

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49471; File No. SR-NASD-2004-037]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc., Revising the Pilot Relating to the Issuance of Market Participant Identifiers

March 25, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 1, 2004, the National Association of Securities Dealers, Inc. (“NASD”), through its subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq has designated the proposed rule change as “non-controversial” under section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposed rule change effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would enable members that are registered as market makers or electronic communications networks (“ECNs”) to request and receive up to a total of ten market participant identifiers (“MMIDs”) with which to enter Attributable Quotes/Orders in the Nasdaq Quotation Montage. In addition, to reflect the increased number of MMIDs available with attributable display privileges to an individual member, the filing proposes technical changes to the policy re-allocating attributable display privileges when Nasdaq reaches its technological limit for such privileges. The text of the proposed rule change is set forth below. Proposed new language is in *italics*; proposed deletions are in [brackets].

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4613. Character of Quotations

(a) Quotation Requirements and Obligations

(1) Two-Sided Quote Obligation. For each security in which a member is registered as a market maker, the member shall be willing to buy and sell such security for its own account on a continuous basis and shall enter and maintain a two-sided quotation (“Principal Quote”), which is attributed to the market maker by a special maker participant identifier (“MMID”) and is displayed in the Nasdaq Quotation Montage at all times, subject to the procedures for excused withdrawal set forth in Rule 4619.

(A) No Change.

(B) No Change.

(2) *The first MMID issued to a member pursuant to subparagraph (1) of this rule, or Rule 4623, shall be referred to as the member’s “Primary MMID.”* For a six-month pilot period beginning March 1, 2004, market makers and ECNs may request the use of [a second MMID.] *additional MMIDs that shall be referred to as “Supplemental MMIDs.” Market makers and ECNs may be issued up to nine Supplemental MMIDs.* A market maker may request the use of [a second] *Supplemental* MMIDs for displaying Attributable Quotes/Orders in the Nasdaq Quotation Montage for any security in which it is registered and meets the obligations set forth in subparagraph (1) of this rule. An ECN may request the use of [a second] *Supplemental* MMIDs⁵ for displaying Attributable Quotes/Orders in the Nasdaq Quotation Montage for any security in which it meets the obligations set forth in Rule 4623. A market maker or ECN that ceases to meet the obligations appurtenant to its [first] *Primary* MMID in any security shall not be permitted to use [the second] *a Supplemental* MMID for any purpose in that security.

(3) Members that are permitted the use of [second] *Supplemental* MMIDs for displaying Attributable Quotes/Orders pursuant to subparagraph (2) of this rule are subject to the same rules applicable to the members’ first quotation, with two exceptions: (a) the continuous two-sided quote requirement and excused withdrawal procedures described in subparagraph (1) above, as well as the procedures described in Rule 4710(b)(2)(B) and

⁵ The Commission corrected the proposed rule text to italicize the letter “s” which is new language. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Ann E. Leddy, Special Counsel, Division of Market Regulation (“Division”), Commission (March 16, 2004).

(b)(5), do not apply to market makers’ [second] *Supplemental* MMIDs; and (b) [the second] *Supplemental* MMIDs may not be used by market makers to engage in passive market making or to enter stabilizing bids pursuant to NASD Rules 4614 and 4619.

(b)–(e) No Change.

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IM-4613-1—Procedures for Allocation of Second Displayable MMIDs

Nasdaq has a technological limitation on the number of displayed, attributable quotations in an individual security, although it has not reached that maximum to date in any security. Therefore, Nasdaq must consider the issuance and display of [a second] *Supplemental* MMIDs to be a privilege and not a right. Nasdaq has developed the following method for allocating the privilege of receiving and displaying [a second] *Supplemental* MMIDs with *attributable display privileges (“display privileges”)* in an orderly, predictable, and fair manner on a stock-by-stock basis.

As described in Rule 4613, Nasdaq will automatically designate a market maker’s first MMID as a “Primary MMID” and [its second] *any additional* MMIDs as [a] “[Secondary] *Supplemental*”⁶ MMIDs.” Market makers are required to use their Primary MMID in accordance with the requirements of NASD Rule 4613(a)(1) above, as well as all existing requirements for the use of MMIDs in Nasdaq systems. Market makers’ use of [Secondary] *Supplemental* MMIDs [are] *is*⁷ subject to the requirements set forth in NASD Rule 4613(a)(2) and (a)(3) above, including the prohibition on passive market making. However, the two-sided quote requirement, and the excused withdrawal procedures under NASD Rule 4619, and 4710(b)(2)(B) and (b)(5) will not apply to [the secondary] *Supplemental* MMIDs. Nasdaq will automatically designate each ECN’s MMIDs as Primary and [Secondary] *Supplemental*. Each ECN MMID will be subject to the requirements of NASD Rule 4623 and the existing ECN requirements of the NASD Rule 4700 Series. Members may also use [a

⁶ The Commission corrected the proposed rule text to italicize the word “Supplemental” which is new language. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Ann E. Leddy, Special Counsel, Division, Commission (March 16, 2004).

⁷ The Commission corrected the proposed rule text to change “are” to “is.” Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Ann E. Leddy, Special Counsel, Division, Commission (March 16, 2004).

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).

Secondary] *Supplemental* MMIDs to enter non-attributable orders into SIZE.

Nasdaq, in conjunction with the NASD, has developed procedures to maintain a high level of surveillance and member compliance with its rules with respect to members' use of both Primary and [Secondary] *Supplemental* MMIDs to display quotations in Nasdaq systems. If it is determined that [a Secondary] one or more *Supplemental* MMIDs [is] are being used improperly, Nasdaq will withdraw its grant of the [Secondary] *Supplemental* MMID(s) for all purposes for all securities. In addition, if a market maker or ECN no longer fulfills the conditions appurtenant to its Primary MMID (e.g., by being placed into an unexcused withdrawal), it may not use [the Secondary] a *Supplemental* MMID for any purpose in that security.

The first priority of Nasdaq's method for allocating the privilege of displaying [a second] *Supplemental* MMIDs is that each market maker or ECN should be permitted to register to display a single quotation in a security under [its] a Primary MMID before any is permitted to register to display [a second] *additional* quotations under [a Secondary] *Supplemental* MMIDs. [Each market maker or ECN may register its Primary MMID to display a quotation in a security, on a first-come-first-served basis. After each market maker or ECN has been permitted to register its Primary MMID to display quotations in a stock,] *If all requests for Primary MMIDs have been satisfied*, Nasdaq will then register [Secondary] *Supplemental* MMIDs to display Attributed Quotes/Orders in that security on a first-come-first-served basis, consistent with the procedures listed below. If Nasdaq comes within [five] ten MMIDs *with display privileges* of its maximum in a particular security, Nasdaq will temporarily cease registering [additional Secondary] *Supplemental* MMIDs *with display privileges* in that security and reserve those [five] *ten* remaining [MMIDs] *display privileges* for members that may register their Primary MMID in that stock in the future. If Nasdaq allocates those reserved [MMIDs] *display privileges* to members requesting Primary MMIDs and then receives additional requests for Primary MMIDs, it will use the procedure described below to re-allocate [Secondary MMIDs] *display privileges* to members requesting Primary MMIDs.

For any stock in which Nasdaq has reached the maximum number of members registered to display quotations, once each month, Nasdaq will rank each of the market participants that has [two MMIDs] *more than one*

Supplemental MMID with display privileges in the stock according to their monthly volume of trading, based on the [lower] volume of that participant's [two] *least used Supplemental* MMID[s] *with display privileges*. Nasdaq will withdraw the [second MMID] *display privilege associated with* [of] the lowest volume [of] *Supplemental MMID* of the participant in that ranking and assign that privilege to the first member that requested a *Primary MMID* or *Supplemental MMID*, *with Primary MMIDs always taking precedence* [the ability to display a second quotation]. Nasdaq will repeat this process as many times as needed to accommodate all pending requests for Primary and [Secondary] *Supplemental* MMIDs. *If after following this process (or at the outset of the allocation process) no member has more than one Supplemental MMID with display privileges, members will be ranked based upon the volume associated with their Supplemental MMID, and Nasdaq will withdraw the display privilege from the member with the lowest volume Supplemental MMID.*

Members that lose the display privilege associated with a Supplemental MMID [The low-ranking member(s) will lose the ability to display a second quotation in that security for that month, but] will still be permitted to use the [second] *Supplemental* MMID to enter non-attributable orders into SIZE for that security or any other, and to display [a second] *additional* quotes in any stocks in which [it is] *they are* properly registered to do so, subject to the conditions described in the rule and this interpretive material.

The objective of the procedure is to re-allocate the display privileges from the least used Supplemental MMIDs to those members requesting Primary or Supplemental MMIDs. For example, assume with respect to security WXYZ member A has nine Supplemental MMIDs with display privileges (which is the maximum—1 Primary MMID + 9 Supplemental MMIDs = 10 MMIDs with display privileges), member B has three Supplemental MMIDs with display privileges, and member C has three Supplemental MMIDs with display privileges and is requesting a fourth. After conducting the monthly ranking, one of B's Supplemental MMIDs is the least used in WXYZ, C has the next lowest volume Supplemental MMID with display privileges in the security, and A has the next lowest in the security after C (i.e., the order for forfeiting their display privilege is: B, C, then A). Based on this ranking, Nasdaq would re-allocate one of B's display privileges to

C. As a result, A keeps its privileges for all nine of its Supplemental MMIDs in WXYZ, C adds a Supplemental MMID with display privileges in the security, and B loses a display privilege in WXYZ "B does not lose use of the Supplemental MMID for submitting non-attributable orders in WXYZ to SIZE, and it does not lose display privileges in any other security in which it is authorized to use the Supplemental MMID.

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

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

Nasdaq is proposing to increase to ten the number of MMIDs available to individual market makers and ECNs to display attributable quotes and orders in the Nasdaq Quotation Montage. In addition, to reflect the increased number of MMIDs available with attributable display privileges, the filing proposes technical changes to Nasdaq's procedures for re-allocating the privileges when Nasdaq reaches its technological limit for displayed, attributable MMIDs.

Nasdaq recently established a pilot program in which market makers and ECNs can request and receive a second MMID with which they can submit Attributable Quotes/Orders to the Nasdaq Quotation Montage (i.e., an additional MMID with "display privileges").⁸ Nasdaq is proposing to increase to ten the total number of MMIDs with display privileges a market maker or ECN can be issued. Under the

⁸ See Securities Exchange Act Release Nos. 47954 (May 30, 2003), 68 FR 34017 (June 6, 2003) (SR-NASD-2003-87) (notice of filing and immediate effectiveness of pilot program); 48619 (October 9, 2003), 68 FR 59832 (October 17, 2003) (SR-NASD-2003-137) (extension of pilot program for a six-month period beginning September 1, 2003); and 49409 (March 12, 2004) (SR-NASD-2004-035) (extension of pilot program for a six-month period beginning March 1, 2004).

current pilot program, they are limited to two. Under the revised pilot program, MMIDs two through ten would be known as "Supplemental MMIDs," whereas the first MMID issued to a member would continue to be known as the member's "Primary MMID."

According to Nasdaq, the purpose of the current dual MMID pilot program is to provide market makers and ECNs the flexibility to route orders and quotes to SuperMontage from different units within their firms, including market making, arbitrage, retail, and institutional trading desks, among others. Increasing to ten the potential number of MMIDs with display privileges available to each market maker and ECN would provide these members even greater flexibility in managing their orders and quotes. Nasdaq believes this proposal would benefit the Nasdaq market by enabling members to contribute more liquidity, add to the transparency of trading interest, and better serve the needs of investors.⁹

The restrictions on the use of the increased number of MMIDs available with display privileges (*i.e.*, Supplemental MMIDs three through nine) would be the same as those presently applicable to a market maker's or ECN's second MMID. In other words, market makers that display additional Attributable Quotes/Orders under a Supplemental MMID would be required to comply with all rules applicable to market makers that display a single Attributable Quote/Order, and ECNs would be required to comply with all rules applicable to ECNs in their display of Attributable Quotes/Orders. There would be only two exceptions to this general principle. First, the continuous two-sided quote requirement and excused withdrawal procedures, as well as the procedures described in Rule 4710(b)(2)(B) and (b)(5) would not apply to market makers' use of Supplemental MMIDs. Second, a market maker would be permitted to use only one MMID, its Primary MMID, to engage in passive market making or to enter stabilizing bids pursuant to NASD Rules 4614 and 4619.¹⁰ In all other respects, market makers and ECNs would have the same

rights and obligations in using a Supplemental MMID to enter quotes and orders and to display quotations as they do today.

Just as with its decision to grant members use of a second MMID, the decision to allow members the use of up to ten MMIDs with display privileges must be balanced against the need to protect the integrity of the Nasdaq market. In this regard, market makers and ECNs would be prohibited from using a Supplemental MMID to accomplish indirectly what they are prohibited from doing directly through a single MMID. For example, members would not be permitted to use a Supplemental MMID to avoid their Manning obligations under IM-2110-2, best execution obligations under NASD Rule 2320, or their obligations under the Commission's Order Handling Rules.¹¹ To the extent that the allocation of Supplemental MMIDs were to create regulatory confusion or ambiguity, every inference would be drawn against the use of Supplemental MMIDs in a manner that would diminish the quality or rigor of the regulation of the Nasdaq market.¹² Accordingly, if it were to be determined that a Supplemental MMID was being used improperly, Nasdaq would withdraw its grant of all Supplemental MMIDs for all purposes for all securities.¹³

The filing also proposes technical modifications to IM-4613-1 to reflect the increased number of MMIDs available with display privileges. IM-4613-1 governs the procedures for re-allocating display privileges when Nasdaq reaches its technological limit for displayed, attributable quotations in an individual security. The filing also would add an example illustrating the re-allocation procedures. Nasdaq represents that it has not reached the maximum display privileges to date in any security.

¹¹ Members also would be required to continue to comply with the firm quote rule, the OATS rules, and the Commission's order routing and execution quality disclosure rules. In addition, NASD Rule 4613(a) specifically prohibits firms from displaying a second Attributable Quote/Order to engage in passive market making or to enter stabilizing bids because this could violate NASD Rules 4614 and 4619 and Regulation M under the Act.

¹² The Commission revised this sentence to insert the first clause. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Ann E. Leddy, Special Counsel, Division, Commission (March 16, 2004).

¹³ The Commission revised this sentence to clarify that all Supplemental MMIDs would be withdrawn in the event that any Supplemental MMID was used improperly. Telephone conversation between Thomas Moran, Associate Vice President and Associate General Counsel, Nasdaq, and Terri Evans, Assistant Director, Division, Commission (March 24, 2004).

Under the revised procedures, Nasdaq would increase from five to ten the number of display privileges it would reserve for members seeking Primary MMIDs. In addition, as explained below, Nasdaq would modify the procedures so that the rankings will be based only on the volume associated with a member's second through ninth Supplemental MMIDs with display privileges—Primary MMIDs and a member's first Supplemental MMID with display privileges would be excluded from the calculation and thus the re-allocation process. In excluding the first Supplemental MMID, Nasdaq is attempting to allow members to retain at least one Supplemental MMID.¹⁴ When re-allocating the display privileges, requests for Primary MMIDs would continue to receive precedence over requests for Supplemental MMIDs.

Currently, members with dual MMIDs are ranked monthly based on the lower volume between their two MMIDs—their Primary MMID and their second MMID. The member with the lowest volume would be the first to lose the display privileges associated with its second MMID. The re-allocation would progress through the second, third, fourth, fifth, etc., lowest volume member until all outstanding requests for Supplemental MMIDs have been fulfilled.¹⁵

Under the revised procedures, after excluding their first Supplemental MMID with display privileges, members would be ranked on the basis of their lowest volume Supplemental MMID with display privileges.¹⁶ The member with lowest volume would continue to be the first to lose the display privilege, but only with respect to the Supplemental MMID that caused them

¹⁴ Members' display privileges associated with their first Supplemental MMIDs would be included in the ranking and re-allocation process when no member has more than one Supplemental MMID, whether at the outset of a re-allocation process or when additional requests for Primary or Supplemental display privileges remain unfilled after the routine process re-allocates the display privileges associated with Supplemental MMIDs two through nine of all members. In these situations members would be ranked based upon the volume associated with their first Supplemental MMID, and Nasdaq would withdraw the display privilege from the member with the lowest volume Supplemental MMID.

¹⁵ This same process would be used to re-allocate display privileges if a member requests a Primary MMID. As discussed earlier, requests for Primary MMIDs always receive precedence over requests for Supplemental MMIDs.

¹⁶ The Commission revised this sentence to clarify members would be ranked on the basis of their lowest volume, rather than least used, Supplemental MMID with display privileges. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Ann E. Leddy, Special Counsel, Division, Commission (March 16, 2004).

⁹ Nasdaq will assess no fees for the issuance or use of a Supplemental MMIDs, other than the Commission-approved transaction fees set forth in NASD Rule 7010.

¹⁰ The Commission revised this sentence to clarify that the Primary MMID is the only MMID a market maker would be permitted to use to engage in passive market making or to enter stabilizing bids. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Ann E. Leddy, Special Counsel, Division, Commission (March 16, 2004).

to have the lowest ranking; the member would not lose its authority to use the Supplemental MMID in that security to submit quotes and orders to SIZE or the display privileges associated with that Supplemental MMID with respect to other securities in which it is permitted to use the identifier. The objective of the procedure is to re-allocate the display privileges from the least used Supplemental MMIDs to those members requesting Supplemental MMIDs.

For example, assume with respect to security WXYZ member A has nine Supplemental MMIDs with display privileges (which is the maximum—1 Primary MMID + 9 Supplemental MMIDs = 10 MMIDs with display privileges), member B has three Supplemental MMIDs with display privileges, and member C has three Supplemental MMIDs with display privileges and is requesting a fourth. After conducting the monthly ranking, one of B's Supplemental MMIDs is the least used Supplemental MMID in WXYZ, C has the next lowest volume Supplemental MMID with display privileges in the security, and A has the next lowest in the security after C (*i.e.*, the order for forfeiting their display privilege is: B, C, then A). Based on this ranking, Nasdaq would re-allocate one of B's display privileges to C. As a result, A keeps its privileges for all nine of its Supplemental MMIDs in WXYZ, C adds a Supplemental MMID with display privileges in the security, and B loses a display privilege in WXYZ—B does not lose use of the Supplemental MMID for submitting orders in WXYZ to SIZE, and it does not lose display privileges in any other security in which it is authorized to use the Supplemental MMID.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the Act, including section 15A(b)(6) of the Act,¹⁷ which requires, among other things, that a national securities association's rules be designed 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 perfect the mechanisms of a free and open market and a national market system, and, in general to protect investors and the public interest. Nasdaq believes that the proposed rule change is consistent with these requirements because it would facilitate transactions in securities, remove

impediments to a free and open market, and protect investors by improving the transparency and efficiency of transactions. Nasdaq believes that increasing to ten the potential number of MMIDs with display privileges available to each market maker and ECN would provide members greater flexibility in how they route orders and quotes to SuperMontage from different units within their firms, including market making, arbitrage, retail, and institutional trading desks, among others. As a result, Nasdaq believes this proposal would benefit its market by enabling members to contribute more liquidity, add to the transparency of trading interest, and better serve the needs of investors.

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

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not:

- (i) Significantly affect the protection of investors or the public interest;
- (ii) Impose any significant burden on competition; and
- (iii) Become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, it has become effective pursuant to section 19(b)(3)(A) of the Act¹⁸ and Rule 19b-4(f)(6) thereunder.¹⁹ At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. Nasdaq will disseminate a Head Trader Alert

¹⁸ 15 U.S.C. 78s(b)(3)(A).

¹⁹ 17 CFR 240.19b-4(f)(6). The Commission notes that Nasdaq provided written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change at least five business days prior to the date of filing of the proposed rule change.

informing members of the operative date of the proposal.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2004-037. 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, comments should be sent in hardcopy or by e-mail but not by both methods. 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 will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2004-037 and should be submitted by April 21, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

Margaret H. McFarland,
Deputy Secretary.

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¹⁷ 15 U.S.C. 78o-3(b)(6).

²⁰ 17 CFR 200.30-3(a)(12).