221 (February 17, 2005), 70 FR 9122 (February 24, 2005); and 51420 (March 23, 2005), 70 FR 15968 (March 29, 2005). In Amendment No. 6, Nasdaq proposed to modify Nasdaq Exchange Rule 4350(k) to reflect a proposed rule change approved by the Commission for the NASD. This proposed rule change requires each listed issuer to be audited by an independent accountant that is registered as a public accounting firm with the Public Company Accounting Oversight Board. See Exchange Act Release No. 52896 (December 6, 2005), 70 FR 74074 (December 14, 2005). The Commission finds that this proposed rule change is consistent with section 6(b)(5) of the Exchange Act for the same reasons

The Commission finds that the proposed corporate governance listing standards contained in the Nasdaq Exchange's proposed rules are consistent with section 6(b)(5) of the Exchange Act and satisfy the requirements of the section 10A(m) of the Exchange Act and Rule 10A-3 thereunder. The Commission believes that the Nasdaq Exchange's corporate governance listing standards are designed to promote independent and objective review and oversight of the accounting and auditing practices of listed issuers and to enhance audit committee independence, authority, and responsibility by implementing the standards set forth in Rule 10A-3. Moreover, in the Commission's view, the listing standards should help safeguard the interests of shareholders and foster greater transparency, accountability, and objectivity in the oversight by, and the decision making processes of, the boards and key board committees of Nasdaq-listed issuers. The Nasdaq Exchange's listing standards also should help promote compliance with high standards of conduct by the issuers' directors, management, and personnel.

#### F. Unlisted Trading Privileges

Rule 602 of Regulation NMS requires the NASD to collect, process and make available to vendors the best bid, best offer, and quotation sizes in NMS securities<sup>218</sup> communicated off an exchange by members acting in the capacity of an OTC market maker. The NASD satisfies this obligation today through its operation of the Nasdaq facility through which NASD members quote and report trades in exchange-listed securities. In offering this quote and trade reporting facility for exchange-listed securities, the NASD does not have rules that comply, in all respects, to section 12(f) of the Exchange Act and Rule 12f-5 thereunder because those provisions apply only to exchanges.<sup>219</sup>

Once registered as an exchange, the Nasdaq Exchange will be permitted by section 12(f) of the Exchange Act to extend unlisted trading privileges to securities listed and registered on other exchanges, subject to Commission rules. Exchange Act Rule 12f-5 requires an

that the Commission approved this rule change under section 15A(b)(6).

<sup>218</sup> An NMS security is any security for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. 17 CFR 242.600(b)(46).

<sup>219</sup> See also section 15A(b)(11) of the Exchange Act.

exchange that extends unlisted trading privileges to securities to have in effect a rule or rules providing for transactions in the class or type of security to which the exchange extends unlisted trading privileges.<sup>220</sup> The Commission notes that the Nasdaq Exchange does not have in effect rules that comply with Rule 12f-5 for all exchange-listed securities currently quoted on the Nasdaq facility of the NASD.<sup>221</sup> Accordingly, to continue trading such securities, the Nasdaq Exchange would have to file a proposed rule change with the Commission and obtain Commission approval of such rules.

#### IV. Exemption From Section 19(b) of the Exchange Act With Regard to NASD Rules Incorporated by Reference

Nasdaq proposes to incorporate by reference many NASD rules as Exchange rules. Thus, for certain Exchange rules, Exchange members will comply with an Exchange rule by complying with the NASD rule referenced.<sup>222</sup> In connection

<sup>220</sup> 17 CFR 240.12f-5. See also Exchange Act Release No. 35737 (April 21, 1995), 60 FR 20891 (April 28, 1995) (adopting Rule 12f-5).

<sup>221</sup> For example, the Nasdaq Exchange does not have rules that comply with Rule 12f-5 for certain exchange-traded funds whose holdings are primarily unregistered foreign securities (such as those formerly known as World Equity Benchmark Shares or WEBS), exchange-traded funds whose holdings are concentrated in a few securities, exchange-traded funds that provide a leveraged performance (such as xtraShares Trust Ultra Funds and Short Funds), and certain commodity or foreign currency based derivative securities (such as streetTracks Gold Shares (GLD), iShares Comex Gold Trust Shares (IAU), and Euro Currency Shares (FXE)).

<sup>222</sup> Nasdaq proposed to incorporate by reference the following NASD rules: Article IV, Section 8 of the NASD By-Laws; IM-1000-1032; 1120; 2111; IM-2110-2; 2210; IM-2210-1; 2211; 2212; 2240; 2250; 2260; IM-2260; 2270; 2310; IM-2310-2; IM-2310-3; 2330; IM-2330; 2340; 2341; 2360; 2361; 2370; 2430; 2510; 2520; 2810; 2830; 3010; IM-3010; 3011; 3012; 3013; IM-3013; 3020; 3030; 3040; 3050; 3060; 3070; 3080; IM-3110; 3120; 3130; IM-3130; 3150; 3510; 6953; 6954; 6955; 6957; the 10000 series; 11860; and 11870. In Amendment No. 6, Nasdaq proposed that the Nasdaq Exchange incorporate by reference recent amendments to the "Manning Rule," NASD IM-2110-2, and NASD Rule 2111, to reflect proposed rule changes approved by the Commission for the NASD. The amendments to NASD IM-2110-2 prohibit a Nasdaq Exchange member from trading for its own account in a Nasdaq or exchange-listed security at a price that is better than an unexecuted customer limit order in that security, unless the Nasdaq Exchange member immediately executes the customer limit order at the price at which the Nasdaq Exchange member traded for its own account or better. See Exchange Act Release No. 52210 (August 4, 2005), 70 FR 46897 (August 11, 2005). NASD Rule 2111 extends the Manning Rule to customer market orders. See Exchange Act Release No. 52226 (August 9, 2005), 70 FR 48219 (August 16, 2005). In addition, as a result of these proposed rule changes, in Amendment No. 6 Nasdaq proposed to delete certain provisions of Rule 6440(f) to reflect an NASD proposed rule change approved by the Commission. See Exchange Act Release No. 52722 (November 2, 2005), 70 FR

with its proposal to incorporate NASD rules by reference, Nasdaq requested, pursuant to Rule 240.0-12,<sup>223</sup> an exemption under section 36 of the Exchange Act from the rule filing requirements of section 19(b) of the Exchange Act for changes to those Nasdaq Exchange rules that are effected solely by virtue of a change to a cross-referenced NASD rule.<sup>224</sup> Nasdaq proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. In addition, the Nasdaq Exchange agrees to provide written notice to its members whenever a proposed rule change to an NASD rule that is incorporated by reference is proposed.

Using its authority under section 36 of the Exchange Act, the Commission previously exempted certain SROs from the requirement to file proposed rule changes under section 19(b) of the Exchange Act.<sup>225</sup> Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules.

In addition, each SRO incorporated by reference only regulatory rules (*i.e.*, margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules (*i.e.*, did not "cherry-pick" certain individual rules within a category). Each exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting Nasdaq's request for exemption, pursuant to section 36 of the Exchange Act, from the rule filing requirements of section 19(b) of the Exchange Act with respect to the rules that the Nasdaq Exchange proposes to incorporate by reference.

68120 (November 9, 2005). The Commission finds that these proposed rule changes are consistent with Section 6(b)(5) of the Exchange Act for the same reasons that the Commission approved these rule changes under section 15A(b)(6).

<sup>223</sup> See 17 CFR 240.0-12.

<sup>224</sup> See letter to Nancy Morris, Secretary, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated January 13, 2006. This letter supersedes and replaces prior similar exemptive requests. See letters to Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated December 8, 2005 and May 6, 2002.

<sup>225</sup> See Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004).



This exemption is conditioned upon the Nasdaq Exchange providing written notice to its members whenever the NASD proposes to change a rule that the Nasdaq Exchange has incorporated by reference. The Commission believes that this exemption will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rule text sought by more than one SRO. Consequently, the Commission grants Nasdaq's exemption request for the Nasdaq Exchange.

## V. Conclusion

It is ordered that the application of the Nasdaq Stock Market LLC for registration as a national securities exchange be, and hereby is, granted.

It is further ordered that operation of the Nasdaq Exchange is conditioned on the satisfaction of the requirements below.

A. *Participation in National Market System Plans.* The Nasdaq Exchange must join the CTA Plan, the CQ Plan, the Nasdaq UTP Plan, the ITS Plan, and the Order Execution Quality Disclosure Plan.

B. *The NASD's Ability to Fulfill its Statutory and Regulatory Obligations.* 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 non-Nasdaq exchange listed securities 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.

C. *Intermarket Surveillance Group.* The Exchange must join the Intermarket Surveillance Group.

D. *Minor Rule Violation Plan.* A MRVP filed by the Nasdaq Exchange under Exchange Act Rule 19d-1(c)(2) must be declared effective by the Commission.<sup>226</sup>

E. *Fingerprint Plan.* A fingerprint plan filed by the Nasdaq Exchange under Exchange Act Rule 17f-2 must be declared effective by the Commission.<sup>227</sup>

F. *17d-2 Agreement.* An agreement pursuant to Exchange Act Rule 17d-2<sup>228</sup> between the NASD and the Nasdaq Exchange that allocates to the NASD regulatory responsibility for those matters specified above<sup>229</sup> must be approved by the Commission, or the Nasdaq Exchange must demonstrate that

it independently has the ability fulfill all of its regulatory obligations.

By the Commission (Chairman Cox and Commissioners Glassman, Atkins, Campos, and Nazareth).

**Nancy M. Morris,**

*Secretary.*

[FR Doc. E6-664 Filed 1-20-06; 8:45 am]

**BILLING CODE 8010-01-P**

## SECURITIES AND EXCHANGE COMMISSION

[File No. 1-31993]

### Issuer Delisting; Notice of Application of Sterling Construction Company, Inc. To Withdraw Its Common Stock, \$.01 Par Value, From Listing and Registration on the American Stock Exchange LLC

January 13, 2006.

On January 9, 2006, Sterling Construction Company Inc., a Delaware corporation ("Issuer"), filed an application with the Securities and Exchange Commission ("Commission"), pursuant to Section 12(d) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 12d2-2(d) thereunder,<sup>2</sup> to withdraw its common stock, \$.01 par value ("Security"), from listing and registration on the American Stock Exchange LLC ("Amex").

On November 15, 2005, the Board of Directors ("Board") of the Issuer authorized management to apply to list the Security on the Nasdaq National Market ("Nasdaq") and upon approval of such listing to withdraw the Security from listing and registration on Amex. The Issuer stated in its application that it decided to transfer the listing of the Security from Amex to Nasdaq because it believes that Nasdaq will provide greater exposure of the Security to investors, especially as more of the members of the Issuer's peer group of construction companies have a Nasdaq listing rather than an exchange listing. The Issuer stated that on January 4, 2006, Nasdaq approved its application to list the Security on Nasdaq. The Issuer expects the Security to trade on Nasdaq on or about January 20, 2006.

The Issuer stated in its application that it has met the requirements of Amex Rule 18 by complying with all applicable laws in effect in the State of Delaware, in which it is incorporated, and provided written notice of withdrawal to Amex.

The Issuer's application relates solely to withdrawal of the Security from

listing on Amex and from registration under Section 12(b) of the Act,<sup>3</sup> and shall not affect its obligation to be registered under Section 12(g) of the Act.<sup>4</sup>

Any interested person may, on or before February 9, 2006, comment on the facts bearing upon whether the application has been made in accordance with the rules of Amex, and what terms, if any, should be imposed by the Commission for the protection of investors. All comment letters may be submitted by either of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/delist.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include the File Number 1-31993 or;

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number 1-31993. This file number should be included on the subject line if e-mail is used. To help us 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/delist.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

The Commission, based on the information submitted to it, will issue an order granting the application after the date mentioned above, unless the Commission determines to order a hearing on the matter.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

**Nancy M. Morris,**

*Secretary.*

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<sup>3</sup> 15 U.S.C. 781(b).

<sup>4</sup> 15 U.S.C. 781(g).

<sup>5</sup> 17 CFR 200.30-3(a)(1).

<sup>226</sup> 17 CFR 240.19d-1(c)(2).

<sup>227</sup> 17 CFR 240.17f-2(c).

<sup>228</sup> 17 CFR 240.17d-2.

<sup>229</sup> See *supra* text accompanying notes 114-117.

<sup>1</sup> 15 U.S.C. 781(d).

<sup>2</sup> 17 CFR 240.12d2-2(d).