

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46410; File No. SR-NASD-2002-56]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving a Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 2 and 3 to the Proposed Rule Change Establishing a Uniform Process for Opening Daily Trading for the Nasdaq SuperMontage

August 23, 2002.

#### I. Introduction

On April 22, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to establish a uniform process for opening daily trading in Nasdaq's future Order Display and Collector Facility ("SuperMontage"). On May 17, 2002, the NASD, through Nasdaq, filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change and Amendment No. 1 were published for comment in the *Federal Register* on May 24, 2002.<sup>4</sup> The Commission received thirteen comment letters from twelve commenters regarding the proposal.<sup>5</sup> Nasdaq responded to the

issues raised in the comment letter on July 12, 2002.<sup>6</sup> On July 12, 2002, the NASD, through Nasdaq, filed Amendment No. 2 to the proposed rule change.<sup>7</sup> On August 22, 2002, the NASD, through Nasdaq, filed Amendment No. 3 to the proposed rule change.<sup>8</sup> This order approves the proposed rule change and Amendment No. 1, and notices and grants accelerated approval to Amendment Nos. 2 and 3.

#### II. Description of the Proposed Rule Change

Nasdaq proposes to amend the operation of SuperMontage during pre-market hours. Specifically, Nasdaq proposes to: (1) Permit the entry of market orders prior to 9:30 a.m. Eastern Time, (2) amend the timeframe for the Trade-or-Move Rule to conform to the changes in the opening process, and (3) modify the opening process by providing for the automatic clearing of locked/crossed quotes between 9:29:30 a.m. and 9:29:59 a.m. Eastern Time.

Director, Nasdaq Trading, Morgan Keegan & Company, Inc., dated June 14, 2002 ("Morgan Keegan Letter"); C.E. Wasson, SVP Director Nasdaq Trading, Legg Mason Wood Walker, Inc. ("Legg Mason"), dated June 20, 2002 ("Legg Mason Letter"); Howard Bernstein, Vice President, Compliance Department, RSSF, dated June 17, 2002 ("RSSF Addendum Letter"); Elliot Levine, Assistant General Counsel, Executive Director, CIBC, dated June 18, 2002 ("CIBC II Letter"); and John P. Hughes, Senior Vice President, Director of Nasdaq & Listed Trading, Janney Montgomery Scott LLC, dated June 12, 2002 ("Janney Montgomery Scott Letter").

<sup>6</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated July 1, 2002 ("Response to Comments").

<sup>7</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Sapna C. Patel, Attorney, Division, Commission, dated July 12, 2002 ("Amendment No. 2"). In Amendment No. 2, Nasdaq made a technical correction to its proposed rule text by replacing "MPID" with "MMID" in proposed NASD Rule 4613.

<sup>8</sup> See letter from Jeffrey S. Davis, Office of General Counsel, Nasdaq, to Sapna C. Patel, Attorney, Division, Commission, dated August 22, 2002 ("Amendment No. 3"). In Amendment No. 3, Nasdaq provided the following: (1) an updated version of its proposed rule language reflecting changes to its rules that have occurred since the initial filing of this proposal; (2) a representation that it will evaluate whether the thirty-second pre-opening unlocking/uncrossing process time period should be shortened in the 60 days following the complete roll-out of SuperMontage, and will report its findings to the Commission within 30 days thereafter; (3) a representation that it will monitor market participants' inability to send Trade-or-Move Directed Orders to SIZE during the Trade-or-Move process, and will file a proposed rule change with the Commission within 90 days of the complete roll-out of SuperMontage to resolve problems to Size accessibility; and (4) clarification that all quotes residing in SuperMontage at the end of the trading day will be carried over to the next trading day, and that the quoting market participant could update that quote prior to the 9:20 a.m. Trade-or-Move process.

#### A. Expansion of Order Entry During Pre-Market Hours

Nasdaq proposes to permit the entry of market orders prior to the 9:30 a.m. market open in SuperMontage. Under current SuperMontage rules, market participants may enter limit orders prior to the market open at 9:30 a.m. Eastern Time, but not market orders.<sup>9</sup> Under the proposal, market participants would be permitted to enter market orders prior to the market open. Market orders and limit orders designated as IOC would not be eligible for execution prior to the market open, and instead would be held in a separate queue until 9:30 a.m., at which time such orders, if marketable, would be executed (in whole or in part) through the SuperMontage Non-Directed Order Process, or, if non-marketable, cancelled and returned (in whole or in part) to the entering firm.<sup>10</sup>

#### B. Modifications to "Trade-or-Move" Rule Timeframes

Nasdaq proposes to amend its Trade-or-Move Rule to require market makers and Electronic Communication Networks ("ECNs") (collectively "Nasdaq Quoting Market Participants") to send Trade-or-Move Directed Orders<sup>11</sup> between 9:20 a.m. and 9:29:29 a.m. (as opposed to 9:29:59 a.m.), in order to permit the pre-market unlocking/uncrossing process to occur from 9:29:30 a.m. to 9:29:59 a.m. Thus, Nasdaq Quoting Market Participants will continue to have an obligation to send Trade-or-Move Directed Orders from 9:20:00 a.m. and 9:29:29 a.m. to all attributable quotes/orders that it may actively lock or cross, even if the Nasdaq Quoting Market Participant is sending its actively locking/crossing quote as a non-attributable quote/order (i.e., SIZE). However, Nasdaq Quoting Market Participants entering a quote/order that would actively lock or cross a quote/order displayed in SIZE would not be obligated to send a Trade-or-Move Directed Order.<sup>12</sup>

<sup>9</sup> Order-entry firms may enter limit (priced) orders before 9:30 a.m. Eastern Time, but these orders must be designated as Immediate or Cancel ("IOC"). Market Makers, ECNs, and UTP Exchanges may enter limit orders, but are not required to designate them as IOC orders.

<sup>10</sup> Prior to 9:29:30 a.m., the Directed Order Process would be the exclusive execution process in SuperMontage. Between 9:29:30 a.m. and 9:29:59 a.m. execution could occur in the Non-Directed Order Process solely to eliminate existing locked or cross markets prior to the 9:30 a.m. Nasdaq opening.

<sup>11</sup> Nasdaq proposes to change the term "Trade-or-Move Message" to "Trade-or-Move Directed Order." See proposed NASD Rule 4613(e)(1)(C).

<sup>12</sup> Presently, SuperMontage is not programmed with the functionality that would enable a Trade-or-Move Directed Order to access SIZE during the Nasdaq pre-market.

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 replaced the original Rule 19b-4 filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 45965 (May 20, 2002), 67 FR 36659.

<sup>5</sup> See letters to Jonathan G. Katz, Secretary, Commission, from Howard Bernstein, Vice President, Compliance Department, Robertson Stephens, Inc. ("RSSF"), dated June 13, 2002 ("RSSF Letter"); Seth Weber, on behalf of Matthew Johnson, Managing Director, Lehman Brothers, Inc., dated June 14, 2002 ("Lehman Brothers Letter"); Keith A. Gertsen, Managing Director, Head, Nasdaq Trading, Deutsche Banc Alex. Brown, Inc. on behalf of Deutsche Bank Securities, Inc., dated June 14, 2002 ("Deutsche Bank Letter"); C. Thomas Richardson, Head, Nasdaq Trading, Salomon Smith Barney, Inc. ("SSB"), dated June 14, 2002 ("SSB Letter"); Michael T. Dorsey, Senior Vice President, General Counsel and Secretary, Knight Trading Group, Inc. ("Knight"), dated June 14, 2002 ("Knight Letter"); Michael A. Bird, Chairman, and John C. Giesea, President and CEO, Security Traders Association ("STA"), dated June 17, 2002 ("STA Letter"); Bruce Turner, CIBC World Markets, dated June 6, 2002 ("CIBC Letter"); Scott W. Anderson, Associate Director, Region Americas Legal, UBS Warburg LLC ("UBSW"), dated June 17, 2002 ("UBSW Letter"); Hedi H. Reynolds, Managing

### C. SuperMontage Pre-Open Clearing of Locking and Crossing Quotes and Orders

Nasdaq also proposes to begin an automated process to clear locked and crossed markets in SuperMontage between 9:29:30 a.m. and 9:29:59 p.m. Eastern Time. Under the proposal, the system will pair off the most aggressively priced buy quote/order against the most aggressively priced sell quote/orders. Once this "best-priced pair" is determined, the system will execute the two identified orders at the price of the newer order until the older order is fully satisfied. If the displayed size becomes exhausted at that price level, SuperMontage will continue to execute against available reserve size at that price level. This process will be repeated until an unlocked and uncrossed market results.

After the initial locks/crosses are cleared, any additional locking or crossing quotes/orders entered between 9:29:30 a.m. and 9:29:59 a.m. would be cleared consistent with the SuperMontage process for clearing locks and crosses applicable during regular market hours.<sup>13</sup> Such executions would occur at the price of the quote/order to be locked/crossed consistent with the locking/crossing process. All quotes/orders residing in SuperMontage, except market orders and orders designated as IOC,<sup>14</sup> including SIZE, would participate in the pre-market clearing of locks and crosses subject to the execution logic described above. All trades executed prior to the 9:30 a.m. market open, including trades that participate in the pre-market lock/cross clearing process, would be designated as "T" to reflect that they were executed outside of normal market hours.

<sup>13</sup> If at any time a market participant enters a quote that would lock/cross the market in the SuperMontage, the Nasdaq system will send the market participant a warning message. If the market participant chooses to override the warning message, the quote will participate in the unlocking/uncrossing process pursuant to NASD Rule 4710(b)(3).

<sup>14</sup> According to Nasdaq, if a market maker or ECN receives an order during the pre-market and its customer does not wish the order to be executed prior to 9:30 a.m., the market participant can enter the order into SuperMontage prior to the open as either a market order or a limit order with an IOC designation. These orders would not drive a quote, would not participate in the pre-market lock/cross clearing process, and would be held in a separate queue until 9:30 a.m., at which time such orders would become eligible for execution (or canceled if not marketable).

Alternatively, if the customer limit order would otherwise be eligible for execution during the pre-market unlocking/uncrossing process, the market participant could hold the orders until 9:30 a.m., to abide by the customer instructions not to effectuate an execution prior to the market open.

### III. Summary of Comments

The Commission received thirteen comment letters from twelve commenters regarding the proposed rule change.<sup>15</sup> Ten of the commenters supported the proposed rule change.<sup>16</sup> These commenters generally agreed that the proposal would provide a more uniform and orderly opening process for the market and improve the accuracy and stability of pricing in the market. One commenter believed that the benefits promised through the proposed technological changes, alone, were sufficient to warrant an expeditious implementation of SuperMontage and that they were remarkable and long overdue developments for the Nasdaq market.<sup>17</sup> One commenter believed that the proposal would protect customers from having their orders executed at prices substantially away from the subsequent unlocked/uncrossed market by enabling them to see an accurate and reasonable opening price.<sup>18</sup> Another commenter noted that currently the unlocking/uncrossing process occurs after the 9:30 a.m. market open, which results in highs/lows being set at prices unrelated to prices established during the remainder of the trading day.<sup>19</sup> This commenter believed that the proposal would address this issue by beginning the unlocking/uncrossing process before the market open. Finally, several commenters supported the new matching algorithm. Specifically, one commenter believed that the matching algorithm that executed paired orders at the price of the newer order made sense because it required a firm that aggressively locks/crosses the market near the open to be good for its quoted price and size.<sup>20</sup> Another commenter believed that the pairing of quotes/orders at the most aggressive price and executing these paired orders at the price of the newer quote/order was more rational because the execution would occur at a price which should be more indicative of where the stock would open.<sup>21</sup>

Two commenters, while generally supporting the intent of the proposal, raised concerns about the proposal.<sup>22</sup>

<sup>15</sup> See *supra* note 5.

<sup>16</sup> See Lehman Brothers Letter, Deutsche Bank Letter, SSB Letter, STA Letter, CIBC Letter, USBW Letter, Morgan Keegan Letter, Legg Mason Letter, CIBC II Letter, and Janney Montgomery Scott Letter.

<sup>17</sup> See USBW Letter.

<sup>18</sup> See STA Letter. See also Legg Mason Letter.

<sup>19</sup> See CIBC Letter. See also Lehman Brothers Letter.

<sup>20</sup> See CIBC Letter.

<sup>21</sup> See Deutsche Bank Letter. See also SSB Letter, which noted that the new opening process would reward the most aggressively priced order and that the price improvement would go to the older order.

<sup>22</sup> See RSSF Letter and Knight Letter.

Specifically, one commenter raised concerns about the use and interaction of SIZE in the pre-market.<sup>23</sup> The commenter stated that because SIZE is "currently unable to relay Trade-or-Move Directed Orders to market participants with pre-opening non-attributable orders posted in SIZE, market participants entering a quote/order that locks or crosses SIZE will be relieved of any obligation to send a Trade-or-Move Directed Order to SIZE."<sup>24</sup> This commenter believed that this component of the proposal could hinder the price discovery process because market participants entering non-attributable quotes/orders would be limited in their capacity to participate in the Trade-or-Move Directed Order process. In addition, the commenter believed that requiring a market participant to send a Trade-or-Move Directed Order to parties it would lock/cross by posting a quote/order in SIZE was contrary to the stated purpose of the SIZE facility, which according to the commenter, was to allow market participants to anonymously post trading interest. Finally, the commenter opined that the inability to access SIZE with Trade-or-Move Directed Orders during the pre-opening might also impede the price discovery process. Subsequently, this commenter sent an addendum to its original letter to express its full support for Nasdaq's goal to eliminate locked or crossed markets at the open, and indicated that it was satisfied that Nasdaq was seeking to resolve the SIZE accessibility issue within a reasonable time after the implementation of SuperMontage.<sup>25</sup> Accordingly, the commenter believed that the proposal should be approved.

Another commenter raised concerns regarding the use of SIZE during the pre-market.<sup>26</sup> Specifically, this commenter believed that because quotes placed in SIZE would not interact with other market participant's quotes/order in the pre-market until the unlocking/uncrossing process began at 9:29:30 a.m. For example, the commenter noted that a market participant could enter a large size quote in SIZE at 9:20 a.m. and cancel the quote just before 9:29:30 a.m., which would leave "all potential buyers and sellers with an incorrect assumption as to the potential price of a stock at 9:29:30 a.m. and the open." The commenter believed that the proposal would permit market participants to enter quotes/orders in SIZE while other market participants

<sup>23</sup> See RSSF Letter.

<sup>24</sup> See RSSF Letter.

<sup>25</sup> See RSSF Addendum Letter.

<sup>26</sup> See Knight Letter.

would be able to determine whether the market participant in SIZE was truly interested in trading at that price. As a solution, the commenter suggested that Nasdaq either: (1) Limit the use of SIZE until after the open to ensure that pre-open quotes are "live," or (2) revise the rule to allow market participants to interact with quotes in SIZE during the 9:20:00 a.m. to 9:30:00 a.m. time frame. This commenter also objected to the length of time Nasdaq proposed for the pre-opening process. Specifically, the commenter believed that 30 seconds was too long and believed that technology was such that ten or five seconds was more appropriate.

In response to these commenters concerns, Nasdaq submitted a letter to the Commission.<sup>27</sup> In the Response to Comments regarding the pre-market accessibility of SIZE, Nasdaq stated that it believed the "scope of harm" is "speculative" but that it would monitor and carefully study the Trade-or-Move process in the SuperMontage environment.<sup>28</sup> Specifically, Nasdaq noted that market participants that wish to enter a locking/crossing quote/order in SIZE have an obligation to resolve the lock/cross by sending a Trade-or-Move Directed Order. Further, Nasdaq noted that the "only time interest in SIZE would not be immediately accessible is if a party wanted to lock/cross an existing SIZE quote that was entered prior to 9:20 a.m.," and that this would be resolved at 9:29:30 a.m. According to Nasdaq, the primary purpose of the Trade-or-Move process is to resolve locked or crossed markets created prior to the open and Nasdaq believes that the proposal accomplishes this goal. However, Nasdaq committed to study the Trade-or-Move process during the phase-in of SuperMontage to determine whether it needs to be augmented, modified or eliminated.

With regard to the gaming concerns, Nasdaq stated that while it was unwilling to prohibit the use of SIZE in the pre-market, it would take all concerns about potential manipulative activity seriously and that it would carefully monitor the use of SIZE in the pre-market. In addition, Nasdaq noted that it had posted a document on its website stating that it is "antithetical to NASD rules for a market maker, ECN, and the customers of market makers and ECNs to enter orders into SIZE and then cancel them prior to the 9:29:30 opening process," and that it will refer any such

violations to NASD for "investigation and disciplinary action."<sup>29</sup> Nasdaq also noted that its MarketWatch staff would monitor pre-market locks/crosses, including those created by SIZE.

Nasdaq also represented that it is "analyzing potential technological changes to resolve any concerns regarding the accessibility of SIZE in the pre-market."<sup>30</sup> For example, Nasdaq stated that in addition to its initial concept of passing Directed Orders through SIZE to the ultimate entering party, it is also considering "moving the pre-market Trade-or-Move process to the non-directed order platform and deeming quotations placed in the system in the pre-market immediately executable to inhibiting the display of SIZE in the pre-market."

With regard to the time period of the pre-opening process, Nasdaq responded that it had "contemplated that the unlocking and uncrossing process will take far less than 30 seconds to complete."<sup>31</sup> Nasdaq reasoned that, because the system would continue to process and execute any incoming quotes/orders that would lock or cross the market during the remainder of the 30-second period, the system as proposed would "provide powerful disincentives to inappropriate quotation or order-entry activity" after the initial pre-market clearing of locks and crosses but before the official market opening which should in turn promote price discovery.<sup>32</sup>

#### IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>33</sup> The Commission finds that the proposal, as amended, is consistent with provisions of Section 15A of the Act,<sup>34</sup> in general and with Section 15A(b)(6) of the Act,<sup>35</sup> in particular, in that the proposal is designed to promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in processing information with respect to and facilitating transactions in securities, as well as removing impediments to and perfect the mechanism of a free and open market,

and, in general, to protect investors and the public interest. The Commission finds that Nasdaq's proposal is designed to eliminate pre-opening locked and crossed markets, which should help to provide more informative quotation information, facilitate price discovery, and contribute to the maintenance of a fair and orderly market. The Commission believes that the proposal should establish a more orderly market opening and is therefore consistent with the Act.

The Commission finds that Nasdaq's proposal to permit the entry of market orders prior to the 9:30 a.m. market opening is consistent with the Act. As originally approved, market orders could not be entered prior to the 9:30 a.m. market open in SuperMontage. Under the proposal, market participants could enter market orders, as well as limit orders, prior to the market open. The Commission believes that the entry of market orders prior to the SuperMontage opening should assist market makers, ECN, and order entry firms, in the management of their quotes and orders. In particular, this could produce efficiencies for market participants as they prepare for the market open. The Commission notes the proposal does not change the time that market orders are eligible for execution because like today, market orders will only be executed during regular market hours (*i.e.*, 9:30 a.m. to 4 p.m.), thus the only change with regard to the handling of market orders would be the time that they are eligible for entry into the system. Further, because market orders entered prior to the open would be held in a separate queue, and not eligible for execution until the market opening, market orders would not be subject to the volatility and lack of liquidity that may prevail during pre-market trading. In addition, since market orders entered before the open would only become eligible for executions at the open after the pre-market clearing of locks and crosses, such orders should receive executions that are based on more accurate and stable market conditions.

The Commission finds that Nasdaq's proposal to amend the timeframe for the Trade-or-Move Process is consistent with the Act. Under the proposal, Nasdaq Quoting Market Participants that are actively locking or crossing an attributable quote/order would be required to send Trade-or-Move Directed Orders between 9:20 a.m. and 9:29:29 a.m. (as opposed to 9:29:59 a.m.), in order to permit the pre-market unlocking/uncrossing process to occur from 9:29:30 a.m. to 9:29:59 a.m. This aspect of the proposal does not effect the operation of Nasdaq's pre-market

<sup>27</sup> See Response to Comments, *supra* note 6.

<sup>28</sup> See Response to Comments. Nasdaq also stated that it currently believes that "attempts to use SIZE to create a locked/crossed market will be limited," based on its ongoing SuperMontage user acceptance testing.

<sup>29</sup> See Response to Comments.

<sup>30</sup> See Response to Comments.

<sup>31</sup> See Response to Comments.

<sup>32</sup> See Response to Comments.

<sup>33</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>34</sup> 15 U.S.C. 78o-3.

<sup>35</sup> 15 U.S.C. 78o-3(b)(6).

Trade-or-Move process in a substantive manner. Thus, the Commission finds that reducing the Trade-or-Move timeframe by 30 seconds does not raise any new regulatory issues, and that the Nasdaq Trade-or-Move rule is still designed to reduce the frequency of pre-opening locked and crossed markets, which should help to provide more informative quotation information, facilitate price discovery, and contribute to the maintenance of a fair and orderly market.

Under the proposal, however, market participants entering a quote/order that would actively lock or cross unattributed quotes/orders in SIZE would not be obligated to send a Trade-or-Move Directed Order. Nasdaq explained that there is an exception to the Trade-or-Move Directed Order obligation for quotes/orders in SIZE because there is no means in the SuperMontage to identify the market participant (or participants) that have their trading interest represented in SIZE via a Trade-or-Move Directed Order. As noted above, two commenters expressed a concern that the quotes/orders in SIZE would be excepted from the Trade-or-Move Directed Order requirement.<sup>36</sup> In particular, the commenters expressed a concern that the potential for gaming the system may exist wherein a party could place a large share amount into SIZE and thereafter remove it immediately before Nasdaq's proposed automated unlocking/uncrossing process commences at 9:29:30 Eastern Time. In response, Nasdaq stated that it will make clear to Nasdaq Quoting Market Participants that it would be antithetical to the NASD Rules to enter orders into SIZE and then cancel those orders immediately prior to the 9:29:30 a.m. pre-market opening process. Further, Nasdaq committed to monitor pre-market locks/crosses, including those created by SIZE, and, where appropriate, to either contact the parties that are creating those locks/crosses or refer the activity to the NASD for investigation and disciplinary action. Nasdaq indicated that it was seeking a technological solution to the SIZE accessibility problem, and that such a solution should be ready for the Commission's review during the fall of this year. Finally, Nasdaq committed to work with the Commission to propose and adopt appropriate rule-based restrictions on using SIZE in the pre-market if remediation is necessary during the SuperMontage roll-out and prior to the implementation of a final technology solution. The Commission

believes that Nasdaq has adequately addressed the concerns of the commenters and that the appropriate regulatory and surveillance mechanisms are in place to protect the public interest and investors. The Commission expects Nasdaq to surveil the pre-market to ensure that manipulative activity does not occur, especially with the use of SIZE. Further, if Nasdaq observes abusive use of SIZE, the Commission expects that Nasdaq would address such activity expeditiously.

The Commission finds that Nasdaq's proposal to establish an automated procedure for clearing locking and crossing quotes in the system prior to the market open is consistent with the Act. Under the proposal, any locked or crossed markets in SuperMontage during the pre-market opening would be cleared between 9:29:30 a.m. and 9:29:59 a.m. Eastern Time by pairing off the most aggressively priced buy quote/order against the most aggressively priced sell quote/orders. Once the "best-priced pair" is identified and executed at the price of the newer, better priced quote/order, the process would be repeated until an unlocked and uncrossed market results. The Commission finds that Nasdaq's provision to address locked and crossed markets is consistent with the Act because it is designed to eliminate locked and crossed markets prior to the market opening, which should in turn help to facilitate more efficient openings. Further, the Commission believes that the Nasdaq's proposal to eliminate locked and crossed markets between 9:29:30 a.m. and 9:29:59 a.m. should help to provide reliable quotation information, facilitate price discovery, and contribute to the maintenance of a fair and orderly market. As the Commission has concluded previously, continued locking and crossing of the market can negatively impact market quality.<sup>37</sup> By clearing locked and crossed markets prior to the market opening, the Commission believes that the proposal should improve market quality and enhance the production of fair and orderly quotations at the market opening.

One commenter, while generally approving of the proposal, opined that the 30-second time frame to clear pre-market locks and crosses was unnecessarily long, as locks and clears would most likely be resolved within the first few seconds of the automated

process.<sup>38</sup> The Commission believes that Nasdaq has adequately addressed this concern. In particular, the Commission agrees with Nasdaq that the proposal clearly contemplates that the initial clearing of locks and crosses would be completed in much shorter time than 30 seconds. The Commission believes this is evidenced by the continued processing of incoming quotes/orders that would lock/cross the market between 9:29:30 a.m. and 9:29:59 a.m. The Commission believes that the continuous potential for execution of locked/crossed markets during the 30-second time frame should promote price discovery while reducing locked and crossed markets. In addition, the Commission believes that the proposal should deter inappropriate quotation or order-entry activity during this pre-market open timeframe. The Commission finds that these factors, when considered in tandem, should help to promote a smoother more efficient market opening for Nasdaq.<sup>39</sup>

Finally, the Commission finds good cause for approving Amendment Nos. 2 and 3 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission finds that Amendment No. 2 provides a technical correction to the proposed rule language. In addition, the Commission finds that Amendment No. 3 provides: (1) An updated version of its proposed rule language reflecting changes to Nasdaq's rules that have occurred since the initial filing of this proposal, (2) a set time frame in which Nasdaq will evaluate whether the thirty-second pre-opening unlocking/uncrossing process time period should be shortened within 60 days of the complete roll-out of SuperMontage, and a commitment to report its findings to the Commission within 30 days thereafter; (3) a set time frame in which Nasdaq will monitor market participants' inability to send Trade-or-Move Directed Orders to SIZE during the Trade-or-Move process, and a commitment to file a proposed rule change with the Commission within 90 days of the complete roll-out of SuperMontage, to resolve any problems regarding the accessibility to SIZE; and (4) clarification that all quotes that reside in SuperMontage at the end of the trading day will be carried over to the next trading day, and that the quoting market participant could update the

<sup>38</sup> See note 26 *supra* and accompanying text.

<sup>39</sup> The Commission notes that Nasdaq has committed to study whether the pre-opening process can or should be shortened and will submit a report of its findings. See Amendment No. 3.

<sup>37</sup> See Securities Exchange Act Release No. 40455 (September 22, 1998), 63 FR 51978 (September 29, 1998) (order approving File No. SR-NASD-98-01).

<sup>36</sup> See notes 22-26 *supra* and accompanying text.

quote prior to the 9:20 a.m. Trade-or-Move process. The Commission finds that Amendment No. 3 does not change the proposal. Amendment No. 3 merely clarifies the proposal and commits Nasdaq to addressing technological issues within specified time frames. Consequently, the Commission finds good cause, consistent with section 6(b)(5) and section 19(b) of the Act to approve Amendment Nos. 2 and 3 to the proposed rule change on an accelerated basis.

## V. Conclusion

For the foregoing reasons, the Commission finds that the proposal, as amended, is consistent with the requirements of the Act and rules and regulations thereunder.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>40</sup> that the proposed rule change (SR-NASD-2002-56) and Amendment No. 1 are approved, and Amendment Nos. 2 and 3 are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>41</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46416; File No. SR-NASD-2002-98]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc. to Eliminate the Regulatory Fee and Institute a New Transaction-Based Trading Activity Fee

August 23, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 24, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. On August 21, 2002, the NASD amended the proposed

rule change.<sup>3</sup> The NASD designated one portion of the proposed rule change as establishing or changing a due, fee, or other charge pursuant to section 19(b)(3)(A)(ii) of the Act,<sup>4</sup> and Rule 19b-4(f)(2) thereunder,<sup>5</sup> which renders that portion of the proposed rule change effective upon filing with the Commission. The NASD designated the portion of the proposed rule change regarding the corporate name change as administrative pursuant to section 19(b)(3)(A)(iii) of the Act,<sup>6</sup> and Rule 19b-4(f)(3) thereunder,<sup>7</sup> which also renders that portion of the proposed rule change effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The NASD proposes to amend Schedule A to the NASD By-Laws to amend its member regulatory pricing structure. Under the current structure, three types of fees and assessments are used to fund the NASD's member regulatory activities: Regulatory Fee,<sup>8</sup> Personnel Assessment, and Gross Income Assessment.<sup>9</sup> The proposed restructuring is comprised of four amendments: (1) Eliminate the Regulatory Fee; (2) institute a new transaction-based Trading Activity Fee similar to the SEC's Section 31 Fee; (3) increase the rates assessed to member firms under the Personnel Assessment; and (4) implement a simplified three-tiered flat rate for the Gross Income Assessment and eliminate current deductions and exclusions.<sup>10</sup> This proposed rule change is a part of a package of two separate yet related rule

<sup>3</sup> See August 21, 2002 letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), SEC, and attachments ("Amendment No. 1"). In Amendment No. 1, the NASD provided new proposed rule language that completely replaces and supersedes the original proposed rule language, and also made minor technical changes to the proposed rule change. For purposes of calculating the 60-day abrogation period, the Commission considers the period to have begun on August 21, 2002, the date the NASD filed Amendment No. 1.

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>5</sup> 17 CFR 240.19b-4(f)(2).

<sup>6</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>7</sup> 17 CFR 240.19b-4(f)(3).

<sup>8</sup> The Regulatory Fee is described in Section 8(a) of Schedule A to the NASD By-Laws.

<sup>9</sup> The Personnel Assessment and Gross Income Assessment are described in Section 1 of Schedule A to the NASD By-Laws.

<sup>10</sup> The changes resulting from the proposed restructuring would be revenue neutral.

filings<sup>11</sup> being filed with the Commission as a result of a review of the overall NASD pricing structure,<sup>12</sup> and is intended to address the first two amendments to the NASD pricing restructuring by eliminating the Regulatory Fee and instituting a new transaction-based Trading Activity Fee.

These fees assessed upon and paid by member firms are used by the NASD to fund the NASD's member regulatory activities, including the supervision and regulation of members through examinations, processing of membership applications, financial monitoring, policy, rulemaking, interpretative, and enforcement activities. These amendments to this pricing structure are intended to serve the following purposes: (1) Simplify the NASD's fee structure; (2) ensure fairness in the NASD's fee structure by assessing higher fees to those member firms that require more NASD regulatory services; (3) assess a transaction-based fee in a manner that, unlike the Regulatory Fee, does not influence where members choose to execute trades; (4) reduce the cyclical nature of the current NASD fee structure; and (5) eliminate the NASD's reliance on funds generated from the Regulatory Fee on transactions executed through Nasdaq.

The current structure of assessing Regulatory Fees for Nasdaq transactions is no longer appropriate for three reasons. First, Nasdaq is separating from the NASD and registering as a national securities exchange. Second, the current fee structure is out of step with recent changes in the markets, such as the drastic growth in trading volumes, reductions in average trade size, decimalization, and trading no longer remaining exclusive to the listing exchange. Finally, the Regulatory Fee is only assessed against Nasdaq-listed and other transactions that are reported through the Automated Confirmation Transaction ("ACT") system,<sup>13</sup> although these fees are used to support member regulatory activities across all markets. In addition, the NASD is proposing revisions to the NASD By-Laws that are technical in nature to reflect the NASD's change in corporate name. For example, references to "the Association" have

<sup>11</sup> See also Securities Exchange Act Release No. 46417 (August 23, 2002)(SR-NASD-2002-99).

<sup>12</sup> The NASD, in its pricing restructuring review, proposed changes to the Regulatory Fee in *Special Notice To Members 02-09* and requested comments. NASD received a number of comments. In response to those comments, the proposal set forth in *Special Notice to \* \* \**.

<sup>13</sup> This package of filings proposes rule changes to the NASD's Member Regulation fees. It is not related to the recent Nasdaq filing regarding Nasdaq Regulatory Fee. See SR-NASD-2002-61.

<sup>40</sup> 15 U.S.C. 78s(b)(2).

<sup>41</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> 17 CFR 240.19b-4.