



Securities Industry Association

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February 5, 2002

By Hand and Via Electronic Mail

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

Re: File No. SR-NASD-2001-90

Dear Mr. Katz:

The Securities Industry Association (“SIA”)¹ is pleased to provide the Securities and Exchange Commission (“Commission” or “SEC”) with comments on the National Association of Securities Dealers, Inc.’s (“NASD”) proposal to establish rules that would govern trading otherwise than on an exchange, including the rules governing the NASD Alternative Display Facility (“ADF”).² The SIA supports the SEC’s decision to address the NASD’s residual facility before The Nasdaq Stock Market, Inc. (“Nasdaq”) becomes an operating, for-profit exchange.³

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 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>.)

² Securities Exchange Act Release No. 45156 (Dec. 14, 2001), 67 Fed. Reg. 388 (Jan. 3, 2002) (“ADF Proposal” or “Proposal”).

³ See Letter from Stuart J. Kaswell, Senior Vice President and General Counsel, SIA, to Jonathan G. Katz, Secretary, SEC, dated Aug. 30, 2001 (stating that “the Commission should address the [NASD’s] residual facility before Nasdaq becomes an operating, for-profit exchange”).

The SIA's comments in this letter, however, will be general in nature. Given the brief comment period, the SIA has had insufficient time to fully analyze a filing of this size, complexity and importance.⁴ Because the Proposal raises such far-reaching and interrelated issues, it is important that the Commission work through the many issues with all interested parties, including the SIA, in order to reach a result that furthers the public interest.⁵ In this regard, the SIA requests the opportunity to meet with the SEC staff at a later date to discuss in greater detail the views of the SIA members on the ADF Proposal itself as well as on how the ADF relates to Nasdaq's exchange application.⁶ Nonetheless, in the Appendix to this letter, we briefly have identified for the SEC's consideration certain technical questions and potential issues regarding the Proposal.⁷

As a conceptual matter, we believe the ADF Proposal raises two broad areas of potential concern. First, at a minimum, we believe the ADF should not degrade the quality of the markets for national market system ("NMS") securities. Indeed, it would be inconsistent with the Securities Exchange Act of 1934 ("Exchange Act") to approve a proposal that contributed to unfair or disorderly markets. In this regard, the SIA believes that the ADF Proposal potentially impairs many essential aspects of the existing national market structure, such as transparency, linkages, market data and best execution. It is simply not clear from the details provided by the NASD how the ADF Proposal will affect these national market issues. For example, it is unclear how investors will continue to obtain best execution of their orders in a post-ADF world, given, for example, the lack of an order routing capability in the current proposal. Therefore, the SIA believes that the SEC must analyze carefully the many collateral effects of approving the ADF and only should approve the Proposal if the SEC is convinced, on the basis of its own independent analysis, that the ADF would not damage the robust trading markets operating today.⁸

⁴ The SIA appreciates the SEC's brief extension of the comment period from January 21 to January 24, and the SEC staff's granting the SIA an additional, informal extension of time until February 5, 2002. Nevertheless, the SIA believes that a more significant extension would have been beneficial, particularly because the Proposal represents a potentially significant restructuring of the over-the-counter market.

⁵ Given the many recent NASD rule filings related to its corporate and market restructuring, including the filings related to SuperMontage, the Nasdaq exchange application and now the ADF, some SIA members believe that the SEC should provide the time and opportunity for interested parties to comment on the broad implications of all the proposals treated as a whole. Furthermore, the SIA members believe that the SEC should ensure that they will have an opportunity to comment on any changes to the NASD's proposals going forward.

⁶ See Securities Exchange Act Release No. 44396 (June 7, 2001), 66 Fed. Reg. 31952 (June 13, 2001) (Notice of Filing of Application for Registration as a National Securities Exchange).

⁷ The contents of the Appendix should not be considered an exhaustive or comprehensive compilation of issues related to the ADF Proposal. On the contrary, the issues listed are merely some of those identified during the SIA members' preliminary review of the Proposal.

⁸ See *Timpinaro v. SEC*, 2 F.3d 453 (D.C. Cir. 1993) (remanding NASD's professional trader rule for the SEC to balance the costs and benefits of the rule change) and *Clement v. SEC*, 674 F.2d 641 (7th Cir. 1982) (vacating rule change because of SEC's failure to perform a careful analysis of the rule change's impact).

Second, assuming the SEC were to conclude -- as it must in order to approve the ADF -- that the ADF will not degrade existing markets, there is the related concern of whether the ADF itself is a practical proposal capable of providing a useful competitive residual market consistent with investor protection. In this regard, the Proposal creates some uncertainty about basic trading practices and associated issues, such as technology and operational costs, which, in turn, affect the quality of the markets. Accordingly, we do not believe the SEC can, or should, approve the Proposal unless the SEC is satisfied that the ADF is truly a workable residual market.⁹

Of special concern to the SIA members are the potential intermarket issues raised by the ADF Proposal. In evaluating the Proposal, the SIA members generally expressed a desire for more detailed guidance regarding the meaning and application of the various ADF rules in the broader market context.¹⁰ For example, the SIA members note that the NASD would require "market participants to provide direct electronic access to other market participants and direct or indirect electronic access to all other NASD members seeking access."¹¹ The NASD, however, has not set forth any criteria, such as minimum technological requirements, for determining whether the types of "direct electronic access"¹² or "indirect electronic access"¹³ provided by ADF participants are appropriate or suitable for NMS trading. Without such specifications, inferior technology or methods may negatively affect trading in the relevant securities.¹⁴ For example, if quotes are not updated in the same expeditious fashion as in the other market centers, leaving stale quotes, many aspects of trading may be disrupted, including best execution¹⁵ and reporting pursuant to SEC Rule 11Ac1-5. Furthermore, the use of bilateral linkages may raise issues associated with locked and crossed markets, trade or move rules, the Manning Rule,¹⁶ the short sale rule, the firm quote rule, trading volume and highs and lows, and other rules and trading practices.

⁹ Furthermore, before allowing the ADF to commence operation, the SEC should require the ADF to undergo appropriate testing to ensure that it is a technically viable approach to trading.

¹⁰ In this regard, the Commission is well aware that the courts will not uphold vague and ill-defined NASD standards. *See Timpinaro v. SEC*, 2 F.3d 453 (D.C. Circuit 1993) (remanding for vagueness considerations). Accordingly, the Commission has a duty under Section 19(b) of the Exchange Act to insist that a self-regulatory organization's proposed rule articulate a standard that provides fair notice to its members before the Commission approves the proposed rule change.

¹¹ ADF Proposal, 67 Fed. Reg. at 451.

¹² *See* Proposed NASD Rule 4300(d)(2).

¹³ *See* Proposed NASD Rule 4300(d)(3).

¹⁴ In this regard, the SEC, in considering the ADF Proposal, must ensure that the NASD has the capability to monitor compliance with any technological specifications for access as well as ADF trading rules in general.

¹⁵ For example, complaints of "backing away" may increase.

¹⁶ NASD IM-2110-2 (Trading Ahead of Customer Limit Order).

Perhaps the most dramatic example of this concern is the lack of clarity in the ADF Proposal as to how broker-dealers will satisfy their best execution obligations if the ADF becomes operational as proposed. According to the NASD's rule filing, although the ADF would provide quote collection, trade comparison and trade reporting services, it "would not provide ADF participants with an order routing capability, other than [the Intermarket Trading System]."¹⁷ The lack of an efficient and effective order routing mechanism may enhance market fragmentation and impede the firms' ability to route orders in their possession to the best market, thereby making best execution an elusive proposition, unless the firms become ADF participants.¹⁸ Although SIA members do not necessarily advocate requiring the NASD to create a linkage with order routing and execution capabilities for the ADF, they do believe that the SEC must address how best execution obligations can be fulfilled in the proposed trading environment.

The SIA also notes that its members may incur potentially significant costs to participate in the ADF. As an illustration, to participate in the ADF, a firm must provide direct and indirect electronic access to other participants. In general, firms are currently accustomed to relying on their self-regulatory organization to provide means for obtaining access to quotes. The effects of shifting this cost from the NASD to individual firms may be considerable. Similarly, the technology costs for the new trade reporting and comparison services, TRACS,¹⁹ and for a quotation service that disseminates quotations on behalf of other markets²⁰ also may be expensive.²¹ The SIA members urge the Commission to scrutinize the cost issue, especially its effect on smaller firms, before approving the Proposal.²²

Given the regulatory uncertainties and costs associated with the commencement of the operation of the ADF, the SIA members believe that, at a minimum, the SEC should ensure that firms are provided with adequate time to make and test any necessary

¹⁷ ADF Proposal, 67 Fed. Reg. at 450-51. Some SIA members believe that the Proposal's suggested voluntary linkage with the Intermarket Trading System may not provide a viable, competitive alternative to Nasdaq's SuperMontage.

¹⁸ Similarly, as the SEC recognized in adopting Regulation ATS, the imposition of fair access requirements may also be necessary to ensure broker-dealers have the ability to satisfy their obligations to their customers. See, e.g., Rule 301(b)(5) under the Exchange Act.

¹⁹ ADF Proposal, 67 Fed. Reg. at 451.

²⁰ See Proposed NASD Rule 4613(e)(2).

²¹ In fact, in its filing, the NASD notes the substantial costs of disseminating quote and trade data. The NASD states that "[a] requirement to disseminate consolidated quotation and trade data from securities exchanges and other market centers would result in significantly increased costs to build the ADF." ADF Proposal, 67 Fed. Reg. at 453.

²² In this regard, as the Commission is aware, Section 15A(b)(9) of the Exchange Act states that the rules of the association may "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title." We do not believe the SEC can approve the Proposal as consistent with the Exchange Act unless it determines that the de facto costs imposed on members are otherwise reasonable.

system changes and to ascertain how their various regulatory responsibilities may be satisfied. Furthermore, the SIA members expect that the SEC and NASD will smooth any transition by providing greater clarity and information about the Proposal. The ADF Proposal states that “[t]he ADF is expected to launch by the end of the first quarter of calendar year 2002, provided that Nasdaq has been approved as a national securities exchange.”²³ With the implications for the protection of investors in mind, the SIA’s members believe that the SEC should consider whether the ADF’s launch should be postponed to a later date, if the ADF Proposal is approved.

In conclusion, the SIA urges the SEC to proceed with caution when considering the ADF Proposal. The SIA recommends that the SEC thoroughly evaluate whether the regulatory, technological and cost burdens of the implementation of the ADF would disrupt the securities markets in general, thereby harming investors and the public interest.²⁴

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If we can provide further information on, or clarification of, the issues discussed in this letter, please contact me or Ann Vlcek, Associate General Counsel, at 202.296.9410.

Sincerely,

Stuart J. Kaswell
Senior Vice President and General Counsel

cc: Annette L. Nazareth, Director, Division of Market Regulation, SEC
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC
Belinda Blaine, Associate Director, Division of Market Regulation, SEC
Robert Glauber, Chief Executive Officer and President, NASD
Alden Adkins, Senior Vice President, NASD

²³ ADF Proposal, 67 Fed. Reg. at 450.

²⁴ The SEC must act in accordance with Section 3(f) of the Exchange Act, which states that “whenever . . . the Commission is engaged in . . . the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”

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Mary Schapiro, President, NASD Regulation

Philip Shaikun, Assistant General Counsel, NASD Regulation

Kathleen O'Mara, Assistant General Counsel, NASD Regulation

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Appendix

In addition to the recommendations set forth in the body of the letter, the SIA members submit the following questions and comments for consideration by the SEC:

1. Market Neutral Linkage. In its order approving SuperMontage, the SEC stated that “the NASD has agreed to provide an alternative quotation and transaction reporting facility for NASD members . . . The facility also will provide a market neutral linkage to the Nasdaq and other marketplaces, but not an execution service.”²⁵ Does the ADF satisfy the requirement to provide “a market neutral linkage”? Does the NASD provide sufficient details in the ADF Proposal to evaluate whether the ADF meets the “market neutral linkage” requirement?
2. Direct and Indirect Electronic Access. SIA members have posed many questions about the meaning of the terms “direct electronic access” and “indirect electronic access,” as used in Proposed Rule 4300(d)(2) and (3). Therefore, the SIA requests clarification of the definition of these terms, perhaps using examples to explain the type of permitted access.

In addition, SIA members have posed practical questions about the implementation of the access requirements. For example, under Proposed NASD Rule 4300(a)(2), an ADF Market Participant may be required to provide direct access to an NASD member under certain conditions. Are there situations in which the ADF Market Participant may deny such direct access -- perhaps by establishing fair access standards akin to those required under Regulation ATS²⁶? Similarly, certain SIA members have asked whether the NASD should allow ADF Market Participants to charge a higher rate to members who redistribute the Participant’s liquidity via the indirect access requirement in order to compensate the Participant for the value of its services.

3. Access Fees. Given the historically contentious nature of the treatment of access fees, SIA members ask for greater clarification of how the NASD will approach access fees with regard to the ADF, particularly the notion of forced fees for accessing a quote.
4. Fees and Assessments. The ADF Proposal does not include any proposed fees or assessments specifically related to the ADF. The NASD states in its filing that “[a]ny specific fees or assessments with respect to the ADF would be the subject of a future rule filing.”²⁷ SIA members believe that fee information is an important consideration in balancing the costs and benefits of such an important Proposal and are concerned about how the lack of fee information may affect an analysis of the Proposal.

²⁵ Securities Exchange Act Release No. 43863 (Jan. 19, 2001), 66 Fed. Reg. 8020, 8024 (Jan. 26, 2001).

²⁶ Rule 301(b)(5) under the Exchange Act (alternative trading systems must establish standards for access to their systems and apply those standards fairly).

²⁷ ADF Proposal, 67 Fed. Reg. at 454.