

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2006-068 on the subject line.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-068. This file number should be included on the subject line if e-mail is used. To help the Commission 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/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-NASD-2006-068 and should be submitted on or before July 31, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁰

J. Lynn Taylor,

Assistant Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54084; File No. SR-NASD-2005-087]

**Self-Regulatory Organizations;
National Association of Securities
Dealers, Inc.; Order Approving
Proposed Rule Change and Notice of
Filing and Order Granting Accelerated
Approval to Amendment No. 1 Relating
to Amendments to the NASD's Rules
Following the Nasdaq Exchange's
Operation as a National Securities
Exchange for Nasdaq UTP Plan
Securities**

June 30, 2006

I. Introduction

On July 11, 2005, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend various NASD rules to reflect the Nasdaq Stock Market, Inc.'s ("Nasdaq") separation from the NASD following the commencement of operations of the Nasdaq Stock Market LLC ("Nasdaq Exchange") as a national securities exchange.

Prior to 2000, Nasdaq was wholly-owned by the NASD. The NASD currently retains voting control of Nasdaq through an outstanding share of Nasdaq Series D preferred stock.³ The NASD and Nasdaq began restructuring their relationship in 2000 with the goal of completely separating Nasdaq from the NASD. As part of this restructuring, Nasdaq filed with the Commission an application to register one of its

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19B-4.

³ The share of Series D preferred stock gives the NASD the right to cast one more than one-half of all votes entitled to be cast at an election by all holders of capital stock of Nasdaq. When Nasdaq ceases to operate pursuant to the NASD's Plan of Allocation and Delegation of Functions by NASD to Subsidiaries (the "Delegation Plan"), the Series D preferred share will expire automatically. See Securities Exchange Act Release No. 53022 (December 23, 2005), 70 FR 77433 (December 30, 2005). To reflect this change, the NASD will file a proposed rule change to revise the Delegation Plan to remove references to Nasdaq as a subsidiary of the NASD. Because this change to the Delegation Plan would terminate the NASD's control under the Series D preferred share, the NASD cannot file this proposed rule change until it can represent to the Commission that its control of Nasdaq is no longer necessary because the NASD can fulfill through other means its obligations with respect to securities reported to the Consolidated Transaction Association Plan ("CTA Plan Securities") See Order Modifying Nasdaq Exchange Conditions, *infra* note 6.

subsidiaries, the Nasdaq Exchange, as a national securities exchange.⁴

The Commission approved the Nasdaq's Exchange's registration as a national securities exchange on January 13, 2006.⁵ In the Nasdaq Exchange Order, the Commission conditioned the Nasdaq Exchange's operation as a national securities exchange on the satisfaction of certain enumerated requirements. The Nasdaq Exchange Order and the conditions therein reflected the Nasdaq Exchange's intentions to begin operations as a national securities exchange for CTA Plan Securities as well as securities listed on Nasdaq and reported to 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 Securities").

The Commission modified the conditions set forth in the Nasdaq Exchange Order on June 30, 2006, to allow the Nasdaq Exchange to operate as a national securities exchange solely with respect to Nasdaq UTP Plan Securities.⁶ During this period, the NASD will continue to control Nasdaq through the Series D preferred share and Nasdaq will continue to perform obligations under the Delegation Plan with respect to CTA Plan Securities. Accordingly, the NASD filed Amendment No. 1 to modify the proposed rule change to reflect the Nasdaq Exchange's operational plan.

II. NASD Proposal

In the proposed rule change, the NASD proposed to: (1) Delete certain NASD rules that pertain to the operation of the Nasdaq Exchange and thus reflect Nasdaq's separation from the NASD;⁷ (2) modify certain NASD rules to clarify the NASD's continued regulation of the over-the-counter ("OTC") market upon the Nasdaq Exchange's operation as an exchange;⁸ (3) amend the NASD's Order Audit Trail System ("OATS") to reflect the use of OATS by Nasdaq Exchange members;⁹ (4) make technical and clarifying changes to the rules governing the NASD's Alternative Display Facility

⁴ In connection with the Nasdaq Exchange registration, Nasdaq became a holding company with the Nasdaq Exchange as its wholly-owned subsidiary.

⁵ See Securities Exchange Act Release No. 53128, 71 FR 3350 (January 23, 2006) ("Nasdaq Exchange Order").

⁶ See Securities Exchange Act Release No. 54085 (June 30, 2006) ("Order Modifying Nasdaq Exchange Conditions").

⁷ See *infra* note 44 and accompanying section.

⁸ See *infra* notes 46-53 and accompanying text.

⁹ See *infra* note 55 and accompanying text.

³⁰ 17 CFR 200.30-3(a)(12).

("ADF");¹⁰ and (5) establish rules governing the NASD's proposed new trade reporting facility ("Trade Reporting Facility").¹¹

The proposed rule change was published for comment in the **Federal Register** on July 22, 2005.¹² The Commission received 14 comment letters from 12 commenters regarding the proposal.¹³ On November 23, 2005, and May 3, 2006, the NASD submitted responses to the comment letters.¹⁴

The NASD filed Amendment No. 1 to the proposal on June 15, 2006. In addition to making several technical corrections and conforming changes,¹⁵

¹⁰ See *infra* notes 77–84 and accompanying section.

¹¹ See *infra* notes 85–101 and accompanying text.

¹² See Securities Exchange Act Release No. 52049 (July 15, 2005), 70 FR 42398 (July 22, 2005).

¹³ See letters to Jonathan G. Katz, Secretary, Commission, from Mary Yeager, Assistant Secretary, New York Stock Exchange, Inc. ("NYSE"), dated August 12, 2005 ("NYSE Letter I") and November 10, 2005 ("NYSE Letter II"); Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated October 13, 2005 ("Nasdaq Letter"); John Boese, Vice President and Chief Regulatory Officer, Boston Stock Exchange, Inc. ("BSE"), dated November 4, 2005 ("BSE Letter"); and Kevin J.P. O'Hara, Chief Administrative Officer and General Counsel, Archipelago Holdings, Inc. ("Archipelago"), dated November 10, 2005 ("Archipelago Letter"); letters to The Honorable Christopher Cox, Chairman, Commission, from Bart J. Ward, Chief Executive Officer, Ward & Company, dated February 10, 2006 ("Ward Letter"); John A. Thain, Chief Executive Officer, NYSE Group, Inc., dated April 27, 2006 ("NYSE Letter III"). See also letters to The Honorable Christopher Cox, Chairman, Commission, from The Honorable Geoff Davis, U.S. House of Representatives, dated February 9, 2006 ("Davis Letter"); The Honorable Melissa L. Bean, U.S. House of Representatives, dated January 16, 2006 ("Bean Letter"); The Honorable Edolphus Towns, U.S. House of Representatives, dated January 12, 2006 ("Towns Letter"); The Honorable Michael E. Capuano, U.S. House of Representatives, dated January 3, 2006 ("Capuano Letter"); The Honorable Patrick T. McHenry, U.S. House of Representatives, dated December 22, 2005 ("McHenry Letter"); The Honorable Jim Gerlach, U.S. House of Representatives, dated December 14, 2005 ("Gerlach Letter"); and The Honorable Richard H. Baker, Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives, dated December 13, 2005 ("Baker Letter"). The comment letters are available in the Commission's Public Reference Room and on the Commission's Internet Web site (<http://www.sec.gov>). The Commission notes that the Archipelago Letter and NYSE Letter II also were submitted as comment letters in response to the Nasdaq Exchange's application to register as a national securities exchange.

¹⁴ See letter to Jonathan G. Katz, Secretary, Commission, from Barbara Z. McSweeney, Senior Vice President and Corporate Secretary, NASD, dated November 23, 2005 ("NASD Response Letter I"); letter to the Honorable Christopher Cox, Chairman, Commission from Robert R. Glauber, Chairman and Chief Executive Officer, NASD, dated May 2, 2006 ("NASD Response Letter II").

¹⁵ For example, the NASD proposes to: (1) Revise NASD Rule 5100, "Short Sale Rule," to indicate that the NASD's Short Sale Rule will continue to operate as a pilot program; (2) retain the NASD Rule 9700 Series, "Procedures on Grievances Concerning

the NASD proposes in Amendment No. 1 to revise its proposal to: (1) Amend the Delegation Plan to retain the delegation to Nasdaq of obligations with respect to CTA Plan Securities, while eliminating Nasdaq's regulatory authority with respect to Nasdaq UTP Plan Securities;¹⁶ (2) amend the Nasdaq Bylaws to reflect changes that were approved in the Nasdaq Exchange Order;¹⁷ (3) retain amended versions of the rules governing Nasdaq's BRUT and INET trading systems;¹⁸ (4) provide that members may continue to quote and trade CTA Plan Securities and participate in the Intermarket Trading System ("ITS") through an NASD facility by retaining in the NASD's rules revised versions of relevant rules;¹⁹ (5) revise an existing NASD rule to make clear that certain securities that will be listed on the Nasdaq Exchange will continue to be treated as CTA Plan Securities;²⁰ and (6) delete from NASD Rule 6120 a provision allowing a national securities exchange that trades Nasdaq securities on an unlisted trading privileges basis ("UTP Exchange") to participate in the Trade Reporting Facility. In addition, the NASD has requested that this proposal become effective only when the Nasdaq Exchange begins operations as a national securities exchange for Nasdaq UTP Plan Securities.

Finally, in Amendment No. 1, the NASD also proposed to renumber NASD Rule 6440(i) as NASD Rule 5110, "Transactions Related to Initial Public Offerings" and to extend its application to transactions in Nasdaq UTP Plan Securities.

After careful consideration and for the reasons discussed below, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the NASD, and, in particular, with the requirements of Sections 15A(b)(2), (6),

the Automated Systems" for appeals of OTC Bulletin Board eligibility determinations and retain NASD Rule 11890, "Clearly Erroneous Transactions," and IM-11890-1 and IM-11890-2; (3) make additional technical changes to the ADF Rules; (4) incorporate NASD rules that have been approved since the NASD filed the proposal; (5) clarify the termination provision in the Trade Reporting Facility LLC agreement to correctly reflect that Nasdaq is not registered as a self-regulatory organization ("SRO"); and (6) retain references to Nasdaq in NASD's Delegation Plan, bylaws and rules to reflect that Nasdaq remains a controlled subsidiary.

¹⁶ See *infra* notes 40–41 and accompanying text.

¹⁷ See *infra* note 42 and accompanying text.

¹⁸ See *infra* notes 72–74 and accompanying text.

¹⁹ See *infra* notes 58–70 and accompanying text.

²⁰ See *infra* note 57 and accompanying text.

and (11) of the Exchange Act.²¹ Section 15A(b)(2) of the Exchange Act requires a registered national securities association to be so organized and have the capacity to be able to carry out the purposes of the Exchange Act. Section 15A(b)(6) of the Exchange Act requires that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities, to remove impediments to and protect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. Section 15A(b)(11) of the Exchange Act requires that the rules of a registered national securities association be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

In addition, the Commission is publishing notice to solicit comments on, and is simultaneously approving, on an accelerated basis, Amendment No. 1. Many of the changes proposed in Amendment No. 1 reflect the new implementation strategy for the Nasdaq Exchange and are necessary for the NASD to fulfill its obligations under the Exchange Act with regard to CTA Plan Securities.

Specifically, the NASD proposes to retain its rules that govern its members' quoting, trading, and transaction reporting of CTA Plan Securities and its ITS rules related to the NASD's and its members' compliance with the requirements of the ITS Plan. In this regard, in Amendment No. 1, the NASD proposes to retain the portions of the NASD's Rule 4700 Series relating to the NASD's participation in the ITS Plan. The NASD also proposes to amend the Rule 4700 Series to delete rules that relate to the operation of the Nasdaq Market Center trading system, while retaining the current rules that relate to the operation of the SuperIntermarket functionality, which facilitates NASD members' compliance with the ITS Plan. In addition, the NASD proposes to retain its Rule 6300 Series and Rule 5200 Series, which, among other things, allow NASD members to enter

²¹ 15 U.S.C. 78o-3(b)(2), (6), and (11). In approving the proposed rule change, the Commission has considered the proposal's impact on efficiency, competition, and capital formation.

quotations in CTA Plan Securities by registering as Consolidated Quote System ("CQS") market makers and as ITS/Computer Assisted Execution System ("ITS/CAES") market makers. Finally, the NASD proposes to retain its 6400 Series, which governs the reporting of transactions in CTA Plan Securities that do not occur in the SuperIntermarket. The retention of these rules, with changes that reflect the Nasdaq Exchange's operation as an exchange for Nasdaq UTP Plan Securities, maintains the current framework for OTC trading of CTA Plan Securities. Accordingly, the Commission finds good cause to accelerate approval of these changes.

To reflect the new implementation strategy of the Nasdaq Exchange, in Amendment No. 1, the NASD proposes to retain in the NASD's rules the Nasdaq By-Laws and, rather than remove all references to Nasdaq in the Delegation Plan, to only eliminate Nasdaq's responsibility under the Delegation Plan with respect to Nasdaq UTP Plan Securities. By retaining references to Nasdaq in the Delegation Plan, the NASD retains control over Nasdaq pursuant to the Series D preferred share.²² The Commission finds good cause to accelerate approval of these changes to the Delegation Plan because they allow Nasdaq to continue to perform the same functions it does today regarding CTA Plan Securities and appropriately limit Nasdaq's delegated authority once it begins operations as a national securities exchange so that it will not be delegated responsibility regarding OTC activities in Nasdaq UTP Plan Securities. Further, these changes ensure that the NASD retains control over Nasdaq so that the NASD will have the means by which to fulfill its obligations through the use of Nasdaq systems with regard to CTA Plan Securities.

In addition, the NASD proposes, in Amendment No. 1, to retain the rules that govern executions of CTA Plan Securities on BRUT and INET. The Commission finds good cause to accelerate approval of these changes because these systems must continue to operate pursuant to NASD rules until the Nasdaq Exchange begins trading CTA Plan Securities.

Finally, the NASD proposes to amend NASD Rule 4400 relating to securities that are dually listed on the NYSE and the Nasdaq Exchange. The revised rule, which reflects language currently found in NASD IM-4400, makes clear that these dually listed securities will continue to be treated as CTA Plan

Securities under the NASD's rules and applicable national market system plans. The Commission finds good cause to accelerate approval of this change because it will ensure that these securities are handled in the same manner as they are today.

In Amendment No. 1, the NASD proposes to renumber NASD Rule 6440(i) as NASD Rule 5110 and to extend its application to Nasdaq UTP Plan Securities. This rule prohibits members from executing transactions in securities that are subject to an initial public offering until such security has opened for trading on the listing exchange, which is indicated by the dissemination of an opening transaction by the listing exchange via the Consolidated Tape.²³ The Commission finds good cause to accelerate approval of extending this rule to Nasdaq UTP Plan Securities because it will result in uniform regulation of securities that are subject to an initial public offering.

In Amendment No. 1, the NASD also proposes to retain the NASD Rule 9700 Series, relating to grievances concerning automated systems, and NASD Rule 11890, relating to clearly erroneous transactions. Because the NASD will continue to operate the OTC Bulletin Board ("OTCBB"), it must retain the NASD Rule 9700 Series, which governs the review of requests for OTCBB eligibility determinations. Accordingly, the Commission finds good cause to accelerate approval of NASD's proposal to retain this rule. The Commission notes that the NASD only proposed to eliminate reference to a Nasdaq committee that is currently required in the NASD Rule 9700 Series. The NASD replaced the Nasdaq committee with an NASD committee designated by the Board that must be comprised of at least 50% non-industry committee members. The current Nasdaq committee requires at least five non-industry members on its committee that may consist of between 8 and 18 members. The Commission finds good cause to accelerate approval of this change because it reflects the NASD's responsibility over the OTCBB.

The NASD also proposes to retain amended paragraph (a) of Rule 11890 so that its application will be limited to transactions in CTA Plan Securities. The NASD originally proposed to delete this rule, which provides Nasdaq with

authority to review any transaction arising from the use of any execution or communication system owned or operated by Nasdaq. After the Nasdaq Exchange commences operations as an exchange for Nasdaq UTP Plan Securities, the only communication systems of the NASD that will be covered by Rule 11890(a) will be the SuperIntermarket, BRUT, and INET. Accordingly, the Commission finds good cause to accelerate approval of this change that limits Nasdaq's authority under this rule to CTA Plan Securities.

With regard to the Trade Reporting Facility, the NASD proposes in Amendment No. 1 to delete the provision in NASD Rule 6120 that would have allowed a UTP Exchange to participate in the Trade Reporting Facility. This provision is unnecessary because a UTP Exchange would not require a means for reporting internalized trades. Accordingly, the Commission finds good cause to accelerate the deletion of this provision. The NASD also proposes to amend the termination provision of the Trade Reporting Facility LLC agreement to reflect that Nasdaq is not a registered SRO. The Commission finds good cause to accelerate approval of this change because the agreement, as amended, accurately reflects Nasdaq's status.

In Amendment No. 1, the NASD also proposes several technical changes. For example, the NASD proposes to indicate that its Short Sale Rule is a pilot. In addition, the NASD proposes to incorporate rule changes that have been approved or have otherwise become effective since it filed its proposed rule change. The Commission finds good cause to accelerate approval of these changes so that the proposal accurately reflects the NASD's current rules.

Finally, the NASD proposes that its proposed rule change become effective upon the operation of the Nasdaq Exchange as an exchange for Nasdaq UTP Plan Securities. The Commission finds good cause to accelerate approval of this proposal because the NASD must retain its current rules until such time as the Nasdaq Exchange begins operation for Nasdaq UTP Plan Securities in order to continue to fulfill its obligations under the Exchange Act.

For the reasons discussed above, the Commission finds good cause for approving Amendment No. 1 to the proposal prior to the 30th day after the date of publication of notice of filing thereof in the **Federal Register**. Accordingly, the Commission finds that it is consistent with Sections 15A(b)(6)

²² See *supra* note 3.

²³ The Commission notes that the NASD committed to file a proposed rule change to amend this rule to reflect that transactions in Nasdaq UTP Plan Securities are reported to the Nasdaq UTP Plan. Telephone call between Kelly Riley, Assistant Director, Division of Market Regulation ("Division"), Commission and Lisa Horrigan, Assistant General Counsel, NASD on June 28, 2006.

and 19(b)(2) of the Exchange Act²⁴ to approve Amendment No. 1 on an accelerated basis.

III. Discussion

A. The NASD's Obligations Under the Exchange Act and Commission Rules

The NASD is a registered national securities association and SRO. One of its statutory obligations as a registered national securities association is to supervise the activities of its members that occur otherwise than on an exchange. In particular, Section 15A(b)(11) of the Exchange Act requires the NASD to have rules that govern the "form and content of quotations relating to securities sold otherwise than on a national securities exchange. * * *" ²⁵ These rules also must be designed to produce fair and informative quotations and to promote orderly procedures for collecting, distributing, and publishing quotations.²⁶ Rule 602 of Regulation NMS also requires the NASD to collect bids, offers, quotation sizes, and aggregate quotation sizes from those members who are responsible broker or dealers.²⁷ The NASD must then make available to vendors, at all times when last sale information is reported, information about the best bids, best offers, and quotation sizes communicated otherwise than on an exchange by its members that act as OTC market makers, and their identity.

Rule 601 of Regulation NMS²⁸ requires the NASD to file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities that are executed by its members otherwise than on a national securities exchange.²⁹ Under Rule 603 of Regulation NMS,³⁰ 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.

The means by which the NASD complies with these requirements today is through operation of its Nasdaq

facility³¹ and the ADF,³² and by participating in the Consolidated Quotation System Plan ("CQ Plan") and CTA Plan for CTA Plan Securities, and the Nasdaq UTP Plan for Nasdaq UTP Plan Securities.

The NASD proposes to continue to operate the ADF for the collection of quotes and transaction reports in Nasdaq UTP Plan Securities.³³ In addition, the NASD's rules will continue to provide for the collection of quotes and transaction reports in CTA Plan Securities.³⁴ Nasdaq systems, however, are currently the exclusive means by which NASD members enter quotations and report trades in CTA Plan Securities. Under the proposal, as amended, the NASD will continue, via its delegation to Nasdaq, to use Nasdaq systems for collecting quotations and transaction reports in CTA Plan Securities.

Finally, Rule 608 of Regulation NMS requires the NASD to comply with and enforce compliance with the terms of each national market system plan of which it is a sponsor or participant.³⁵ In addition to the CQ Plan, CTA Plan and Nasdaq UTP Plan, the NASD is a member of the ITS Plan. The ITS Plan contains the rules pursuant to which ITS Participants interact and contains a trade-through rule.³⁶ Accordingly, most

³¹ Nasdaq systems collect quotations and transaction reports from NASD members, including registered market makers and electronic communication networks ("ECNs"), for both Nasdaq UTP Plan Securities and CTA Plan Securities. The quotations and transaction reports in Nasdaq UTP Plan Securities are reported by Nasdaq systems to the Nasdaq UTP Plan, pursuant to the NASD's participation in the plan for dissemination to vendors. The quotations and transaction reports in CTA Plan Securities are reported by Nasdaq systems to the CQ and CTA Plans, pursuant to the NASD's participation in these plans for dissemination to vendors.

³² See Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (File No. SR-NASD-2002-97) (order approving the ADF on a pilot basis). See also Securities Exchange Act Release No. 53699 (April 21, 2006), 71 FR 25271 (April 28, 2006) (notice of filing and immediate effectiveness of File No. SR-NASD-2006-050) (extending the ADF pilot program through January 26, 2007). The ADF was developed to provide NASD members with an alternative to the Nasdaq systems for the reporting of quotations and transaction reports in Nasdaq UTP Plan Securities. These quotations and trade reports are provided to the Nasdaq UTP Plan for dissemination to vendors.

³³ See NASD Rule 4000A Series and Rule 5000 Series. As discussed more fully below, transaction reports for Nasdaq UTP Plan Securities also may be submitted to the new Trade Reporting Facility.

³⁴ See NASD Rules 4000 Series, 4700 Series, 5000 Series, 5200 Series, 6300 Series, and 6400 Series.

³⁵ 17 CFR 242.608(c).

³⁶ In June 2005, the Commission adopted Regulation NMS, which included the new Rule 611. 17 CFR 242.611. This rule 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

OTC transactions in CTA Plan Securities regulated by the NASD are subject to the requirements of the ITS Plan. The NASD expects 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 with access to exchanges' quotations.

Current NASD rules reflect the NASD's participation in the ITS Plan.³⁷ In Amendment No. 1, the NASD also proposes to retain the rules that allow its members to enter quotations in CTA Plan Securities by registering as CQS market makers³⁸ and ITS/CAES market makers.³⁹ Accordingly, as discussed further below, the Commission finds that these rules, as amended, are consistent with Section 15A(b)(11) of the Exchange Act and the Commission also believes that these changes should enable the NASD to satisfy its obligation under Rule 602 of Regulation NMS.

B. Changes to the NASD's Governing Documents

The proposal, as amended, revises the Delegation Plan to eliminate Nasdaq's responsibility for operating the OTC market for Nasdaq UTP Plan Securities, while continuing to delegate to Nasdaq the responsibility for operating the OTC market for CTA Plan Securities.⁴⁰ This change to the Delegation Plan will accurately reflect the scope of the delegation to Nasdaq after the Nasdaq Exchange begins to operate as a national securities exchange for Nasdaq UTP Plan Securities and will ensure that the NASD continues to have the ability to fulfill its obligations with respect to CTA Plan Securities, as described above. Further, eliminating Nasdaq's

NMS stocks. Rule 611 became effective on August 29, 2005; compliance with this rule has been extended to a series of five dates beginning on October 16, 2006. See Securities Exchange Act Release No. 53829 (May 18, 2006), 71 FR 100 (May 24, 2006).

³⁷ See NASD Rule 5200 Series and 4700 Series.

³⁸ See NASD Rule 6320.

³⁹ See NASD Rule 5220.

⁴⁰ Among other things, the Delegation Plan, as amended, delegates to Nasdaq the responsibility for: (1) Operating the OTC market for CTA Plan Securities and the automated systems supporting it; (2) providing and maintaining a telecommunications network infrastructure linking market participants for the efficient processing and handling of quotations, orders, transaction reports, and comparisons of transactions in the OTC market for CTA Plan Securities; (3) developing and adopting rules applicable to the collection, processing, and dissemination of quotation and transaction information for securities traded in the OTC market for CTA Plan Securities; (4) developing and adopting other rules and policies for the OTC market for CTA Plan Securities; and (5) establishing standards for participation in the OTC market for CTA Plan Securities. See Delegation Plan, Section III, A.1.

²⁴ 15 U.S.C. 78o-3(b)(6) and 15 U.S.C. 78s(b)(2).

²⁵ 15 U.S.C. 78o-3(b)(11).

²⁶ *Id.*

²⁷ 17 CFR 242.602.

²⁸ 17 CFR 242.601.

²⁹ Under Rule 601(b) of Regulation NMS, broker-dealers are prohibited from executing a transaction otherwise than on a national securities exchange unless there is an effective transaction reporting plan. New NASD Rule 5000 requires NASD members to report transactions in exchange-listed securities effected otherwise than on an exchange to the NASD.

³⁰ 17 CFR 242.603.

delegation of regulatory authority with regard to Nasdaq UTP Plan Securities satisfies one of the conditions for the Nasdaq Exchange to begin trading Nasdaq UTP Plan Securities.⁴¹

Because Nasdaq will continue to be controlled by the NASD when the Nasdaq Exchange begins to operate as a national securities exchange for Nasdaq UTP Plan Securities, the proposal retains Nasdaq's By-Laws in the NASD's rules.⁴² The Nasdaq By-Laws that the NASD proposes to retain in its rules reflect changes made to the Nasdaq By-Laws as part of the Nasdaq Exchange application and that were approved by the Commission in the Nasdaq Exchange Order.⁴³ The Commission finds that these changes are consistent with the Exchange Act because they ensure that Nasdaq's By-Laws are accurately reflected in the NASD's rules, while also ensuring that Nasdaq's governing documents reflect its status as a parent company of an SRO.⁴⁴

C. Deleted Rules

The NASD also proposes to delete several rules in their entirety because the NASD will no longer require them after the Nasdaq Exchange commences operation as a national securities exchange for Nasdaq UTP Plan Securities. In this regard, the NASD proposes to delete in their entirety NASD Rules 2870 through 2885, relating to the listing and trading of Nasdaq index options. Similarly, the NASD proposes to delete NASD Rules 2852 and 2854 relating, respectively, to reporting requirements and trading halts or suspensions for index warrants listed on Nasdaq and reported to the Nasdaq UTP Plan.

In addition, the NASD proposes to delete from NASD Rules 2841, 2850, and 2851 provisions relating to index warrants listed on Nasdaq, while retaining provisions in those rules relating to index warrant trading in the OTC market. Similarly, the NASD proposes to delete provisions in NASD Rule 2860 relating to standardized options displayed on Nasdaq, and to retain provisions relating to options trading in the OTC market.

Because the NASD will not list or trade index options or list warrants after the Nasdaq Exchange commences

operations as a national securities exchange, the NASD will no longer require these rules. Accordingly, the Commission finds that it is consistent with Section 15A(b)(6) of the Exchange Act for the NASD to delete from its rules provisions governing the listing and trading of index options and warrants listed on Nasdaq.

The NASD also proposes to delete the NASD Rule 6800 Series relating to the Mutual Fund Quotation Service because the Nasdaq Exchange will operate this service. Finally, the NASD proposes to delete the NASD Rule 5100 Series, "Nasdaq International Service Rules," to reflect the expiration of the Nasdaq International Service pilot program.⁴⁵

Because the Nasdaq Exchange, rather than the NASD, will operate the Mutual Fund Quotation Service, the Commission finds that the deletion of the Mutual Fund Quotation Service rules from the NASD's rules is consistent with Section 15A(b)(6) of the Exchange Act. Similarly, the Commission finds that the NASD's deletion of the Nasdaq International Service pilot program rules, which reflects the expiration of the pilot program, is consistent with Section 15A(b)(6) of the Exchange Act.

D. OTC Reporting Facility

The NASD proposes to establish the OTC Reporting Facility. NASD members will use this facility to report trades in PORTAL Securities,⁴⁶ OTC Equity Securities,⁴⁷ and Direct Participation Program ("DPP") Securities.⁴⁸ Currently, the NASD uses Nasdaq systems to accept these trade reports. According to the NASD, it plans to enter into a contract with Nasdaq so that the NASD may continue to use Nasdaq's Automated Confirmation Transaction Service ("ACT")⁴⁹ as its facility to collect these transaction reports.⁵⁰

1. PORTAL Securities

The current NASD Rule 5300 Series provides qualification and transaction

reporting requirements relating to PORTAL Securities, which are foreign and domestic securities that are eligible for resale under Rule 144A under the Securities Act of 1933. The NASD proposes to delete from the NASD Rule 5300 Series rules relating to the qualification requirements for, or designation of, PORTAL Securities, a function that the Nasdaq Exchange will perform.⁵¹ The new NASD Rule 6700 Series will govern transaction reporting in PORTAL Securities and other requirements applicable to the trading of PORTAL Securities.⁵² Because these changes will more accurately reflect the NASD's proposed activities with regard to PORTAL Securities after the Nasdaq Exchange begins to operate as an exchange for Nasdaq UTP Plan Securities, the Commission finds them consistent with Section 15A(b)(5) of the Exchange Act.

2. OTC Equity Securities

The NASD proposes to combine its current NASD Rule 6600 and 6700 Series into a single NASD Rule 6600 Series, which will govern reporting requirements for certain quotations and transactions in OTC Equity Securities.⁵³ The NASD's rules define OTC Equity Securities as any equity security not traded on an exchange and certain exchange-listed securities that do not qualify for real-time trade reporting. Because these changes will maintain the regulatory requirements for trading and reporting transactions in OTC Equity Securities, the Commission believes that they are consistent with Section 15A(b)(6) of the Exchange Act.

3. DPP Securities

The NASD Rule 6900 Series governs the trade reporting of off-exchange secondary market transactions in DPP Securities. The NASD proposes to amend these rules to reflect that such transactions will be reported to the NASD's OTC Reporting Facility rather than the Nasdaq Market Center. The Commission finds these changes consistent with the Exchange Act because the substantive requirements of the NASD Rule 6900 Series will remain unchanged.

⁴¹ See Order Modifying Nasdaq Exchange Conditions, *supra*, note 6.

⁴² See Amendment No. 1.

⁴³ See *supra*, note 5.

⁴⁴ In Amendment No. 1, the NASD also proposes to retain the references to Nasdaq in the By-Laws of NASD Dispute Resolution, NASD Regulation, and the NASD to reflect that Nasdaq will continue to be controlled by the NASD when the Nasdaq Exchange begins to operate as an exchange for Nasdaq UTP Plan Securities.

⁴⁵ The Nasdaq International Service pilot program was most recently extended through October 9, 2003. See Securities Exchange Act Release No. 46589 (October 2, 2002), 67 FR 63001 (October 9, 2002) (notice of filing and order granting accelerated approval of File No. SR-NASD-2002-130).

⁴⁶ See NASD Rule 6732.

⁴⁷ See NASD Rule 6600 Series.

⁴⁸ See NASD Rule 6900 Series.

⁴⁹ In 2004, Nasdaq generally discontinued its use of the term "ACT" and replaced it with the term "Nasdaq Market Center" or "service." See Securities Exchange Act Release No. 50074 (July 23, 2004), 69 FR 45866 (July 30, 2004) (notice of filing and immediate effectiveness of File No. SR-NASD-2004-076). To be consistent with the commenters to this proposal, this order also will use the term "ACT."

⁵⁰ See Amendment No. 1.

⁵¹ See Nasdaq Exchange Rule 6500 Series.

⁵² Specifically, the new NASD Rule 6700 Series incorporates existing NASD Rules 5330, "Requirements Applicable to Members of the Association," 5331, "Limitations on Transactions in PORTAL Securities," 5332, "Reporting Debt and Equity Transactions in PORTAL Securities," 5340, "Arbitration," and 5350, "Rules of the Association."

⁵³ The NASD also proposes to make minor changes designed to reflect Nasdaq's separation from the NASD and to identify the NASD as the operator of the OTCBB.

E. NASD Rule 9700 Series and 11890 Series

In the original proposal, the NASD proposed to delete in its entirety the NASD Rule 9700 Series, "Procedures on Grievances Concerning the Automated Systems." Because the NASD Rule 9700 Series governs the review of requests for OTCBB eligibility determinations under NASD Rule 6530, "OTCBB—Eligible Securities," the NASD proposes in Amendment No. 1 to retain a revised version of the NASD Rule 9700 Series. The NASD Rule 9700 Series, as amended, replaces references to Nasdaq, the Nasdaq Listing and Review Hearing Council, and systems owned by Nasdaq with references to, respectively, the NASD, a committee designated by the NASD's Board of Governors, and NASD systems. Because these changes to the NASD Rule 9700 Series provide for the continued availability of existing procedures for reviewing OTCBB eligibility determinations, the Commission finds that they are consistent with Section 15A(b)(6) of the Exchange Act.

In addition, Amendment No. 1 revises NASD Rule 9740, "Consideration of Applications," to permit applicants seeking redress pursuant to the NASD Rule 9700 Series to be heard telephonically by a hearing panel, as well as in person. The Commission believes that this change is consistent with Section 15A(b)(6) of the Exchange Act because it will provide additional flexibility for applicants seeking redress under the NASD Rule 9700 Series.

In its original proposal, the NASD proposed to delete NASD Rule 11890, "Clearly Erroneous Transactions," in its entirety. In Amendment No. 1, the NASD proposes to retain a modified version of NASD Rule 11890. NASD Rule 11890(a), "Authority to review Transactions Pursuant to Complaint of Market Participant," currently provides Nasdaq with the authority to review any transaction arising from the use of any execution or communication system owned or operated by Nasdaq. Because Nasdaq will no longer operate an execution or communication system for the NASD for Nasdaq UTP Plan Securities pursuant to the Delegation Plan after the Nasdaq Exchange begins to operate as an exchange for Nasdaq UTP Plan Securities, the NASD is amending NASD Rule 11890(a) to eliminate Nasdaq's authority under the rule to review complaints regarding transactions in Nasdaq UTP Plan Securities. NASD Rule 11890(a) will continue to provide Nasdaq with authority to review complaints regarding transactions in CTA Plan

Securities arising from the use of an execution or communication system owned or operated by Nasdaq.⁵⁴ For the same reason, NASD Rule 11890(b)(1), as amended, will continue to allow Nasdaq to review, on its own motion, any transaction in a CTA Plan Security in the event of extraordinary market conditions or a disruption or malfunction in the use or operation of any quotation, execution, communication, or trade reporting system owned or operated by Nasdaq, while eliminating this authority with respect to Nasdaq UTP Plan Securities. The Commission finds that these changes are consistent with Section 15A of the Exchange Act because Nasdaq will no longer operate, or be delegated authority with respect to, an NASD execution facility for Nasdaq UTP Plan Securities after the Nasdaq Exchange begins to operate as an exchange for Nasdaq UTP Plan Securities.

In addition, the NASD proposes to amend NASD Rule 11890(b)(2) to allow it to review, on its own motion, any transaction in a Nasdaq UTP Plan Security or an OTC Equity Security in the event of extraordinary market conditions or a disruption or malfunction in the use or operation of any quotation, communication, or trade reporting system owned or operated by the NASD. Thus, NASD Rule 11890(b)(2), as amended, will allow the NASD to declare clearly erroneous transactions in Nasdaq UTP Plan Securities reported to the ADF or to the Trade Reporting Facility. The NASD believes that this authority may be appropriate in very limited circumstances, for example, when an extraordinary event occurs and multiple SROs are canceling or modifying trades.

The Commission finds that NASD Rule 11890(b)(2), as amended, is consistent with Section 15A of the Exchange Act because the expansion of the NASD's authority under NASD Rule 11890(b)(2) replaces authority previously delegated to Nasdaq and should facilitate the fair and efficient resolution of disputes involving clearly erroneous transactions in Nasdaq UTP Plan Securities and OTC Equity Securities.

F. OATS

The NASD proposes to revise its OATS rules regarding orders routed to non-members, including the Nasdaq Exchange, to ensure that the audit trail for transactions executed on the Nasdaq

Exchange continues in the same manner as it does today, when transactions are executed on Nasdaq systems that are NASD facilities. Specifically, the NASD proposes that orders routed to non-members, which includes national securities exchanges, be identified with a routed order identifier or other unique identifier required by the non-member receiving the order, and to indicate the national securities exchange or registered securities association to which the order is transmitted.⁵⁵ In addition, the NASD proposes to clarify existing requirements by providing that members are permitted to use a routed order identifier that is different from the order identifier used for origination purposes and that a member transmitting an order to another member must provide the routed order identifier to the member receiving the order. The Commission finds that the proposed changes are consistent with Section 15A(b)(2) of the Exchange Act⁵⁶ in that they are designed to ensure that the NASD and the Nasdaq Exchange can conduct surveillance and investigations of their members for potential violations of NASD rules, Nasdaq Exchange rules, and the federal securities laws.

G. OTC Trading of CTA Plan Securities

1. Dually Listed Securities

The NASD proposes to eliminate current NASD Rule 4400 and to modify NASD IMZ—Rule 4400, which will become its new Rule 4400. New NASD Rule 4400 describes the treatment of securities that are dually listed on the Nasdaq Exchange and the NYSE. Specifically, the rule indicates that such dually listed securities will continue to be subject to the CQ and CTA Plans and will continue to be treated as CTA Plan Securities under the NASD's rules.⁵⁷ The Commission finds that new NASD Rule 4400 is consistent with Section 15A of the Act because it clarifies that the NASD will treat these securities in the same manner as it does today.

2. SuperIntermarket Facility

Through its delegation to Nasdaq under the Delegation Plan, the NASD

⁵⁵ See NASD Rule 6954(c)(6).

⁵⁶ 15 U.S.C. 78o-3(b)(2).

⁵⁷ Among other things, new NASD Rule 4400 indicates the NASD will continue to send all quotes and transaction reports in dually listed securities to the processor for the CTA Plan while such securities continue to trade through the facilities of the NASD. In addition, the rule notes that market makers in dually listed securities will retain all of the obligations imposed by the NASD Rule 5200, 6300, and 6400 Series regarding quoting, trading, and transaction reporting of CQS securities, and that the NASD will continue to honor the trade halt authority of the primary market under the CQ and CTA Plans.

⁵⁴ As noted above, Nasdaq will continue to operate the SuperIntermarket pursuant to a delegation from the NASD after the Nasdaq Exchange begins to operate as an exchange for Nasdaq UTP Plan securities.

will continue to use technology owned by Nasdaq, *i.e.*, the SuperIntermarket, as its facility to collect OTC quotes and transaction reports in CTA Plan Securities. In addition, the SuperIntermarket will continue to permit NASD members quoting in the facility to participate in ITS and satisfy the NASD's obligations under the ITS Plan.⁵⁸

a. Quotations

In Amendment No. 1, the NASD proposes to retain its rules that allow its members to register as CQS market makers⁵⁹ and ITS/CAES market makers.⁶⁰ These rules are essential to the NASD's ability to fulfill its statutory⁶¹ and regulatory obligations,⁶² and to NASD members' ability to fulfill their regulatory obligation to submit their OTC quotations to the NASD.⁶³ The NASD must collect quotations in subject securities that OTC market makers communicate otherwise than on an exchange.⁶⁴ NASD rules currently provide that members that communicate quotations off an exchange in CTA Plan Securities must register as CQS market makers and ITS/CAES market makers.⁶⁵ The NASD has only proposed minor changes to the rules for CQS market makers and ITS/CAES market makers, including replacing references to the Nasdaq Market Center with references to Nasdaq. The NASD also proposes to adopt NASD Rule 6431, "Trading Halts," to provide a trading halt rule for CTA Plan Securities.⁶⁶

⁵⁸ See *supra* notes 25–39 and accompanying text.

⁵⁹ See NASD Rule 6300 Series. NASD members that submit quotes in CQS securities must be registered as CQS market makers. See NASD Rule 6320(a). CQS market makers must also register as ITS/CAES market makers. See NASD Rule 6320(e). See also NASD Rule 5210(e).

⁶⁰ See NASD Rule 5200 Series. NASD members that participate in ITS must register as ITS/CAES market makers. See NASD Rule 5220. ITS/CAES market makers must also register as CQS market makers. See NASD Rule 5220(a). See also NASD Rule 6320(e).

⁶¹ 15 U.S.C. 78o–3(b)(11). See *supra* notes 25–39 and accompanying text.

⁶² See Rule 602(a) under the Exchange Act, 17 CFR 242.602(a).

⁶³ See Rule 602(b) of Regulation NMS under the Exchange Act, 17 CFR 242.602(b).

⁶⁴ See Rule 602(b) of Regulation NMS under the Exchange Act, 17 CFR 242.602(b).

⁶⁵ See NASD Rules 6320(a) and 5210(e). An NASD member that does not communicate quotations off an exchange, but that executes a transaction in a CTA Plan Security off an exchange, may report its transaction to the NASD through ACT, which Nasdaq will operate for the NASD under the Delegation Plan.

⁶⁶ NASD Rule 4120 currently contains Nasdaq's authority to halt OTC trading of Nasdaq UTP Plan Securities and CTA Plan Securities. The proposal revises NASD Rule 4120 and rennumbers it as NASD Rule 4633, "Trading Halts," which now relates

The Commission finds that the NASD's proposal to retain, with minor clarifying changes, its rules governing CQS and ITS/CAES market makers is consistent with Section 15A of the Exchange Act because it will allow the NASD to continue to fulfill its statutory and regulatory obligations,⁶⁷ and allow NASD members to continue to fulfill their regulatory obligation to submit their OTC quotations to the NASD.⁶⁸ In addition, the Commission finds that the proposal to adopt NASD Rule 6431 is consistent with Section 15A of the Exchange Act because it could help the NASD to maintain a fair and orderly market.

b. Executions

As noted above, the NASD will remain a member of the ITS Plan. As such, the NASD is required to comply with, and enforce compliance by its members with, the provisions of the ITS Plan.⁶⁹ Currently, the NASD uses its Nasdaq SuperIntermarket facility to provide its members with access to ITS participant exchanges and to provide ITS participant exchanges with access to ITS/CAES market makers' quotations. The NASD proposes to continue to use the SuperIntermarket system as its facility for these purposes through its delegation to Nasdaq.

In Amendment No. 1, the NASD proposes to retain certain parts of its Rule 4700 Series that relate to the SuperIntermarket, and to eliminate from the 4700 Series those rules that pertain to the trading of Nasdaq UTP Plan Securities on the Nasdaq Market Center. The Commission finds that these changes are consistent with the requirements of the Exchange Act because they will permit the NASD and its members to continue to participate in ITS as they do today.⁷⁰ The Commission also finds that the elimination of rules that pertain to the trading of Nasdaq UTP Plan Securities is consistent with the Exchange Act because the NASD will no longer be operating an execution facility for Nasdaq UTP Plan Securities.

c. Transaction Reporting

Members effecting trades in CTA Plan Securities off an exchange, yet outside

solely to the Trade Reporting Facility. New NASD Rule 6431, which includes the same provisions as NASD Rule 4633, applies to CTA Plan Securities.

⁶⁷ See *supra* notes 61 and 62.

⁶⁸ See note 63, *supra*, and accompanying text.

⁶⁹ See Rule 608(c) of Regulations NMS under the Exchange Act, 17 CFR 242.608(c).

⁷⁰ See Securities Exchange Act Release No. 49349 (March 2, 2004), 69 FR 10775 (March 8, 2004) (order approving the use of SuperMontage for trading ITS securities). The Commission notes that required participation in the ITS Plan is of limited duration. See *supra* note 36.

of the SuperIntermarket facility, will continue, as they do today, to submit trade reports to ACT. Nasdaq will have delegated responsibility under the Delegation Plan to operate ACT for the NASD for this purpose. Accordingly, the NASD proposes to retain its 6400 Series, "Reporting Transactions in Listed Securities," with minor changes, including replacing references to the Nasdaq Market Center with references to Nasdaq.⁷¹

The Commission finds that these changes are consistent with the Exchange Act. With respect to CTA Plan Securities, the only means currently available to the NASD to fulfill its statutory and regulatory obligations is through NASD facilities owned by Nasdaq. The Commission believes that the NASD Rule 6400 Series, as amended, will enable the NASD to continue to satisfy its obligations under Rules 601 and 603 of Regulation NMS and the CTA Plan to collect its members' transaction reports for OTC trades of CTA Plan Securities.

3. BRUT and INET Rules

Because the Nasdaq Exchange will not commence trading in CTA Plan Securities at this time, any trading of these securities that occurs in BRUT and INET would occur over-the-counter. Accordingly, the NASD has proposed in Amendment No. 1 to retain its current rules that govern the operation of the BRUT⁷² and INET⁷³ systems with regard to CTA Plan Securities. These trading platforms will continue to be facilities of the NASD for CTA Plan Securities that are operated by Nasdaq pursuant to the Delegation Plan. The NASD has proposed to make some changes to these rules to reflect that NASD members may not use these systems to execute OTC trades in Nasdaq UTP Plan Securities.⁷⁴ The Commission finds that these changes are consistent with the Exchange Act because they clarify and appropriately limit the use of these systems by NASD members after the Nasdaq Exchange begins to operate an exchange for Nasdaq UTP Plan Securities.

⁷¹ As described more fully above, the NASD also proposes to adopt NASD Rule 6431, relating to trading halts for CTA Plan Securities.

⁷² See NASD Rule 4900 Series.

⁷³ See NASD Rule 4950 Series.

⁷⁴ Once the Nasdaq Exchange begins operations as a national securities exchange in Nasdaq UTP Plan Securities, transactions in Nasdaq UTP Plan Securities that occur in Brut and INET will be Nasdaq Exchange trades subject to the Nasdaq Exchange's rules and regulatory jurisdiction.

H. OTC Trading of Nasdaq UTP Plan Securities

1. NASD Rule 5110

The NASD proposes to renumber NASD Rule 6440(i) as NASD Rule 5110, "Transactions Related to Initial Public Offerings," which prohibits a member from executing, directly or indirectly, a transaction otherwise than on an exchange in a security subject to an initial public offering until the security has first opened for trading on the national securities exchange listing the security, as indicated by the dissemination, via the Consolidated Tape, of an opening transaction in the security by the listing exchange. In addition, the NASD proposes to extend its application to transactions in Nasdaq UTP Plan Securities. New NASD Rule 5110 is substantially the same as current NASD Rule 6440(i).⁷⁵ The Commission finds that new NASD Rule 5110 is consistent with the Exchange Act because it is substantially the same as current NASD Rule 6440(i). In addition, the Commission believes that the application of NASD Rule 5110 to Nasdaq UTP Plan Securities, as well as CTA Plan Securities, after the Nasdaq Exchange begins to operate as a national securities exchange is consistent with the Exchange Act because it will provide consistent treatment for all exchange-traded securities.⁷⁶

2. Changes to the ADF Rules

The ADF is an NASD facility for members to quote and report off-exchange trades in Nasdaq UTP Plan Securities. NASD members that use the ADF must comply with the NASD Rule 4000A Series, "NASD Alternative Display Facility," and the NASD Rule 6000A Series, "NASD ADF Systems and Programs."

The NASD proposes to make the following changes to its ADF rules. First, the NASD proposes to clarify that the following ADF rules apply to Registered Reporting ECNs as well as Registered Reporting ADF Market Makers: NASD Rules 4613A(b), relating to firm quote requirements, and 4613A(c), requiring quotations to be reasonably related to the prevailing market; NASD Rule 4617A, relating to normal business hours; NASD Rule 4618A, relating to clearance and

settlement requirements; and NASD Rules 4621A and 4622A, relating to the NASD's ability to suspend or terminate quotations or ADF services. The Commission finds that these changes are consistent with Section 15A(b)(6) of the Exchange Act⁷⁷ because they will apply ADF rules consistently to Registered Reporting ADF Market Makers and Registered Reporting ECNs.

Second, the NASD proposes to revise NASD Rule 4632A, "Transactions Reported by Members," to incorporate the trade reporting requirements currently set forth in NASD Rule 5430, "Transaction Reporting," which is being deleted. The NASD proposes to delete the NASD Rule 5400 Series, "Nasdaq Stock Market and Alternative Display Facility Trade Reporting." NASD Rule 5410 states that the NASD will operate two facilities for collecting trade reports, the Nasdaq Stock Market and the ADF, and notes that the NASD Rule 5400 Series establishes rules governing which member must report a trade and whether the trade must be reported to the Nasdaq Market Center or to the ADF. The provisions in the NASD Rule 5400 Series relating to the reporting of transactions to the Nasdaq Market Center will be no longer relevant after the Nasdaq Exchange commences operations as a national securities exchange for Nasdaq UTP Plan Securities and, accordingly, the NASD proposes to delete these provisions. Therefore, the Commission finds that elimination of these rules is consistent with the Exchange Act.

The NASD proposes to relocate the provisions in the NASD Rule 5400 Series relating to the ADF to NASD Rules 4630A, "Reporting Transactions in ADF-Eligible Securities," and 4632A, "Transactions Reported by Members," which will govern the reporting of transactions in ADF-eligible securities through the NASD's Trade Reporting and Comparison System ("TRACS"). The Commission believes that the proposal to move the NASD Rule 5400 Series to the ADF rule series should clarify the applicability of the NASD's rules and, therefore the Commission finds that these changes are consistent with Section 15A(b)(6) of the Exchange Act.⁷⁸ The Commission believes that this change will help to consolidate the ADF's trade reporting requirements while substantially preserving the current requirements of NASD Rule 5430.

Third, the NASD proposes to make the ADF's trade reporting requirements more consistent with the trade reporting

rules that apply to Nasdaq systems. For example, the NASD proposes to require that the execution time in hours, minutes, and seconds based on Eastern Time in military format be included in all ADF trade reports,⁷⁹ to add certain trade report modifiers,⁸⁰ and to establish provisions relating to the reporting of cancelled trades.⁸¹ The NASD also proposes to clarify that all applicable trade modifiers must be included in "as/of" trades.⁸² In addition, the NASD proposes to add to NASD Rule 4632A a provision stating that a pattern or practice of late reporting without exceptional circumstances may be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade.⁸³ The Commission finds that these changes, which currently apply to Nasdaq trade reports, are consistent with Section 15A(b)(6) of the Exchange Act in that they are designed to protect investors and the public interest by helping to ensure the timeliness and accuracy of the transaction reports submitted to the ADF.

Fourth, the NASD proposes to revise NASD Rule 4120A to provide that it will halt trading in an ADF-eligible security in the OTC market when there is extraordinary market activity in a security that is likely to have a material effect on the market for the security and the NASD determines, or determines after consultation with a national securities exchange trading the security, that the activity is caused by the misuse or malfunction of an NASD or exchange quotation, communication, reporting, or execution system. The Commission believes that this authority may help the NASD to maintain a fair and orderly market. In addition, the Commission notes that current NASD Rule 4120(a)(6) provides the NASD with comparable trading halt authority.

Finally, the NASD proposes to eliminate the availability of passive market making on the ADF and therefore is deleting ADF rules that relate to passive market making.⁸⁴ According to the NASD, passive market making rules for the ADF are unnecessary because only Registered Reporting ECNs participate in the ADF. The NASD notes that if a market maker were, in the future, to quote in the ADF and participate in a secondary offering

⁷⁵ NASD Rule 6440(i) prohibits members from executing, directly or indirectly, an OTC transaction in a security subject to an initial public offering until the security has first opened for trading on the national securities exchange listing the security, as indicated by the dissemination, via the Consolidated Tape, of an opening transaction in the security by the listing exchange.

⁷⁶ See *supra* note 23.

⁷⁷ 15 U.S.C. 78o-3(b)(6).

⁷⁸ *Id.*

⁷⁹ See NASD Rules 4632A(c)(2)(I) and 4632A(d)(2)(D). These changes were proposed in Amendment No. 1.

⁸⁰ See NASD Rule 4632A(a)(7), (8), and (9).

⁸¹ See NASD Rule 4632A(m). This was proposed in Amendment No. 1.

⁸² See NASD Rule 4632A(a)(10).

⁸³ See NASD Rule 4632A(a)(6).

⁸⁴ See NASD Rule 4619A.

of a security, the ADF market maker would be required to stop quoting in the ADF in order to comply with Regulation M. The Commission finds that these changes are consistent with the Exchange Act because these rules are not used currently and Rule 103 of Regulation M does not require the NASD to make passive market making available in the ADF.

3. The Trade Reporting Facility

The NASD proposes to establish a new facility, the Trade Reporting Facility, which will provide NASD members with another facility, in addition to the ADF,⁸⁵ for reporting transactions in Nasdaq UTP Plan Securities executed otherwise than on an exchange.⁸⁶ The Trade Reporting Facility will allow NASD members that currently internalize customer orders through the Nasdaq Stock Market facility of the NASD to continue to internalize such orders pursuant to NASD rules and to report trades to the new Trade Reporting Facility of the NASD.

The Trade Reporting Facility will be operated by the Trade Reporting Facility LLC ("TRF LLC"), which is owned by the NASD and Nasdaq. The TRF LLC proposes to contract with the Nasdaq Exchange to use its technology, *i.e.*, ACT, to accept OTC trade reports from NASD members in Nasdaq UTP Plan Securities. Accordingly, this proposal is intended to maintain the *status quo* with respect to the technology used by NASD members to report OTC transactions in Nasdaq UTP Plan Securities. Further, the NASD proposes to maintain its current rules for accepting transaction reports in Nasdaq UTP Plan Securities. By keeping its current rules, NASD members will be able to continue to choose between two facilities, the Trade Reporting Facility and the ADF, for submitting transaction reports for OTC trades in Nasdaq UTP Plan Securities.⁸⁷

⁸⁵ As noted above, the ADF currently accepts quotes and transaction reports only for Nasdaq UTP Plan Securities.

⁸⁶ See NASD Rule 4000 Series. See also NASD Rule 5000. New NASD Rule 4000 would permit NASD members to report transactions in Nasdaq UTP Plan Securities executed otherwise than on an exchange to the NASD through the new Trade Reporting Facility. Members also may report transactions in Nasdaq UTP Plan Securities to the ADF. These transaction reports will then be reported to the Nasdaq UTP Plan for dissemination pursuant to the NASD's participation in this Plan. The Commission finds that this proposed change is consistent with Rule 601 under Regulation NMS. See also NASD Rule 4100.

⁸⁷ The NASD represents that it will have an integrated audit trail and integrated surveillance facilities for members reporting trades on both the ADF and the Trade Reporting Facility. See

The NASD proposes that its new Rule 4000 Series⁸⁸ and Rule 6100 Series,⁸⁹ which contain clearing and comparison rules, will govern the reporting of trades to its Trade Reporting Facility. Specifically, the NASD proposes to combine in the new NASD Rule 4630 Series the trade reporting requirements in the current NASD Rule 4630, 4640, and 4650 Series (Nasdaq National Market securities, Nasdaq Capital Market securities, and Nasdaq convertible debt securities, respectively). The Commission believes that the new NASD Rule 4630 Series retains the requirements and general organization of the NASD's current trade reporting rules. In addition, the NASD represents that it intends to interpret and apply the trade reporting rules of the Trade Reporting Facility in the same manner in which it interprets and applies its current trade reporting rules.

The Commission finds that the NASD's rules governing the reporting of trades to the Trade Reporting Facility are consistent with the Exchange Act. The NASD's proposal is designed to allow the NASD and its members to continue to fulfill their obligations under the Commission's rules and the national market system plans with regard to Nasdaq UTP Plan Securities. The Commission also believes that the establishment of the Trade Reporting Facility is consistent with the Congressional finding in Section 11A(a)(1)(C)(iii) of the Exchange Act that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the availability of information with respect to transactions in securities.

Amendment No. 1. The Commission believes that an integrated audit trail and integrated surveillance capabilities are important to the NASD's ability to conduct effective surveillance of OTC trading in Nasdaq UTP Plan Securities when transactions in those securities can be reported to both the ADF and the Trade Reporting Facility.

⁸⁸ The proposal deletes from the current NASD Rule 4000 Series rules that relate to Nasdaq, including listing standards, trading rules for the Nasdaq National Market Center, and Nasdaq market maker registration requirements. The proposal retains an amended version of the NASD Rule 4700 Series, which will govern ITS/CAES members' use of the SuperIntermarket.

⁸⁹ The current NASD Rules 6100 Series, which is being deleted, contains rules for the reporting of trades that are executed on the Nasdaq Market Center and ACES. The Commission believes that it is consistent with the Exchange Act to eliminate the NASD Rule 6100 Series because these rules relate solely to the Nasdaq systems that will no longer be NASD facilities after the Nasdaq Exchange begins to trade Nasdaq UTP Plan Securities.

a. TRF LLC

As noted above, the NASD and Nasdaq will jointly own the TRF LLC, which will operate the Trade Reporting Facility. The NASD has filed the limited liability company agreement ("LLC Agreement") for the TRF LLC as part of the current proposal.⁹⁰ The LLC Agreement makes clear that the NASD will have sole regulatory responsibility for the activities of NASD members related to the facility operated by the TRF LLC. The LLC Agreement identifies the NASD as the "SRO Member" of the LLC and provides the NASD with certain rights that are intended to preserve its regulatory authority and control. Specifically, pursuant to the LLC Agreement, the NASD must consent before certain "Major Actions" with respect to the TRF LLC are effective. The LLC Agreement defines a "Major Action" as: (1) Approving pricing decisions that are subject to the Commission filing process; (2) approving contracts between the TRF LLC and Nasdaq; (3) approving director compensation; (4) selling, licensing, leasing, or otherwise transferring material assets used in the operation of the TRF LLC outside the ordinary course of business with an aggregate value in excess of \$3 million; (5) approving or undertaking a merger or other reorganization of the TRF LLC with another entity; (6) entering into any partnership, joint venture, or other similar joint business undertaking; (7) making any fundamental change in the market structure of the TRF LLC; (8) voluntary or involuntary dissolution of the TRF LLC other than termination as provided for in the LLC Agreement;⁹¹ (9) conversion of the TRF LLC to any other type of entity; (10) expanding or modifying the business, which would

⁹⁰ The Commission notes that any changes to the LLC Agreement that are stated policies, practices, or interpretations of the NASD, as defined in Rule 19b-4 under the Exchange Act, must be filed with the Commission pursuant to Section 19(b) of the Exchange Act and Rule 19b-4 thereunder.

⁹¹ As set forth in Section 20 of the LLC Agreement, two years after the effective date of the LLC Agreement, either the NASD or Nasdaq may dissolve the TRF LLC by providing the other with prior written notice of at least one year (unless such notice is revoked). If the NASD provides the notice of dissolution, the NASD and Nasdaq will negotiate in good faith to: (i) Allow Nasdaq to continue to operate the TRF LLC or the business of the TRF LLC under the NASD's SRO registration; (ii) restructure the TRF LLC so that Nasdaq can operate the TRF LLC or its business under its SRO registration or that of any of its affiliates, as the case may be; or (iii) sell the TRF LLC or its business to the NASD based on a valuation of the TRF LLC's business and assets as set forth in the LLC Agreement, and consideration for the sale may include a contract for Nasdaq to provide services to the NASD relating to the operation of the TRF LLC and the business of the TRF LLC.

result in a material change in the business of the TRF LLC; (11) changing the number of directors or composition of the TRF LLC Board; and (12) adopting or amending policies regarding access and credit matters affecting the TRF LLC.⁹²

Nasdaq will be primarily responsible for the management of the TRF LLC's business affairs to the extent that those activities are not inconsistent with the regulatory and oversight functions of the NASD. All profits and losses from the TRF LLC will be allocated to Nasdaq.⁹³

Although the TRF LLC itself will not carry out any regulatory functions, all of its activities must be conducted in a manner that is consistent with the Exchange Act. In this regard, under Section 9(d) of the LLC Agreement, each member of the TRF LLC agrees to comply with the federal securities laws and rules and regulations thereunder and to cooperate with the Commission pursuant to its regulatory authority and the provisions of the LLC Agreement. Section 10(b) of the LLC Agreement imposes similar obligations on each director of the TRF LLC. Under Section 10(b), each director agrees to comply with the federal securities laws and the rules and regulations thereunder and to cooperate with the Commission and the NASD in carrying out their regulatory authority and the provisions of the LLC Agreement. In addition, Section 10(b) states that each director agrees that in discharging his or her responsibilities as a member of the TRF LLC Board, each director will take into consideration whether his or her actions as a director would cause the TRF LLC or either member to engage in conduct that would be inconsistent with the purposes of the Exchange Act.

The Commission believes that these provisions reinforce the notion that the TRF LLC, as the operator of an NASD facility, is not solely a commercial enterprise; it is an integral part of an SRO registered pursuant to the Exchange Act and, as such, is subject to obligations imposed by the Exchange Act. The Commission underscores that these obligations endure so long as the TRF LLC operates an NASD facility.

The LLC Agreement includes additional provisions that make special accommodations for the NASD as the SRO responsible for the NASD facilities operated by the TRF LLC. For example, Section 10(a) of the LLC Agreement provides that the TRF LLC Board shall, at all times, include at least one director (the "SRO Member Director") designated by the NASD. Under Section

10(e) of the LLC Agreement, no "Major Action," as defined in the LLC Agreement, will be effective unless approved by consent of the SRO Member Director.⁹⁴ Section 19 of the LLC Agreement prohibits either the NASD or Nasdaq from transferring or assigning its interest in the TRF LLC except to an affiliate, as defined in the LLC Agreement, and the NASD may transfer its interest only to an affiliate that has proper authority to perform the self-regulatory responsibilities of the NASD.

The Commission believes that the provisions described above will allow the NASD to carry out its self-regulatory responsibilities with respect to its facilities operated by the TRF LLC. Moreover, the Commission believes that the limits in Section 19 of the LLC Agreement on transfers of interest in the TRF LLC, together with the requirements of Section 19(b) of the Exchange Act and Rule 19b-4 thereunder, provide the Commission with sufficient authority over changes in control of the TRF LLC to enable the Commission to carry out its regulatory oversight responsibilities with respect to the NASD and its facilities.

The Commission also believes that, as highlighted by the terms of the LLC Agreement, the Commission and the NASD have sufficient regulatory jurisdiction over the controlling parties of the TRF LLC to carry out their responsibilities under the Exchange Act. In Section 17(b) of the LLC Agreement, the NASD and Nasdaq acknowledge that—to the extent directly related to the TRF LLC's activities—their books, records, premises, officers, directors, governors, agents, and employees will be deemed to be the books, records, premises, officers, directors, governors, agents, and employees of the NASD itself and its affiliates for the purposes of, and subject to oversight pursuant to, the Exchange Act. This provision will reinforce the Commission's ability to exercise its authority under Section 19(h)(4) of the Exchange Act⁹⁵ with respect to the officers and directors of the TRF LLC because all such officers and directors—to the extent that they are

acting in matters related to the TRF LLC's activities—would be deemed to be the officers and directors of the NASD itself. Furthermore, under Section 17(b) of the LLC Agreement, the records of the NASD and Nasdaq, to the extent that they are related to the TRF LLC's activities, are deemed to be records of the NASD itself and are subject to the Commission's examination authority under Section 17(b)(1) of the Exchange Act.⁹⁶

In addition, under Section 17(c) of the LLC Agreement, the NASD and Nasdaq, and each officer, director, agent, and employee thereof, irrevocably submits to the jurisdiction of the U.S. Federal courts, the Commission, and the NASD for the purpose of any suit, action, or proceeding pursuant to the U.S. federal securities laws and the rules and regulations thereunder arising from, or relating to, the TRF LLC's activities. In addition, each Member, and each officer, director, agent, and employee thereof, waives and agrees not to assert by way of motion, as a defense or otherwise, in any suit, action, or proceeding, any claim that it is not personally subject to the jurisdiction of the Commission; that the suit, action, or proceeding is an inconvenient forum; that the venue of the suit, action, or proceeding is improper; or that the subject matter of the suit, action, or proceeding may not be enforced in or by such courts or agency. Moreover, Section 17(e) of the LLC Agreement states that the TRF LLC, the NASD, and Nasdaq will cause their respective affiliates, officers, directors, governors, employees, representatives, and agents to comply with these requirements.

The Commission also believes that, even in the absence of these provisions of the LLC Agreement, under Section 20(a) of the Exchange Act,⁹⁷ any person with a controlling interest in the TRF LLC would be jointly and severally liable with and to the same extent that the TRF LLC is liable under any provisions 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 Act⁹⁸ creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person for violation of any provision of the Exchange Act or rule thereunder. Further, Section 21C of the Exchange Act⁹⁹ authorizes the Commission to

⁹⁴ See *supra* text accompanying notes 90–92.

⁹⁵ 15 U.S.C. 78s(h)(4). Section 19(h)(4) of the Exchange Act authorizes the Commission, by order, to remove from office or censure any officer or director of an SRO if it finds after notice and an opportunity for hearing that such officer or director has: (1) Willfully violated any provision of the Exchange Act or the rules and regulations thereunder, or the rules of such SRO; (2) willfully abused his or her authority; or (3) without reasonable justification or excuse, has failed to enforce compliance with any such provision by a member or person associated with a member of the SRO.

⁹⁶ 15 U.S.C. 78q(b)(1).

⁹⁷ 15 U.S.C. 78t(a).

⁹⁸ 15 U.S.C. 78t(e).

⁹⁹ 15 U.S.C. 78u-3.

⁹² See Section 10(e) of the LLC Agreement.

⁹³ See Section 15 of the LLC Agreement.

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.

The Commission believes that, together, these provisions grant the Commission sufficient jurisdictional authority over the controlling parties and Members of the TRF LLC. Moreover, the NASD is required to enforce compliance with the provisions of the LLC Agreement because they are “rules of the association” within the meaning of Section 3(a)(27) of the Exchange Act.¹⁰⁰ A failure on the part of the NASD to enforce its rules could result in a suspension or revocation of its registration pursuant to Section 19(h)(1) of the Exchange Act.¹⁰¹

4. Comments

The Commission received 13 comment letters from 12 commenters opposing the NASD’s proposal to establish the TRF LLC.¹⁰² In light of its interest in the TRF LLC, Nasdaq submitted a comment letter to address the issues raised by the NYSE.¹⁰³ In addition, because the Archipelago Letter and the NYSE Letter II also were submitted in response to the Nasdaq Exchange’s application to register as a national securities exchange, Nasdaq also addressed the comments raised in those letters in its response to comments concerning its exchange application.¹⁰⁴ The NASD also responded to the issues raised by the commenters.¹⁰⁵ The principal issues raised by commenters are discussed below.

a. Trade Reporting Facility is a Facility of the NASD

Because of the affiliation between the Nasdaq Exchange and the TRF LLC, several commenters argue that the Trade Reporting Facility would not truly be a facility of the NASD, but instead would be a facility of the Nasdaq Exchange.¹⁰⁶ These commenters argue that the Trade Reporting Facility is a facility of the

Nasdaq Exchange because the Nasdaq Exchange’s parent company controls the board of the TRF LLC, directs all business decisions, provides technology, and will reap the economic benefits of the TRF LLC. Based on the premise that the Trade Reporting Facility is a facility of the Nasdaq Exchange, these commenters believe that approval of the Trade Reporting Facility would be inconsistent with what they view as the Commission’s policy that an exchange must provide an opportunity for all exchange orders to interact with each other.¹⁰⁷

Several commenters also argue that the Trade Reporting Facility, as a facility of the Nasdaq Exchange, would allow an exchange to take credit and receive remuneration for trades that do not occur on that exchange, which these commenters maintain is inconsistent with current law.¹⁰⁸ One commenter said that allowing Nasdaq to take credit for off-exchange trades would reduce transparency and lead to a mistaken sense of an exchange’s liquidity and depth of market.¹⁰⁹

Commenters also argue that approval of the Trade Reporting Facility as operated by the TRF LLC will result in the proliferation of print facilities because other markets will seek to establish similar arrangements.¹¹⁰ One commenter argued that this would result in less order interaction.¹¹¹ Several commenters also argue that providing revenue and trade information to markets that have no nexus with the actual trades may contravene the public interest.

Section 3(a)(2) of the Exchange Act¹¹² defines the term “facility” of an exchange to include “its premises, tangible or intangible property whether on the premises or not, any right to the use to such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.” While the Trade Reporting Facility plainly is an affiliate

of Nasdaq, the Commission does not believe that the Trade Reporting Facility is a facility of the Nasdaq Exchange within the terms of the Exchange Act. Nasdaq owns the system that the TRF uses for reporting trades; however, the Trade Reporting Facility is not a service “for the purpose of effecting or reporting a transaction” on the Nasdaq Exchange. Instead, the Trade Reporting Facility is a service for the purpose of reporting transactions to the NASD. Therefore, the Commission believes that the Trade Reporting Facility is a facility of the NASD and not a facility of the Nasdaq Exchange.¹¹³

NASD members would report trades to the Trade Reporting Facility pursuant to NASD rules. In addition, transactions reported to the Trade Reporting Facility will be disseminated with a modifier indicating that they are NASD trades, which will clearly distinguish them from transactions executed on or through the Nasdaq Exchange. Because the Trade Reporting Facility is an NASD facility, the NASD will have the responsibility under the Exchange Act to regulate its members’ activities related to the Trade Reporting Facility.¹¹⁴ The Commission believes that the LLC Agreement provides the NASD with sufficient authority to carry out its SRO responsibilities because the LLC Agreement provides, among other things, that the NASD will have sole regulatory responsibility for the activities of the TRF LLC, including the right to review and approve the regulatory budget, approve rule proposals relating to the activities of the TRF LLC prior to their filing with the

¹¹³ The Commission has previously approved arrangements similar to the Trade Reporting Facility in which a third party technology provider operates an SRO’s facility in return for payment of related revenues. For example, the Pacific Exchange’s equity trading facility was for several years operated by an unaffiliated third party—ArcaEx. See Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (order approving the Archipelago Exchange as the equities trading facility of PCX Equities, Inc., a subsidiary of the Pacific Exchange, Inc.) (“ArcaEx Order”). Under the Agreement, PCX paid the parent of ArcaEx market data revenue and transaction and listing fees. See Archipelago Holdings, Inc. Annual Report on Form 10-K for fiscal year ended December 31, 2004. In September 2005, the parent of ArcaEx—Archipelago—acquired the Pacific Exchange. Accordingly, the exchange and the facilities operator became affiliated. See Securities Exchange Act Release No. 52497 (September 22, 2005), 70 FR 56949 (September 29, 2005). Recently, the NYSE and Archipelago merged, and the Pacific Exchange was renamed NYSE Arca.

¹¹⁴ Similar arrangements that have been approved by the Commission provided for the same obligations with respect to such facilities. See Securities Exchange Act Release Nos. 49067 (January 13, 2004), 69 FR 2761 (January 20, 2004) (order approving the Boston Options Exchange as a facility of the Boston Stock Exchange, Inc.); and Arca Ex Order, *supra* note 113.

¹⁰⁰ 15 U.S.C. 78c(a)(27).

¹⁰¹ 15 U.S.C. 78s(h)(1).

¹⁰² See Archipelago Letter, BSE Letter, NYSE Letters I, II and III, Ward Letter, Davis Letter, Bean Letter, Towns Letter, Capuano Letter, McHenry Letter, Gerlach Letter, and Baker Letter, *supra* note 13.

¹⁰³ See Nasdaq Letter, *supra* note 13.

¹⁰⁴ See letter from Edward Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated December 13, 2005 (“Nasdaq Letter II”).

¹⁰⁵ See NASD Response Letters I and II, *supra* note 14.

¹⁰⁶ See Archipelago Letter, *supra* note 13. See also NYSE Letter I, BSE Letter, Bean Letter, Towns Letter, Gerlach Letter, *supra* note 13.

¹⁰⁷ See Bean Letter, Archipelago Letter, NYSE Letter I, BSE Letter, and Towns Letter, *supra* note 13. See also Ward Letter, *supra* note 13.

¹⁰⁸ See Davis Letter, Bean Letter, Archipelago Letter, NYSE Letter I, BSE Letter, Towns Letter, McHenry Letter, Baker Letter, Gerlach Letter, *supra* note 13.

¹⁰⁹ See Ward Letter, *supra* note 13.

¹¹⁰ See Ward Letter, Bean Letter, Towns Letter, Capuano Letter, Gerlach Letter, Baker Letter, Archipelago Letter, BSE Letter, *supra* note 13.

¹¹¹ See Archipelago Letter, *supra* note 13.

¹¹² 15 U.S.C. 78c(a)(2).

Commission, adopt and interpret policies regarding NASD facilities, and perform real time market surveillance. In addition, under the LLC Agreement no "Major Action," as defined in the LLC Agreement, may become effective without the NASD's consent.¹¹⁵

To the extent that approval of the Trade Reporting Facility results in other markets seeking to establish similar arrangements with the NASD, the Commission notes that the NASD would have to file any proposed rule change generated by such proposals pursuant to Section 19 of the Exchange Act, and the Commission would be required to determine that such proposed rule change complied with the requirements of the Exchange Act. The Commission notes, however, that the Exchange Act does not prohibit the NASD from establishing different facilities for purposes of fulfilling its regulatory obligations. Indeed, the Commission notes that the NASD currently operates two facilities for the reporting of OTC trades in Nasdaq-listed securities—the ADF and the Nasdaq Market Center.

b. Impact on Internalization Practices

Based on the premise that the Trade Reporting Facility is a facility of the Nasdaq Exchange, commenters conclude that the Trade Reporting Facility would allow Nasdaq Exchange members to execute and report trades without regard to orders resident on the Nasdaq Exchange book and thereby increase the internalization of orders.¹¹⁶ One commenter objects to NASD members' current ability to execute trades in the OTC market without interacting with other better-priced orders on exchanges.¹¹⁷ Another Commenter suggests that NASD members would not be required to provide the best prices in the market.¹¹⁸ Commenters also contend that approval of the NASD's Trade Reporting Facility would result in a different standard for the Nasdaq Exchange as compared to other exchanges because, unlike other exchanges, the Nasdaq Exchange would not be required to have a consolidated limit order book.¹¹⁹

As discussed above, the Commission does not believe that the Trade Reporting Facility is a facility of the Nasdaq Exchange. Moreover, the Commission does not believe that the Trade Reporting Facility will increase

the internalization of orders. The Trade Reporting Facility simply preserves the ability of an NASD member, who may also be a member of the Nasdaq Exchange or another exchange, to report trades executed otherwise than on an exchange to the NASD through the Trade Reporting Facility without regard to the orders on the Nasdaq Exchange or any other exchange's consolidated limit order book. The Commission notes that the ability to report internalized trades to an NASD facility exists and is widely used today. In this regard, an NASD member today may report internalized trades to the Nasdaq facilities of the NASD without regard to the priority rules of the Nasdaq's SuperMontage system or any exchange of which it is a member. There is no reason to expect the Trade Reporting Facility to increase such practices.

Finally, the Commission notes that a broker-dealer has a legal duty to seek to obtain the best execution of customer orders.¹²⁰ This duty requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances.¹²¹ Further, the NASD noted that its members are subject to, among other things, NASD Rule 2320, which would prohibit an NASD member from disregarding the market.¹²² Accordingly, the Commission does not agree with the commenters that argued that the Trade Reporting Facility would permit NASD members to ignore disseminated quotes and their best execution obligations.¹²³

c. Unfair Competition

Several commenters object to the NASD's payment to Nasdaq of the

market data revenue generated by trades reported to the Trade Reporting Facility operated by the TRF LLC.¹²⁴ One commenter argues that the transfer of market data revenue from the NASD to Nasdaq through the TRF LLC is inconsistent with Section 11A of the Exchange Act and Regulation NMS.¹²⁵ Others state that payment of market revenue would amount to a subsidy of the Nasdaq Exchange by the NASD, which would provide the Nasdaq Exchange with an unfair economic advantage over other national securities exchanges.¹²⁶ One commenter also maintains that the Nasdaq Exchange would be able to use revenue generated by off-exchange trades to defray its business and exchange surveillance expenses, thereby discriminating against other exchanges.¹²⁷

One commenter raises competitive issues regarding the technology that will be used by the Trade Reporting Facility to collect trade reports.¹²⁸ Specifically, the commenter argues that Nasdaq's ACT is an industry utility because virtually all market participants use the system for reporting OTC trades. This commenter argues that Nasdaq's competitors should have equal access to ACT and the Trade Reporting Facility to eliminate the unfair competitive advantage the commenter believes exists due to Nasdaq's monopoly on ACT.

Section 15A(b)(9) of the Exchange Act¹²⁹ prohibits the NASD from having rules that impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission finds that the proposal does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. As the NASD and Nasdaq note, the LLC Agreement does not preclude the NASD from entering into similar arrangements with other national securities exchanges.¹³⁰ For this reason, the Commission believes that the Trade Reporting Facility does not impose any unfair burden on competition, as required by the Exchange Act.

The NASD notes that an exchange may develop its own proprietary system for reporting trades, and the NASD

¹²⁰ See, e.g., *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269–70 (3d Cir.), cert. denied, 525 U.S. 811 (1998); *Certain Market Making Activities on Nasdaq*, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing *Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971)); *Arleen Hughes*, 27 SEC 629, 636 (1948), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). See also *Order Execution Obligations*, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) and NASD Rule 2320, "Best Execution and Interpositioning."

¹²¹ *Newton*, 135 F.3d at 270. *Newton* also noted certain factors relevant to best execution—price order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *Id.* at 270 n. 2 (citing *Payment for Order Flow*, Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937–38 (Oct. 13, 1993) (Proposed Rules)). See *In re E.F. Hutton & Co.* ("Manning"), Securities Exchange Act Release No. 25887 (July 6, 1988). See also *Securities Exchange Act Release No. 34902* (Oct. 27, 1994), 59 FR 55006 at 55008–55009 (Nov. 6, 1994) (*Payment for Order Flow Final Rules*).

¹²² See Amendment No. 1.

¹²³ See BSE Letter, *supra* note 13. See also Capuano Letter, *supra* note 13.

¹¹⁵ See *supra* text accompanying note 92 for the LLC Agreement's definition of "Major Action."

¹¹⁶ See Archipelago Letter, BSE Letter, NYSE Letter I, *supra* note 13.

¹¹⁷ See BSE Letter, *supra* note 13.

¹¹⁸ See Capuano Letter, *supra* note 13.

¹¹⁹ See Archipelago Letter, BSE Letter, NYSE Letter I, *supra* note 13.

¹²⁴ See NYSE Letters I, II, and III, *supra* note 13. See also Gerlach Letter, Ward Letter, *supra* note 13.

¹²⁵ See NYSE Letters I, *supra* note 13.

¹²⁶ See NYSE Letters I and II, Ward Letter, and Gerlach Letter, *supra* note 13.

¹²⁷ See NYSE Letters I and II, *supra* note 13.

¹²⁸ See NYSE Letter III, *supra* note 13.

¹²⁹ 15 U.S.C. 78o–3(b)(9).

¹³⁰ See NASD Response Letters I and II, *supra* note 14 and Nasdaq Letter, *supra* note 13. See also Amendment No. 1.

represents that it is prepared to implement a trade reporting facility with any exchange based on the technology available to the exchange.¹³¹ The NASD represents that it has, in fact, discussed trade reporting facility arrangements with a number of exchanges.¹³² Because another exchange may develop a proprietary trade reporting system and enter into a similar trade reporting facility arrangement with the NASD, the Commission does not believe that the unavailability of ACT to other exchanges imposes a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission notes that the NASD bears the responsibility for overseeing the entities that report trades to the Trade Reporting Facility and for providing regulatory services to the Trade Reporting Facility. The TRF LLC will pay the NASD for these services using revenues generated by the Trade Reporting Facility. Under the LLC Agreement, Nasdaq must ensure that the TRF LLC has funds sufficient to satisfy its regulatory obligations and must guarantee the TRF LLC's payment of obligations relating to the costs associated with the NASD's performance of regulatory services for the Trade Reporting Facility.¹³³ As the NASD states in its response to the commenters, Nasdaq bears the economic risks associated with the operation of the Trade Reporting Facility, including any losses if revenues fail to cover regulatory and other costs associated with operating the Trade Reporting Facility.¹³⁴ In light of the costs, and potential losses, that Nasdaq must bear in connection with the operation of the Trade Reporting Facility, the Commission does not believe that allocating revenues generated by the Trade Reporting Facility to Nasdaq, net of costs, would provide the Nasdaq Exchange with an unfair economic advantage over other national securities exchanges or impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. Moreover, the Commission does not believe that an agreement by the NASD under which it pays Nasdaq market data revenue in exchange for Nasdaq providing the technology and bearing other costs of operating the facility is inconsistent with Regulation NMS or

the Exchange Act and the rules and regulations thereunder.

Finally, the Commission disagrees with the characterization of Nasdaq's ACT system as an industry utility. ACT is an automated system owned and operated by Nasdaq that, among other things, provides for the reporting of transactions in securities. The Exchange Act, however, does not prevent any other party, including an exchange, from developing similar technology for use as an NASD facility. Further, the Commission does not believe that the inability of competitors to use ACT for purposes of receiving compensation for trades reported by their members constitutes a denial of access under Section 19(d) of the Exchange Act. Under the proposal, all market participants that are members of the NASD will continue to have the ability to report internalized trades through ACT. Thus, the proposal does not prohibit or limit any person with respect to access to services offered by the NASD in violation of Section 19(d) of the Exchange Act. The Commission does not believe that Section 19(d) or any other provision of the Exchange Act requires Nasdaq to make its proprietary trade reporting system available to a competing exchange.

d. Impact on the NASD's Ability to Effectively Regulate

One commenter also questions whether the payment of market data revenue to Nasdaq would adversely impact the NASD's ability to regulate the Trade Reporting Facility or provide NASD members with reduced membership fees, or would impair the NASD's regulatory independence.¹³⁵ In particular, the commenter claims that it would compromise the NASD's regulatory integrity and neutrality as the SRO for the OTC market and would perpetuate the conflicts that the separation of the Nasdaq Exchange from the NASD was designed to ameliorate. Nasdaq asserts that it would receive the revenues associated with the TRF LLC "because it would provide the connectivity and reporting technology and bear all costs associated with the facility."¹³⁶ In addition, the LLC Agreement requires Nasdaq to ensure that the TRF LLC has funds sufficient to satisfy its regulatory obligations and to guarantee the TRF LLC's payment obligations relating to costs associated with the NASD's performance of its SRO responsibilities related to the activities of the TRF LLC.¹³⁷ This obligation is

independent of the revenue associated with the TRF LLC. Therefore, the Commission does not believe that the LLC Agreement or the TRF LLC would impair the NASD's ability to carry out its obligations under Section 15A of the Exchange Act.¹³⁸

e. Compliance With CTA Plan and the Nasdaq UTP Plan

One commenter contends that the payment of market data revenue to the Nasdaq Exchange by the NASD would violate both the CTA and Nasdaq UTP Plans.¹³⁹ This commenter refers to its earlier comment letters regarding Nasdaq's application for exchange registration, in which the commenter opposed Nasdaq's proposed transaction reporting rules.¹⁴⁰ The proposed rules would have allowed the Nasdaq Exchange to report—and receive revenue for—internalized and other off-exchange trades. This commenter argued that the proposed transaction reporting rules would not comply with Section VIII(a) of the CTA Plan, which requires each participant exchange to report all trades occurring on its floor and requires the NASD to report all trades that do not take place on the floor of an exchange.¹⁴¹ Similarly, the commenter maintained that the proposed rules would violate Section VIII(B) of the Nasdaq UTP Plan.¹⁴² By not complying with the terms of these plans, the commenter concludes that both Nasdaq and the NASD would

¹³⁸ 15 U.S.C. 78o-3.

¹³⁹ See NYSE Letter I and attached letters, *supra* note 13.

¹⁴⁰ See letters from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated February 15, 2002 ("NYSE February 2002 Letter"); and James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated August 27, 2001.

¹⁴¹ Specifically, Section VIII(a) of the CTA Plan states that the exchange participants will each collect and report to the Processor all last sale price information to be reported by it relating to transactions in Eligible Securities taking place on its floor. Section VIII(a) states, further, that the NASD shall collect from its members all last sale price information to be included in the consolidated tape relating to transactions in Eligible Securities not taking place on the floor of an exchange and shall report all such last sale price information to the Processor in accordance with the provisions of Section VIII(b) of the CTA Plan.

¹⁴² See NYSE February 2002 Letter, *supra* note 140. Section VIII(B) of the Nasdaq UTP Plan states that each Participant shall be responsible to promptly collect and transmit to the Processor Transaction Reports in Eligible Securities executed in its Market. Section III(E) of the Nasdaq UTP Plan defines "Market," when used in connection with Transaction Reports, to mean the Plan Participant through whose facilities the transaction took place or was reported, or the Plan Participant to whose facilities the order was sent for execution.

¹³¹ See NASD Response Letter II, *supra* note 14.

¹³² See NASD Response Letter II, *supra* note 13.

¹³³ See LLC Agreement, Section 12.

¹³⁴ See NASD Response Letter I, *supra* note 14.

See also LLC Agreement, Section 15 (allocating the profits and losses of the Trade Reporting Facility to Nasdaq).

¹³⁵ See NYSE Letter I, *supra* note 13.

¹³⁶ See Nasdaq Letter II, *supra* note 13.

¹³⁷ 137 See LLC Agreement Section 12.

violate Rule 608 of Regulation NMS,¹⁴³ which requires each SRO to comply with the terms of an effective national market system plan in which it participates and to enforce compliance with such plan by its members and persons associated with its members.¹⁴⁴

As noted in the Nasdaq Exchange Order, Nasdaq amended its exchange application so that only trades executed through the systems of the Nasdaq Exchange will be reported to the Nasdaq Exchange.¹⁴⁵ Through its Trade Reporting Facility and related rules, the NASD, rather than Nasdaq, will report all off-exchange trades and collect transaction reports for trades reported through the Trade Reporting Facility, as required by the Nasdaq UTP Plan. Accordingly, the Commission believes that the LLC Agreement and the proposed rules of the Trade Reporting Facility are consistent with the terms of the Nasdaq UTP Plan.¹⁴⁶

f. Consistency With Market Data Revenue Allocation Formula

One commenter states that the TRF LLC proposal is inconsistent with the objectives of the market data revenue allocation rules adopted by the Commission in conjunction with Regulation NMS.¹⁴⁷ According to this commenter, the new market data revenue allocation rules were intended to decrease incentives to engage in sham trades, wash sales, and tape shredding.

In addition to modifying Exchange Act rules governing the display and distribution of market data, the Commission amended the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan (each a "Plan" and, collectively, the "Plans") to incorporate a new net income allocation formula into each Plan.¹⁴⁸ The amendments to each of the Plans incorporated a broad-based measure of the contribution of an SRO's quotes and trades to the consolidated data stream.

The Commission does not believe that the TRF LLC is inconsistent with the objectives of the new Plan formulas, which included reducing the incentives

for distortive behavior, such as sham trades, wash sales, and tape shredding. The TRF LLC does not alter the new Plan formulas. Further, the NASD's proposed Trade Reporting Facility rules do not appear to create any incentives for distortive behavior.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether Amendment No. 1 is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-NASD-2005-087 on the subject line.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File No. SR-NASD-2005-087. This file number should be included on the subject line if e-mail is used. To help the Commission 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/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File No. SR-NASD-2005-087 and should be submitted on or before July 31, 2006.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act,¹⁴⁹ that the proposed rule change (SR-NASD-2005-087), as amended, is approved.

By the Commission.

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. 06-6083 Filed 7-7-06; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54089; File No. SR-NASD-2006-077]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Eliminate Its Current General Revenue Sharing Program Under NASD Rule 7010(u) and To Adopt a Revenue Sharing Program Limited to Transactions in Nasdaq-Listed Securities Reported to the Trade Reporting Service of the Nasdaq Market Center

June 30, 2006.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 22, 2006, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by Nasdaq. Nasdaq has filed the proposal as a "non-controversial" proposed rule change pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹⁴⁹ 15 U.S.C. 78s(b)(2).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ Nasdaq gave the Commission written notice of its intent to file the proposed rule change on May 31, 2006 and has asked the Commission to waive the 30-day operative delay. See Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

¹⁴³ Rule 608 of Regulation NMS was formerly Exchange Act Rule 11Aa3-1.

¹⁴⁴ See Rule 608(c) of Regulation NMS, 17 CFR 242.608(c).

¹⁴⁵ See Nasdaq Exchange Order, *supra* note 5.

¹⁴⁶ The Commission notes that the Trade Reporting Facility will not accept trade reports for CTA Plan Securities and, thus, the NASD will not report such trades to the CTA Plan through the Trade Reporting Facility. Accordingly, the Trade Reporting Facility and the TRF LLC will not receive CTA Plan revenue.

¹⁴⁷ See NYSE Letter II, *supra* note 13.

¹⁴⁸ See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (adopting Regulation NMS).