



Securities Industry Association

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August 30, 2001

By Hand and Via Electronic Mail

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

Re: The Nasdaq Stock Market, Inc.; Notice of Filing of Application for
Registration as a National Securities Exchange Under Section 6 of the
Securities Exchange Act of 1934, Release No. 34-44396, File No. 10-131

Dear Mr. Katz:

The Securities Industry Association ("SIA")¹ is pleased to provide the U.S. Securities and Exchange Commission ("Commission") with comments on The Nasdaq Stock Market, Inc.'s ("Nasdaq") application to register as a national securities exchange ("Form 1") under Section 6 of the Securities Exchange Act of 1934 ("Exchange Act").² As you are aware, the Commission initially requested comment by July 30, 2001, but extended the comment period until August 29, 2001 at the request of several members of

¹ The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated \$314 billion of revenue directly in the U.S. economy and an additional \$110 billion overseas. Securities firms employ approximately 770,000 individuals in the U.S. (More information about SIA is available on its home page: <http://www.sia.com>.)

² The Commission issued notice of Form 1 on June 7, 2001. See Securities Exchange Act Release No. 44396 (June 7, 2001). Nasdaq, a subsidiary of the National Association of Securities Dealers, Inc., initially filed Form 1 with the Commission on November 9, 2000; however, as the SEC explains in this release, "Exhibits A and C...were incomplete, and therefore on March 15, 2001, Nasdaq submitted to the Commission revised Exhibits A and C to address the deficiencies. As a result, Nasdaq's Form 1 was completed and officially filed with the Commission on March 15, 2001."

the public, including the SIA.³ The Commission is required to take action on Nasdaq's application by September 11, 2001, unless Nasdaq consents to an extension of time.⁴

As stated in the Commission's release issuing notice of Nasdaq's application to register as an exchange, "[t]he Commission shall grant such registration if it finds that the requirements of the Exchange Act and the rules and regulations thereunder with respect to Nasdaq are satisfied." Accordingly, the SIA first offers certain general observations on Nasdaq's application, and then raises important issues that we believe the Commission should consider in its deliberations to determine whether the application meets the requirements of the Exchange Act and the rules and regulations thereunder.

General Comments

The Form 1 represents a major restructuring of the U.S. securities markets that transfers much of the key facilities of the nation's over-the-counter ("OTC") market to a for-profit exchange market. Because of the far-reaching implications of this application, SIA member firms consider the filing to be of great importance and one that requires considerable thought and review by member firms and other interested parties. Although the SIA is pleased to offer general observations on this application and to raise a number of issues for the Commission's consideration, the SIA cannot provide at this time any final determinations as to whether the Form 1 satisfies the requirements of the Exchange Act for the following reasons:

(1) The comment period, although extended for one month, was too limited in view of the size, complexity, and importance of the filing.⁵ Nasdaq's provision of a guideline or meaningful comparison between the Nasdaq and National Association of Securities Dealers, Inc. ("NASD") rulebooks at an early date would have facilitated the review of this filing; however, the SIA did appreciate receiving the "red-lined" version of the Form 1 trade reporting rules provided by Nasdaq on August 7, 2001.⁶

³ See Securities Exchange Act Release No. 44625 (July 31, 2001). On July 24, 2001, the SIA requested the Commission to seek the consent of Nasdaq to delay the action date of the application until December 17, 2001, and to extend the comment period for an additional three-month period until October 31, 2001. See Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Marc E. Lackritz, President, SIA, dated July 24, 2001. In response to the SIA request and those of others, the Commission extended the comment period until August 29, 2001. On August 29, 2001, the Commission staff granted orally to the SIA an additional one-day extension in the comment period at the SIA's request.

⁴ Sections 6(a) and 19(a) of the Exchange Act, 15 U.S.C. 78(f)(a) and 15 U.S.C. 78(s)(a).

⁵ The filing is unusually voluminous and complex (comprising some eight volumes of material). Also, as predicted in the July 24, 2001 SIA letter requesting an extension of the comment period, member firms' efforts to review the Form 1 were impacted by the fact that the public comment period extended just over the summer months when the staffs of member firms usually take their vacations.

⁶ Although we recognize that Nasdaq was not required to provide a detailed explanation of the content of its Form 1 application, we note that, as a result of not having such a description or other tools to facilitate the review of this filing and especially given the length of the filing, the review process becomes necessarily a more time-consuming process for member firms to undertake. The August 7, 2001 red-lined version of the trade reporting rules was provided by Nasdaq's General Counsel's office and disseminated to SIA member firms.

(2) Certain critical pieces of information related to the filing are unavailable or lack clarity. This information is essential to analyzing the impact of this application on the securities markets and to determining whether the Form 1 satisfies the requirements of the Exchange Act. This information includes:

- o Clarifying information on Nasdaq's proposed trade reporting rules (*see* section 1.A.).
- o Clarifying information on the Form 1 rules regarding governance of members, the text of which Nasdaq intends to delete in order to incorporate by reference the pertinent NASD rules, and on membership fees, dues and examination requirements (*see* section 1.B.).
- o Clarifying information on Nasdaq's plans to continue operating the Bulletin Board and any related request for exemption from the Exchange Act (*see* section 1.C.).
- o Additional information on certain trading systems, including SuperSoes and SuperMontage (*see* section 1.E.).
- o Clarifying information on the approximate 75 amendments to NASD rules that have been made since the Form 1 was filed with the Commission, and particularly on whether they impact any of the proposed Nasdaq rules (since the Nasdaq rulebook is based primarily on the NASD rulebook) (*see* section 1.F.).
- o Clarifying information on the impact on Form 1 of the NASD's rule modernization project (*see* section 1.G.).
- o Information on the NASD's plans for the future operation of a quotation and transaction reporting facility for the residual OTC market⁷ (*see* section 2.A.).
- o Clarifying information on Nasdaq's role as an exclusive securities information processor ("SIP") and in existing national market system ("NMS") plans, among other contractual arrangements (*see* section 2.A.).
- o Information on Nasdaq's intentions to request exemption from several provisions of the Exchange Act (*see* sections 2.B., 2.C., 2.D., and 2.E.).

⁷ The NASD agreed to provide such a facility for the residual OTC market when the Commission approved SuperMontage, Nasdaq's new trading system (and before the filing of Nasdaq's completed Form 1 on March 15, 2001). *See* Letter to Arthur Levitt, Chairman, Securities and Exchange Commission, from Robert Glauber, Chief Executive Officer and President, National Association of Securities Dealers, Inc., dated December 13, 2000. For the Commission order approving SuperMontage, *see* Securities Exchange Act Release No. 43863 (January 19, 2001).

- o Selected information on the Regulatory Services Agreement signed by Nasdaq and NASD Regulation, Inc. (“NASDR”) (see section 2.F.).

Many SIA member firms advocate not approving Nasdaq’s exchange application until the alternative display facility for the residual OTC market is operational, and strongly believe that, given the record before it, the Commission cannot at this time make the necessary findings to approve Nasdaq’s exchange application.

Many other firms believe, however, that approval of Nasdaq’s application should not be held up because the NASD’s residual facility is not yet operational. These firms would support the Commission’s approving Nasdaq’s application if the Commission finds that it otherwise satisfies the requirements of the Exchange Act, but with the condition that the NASD facility be operational before Nasdaq actually begins operation as an exchange.

Either way, SIA believes that the Commission should address the residual facility before Nasdaq becomes an operating, for-profit exchange.

Discussion of Issues

We note that the Commission raised certain issues in its release issuing notice of the Form 1 that it believed warranted particular attention. Specifically, the Commission stated that “[t]here are a number of implications to Nasdaq’s separation from the NASD and application to register and operate as an exchange. For example,

- o Nasdaq will have to demonstrate that it has the capacity to comply, and enforce compliance by its members, with the Exchange Act and its own rules.
- o In addition, while members of a national securities association are not subject to Section 10(a) when trading Nasdaq stocks, if the Commission approves Nasdaq’s registration as an exchange, Section 10(a) will apply to such trading.
- o Moreover, while Nasdaq members are not subject to Section 11(a) of the Exchange Act for their Nasdaq transactions, they would be subject to Section 11(a) if Nasdaq becomes an exchange.
- o Furthermore, while the Form 1 contemplates that Nasdaq will be an exchange trading Nasdaq National Market securities and Nasdaq SmallCap securities, the future operation of the Over-the-Counter Bulletin Board must be addressed.
- o Before Nasdaq can register as a national securities exchange, it must be able to satisfy its obligations under Section 11A of the Act.
- o Finally, Nasdaq’s exchange registration has implications for the NASD which, as a national securities association, will continue to be required to collect bids,

offers and quotation sizes for those entities seeking to trade listed securities, including Nasdaq securities, otherwise than on a national securities exchange. The Commission notes that the NASD's quotation and transaction reporting facility must be operational upon Nasdaq's exchange registration.”

SIA member firms focused on these issues in their review of the Form 1, and also identified several other critical issues that they believe the Commission should consider in its deliberations. The list of issues below should not be considered exhaustive; it contains only those issues identified by member firms to date in the limited amount of time they had to review the application. The SIA appreciates the opportunity to discuss these important concerns, and trusts that the Commission will find this discussion helpful in their deliberations to determine whether the application satisfies the requirements of the Exchange Act and the rules and regulations thereunder.

1. Form 1: Proposed Rules and Exhibits

Nasdaq has stated that it relied heavily upon the NASD rulebook in formulating its proposed rules, and that the only substantive changes made were in the trade reporting rules, specifically Rules 4630-4633 and the Rule 6400 series.⁸ SIA member firms concentrated their review on the trade reporting rule sections because of Nasdaq's representations, the initial lack of any guideline or meaningful comparison between the two rulebooks, and the limited amount of time to review the entire filing. A few firms, however, did briefly review the other sections of the application, and their concerns and questions are also presented below.

A. Trade Reporting Rules: Rules 4630-4633 and Rule 6400 Series

The new trade reporting rules will impact broker-dealers and self-regulators in different ways. The Commission should consider carefully the rules' impact when determining whether they meet the Exchange Act's requirements, particularly those in Sections 6(b)(5) and 6(b)(8). These sections require that the Commission determine that:

- The rules of the exchange are 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 perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange; and

⁸ Information on Nasdaq's intentions discussed in this letter is based on SIA staff conversations with, and material received from, Nasdaq's General Counsel's office in August 2001, and also on visits made by Nasdaq to several SIA member firms in August 2001.

- o The rules of the exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.

When Nasdaq becomes an exchange, it will no longer be able to deem any trade of a Nasdaq security as a "Nasdaq trade," as it does today. Since Nasdaq will no longer be both a quasi-exchange and the OTC market, a definition must be created to determine when a trade has actually taken place "on Nasdaq" or in the OTC market, which will be operated by the NASD.⁹ Rules 4630-33 (which include interpretations IM-4630-1 and IM-4633-1, 2, 3 and 4) cover the reporting of trades of Nasdaq securities, and the Rule 6400 series of rules addresses the reporting of trades in securities listed on another exchange but traded on Nasdaq pursuant to unlisted trading privileges.

IM-4630-1 attempts to define a Nasdaq transaction. Section (1) of that rule codifies as Nasdaq trades those trades made on one of its systems, such as via SuperSoes, SelectNet or, eventually, SuperMontage. Sections (2) and (3) of the rule, however, define a Nasdaq transaction as any transaction involving a Nasdaq registered member or Nasdaq registered ECN. This part of the rule is intended to capture as Nasdaq trades all transactions internally crossed or matched by market makers or electronic communication networks ("ECNs").

Many member firms are concerned over this broad definition in IM-4630-1 of a Nasdaq exchange trade, which could classify certain OTC transactions as Nasdaq exchange transactions. They believe that this definition inappropriately extends Nasdaq's regulatory jurisdiction into their member firms' OTC activity in contravention of Section 11A of the Exchange Act, Rule 19c-3 thereunder, and recent Commission policy regarding exchange off-board trading rules. Other firms, however, do not have these concerns and, indeed, support the definition.

Rule 4633 attempts to define the various possible scenarios of executions and how each transaction will be reported. On its face, this rule may not present any problems for broker-dealers, but it could perhaps cause some confusion. For example, Rule 4633(a)(2) allows non-registered reporting members to voluntarily report transactions in Nasdaq securities to Nasdaq, even though NASD trade reporting rules (which must be drafted to complement the new Nasdaq reporting rules) would most likely mandate reporting of such transactions to the NASD. Rule 4633(c) expands on 4633(a)(2) by describing the various executions and reporting scenarios. Also, IM-4633-4 again allows for a choice, on a transaction-by-transaction basis, to report to either Nasdaq or the NASD. Giving participants the ability to choose where to report transactions could cause not only confusion, but also perhaps reports inadvertently not being made in some cases.

⁹ If it is an OTC trade, the trade report must be made to the NASD, not Nasdaq. This is no different than today when a NYSE security is traded other than on the floor of the exchange and the report is made to the NASD as a third market transaction. Defining whether a trade is made "on Nasdaq," however, is much more complicated than making that determination on the NYSE.

IM-4633-3 explains trade reporting for ECNs and attempts to standardize such trade reporting. The proposed changes will certainly require reprogramming for everyone, ECNs and market makers alike, but it will particularly affect certain ECNs with respect to volume calculations as a percentage of Nasdaq's overall volume.

Most of the comments just made regarding Rules 4630-33 are applicable to the Rule 6400 series, as the changes made by Nasdaq in the Rule 6400 series essentially parallel those made in the Rules 4630-33 series. Therefore, what may be somewhat confusing in Rules 4630-33 is also confusing in the Rule 6400 series, such as the ability of non-registered reporting members to report to Nasdaq voluntarily. This lack of clarity could result in trade statistics that are not meaningful.

The SIA recommends that the Commission review these important rules carefully to ensure that they are written clearly, will not create confusion as to their trade reporting requirements,¹⁰ are appropriate in the public interest, and otherwise meet the requirements of the Exchange Act to, among other things, promote just and equitable principles of trade, facilitate transactions in securities, and not go beyond the "administration of an exchange."¹¹

B. Membership Provisions

Nasdaq's for-profit status heightens the need for Commission scrutiny of the rules and regulatory burdens Nasdaq imposes on members and of the fees Nasdaq charges firms. In this regard, the SIA understands that Nasdaq has submitted to the Commission a list of proposed rules pertaining to governing members that, if the Commission approves, the text of such rules will be deleted from the proposed Nasdaq rulebook, and the corresponding NASD rules and any interpretive material issued thereunder will be incorporated by reference. Nasdaq believes that this is the most expedient way to ensure that the latest NASD rules and interpretations will apply to Nasdaq members, as the NASD has agreed to act as Nasdaq's regulatory authority. Although SIA member firms may not have any concerns with this action, they would have appreciated the opportunity during the Form 1 comment period to review the list of affected rules and the implications of incorporating by reference the NASD's rules.

The SIA recommends that the Commission determine whether the affected rules and the implications of this action are consistent with the Exchange Act, particularly Sections 6(b)(2), 6(b)(5), 6(b)(6) and 6(b)(7). According to these provisions, the Commission must ensure, respectively, that:

- o Subject to the provisions of subsection (c) of this section, the rules of the exchange provide that any registered broker or dealer or natural person associated

¹⁰ Member firms also are unclear how Nasdaq's trade reporting rules will impact the NASD's Order Audit Trail System ("OATS") (whether there will be any redundancy), and also whether these trade reporting concepts will be difficult to program for BRASS or other systems. Firms believe that Nasdaq's trade reporting rules and those of the NASD OTC residual facility must clearly delineate when the different sets of rules apply.

¹¹ Section 6(b)(5) of the Exchange Act, 15 U.S.C. 78(f)(b)(5).

with a registered broker or dealer may become a member of such exchange and any person may become associated with a member thereof.

- o The rules of the exchange are, among other things, not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.
- o The rules of the exchange provide that its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this title, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.
- o The rules of the exchange are in accordance with the provisions of subsection (d) of this section, and, in general, provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.

With regard to membership fees and dues, there appears to be no mention of what fees or dues will be assessed for the initial membership application or annually, even though the membership application grants Nasdaq the authority to assess fees on members.¹² The only fee discussion appears to be in the 7000 rule series in Exhibit E (transaction fees). The SIA suggests to the Commission that it review this subject with Nasdaq to ensure that they meet the requirements of the Exchange Act, particularly Section 6(b)(4) which states that the rules of the exchange “...provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities.”

Finally, once Nasdaq is registered as an exchange, it intends for member firms to file slightly revised Form B-Ds and Form U-4s after a 90-day “grandfather” period.¹³ Member firms strongly recommend to the Commission that they work with Nasdaq to streamline, where possible, this enormous administrative task. In addition, Nasdaq should clarify the examination requirements for associated persons of members; for example, it is unclear whether an individual will be required to take multiple examinations if he/she wishes to be associated with a firm with multiple exchange memberships.

C. Bulletin Board Rules

Nasdaq proposes in its Rule 6500 series to operate the Bulletin Board as an exchange facility, and is or will be submitting an exemption request to the Commission

¹² See Exhibit A to the Membership Application Form, which is Exhibit F to the Form 1.

¹³ See Exhibit L to the Form 1.

under Section 12 of the Exchange Act in order to do so. As explained later in section 2.D. of this letter, SIA member firms have not had an opportunity to review any such exemption request, and also have differing opinions on Nasdaq's intentions with the Bulletin Board and whether this should even be an issue for the Commission to consider in its deliberations on the Form 1.

D. Affiliations

Section 6(b)(1) of the Exchange Act requires that the Commission determine that Nasdaq is "...so organized and has the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to Section 17(d) or 19(g)(2) of this title) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange."

Exhibit C to the Form 1 shows that Nasdaq is involved in a substantial number of business ventures with numerous financial partners, particularly those pertaining to their global expansion objectives. The SIA is not taking a position on these affiliations, but assumes that the Commission will carefully review Nasdaq's outside activities to ensure the viability of the core market.

E. Trading Systems: Rules and User Guides

The SIA recommends that the Commission ensure that all of Nasdaq's systems are described adequately in the Form 1, and otherwise meet the requirements of Section 6(b)(5) of the Exchange Act. The SIA notes that the rules for Nasdaq's recently-approved system, SuperMontage, are not included in Form 1 and yet Nasdaq maintains that this will be the primary trading platform once Nasdaq's exchange application is approved. Since these rules will significantly change the core of Nasdaq's exchange trading facilities, some firms believe that their absence is a material deficiency in the filing that precludes an assessment of their impact on the application and the provisions of the Exchange Act.

Exhibit E to the Form 1 contains the Nasdaq user guides. The SIA recommends to the Commission that it ensure, before it takes final action on the application, that this section includes descriptions of SuperSoes (the system currently in use) and SuperMontage, and is otherwise up-to-date.

F. Recent NASD Rule Changes

Nasdaq has informed the SIA that approximately 75 of the NASD's rules, upon which they based their Nasdaq rules, have been amended since the filing of the Form 1 with the Commission. The SIA recognizes that it would be difficult for the NASD and Nasdaq, in its present form as a NASD subsidiary, to remain completely static through the Form 1 approval process, and also that there will be opportunity for public comment on any amendments proposed to the Nasdaq rules to conform with the NASD rule

amendments.¹⁴ Nevertheless, SIA member firms believe that, short of an amendment at this time to the Form 1, a list or other information noting those NASD amendments that impact Nasdaq's proposed rules would have been useful to review during the Form 1 comment period and would have facilitated any determination as to whether the Form 1 satisfies the requirements of the Exchange Act.

G. NASD Rule Modernization Project

The NASD is undergoing a major NASD rule modernization project, for which the SIA provided comment.¹⁵ In that Nasdaq's proposed rulebook is based almost entirely on the NASD's rulebook, it is necessary to understand the potential impact of this project on Nasdaq's proposed rules in order to perform a complete analysis of this application. Any relevant information on this project would have facilitated member firms' review of the application and their determination of whether the Form 1 satisfies the requirements of the Exchange Act.

2. Form 1: Impact on the Securities Exchange Act of 1934

Nasdaq's application to register as an exchange impacts a great number of statutory and regulatory provisions that govern the trading of securities on an exchange. The SIA understands that, in some cases, Nasdaq has filed, or intends to file, with the Commission requests for exemption from certain Exchange Act provisions. In other cases where an exemption may be warranted, firms are unclear whether Nasdaq intends to file an exemption request. The SIA understands that no exemption requests have been made public by the Commission at this time. SIA member firms, therefore, have not had an opportunity to review any such requests or to evaluate Nasdaq's justifications for such exemptions. As a result, firms do not have a complete picture of how Nasdaq intends to comply with the statutory requirements applicable to other exchange markets, nor why it should be exempted from certain requirements. The unavailability of this information, which many SIA member firms consider critical to their review of Nasdaq's application, contributed to those firms' difficulty in reaching any final determinations on whether the Form 1 satisfies the requirements of the Exchange Act.

A. Sections 6, 11A and 15A of the Exchange Act

The following sections of the Exchange Act mandate that there be fair competition between exchange markets and markets other than exchange markets, and give specific direction to the NASD:

¹⁴ In order for Nasdaq to include similar amendments in its exchange rules, Sections 6 and 19(b) of the Exchange Act require Nasdaq either to amend its application to include such changed rules or to submit such changes for Commission approval pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder after its registration as an exchange – both of which processes involve a public comment period.

¹⁵ See Special NASD Notice to Members 01-35; *see also* Letter to Barbara Z. Sweeney, NASD Regulation, Inc., from Christopher R. Franke, Chairman, Self-Regulation and Supervisory Practices Committee, Joseph Polizzotto, Chairman, Federal Regulation Committee, and Michael H. Stone, President, Compliance and Legal Division, SIA, dated July 31, 2001.

- o Sections 6(b)(5) and 6(b)(8) of the Exchange Act state that the rules of a registered exchange must be designed to remove impediments to, and perfect the mechanism of, a free and open market and a national market system, and to not be unjustifiably anti-competitive or result in unfair discrimination.
- o Section 11A of the Exchange Act expressly establishes for the Commission the objective of fair competition “between exchange markets and markets other than exchange markets.”
- o Section 15A(b)(11) of the Exchange Act specifically directs the NASD, as a registered national securities association, to develop rules and promote orderly procedures for “collecting, distributing and publishing quotations.” Consistent with this framework, the Commission’s rules establishing a national market system have required the NASD to provide for the collection and dissemination of OTC quotations and transactions for all NMS securities.

Nasdaq’s registration as an exchange will eliminate the only non-exchange facilities that exist for trading NMS securities, and thus signals a fundamental change in the U.S. securities markets. The OTC market has been a vital part of our securities industry, mandated by law. It is therefore important to understand the market structure implications of Nasdaq’s proposal, to consider what happens to the OTC market, and to ensure that fair competition remains between all market participants for the benefit of the U.S. securities markets and public investors.

The SIA notes that the Commission reaffirmed the importance of the OTC market when it sought, and received, the NASD’s agreement to provide a quotation and transaction reporting facility for the residual OTC market as a condition to approving SuperMontage, Nasdaq’s new trading system. Also, in the Commission’s release issuing notice of the Form 1, the Commission noted that “...Nasdaq’s exchange registration has implications for the NASD which, as a national securities association, will continue to be required to collect bids, offers and quotation sizes for those entities seeking to trade listed securities, including Nasdaq securities, otherwise than on a national securities exchange. The Commission notes that the NASD’s quotation and transaction reporting facility must be operational upon Nasdaq’s exchange registration.” The SIA understands that the NASD’s plans for this facility are not yet publicly available.

For the reasons discussed below, many member firms believe that it is essential that the Commission withhold approval of Nasdaq’s registration as an exchange until a viable NASD quotation display and trade reporting facility is in place to meet the needs of the OTC market. These firms believe that the Form 1, in its current form, is not consistent with the interests of investors and the requirements of the Exchange Act. On the other hand, many other firms maintain that, if the Form 1 otherwise meets the requirements of the Exchange Act, they would support the Commission’s approving Nasdaq’s application but with the condition that the NASD OTC residual facility be operational before Nasdaq can operate as an exchange.

First and foremost, member firms believe that, without an alternative display facility for the residual OTC market, investors and markets will be deprived of the innovation and competitive benefits that Congress expressly sought to achieve in the Exchange Act. Absence of an alternative OTC market would essentially mandate market makers and ECNs to become a member of the Nasdaq exchange; they would have no option to meet their regulatory obligations – particularly their quotation dissemination and access requirements – other than through Nasdaq, the exchange. Therefore, many firms maintain that, without an operational NASD OTC facility, a Nasdaq exchange would impose an inappropriate burden on competition since it would eliminate the OTC marketplace. These firms claim that the Exchange Act calls for preserving the ability of broker-dealers who wish not to join an exchange to operate only in the OTC market.

Section 15A of the Exchange Act requires that the NASD have rules regarding the “form and content of quotations relating to securities otherwise than on a national securities exchange.” The NASD will have to create new rules regarding this facility and new systems to collect and distribute this information. Member firms believe that the NASD’s residual facility for the OTC market will enable ECNs and market makers to meet their regulatory obligations under the Exchange Act without using the facilities of an exchange.

Second, there is an open securities information processing issue that causes some confusion. At this time, Nasdaq is the exclusive SIP for OTC securities registered with the Commission under Section 11A(b) of the Exchange Act. As such, Nasdaq performs two closely related functions – it collects information and quotations for the OTC market and acts as the exclusive processor for the Nasdaq/UTP Plan. Because the Exchange Act and legislative history¹⁶ require an exclusive SIP to be neutral, there are questions regarding Nasdaq’s intentions in this area, and whether Nasdaq can continue to serve as the exclusive SIP for Nasdaq-listed stocks and also operate a competing exchange. SIA member firms have differing opinions on this issue, and also realize that this may be part of a larger market structure debate best left for another forum.

Third, Nasdaq’s application fails to provide an adequate basis to understand and comment upon its continuing role in existing NMS Plans and under other contractual arrangements entered into while it has been acting as an arm of the NASD. SIA member firms have no knowledge of how these plans and agreements will be amended or renegotiated, or any basis for evaluating Nasdaq’s status under these plans and agreements. Information on these plans and agreements would have facilitated SIA member firms’ consideration of Nasdaq’s application to register as an exchange.

B. Section 10

¹⁶ Congress has made clear that Nasdaq, as an exclusive SIP, must act as a neutral industry utility rather than as an entity under the control or domination of an exchange or other market participant. Specifically, the legislative history to the Securities Acts Amendments of 1975 states that “[a]ny exclusive processor is, in effect, a public utility, and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms.”

When Nasdaq registers as an exchange, its securities will be “exchange-listed,” and therefore subject to Rule 10a-1, the short sale rule, that is based on last sale reports. The SIA understands that Nasdaq is seeking an exemption from Rule 10a-1 and wishes to continue applying its own Rule 3350, which uses a bid test.¹⁷ Since any such exemption request has not yet been published for public comment, member firms cannot adequately determine whether the request is appropriate in the public interest and consistent with the Exchange Act.

Some member firms, however, offer preliminary views. These firms maintain that Rule 10a-1 does not work in the context of Nasdaq's market structure, and that a bid test is more appropriate than a tick test. In addition, they explain that the NASD's rule includes a market maker exemption, which is an important feature that facilitates market makers' willingness to provide liquidity to the market. Furthermore, they state that the NASD's rule also includes a hedge exemption for listed options market makers, which is an essential risk management tool.

Other member firms, however, believe that Rule 10a-1 provides Nasdaq as an OTC market with greater latitude than the exchange markets, and that it may not be consistent with the Exchange Act's requirements of fair competition to retain their current rule.

Finally, some member firms advocate that the Commission should grant a temporary exemption for Nasdaq from Rule 10a-1, but then pursue its anticipated rulemaking efforts in this area to ensure that both Nasdaq and a specialist exchange can function in the most effective manner possible.

C. Section 11

Section 11(a) was designed to address problems on exchanges that limit membership and access to a physical trading floor (the time and place advantage that trading on the physical floor of an exchange would give to dealers). Section 11 prohibits a member of a national securities exchange from effecting transactions on such exchange for “covered accounts,” which includes (1) a member's proprietary account; (2) an account of an associated person of a member (such as a parent, affiliated or subsidiary company); and (3) an account for which the member of an associated person of a member exercises investment discretion. Given the dispersed and electronic nature of the Nasdaq market (particularly its open membership and equal access to information for all members), the Commission has never in the past applied this section to Nasdaq. The question is whether a change in Nasdaq's regulatory status, without a change in their market structure, requires that Nasdaq be subject to Section 11(a).

The SIA understands that Nasdaq is or will be submitting an exemption request to the Commission to preserve the status quo. Many member firms stated that, because they have not had an opportunity to review this request and its Exchange Act implications,

¹⁷ Of note is the fact that NASD Rule 3350 has never been permanently approved by the SEC; it has been a pilot rule for several years.

they are unable to comment on the impact of Nasdaq's exchange registration on Section 11(a). A few firms, however, offered the preliminary view that it may be appropriate for Nasdaq to maintain its Section 11(a) exemption in view of its being an electronic market.

D. Section 12

1) Section 12(a)

As mentioned earlier, the SIA understands that Nasdaq is or will be seeking an exemption from Section 12(a) of the Exchange Act in order to continue operating the Bulletin Board as an exchange facility. A preliminary view of some member firms is that the Bulletin Board should remain an OTC market facility; however, other firms do not consider Nasdaq's intentions in this area to be of concern or even an issue for the Commission to consider in its deliberations on Form 1. The SIA notes that there is no information publicly available on any request for an exemption from Section 12(a), which would have facilitated the review of this issue by those member firms who believe that the issue should be addressed (as part of their determination as to whether the Form 1 is consistent with the Exchange Act, particularly Sections 6(b)(5) and 6(b)(8) promoting fair competition between and among markets).

2) Sections 12(b) and 12(g)

The Exchange Act requires that securities listed on an exchange must be registered pursuant to Section 12(b), whereas securities listed on Nasdaq must be registered pursuant to Section 12(g). The SIA understands that Nasdaq is or will be requesting an exemption from the Exchange Act for current issuers and any future issuers listed on Nasdaq until it becomes an exchange that would deem securities registered pursuant to Section 12(g) as registered pursuant to Section 12(b). After Nasdaq becomes registered as an exchange, securities will be listed on Nasdaq in accordance with Section 12(b).

This exemption request also has not been made available to the public by the Commission. Although the reporting requirements under the two sections are nearly identical and there may be no concerns here, member firms believe it is still necessary to consider the statutory and regulatory implications under Section 12 of the Exchange Act for issuers shifting from OTC to exchange trading. Some firms maintain that there are certain differences between Sections 12(b) and 12(g) that reflect an elaborate set of policy distinctions made by Congress, and that these warrant a compelling justification and full opportunity for public comment on Nasdaq's request.

E. Section 16

Section 16(d) of the Exchange Act currently provides an exemption from the "short swing profit" and related short sale provisions of Sections 16(b) and (c) for dealers in certain market making activities off of an exchange. Nasdaq market makers have availed themselves of this exemption, and some member firms question whether Nasdaq will be requesting an exemption to allow Nasdaq market makers to continue to operate

under this exception after Nasdaq becomes an exchange. SIA member firms have not yet seen any public information on such an exemption request, and are therefore unable to fully assess whether there are any Exchange Act implications here. The preliminary view of a few firms, however, is that this exemption is necessary for Nasdaq market makers to continue their market making effectively in a Nasdaq exchange environment.

F. Relationship between Nasdaq and the NASD

Some member firms caution that the extensive interrelationship between Nasdaq and the NASD requires careful Commission attention, particularly in view of the fact that the two organizations will be sharing office space and that Nasdaq is the NASD's biggest "customer" for regulatory services.

The Commission should assure that the NASD facilities serving the OTC markets are established on a viable, arm's length basis, consistent with the requirements of the Exchange Act. According to some firms, all reasonable steps need to be taken to ensure that Nasdaq's legacy as a NASD subsidiary not give it an unfair competitive advantage over the market makers and ECNs it will compete against (and who will be regulated by the NASD) and that the relationship otherwise meets the Section 6(b)(5) requirements that the rules of the exchange be "... designed to... remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest."

With regard to the NASD's continuing to serve as the regulatory authority for members of the Nasdaq exchange, the SIA is aware that Nasdaq and the NASDR have signed a Regulatory Services Agreement. The SIA also understands that Nasdaq has requested confidentiality for certain, limited parts of this agreement. Member firms believe that there needs to be full disclosure of all terms of the agreement, particularly if they are material. Some firms also believe that the Commission should monitor the NASDR-Nasdaq relationship going forward to ensure that it is consistent with the Exchange Act and appropriate in the public interest.¹⁸

G. Modifications to Technological Systems

Member firms wish to remind the Commission that, in addition to systems work to accommodate Nasdaq's new trade reporting rules, their systems in other areas may be impacted and will require time to be adjusted. It is important that adequate time be provided to member firms to make any necessary systems changes and to conduct any testing that may be needed due to these rule changes.

H. Other Market Structure Implications

There are certain far-reaching market structure implications that are raised by Nasdaq's application to register as an exchange. Although some firms believe that they are perhaps the subject of another debate, several SIA member firms thought it useful to raise them at this time.

¹⁸ Some member firms have raised certain questions regarding this relationship, including potential conflicts of interest and the issue of fines as a revenue source.

First, member firms are deferring to the Commission's judgment in determining the most appropriate methods to judge or minimize potential conflicts of interest between a for-profit exchange serving the public good and its member-owners with interests in profit-making. At this point, member firms are not commenting on this larger market structure debate, but wish to bring the issue to the Commission's attention.

Second, some firms advocate that Nasdaq's exchange application presents a perfect opportunity for the Commission to address market fragmentation. These firms believe that the Commission needs to address fragmentation in general, but in particular that which would result from Nasdaq becoming an exchange and significant market participants operating solely in the NASD's OTC market and away from any exchange. These firms are concerned about the impact on investors of increased fragmentation in the markets and decreased transparency (which, among other things, makes it more difficult to comply with a firm's best execution obligations). In this regard, some firms advocate that the Commission reconsider the building of a universal linkage for all stocks among the various market centers trading U.S. securities. Other firms, however, advocate market centers freely negotiating linkage terms among themselves on a bilateral basis.

Conclusion

The SIA welcomes this opportunity to comment on Nasdaq's application to register as an exchange, and appreciates the efforts of the Commission staff in reviewing the Form 1 and publishing it for comment. The SIA also appreciates the extension in the comment period, but considered it still too brief in view of the size, complexity and importance of the filing.

Because of this limited comment period and the fact that Nasdaq's application was not accompanied by information on the NASD's plans for the OTC residual facility and other information essential to analyzing the impact on the securities markets of its proposed registration as an exchange, the quality of the public debate on this fundamental restructuring of the U.S. securities markets was compromised.

The SIA believes that the Commission should proceed cautiously, and with complete information, in its deliberations on this application to determine whether it satisfies the requirements of the Exchange Act and is thus necessary or appropriate in the public interest and consistent with the protection of investors. The SIA would be pleased to continue its participation in this important debate, and to offer further comments as the process moves along if the Commission finds it helpful.

If we can provide further information or clarification of the points made in this letter, please contact me or Ann Vlcek, Assistant General Counsel, at 202-296-9410.

Sincerely,

Stuart J. Kaswell
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