

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-2003-128 and should be submitted by October 21, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48527; File No. SR-NASD-2003-85]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendments No. 1 and 2 Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3, 4, 5, and 7 Thereto Relating to a Post-Trade Anonymity Feature in SuperMontage

September 23, 2003.

#### I. Introduction

On May 22, 2003, the National Association of Securities Dealers, Inc. ("NASD"), 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 add a post-trade anonymity feature to SuperMontage. On June 2, 2003, Nasdaq filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On June 23, 2003, Nasdaq filed Amendment No. 2 to the proposed rule change.<sup>4</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on July 2, 2003.<sup>5</sup> The Commission received five comment letters on the proposal, as amended by Amendment Nos. 1 and 2.<sup>6</sup> On August 6, 2003, Nasdaq filed a response to the comment letters.<sup>7</sup> On

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

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

<sup>3</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Terri Evans, Assistant Director, Division of Market Regulation ("Division"), Commission, dated May 29, 2003 ("Amendment No. 1").

<sup>4</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Terri Evans, Assistant Director, Division, Commission, dated June 20, 2003 ("Amendment No. 2").

<sup>5</sup> See Securities Exchange Act Release No. 48088 (June 25, 2003), 68 FR 39605 (July 2, 2003) ("Notice").

<sup>6</sup> See Letters to Jonathan G. Katz, Secretary, Commission, from Jim Dyer, Senior Vice President & Trading Room Manager, Brokerage America, LLC, dated July 24, 2003 ("BAMM Letter"); Kim Bang, Bloomberg Tradebook LLC, dated July 24, 2003 ("Bloomberg Letter"); William O'Brien, Chief Operating Officer, Brut, LLC, dated July 29, 2003 ("Brut Letter"); C. Thomas Richardson, Managing Director, Citigroup Global Capital Markets, Inc., dated July 25, 2003 ("Citigroup Letter"); and John Hughes, Chairman, and John C. Giese, President and Chief Executive Officer, Security Traders Association, dated July 23, 2003 ("STA Letter"). The letters are described in Section III, *infra*.

<sup>7</sup> See Letter from Edward S. Knight, Executive Vice President, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated August 4, 2003 ("Nasdaq Response Letter").

August 11, 2003, Nasdaq filed Amendment No. 3 to the proposed rule change.<sup>8</sup> On September 8, September 16, September 17, and September 22, 2003, Nasdaq filed Amendment Nos. 4,<sup>9</sup> 5,<sup>10</sup> 6,<sup>11</sup> and 7<sup>12</sup> respectively, to the proposed rule change. This order approves the proposed rule change, as amended, and issues notice of, and grants accelerated approval to, Amendment Nos. 3, 4, 5, and 7.

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

Nasdaq's current pre-trade anonymity feature allows market makers, electronic communication networks ("ECNs") and order entry firms ("OE Firms") to submit anonymous orders to SuperMontage for display under the "SIZE" market participant identifier

<sup>8</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Terri Evans, Assistant Director, Division, Commission, dated July 31, 2003 ("Amendment No. 3"). In Amendment No. 3, Nasdaq clarified in certain NASD rules that Nasdaq will remove a member from Nasdaq's systems when the member loses its clearing relationship. Members removed from a Nasdaq system can invoke their right to seek redress under the NASD Rule 9700 Series. The amendment also contains non-substantive changes to NASD Rules 4705, 5012, and 6120 to reflect that indirect participation in a clearing agency occurs through a "participant," as such term is defined in Section 3(a)(24) of the Act.

<sup>9</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Marc McKayle, Special Counsel, Division, Commission, dated September 4, 2003 ("Amendment No. 4"). In Amendment No. 4, Nasdaq created an additional exception to the anonymous processing of orders; made technical corrections in its rule text clarifying that Nasdaq must reveal member's identity in certain circumstances; explained how the help desk will operate to assist members with anonymous trades; and clarified Nasdaq's record keeping obligations.

<sup>10</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Terri Evans, Assistant Director, Division, Commission, dated September 15, 2003 ("Amendment No. 5"). In Amendment No. 5, Nasdaq codified its earlier representations regarding retention of information on behalf of its members to satisfy the members' books and records obligation. See Amendments 2 and 4, *supra* notes 4 and 9, respectively.

<sup>11</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Thomas McGowan, Assistant Director, Division, Commission, dated September 16, 2003 ("Amendment No. 6"). In Amendment No. 6, Nasdaq made a technical correction to its rule text to clarify those circumstances when members would be required to retain their recordkeeping obligations.

<sup>12</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Thomas McGowan, Assistant Director, Division, Commission, dated September 17, 2003 ("Amendment No. 7"). In Amendment No. 7, Nasdaq, in essence, withdrew Amendment No. 6 since it replaced in its entirety proposed Rule 4719(e)(ii), which was initially proposed in Amendment No. 5 and subsequently amended by Amendment No. 6.

<sup>8</sup> 17 CFR 200.30-3(a)(12).

("MPID").<sup>13</sup> When a trade is executed with an order that resides under the SIZE MPID, the identity of the member that anonymously submitted the order is revealed immediately to the other member involved in the trade.<sup>14</sup> SuperMontage produces an execution report that is sent to the parties to the trade and also creates a report in Nasdaq's Automated Confirmation Transaction Service ("ACT"). These reports contain the MPIDs for the members that executed the trade.

The proposed anonymity feature builds upon the pre-trade anonymity feature available today using the Non-Attributable Quote/Order feature and generally extends anonymity beyond the time of execution by masking the identities of the members executing the trade. Under the proposal, when a member uses the Non-Attributable Quote/Order feature, instead of revealing the members' MPIDs, SuperMontage will generally substitute a four-letter identifier that indicates the trade is anonymous (*i.e.*, SIZE). Therefore, instead of seeing its contra-party's MPID on the reports, the reports will indicate SIZE as the contra-party.<sup>15</sup> Replacing the members' MPIDs with SIZE would not alter how information is reported to the consolidated tape or Nasdaq's surveillance systems or the type of information reported to the consolidated tape or Nasdaq's surveillance systems. In addition, clearing firms would continue to receive immediate notification of trades executed by their correspondent firms,<sup>16</sup> and, except as described below, the new anonymity feature would not change

<sup>13</sup> Market makers and ECNs may also display Attributable Quotes/Orders under the market participant's MPID. However, OE Firms can only post Non-Attributable Quotes/Orders for display in SuperMontage. See Securities Exchange Act Release No. 47830 (May 12, 2003), 68 FR 27126 (May 19, 2003).

<sup>14</sup> For the purpose of execution reports, OE Firms have distinct MPIDs. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Marc McKayle, Special Counsel, Division, Commission, on June 24, 2003.

<sup>15</sup> Nasdaq will know the identities of the members executing an anonymous trade and will provide a "help desk" that members can call to assist them in resolving disputed anonymous trades. Nasdaq staff's role will be limited to helping members resolve disputes, such as erroneous trades, when the members choose not to utilize the clearly erroneous trade adjudication process provided in NASD Rule 11890. See Amendment No. 4, *supra* note 9.

<sup>16</sup> When a correspondent firm executes an anonymous order in SuperMontage, its clearing firm would continue to receive a real-time SuperMontage execution report and ACT report containing all the trade details (*e.g.*, the number of shares and the price of the trade), except the identity of the correspondent's contra-party. The details of anonymous trades also would be included in ACT's risk management tools.

how trades would be processed and settled through the National Securities Clearing Corporation ("NSCC").<sup>17</sup>

The ACT reports that the NSCC receives from Nasdaq for anonymous trades would contain the identities of the parties to the trade. This measure would enable the NSCC to continue its normal risk management functions and settle anonymous trades in the same manner as trades that are executed without the anonymity feature with one exception. The ACT report sent to the NSCC would contain an indicator noting that the trade is anonymous. The effect of this indicator is that, on the contract sheets the NSCC issues to its participants, the NSCC would substitute SIZE for the MPID of the contra-party. The purpose of this masking is to preserve anonymity through settlement.

Nasdaq also proposes to offer members additional risk management tools for monitoring their exposure to members they have traded with on an anonymous basis. First, Nasdaq would provide members with an intra-day concentration report that would disclose a member's aggregate dollar value of purchases and sales with other members with whom it has traded anonymously. Second, Nasdaq would reveal after 4 p.m. Eastern Time the identities of the members listed on the intra-day concentration report. With this information, members would know the exact dollar value of their aggregate purchases and sales with individual contra-parties. Third, Nasdaq would begin providing trade information to the NSCC in real-time as trades are executed in SuperMontage. With real-time submission, the NSCC would possess trade information within seconds after a trade is executed and can incorporate this information into its risk analysis of its participants. Once the NSCC ceases to act for a participant, that firm, and any other firm that clears through the participant, would not be able to continue trading.<sup>18</sup> Fourth, once the NSCC has ceased to act for a participant and determined not to guarantee the settlement of the participant's trades,

<sup>17</sup> Nasdaq would not assume any responsibility to settle anonymous trades and the NSCC's settlement guarantee, and close-out procedures for failed firms, would not be affected by Nasdaq's anonymity proposal. Therefore, as required today by NASD Rules 4712 and 6160, members would be obligated to settle matched trades reported to the NSCC, including trades executed anonymously that have been matched and reported to the NSCC, but not yet guaranteed by the NSCC.

<sup>18</sup> See Amendment No. 3, *supra* note 8. In Amendment No. 3, Nasdaq clarified the process through which its members may be removed from SuperMontage for failure to maintain a clearing relationship. Members who are removed from a Nasdaq system can invoke their right to seek redress under the NASD 9700 series.

Nasdaq would coordinate with the NSCC and Nasdaq would promptly disclose to members each trade executed anonymously with the firm the NSCC ceased to act for and any firms that cleared through that NSCC participant.<sup>19</sup>

Nasdaq would also reveal contra-party identities on a trade-by-trade basis when a member whose Quote/Order is decremented (*i.e.*, the liquidity providing member) is an Order Delivery ECN that charges an access fee. The ultimate result is that members would not trade with complete anonymity when accessing liquidity provided by Order Delivery ECNs that charge access fees. Order Delivery ECNs would generally be prohibited, however, from disclosing the identity of the member that submitted the Non-Attributable Quote/Order that decremented their Quote/Order.<sup>20</sup>

Nasdaq would also disclose contra-party information when a member executes an order by matching against other trading interest it has in the system on the other side of the market (*e.g.*, internalizes) on a trade-by-trade basis,<sup>21</sup> including if a member executes a Preferred Order<sup>22</sup> sent to the same or another MPID used by that member.<sup>23</sup> If the buying and selling interest submitted under the same MPID matches, Nasdaq would reveal, in all cases, to the member at the time of

<sup>19</sup> Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Marc McKayle, Special Counsel, Division, Commission, on September 11, 2003.

<sup>20</sup> Under the proposed rule change, Non-Attributable Quotes/Orders would contain an indicator noting that the order is to be processed anonymously. As such, Order Delivery ECNs would be able to distinguish Non-Attributable Quotes/Orders from those orders for which the prohibition would not apply. The prohibition contains an exception, however, if the ECN is requested to provide such information to regulators or is ordered to disclose the information by a court or arbitrator. NASD would also be entitled to reveal a member's identity for regulatory purposes, including enabling a member to pursue arbitration, or to comply with an order of an arbitrator or a court. See Amendment No. 4, *supra* note 9.

<sup>21</sup> See Amendment No. 4, *supra* note 9.

<sup>22</sup> See NASD Rule 4701(aa).

<sup>23</sup> Telephone conversation between Thomas Moran, Associate General Counsel, Nasdaq, and Marc McKayle, Special Counsel, Division, Commission, on September 10, 2003, clarifying that a Preferred Order may be sent to the same MPID or another MPID of the member. Members cannot submit anonymous orders through the SuperMontage Directed Order process. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Terri Evans, Assistant Director, Division, Commission, on September 18, 2003. See also Letter from Edward S. Knight, Executive Vice President, Nasdaq, to Catherine McGuire, Associate Director and Chief Counsel, Division, Commission, dated September 15, 2003 ("Rule 10b-10 Exemption Request").

execution, that it has internalized a trade through SuperMontage. Nasdaq would also reveal to the member at the end of the day when it has internalized across MPIDs.<sup>24</sup>

Nasdaq also committed to retain, for the period specified in Rule 17a-4(a), the actual identities of the members that executed anonymous trades through SuperMontage in its original form or a form approved under Rule 17a-6.<sup>25</sup> For anonymous trades, Nasdaq would possess the information necessary under Rule 17a-3(a)(1) and would retain member identities for the period of time that broker-dealers are required to by Rule 17a-4(a) under the Act. However, for the universe of trades for which Nasdaq reveals to members the identities of the contra-parties, including when the contra-party is themselves, members would retain the record keeping obligation because the members would have the information to comply with Rule 17a-3(a) under the Act.<sup>26</sup> In addition, members that submit, and receive an execution of, a Non-Attributable Quote/Order that is a Preferred Order would have to comply with Rules 17a-3(a)(1) and 17a-4(a) since they would possess the identity of their contra-party.<sup>27</sup>

### III. Summary of Comments and Nasdaq's Response

The Commission received five comment letters on the proposed rule change.<sup>28</sup> BMM, Citigroup and STA supported the proposed rule change. Bloomberg expressed support for Nasdaq's goals, but expressed reservations regarding the proposal in its current form. Brut did not explicitly state whether it supported or opposed the proposal, but advised the Commission to review compliance, risk management and administrative issues carefully prior to taking action.

BMM, Citigroup and STA generally believed that post-trade anonymity is commonplace today. Specifically,

<sup>24</sup> See Amendment No. 4, *supra* note 9. Nasdaq also is studying the feasibility of immediately revealing to members when they internalize across MPIDs.

<sup>25</sup> See Amendment Nos. 2 and 5, *supra* notes 4 and 10.

<sup>26</sup> See Amendment Nos. 4 and 7, *supra* notes 9 and 12.

<sup>27</sup> *Id.*

<sup>28</sup> See *supra* note 6. Citigroup and STA also commented on ECN access fees in general. STA reiterated its view that ECN access fees should be abolished. Citigroup stated that "either all broker/dealers that represent orders as agent or riskless principal in the public market should be permitted to charge an access fee, or none should." The Commission notes that ECN access fees are not at issue in the current proposal, instead what is at issue is whether post-trade anonymity feature, as proposed herein, is consistent with the Act.

Citigroup noted that exchanges and ECNs currently offer anonymity through execution and BMM stated that anonymity has become a core feature of execution systems. As a result, these commenters believed that allowing Nasdaq to provide post-trade anonymity would level the competitive playing field.<sup>29</sup> Citigroup also suggested that the proposal would improve the Nasdaq market because the current pre-trade anonymity feature does not adequately minimize market impact, and post-trade anonymity would assist brokers and dealers in obtaining better executions for their customers.<sup>30</sup> According to Citigroup, "Nasdaq's proposal should promote efficiency, reduce trading costs, and increase competition in the market, as broker/dealers will now be able to represent and execute their customer orders on an anonymous basis directly through a Nasdaq facility." BMM stated that by increasing choice and competition, the proposal would increase liquidity in the marketplace, reduce fragmentation, and further reduce transaction costs.

#### A. ECN Participation

Bloomberg believed that the proposal "unnecessarily denies [ECNs] the opportunity to use SuperMontage's facilities in the way all other market participants can use them." The basis of Bloomberg's assertion was that market makers and OE Firms receive post-trade anonymity when taking and posting liquidity, but ECNs benefit from post-trade anonymity only when taking liquidity and not when posting liquidity. Bloomberg suggested that a viable solution would be to keep the execution report anonymous while providing broker-dealers with information after settlement disclosing an aggregate total of fees a broker-dealer had accumulated through an ECN. Bloomberg also opined that the disparate treatment puts ECNs at a competitive disadvantage, which is in contravention of sections 15A(b)(6) and 15A(b)(9) of the Act.<sup>31</sup>

Nasdaq responded to Bloomberg's concerns regarding the disparate

<sup>29</sup> See BMM Letter and Citigroup Letter. See also STA Letter.

<sup>30</sup> See also BMM Letter.

<sup>31</sup> Furthermore, Bloomberg noted that they are not currently able to use the SIZE facility, because SuperMontage does not provide a "locked/crossed" warning message as SuperMontage does for quotations entered by Order Delivery ECNs under their own acronyms. Without such warning, Bloomberg stated they will not be able to avoid the possibility of double execution. See Bloomberg Letter. Nasdaq, in its response, stated that it would be implementing a systems change to address the double execution issue. See Nasdaq Response Letter.

treatment of ECNs.<sup>32</sup> Nasdaq stated that the proposal balances the need for post-trade anonymity with an ECN's ability to charge quote access fees and not accept automatic executions in SuperMontage. Nasdaq opined that there is a reasonable distinction between how ECNs and other members participate in SuperMontage, and that the special accommodations that have been made to allow ECNs to participate in SuperMontage are not discriminatory. According to Nasdaq, the anonymity feature is designed to provide ECNs the information they need to administer their access fees. Similarly, revealing the ECN's identity provides other members information they desire to monitor these fees. In contrast, market makers and OE Firms are not permitted to charge quote access fees, and they must accept automatic executions in SuperMontage. Accordingly, similar accommodations are not necessary when these parties execute trades with each other in SuperMontage.

Furthermore, Nasdaq asserted that its proposal cannot be deemed discriminatory when it is the ECN's decision that would result in the inability to remain anonymous. In Nasdaq's view, an ECN's ability to retain anonymity when its quote is hit through SIZE is a result of the way the ECN chooses to participate in SuperMontage (charging a quote access fee and not accepting automatic executions), and not a result of Nasdaq's unfair discrimination. Nasdaq stated that Bloomberg's suggestion to preserve the contra-party anonymity for SIZE trades that hit the quote of Order Delivery ECNs, would "impose additional costs and burdens on other members and Nasdaq, not to mention that it would be unfair to those members that traded with Bloomberg to expose their identities immediately while masking Bloomberg's identity until the end of the day. Nasdaq believes these costs and burdens are unnecessary in light of the other options available to ECNs seeking full anonymity."

#### B. Risk Management

BMM and Citigroup believed that Nasdaq adequately addressed certain operational or regulatory issues in its proposal, such as back office processing<sup>33</sup> and risk exposure.<sup>34</sup> For example, Citigroup believed that the intra-day concentration report would assist members with measuring their exposure if one or all of their contra-parties failed to settle all trades

<sup>32</sup> See Nasdaq Response Letter.

<sup>33</sup> See BMM Letter.

<sup>34</sup> See Citigroup Letter.

executed anonymously. According to Citigroup, members could then determine whether any risk-limiting actions should be taken. Additionally, by revealing the identities of those listed on the intra-day concentration report, members would know the exact dollar value of their aggregate purchases and sales with individual contra-parties. Citigroup believed that this added level of information about risk concentration and exposure should give members and their clearing firms better tools to limit their risk. Citigroup also believed that risk to clearing member firms should be reduced substantially because SuperMontage would provide trade information to the NSCC on a real-time basis.

Bloomberg and Brut expressed concern, however, that the proposal imposes new or increased financial risk on market participants. The commenters noted that from the time of the transaction until midnight of T+1, when the NSCC steps in as guarantor, the broker-dealer would be exposed to the risk of the anonymous contra-party's failure to settle a transaction. Brut questioned whether the proposal was worth such incremental risk, and whether Nasdaq should assume fiscal responsibility for such trades like ECNs and other providers of anonymous transaction services. Bloomberg also noted that specialists stand as guarantors of trades on SuperDot on the New York Stock Exchange ("NYSE"), and ECNs stand as the guarantors of anonymous trades within their internal systems.

In response to comments that the proposal increases risk, Nasdaq stated that there would be "little, if any, effect on a clearing firm's ability to monitor trading by itself or its correspondents."<sup>35</sup> Specifically, Nasdaq asserted that Nasdaq and the NSCC would know the identities of the members who traded using the anonymity feature. Furthermore, Nasdaq noted that members trading anonymously and individual trades executed anonymously, would be subject to NSCC's full risk management systems and included in ACT's risk management calculations. Nasdaq stated that a member's ability to assess its contra-party risk through the use of intra-day reports would be affected only to the degree the member uses its contra-parties' identities on a trade-by-trade intra-day basis. Nasdaq also disagreed with the assertion that a systemic risk is created by Nasdaq's unwillingness to guarantee settlement of anonymous trades in the period

between execution and the attachment of the NSCC guarantee. Nasdaq asserted that currently members are subject to the same risk that their contra-party, including ECNs, will default before the NSCC guarantee attaches.

#### C. Books and Records

Brut also commented that broker-dealers have certain recordkeeping requirements, such as recording the name or other designation of the person that is the contra-party to the transaction. Brut recommended, notwithstanding Nasdaq's representation that it would retain records to satisfy the recordkeeping requirements under Rule 17a-3 under the Act, that the Commission explicitly grant broker-dealers relief from the rule for transactions effected through SIZE. With regard to Brut's concerns regarding a broker-dealer's obligations under Rule 17a-3, Nasdaq stated that it was a matter for the Commission to resolve.<sup>36</sup>

#### D. Operation of Help Desk

Brut also expressed concern that completely anonymous trades between broker-dealers could create difficulties in resolving erroneous or disputed trades, which typically are resolved through direct broker-to-broker communication. Brut suggested that the Commission should ensure that the help desk has adequate resources and procedures to prevent unfair discrimination by Nasdaq in the resolution of disputes among SIZE users.

In response to Brut's concerns regarding the resolution of disputed trades, Nasdaq noted that erroneous trades, whether anonymous or not, may be resolved in accordance with NASD Rule 11890.<sup>37</sup> Further, Nasdaq clarified that the Market Operations Department would also be responsible for responding to requests from members.<sup>38</sup> Nasdaq staff would resolve disputes when the members choose not to utilize the clearly erroneous trade adjudication process provided in NASD Rule 11890. According to Nasdaq, Nasdaq staff would only effectuate the resolutions agreed to by the members who are the parties to the trade; Nasdaq staff will not issue independent decisions.<sup>39</sup>

<sup>36</sup> *Id.* See *infra* discussion at note 56 and accompanying text.

<sup>37</sup> *Id.*

<sup>38</sup> See Amendment No. 4, *supra* note 9.

<sup>39</sup> According to Nasdaq, the existence of the help desk does not preclude members from pursuing other means to resolve disputed anonymous trades. For example, a member can seek arbitration to resolve a disputed trade. Nasdaq would reveal a contra-party's identity upon receiving a written request from a member, who is a party to the disputed trade, which indicates the information is

#### IV. Discussion

The Commission has carefully reviewed the proposed rule change, the comment letters, and Nasdaq's response and 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>40</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with section 15A of the Act.<sup>41</sup> Specifically, the Commission finds that the proposed rule change is consistent with section 15A(b)(6) of the Act because it is designed to promote just and equitable principals 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.<sup>42</sup>

The Commission finds that Nasdaq's proposal to generally extend anonymity through clearance and settlement of a trade, subject to certain exceptions, to be consistent with the Act. The Commission notes that post-trade anonymity is not new<sup>43</sup> and is offered by other market participants, including the Pacific Stock Exchange Equities ("PCXE").<sup>44</sup> As a result, the Commission does not believe that Nasdaq should be prohibited from offering similar services. The Commission believes that the SuperMontage post-trade anonymity feature should allow Nasdaq to offer some of the same benefits associated with anonymity, such as minimizing the market impact of institutional orders. As expressed by commenters, trading information can have an impact on the price of a security.<sup>45</sup> For example, Citigroup stated that other market participants will adjust their trading

being requested for the purposes of pursuing a claim in arbitration. According to Nasdaq, revealing a contra-party's identity so that a member can pursue its right to arbitrate is consistent with Nasdaq's authority, under proposed Rule 4719(c)(2), to reveal a contra-party's identity for regulatory purposes. See Amendment No. 4, *supra* note 9.

<sup>40</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>41</sup> 15 U.S.C. 78o-3.

<sup>42</sup> 15 U.S.C. 78o-3(b)(6).

<sup>43</sup> See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290, 48310, note 243 and accompanying text (September 12, 1996) (adopting Rule 11Ac1-4 and amending Rule 11Ac1-1) (discussing the benefits of anonymous trading).

<sup>44</sup> See PCXE Rules 7.7 and 7.36(b).

<sup>45</sup> See BMM, Citigroup and STA letters.

<sup>35</sup> See Nasdaq Response Letter.

strategy, if they see a pattern in which they see Citigroup or another broker or dealer that normally handles institutional orders actively buying a stock, in anticipation of a strong buy demand. Citigroup compared this to the full anonymity offered by ECNs and exchanges that prevents market sensitive data from being disseminated on a real-time basis.

The Commission recognizes that in certain securities, specific market makers may be viewed as price leaders, and other market participants may follow the quoting patterns of such market makers, which could result in price changes that frustrate a firm's ability to efficiently work large orders for its customers or obtain executions at improved prices. Therefore, the Commission believes that Nasdaq's proposal may reduce the type of market intelligence that can contribute to market impact. Further, the Commission believes that the proposal may assist broker-dealers in their efforts to satisfy their duty of best execution in working customer orders.

The Commission notes that one commenter stated that the proposal "discriminates unfairly" against ECNs because the execution reports would reveal contra-party identity when the quote of an Order Delivery ECN is decremented.<sup>46</sup> Another commenter, however, expressed concern that Nasdaq and market participants must make special accommodation for fee-charging ECNs.<sup>47</sup> The Commission believes that the contra-party identity exception does not unfairly discriminate against Order Delivery ECNs. Instead, the Commission believes that Nasdaq has attempted to accommodate the business models of ECNs and the manner that they participate in SuperMontage.

In the Notice, Nasdaq explained that trades executed with Order Delivery ECNs are processed differently because they have the discretion to reject trades with certain contra-parties if the ECN is in dispute with the contra-party concerning its quote access fee.<sup>48</sup> Thus, to provide fee-charging Order Delivery ECNs with the opportunity to reject trades with certain members, Nasdaq determined to continue to disclose each contra-party's identity in trades through SIZE where one of the contra-parties is a liquidity providing, fee-charging Order Delivery ECN. Nasdaq believes that this exception also benefits members that execute against the fee-charging Order Delivery ECN by enabling them to track

the fee charges accumulated with each Order Delivery ECN. OE Firms and market makers must accept automatic executions in SuperMontage and do not charge access fees. Therefore, the same disclosure of contra-party information is not required.

As a result, the Commission believes that the proposed rule change reasonably accommodates the different entities; Order Delivery ECNs that charge access fees, market makers, OE Firms, and ECNs that do not charge a fee. As noted by Nasdaq, an ECN may alter the way it participates in SuperMontage to achieve full anonymity. Further, the Commission notes the original SuperMontage filing was amended, in response to ECN comments, to reveal the identity of Nasdaq market participants trading through SIZE by affixing the MPID of the sender on delivered orders and identifying the contra-parties in execution reports.<sup>49</sup> With regard to trade reports, the system will essentially work in the manner that it does today for Order Delivery ECNs when their quote is hit, which permits them to evaluate their risk on a trade-by-trade basis.<sup>50</sup> Accordingly, the Commission believes that Nasdaq has reasonably balanced the divergent interests of its members in a manner that is consistent with the Act.

The Commission believes that Nasdaq has also adequately addressed concerns related to risk management. In particular, under the proposed rule change, Nasdaq will: (1) Provide an intra-day concentration report that will disclose a member's aggregate dollar value of purchases and sales with other members with whom it has traded anonymously; (2) report the identities of the members and the aggregated trading listed on the intra-day concentration reports after 4 p.m. Eastern Time; (3) provide the NSCC with real-time trade information for trades executed in SuperMontage; and (4) coordinate disclosure with the NSCC of trades executed anonymously with a firm that the NSCC has ceased to act for and any

<sup>49</sup> Specifically, Nasdaq amended the original SuperMontage filing, in response to comments regarding credit risk by Bloomberg and Island, so that execution reports immediately revealed the identities of contra-parties for trades that occurred through SIZE. See Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020, 8033 (January 26, 2001) ("Original SuperMontage Approval Order").

<sup>50</sup> Bloomberg suggested that Nasdaq could have opted to reveal the contra-party identity through an execution file at the end of the trading day. Nasdaq, however, believed it would be unfair to those members that traded with Bloomberg to expose their identities immediately while masking Bloomberg's identity until the end of the day. See Nasdaq Response Letter.

firms that cleared through that the NSCC participant.

The Commission believes that this information will assist market participants in managing their risk. The Commission emphasizes that the NSCC and Nasdaq will continue to maintain the identities of all contra-parties for trades that occur through SIZE. In particular, the NSCC will be able to continue its normal risk management functions and settle anonymous trades in the manner that it does today. The only difference will be that the NSCC will withhold the identities of the contra-parties on the contract sheets issued to participants to preserve anonymity through settlement.

The Commission also believes that the proposal should enhance NSCC's ability to incorporate trade execution information into its risk analysis since Nasdaq will be providing this information on a real-time basis. The Commission believes that this may assist the NSCC in deciding sooner to cease to act for a participant, which would prevent other members from executing any additional trades with the firm or a firm that clears through that participant. The Commission notes that Nasdaq developed this process in conjunction with the NSCC and believes that it is consistent with section 15A(b)(6), which requires, in part, that the rules of the NASD foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities.<sup>51</sup>

The Commission notes that Bloomberg and Brut stated that the proposal created a systemic risk due to Nasdaq's failure to guarantee trades prior to the attachment of the NSCC guarantee at T + 1.<sup>52</sup> After carefully considering these comments and Nasdaq's response, the Commission does not believe that the proposed rule change adds new risk that does not currently exist for Nasdaq market participants. Currently, Nasdaq does not act as a guarantor of trades prior to the NSCC guarantee attaching,<sup>53</sup> and

<sup>51</sup> See Securities Exchange Act Release Nos. 48122 (July 2, 2003), 68 FR 41410 (July 11, 2003) (Notice of File No. NSCC-2003-14) and 48526 (September 23, 2003) (Order approving File No. NSCC-2003-14 to allow NSCC to list an acronym instead of the actual contra-side for a trade in its report of trade data to members).

<sup>52</sup> Generally, transactions are guaranteed as of the later of: (i) Midnight of T + 1, and (ii) midnight of the day they are reported as compared or as of midnight on the day they appear on T-Contracts for locked-in trades. See Addendum K to NSCC Rules and Procedures for additional explanation.

<sup>53</sup> See NASD Rule 4705(g). The Commission notes that other self-regulatory organizations expressly

<sup>46</sup> See Bloomberg Letter.

<sup>47</sup> See Citigroup Letter.

<sup>48</sup> See Notice, *supra* note 5.

Nasdaq members are obligated to settle all matched trades reported to the NSCC prior to the NSCC guarantee.<sup>54</sup> This proposal does not change the responsibilities of Nasdaq, its members, or the NSCC. The Commission notes that, like today, a firm's primary exposure prior to T + 1, when the NSCC guarantee attaches, would be its contra-party defaulting on the trade. This risk exists today. Further, to the extent that market participants are concerned with their ability to effectively monitor and manage their risk exposure as a result of anonymous trades, the Commission notes that Nasdaq will provide intra-day concentration reports that will disclose a member's aggregate dollar value of purchases and sales with other members with whom it has traded anonymously. This information should assist members in calculating a worst-case scenario and allow them to take risk-limiting actions, if desired.

The Commission has long held the view that competition and innovation are essential to the health of the securities markets. Indeed, competition is one of the hallmarks of the national market system. The Commission believes that the post-trade anonymity feature being proposed by Nasdaq is a reasonable effort by the NASD to enhance the quality of the Nasdaq market and provide market participants with the benefits of anonymity currently being offered by ECNs and PCXE. The Commission notes that to the extent that market participants are unwilling to trade in SuperMontage because of concerns regarding risk, broker-dealers may continue to use other alternative order routing and execution services such as ECNs, which guarantee trades executed through their systems, exchanges trading Nasdaq securities pursuant to unlisted trading privileges, and the NASD's alternative display facility.

Brut also requested that the Commission clarify a broker-dealer's obligations under Rule 17a-3 under the Act with respect to completely anonymous transactions on SuperMontage. Rule 17a-3(a)(1) under the Act requires that broker-dealers make and keep current records of all purchases and sales of securities, including "the name or other designation of the person from whom purchased or received or to whom sold or delivered." Rule 17a-4(a) under the Act requires that the records be

preserved for six years, the first two years "in an easily accessible place." Nasdaq has represented and codified in its rules that it will, except in limited circumstances, retain for the period specified in Rule 17a-4(a) a record of the identities of the members that execute anonymous trades through SuperMontage in its original form or a form approved under Rule 17a-6.<sup>55</sup> Commission staff will not recommend enforcement action to the Commission if, in lieu of making and preserving a separate record, the broker-dealer relies on Nasdaq's retention of the identities of members that execute anonymous trades through SuperMontage to satisfy the requirements of Rules 17a-3(a)(1) and 17a-4(a) under the Act.<sup>56</sup>

Brut also suggested that the Commission review the procedures and resources that Nasdaq will dedicate to the help desk to coordinate the resolution of erroneous or disputed trades for anonymous contra-parties. The Commission believes that Nasdaq has adequately responded to Brut's comments. As Nasdaq clarified, market participants involved in anonymous trades can use NASD Rule 11890 to resolve erroneous transactions, as well as the help desk. Further, market participants will continue to be able to arbitrate trades since Nasdaq will provide the identity of a contra-party in those instances where one party wishes to arbitrate a dispute.<sup>57</sup> The Commission expects that Nasdaq will continue to monitor its procedures and the adequacy of the help desk resources as post-trade anonymity is utilized and, if necessary, provide additional resources to ensure the maintenance of a fair and orderly market.

The Commission finds good cause for accelerating approval of Amendment Nos. 3, 4, 5, and 7 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. Amendment No. 3 merely clarifies the

<sup>55</sup> See Amendment Nos. 2, 4, 5, and 7, *supra* notes 4, 9, 10, and 12, respectively.

<sup>56</sup> The Commission notes that a broker-dealer has the responsibility to make, keep current, and preserve records of all purchases and sales of securities in accordance with Exchange Act Rules 17a-3 and 17a-4 for trades through SuperMontage if the broker-dealer knows the identity of the contra-party, including those instances where Nasdaq discloses the contra-party to a trade (*e.g.*, internalized trades). Also, a member that submits a Non-Attributable Quote/Order that is a Preferred Order to another member retains the recordkeeping responsibilities described above because that member would know the identity of the contra-party to which it sent the Preferred Order. In addition, even where the broker-dealer does not know the identity of the contra-party, the broker-dealer retains the responsibility to maintain such records, except for a record of the identity of the contra-party.

<sup>57</sup> See Nasdaq Response Letter.

process by which the Nasdaq would remove a member from SuperMontage if the member failed to maintain a clearing relationship, and makes non-substantive conforming changes to NASD Rules 4705, 5012, and 6120. Amendment No. 4 merely: (1) Conforms its rule text to reflect the mandatory nature of certain disclosures as described in the Notice, (2) responds to comments regarding the operation of the help desk, (3) clarifies Nasdaq's commitment to retain certain records, and (4) ensures that members will be able to satisfy their obligations under Rule 10b-10.<sup>58</sup> Amendment Nos. 5 and 7 merely codify Nasdaq's earlier representation in Amendment Nos. 2 and 4 regarding its retention of information on behalf of its members. The Commission notes Amendment No. 2, which includes Nasdaq's general representation that it would retain contra-party information on behalf of its members, was published for notice and comment. Only one comment, that the Commission be explicit in granting relief, was received on the issue. The Commission believes that these amendments merely clarify the recordkeeping obligations of Nasdaq and its market participants, assist Nasdaq members in complying with their Rule 10b-10 obligations, and do not raise any substantive issues. The Commission finds specifically that Amendment Nos. 3, 4, 5, and 7 are consistent with section 15A(b)(6) of the Act as they are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>59</sup> Accordingly, pursuant to section 19(b)(2) of the Act,<sup>60</sup> the Commission finds good cause to approve Amendment Nos. 3, 4, 5, and 7 prior to the thirtieth day after notice of the Amendment is published in the **Federal Register**.

## V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 3, 4, 5, and 7, including whether Amendment Nos. 3, 4, 5, and 7 are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary,

<sup>58</sup> See also Rule 10b-10 Exemption Request, *supra* note 23. The Division, pursuant to delegated authority, granted limited exemptive relief from the contra-party identity requirement of Rule 10b-10(a)(2)(i)(A) to NASD members using the post-trade anonymity feature. Letter from Brian A. Bussey, Assistant Chief Counsel, Division, Commission, to Edward S. Knight, Executive Vice President, Nasdaq, dated September 23, 2003.

<sup>59</sup> 15 U.S.C. 78o-3(b)(6).

<sup>60</sup> 15 U.S.C. 78s(b)(2).

disclaim any liability that arises from the use of their facilities. See *e.g.*, NYSE Constitution, Article II, Section 6, American Stock Exchange Constitution, Article 4, Section 1(e), and PCXE Rules 7.42 and 13.2.

<sup>54</sup> See NASD Rules 4712 and 6160.

Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to Amendment Nos. 3, 4, 5, and 7 that are filed with the Commission, and all written communications relating to Amendment Nos. 3, 4, 5, and 7 between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2003-85, and should be submitted by October 21, 2003.

## VI. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>61</sup> that the proposed rule change (SR-NASD-2003-85), as amended, be, and hereby is, approved.<sup>62</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>63</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48526; File No. SR-NSCC-2003-14]

### Self-Regulatory Organizations; National Securities Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Anonymity Features on Trading Systems

September 23, 2003.

#### I. Introduction

On June 19, 2003, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") and on June 23, 2003, amended proposed rule change SR-NSCC-2003-14 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on July 11, 2003.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

#### II. Description

Pursuant to the rule filing, NSCC is adding language to Section II.C.1 of NSCC Rules and Procedures<sup>3</sup> whereby NSCC may receive locked-in trade data from a self-regulatory organization ("SRO") that operates a trading system that provides trade anonymity.<sup>4</sup> If trade data received from an SRO is from an anonymous trade, NSCC in reporting back to its members may report such trades identifying as the contraside an acronym selected by the SRO instead of naming the actual contraside. In the case of anonymous trades, the contraside shall be deemed to be one of the entities the SRO includes as an entity eligible to participate in the anonymous trading system. New language is also being added to Section II.C.1 to provide that if NSCC ceases to act for a member which is the unnamed contraside of an anonymous trade or trades and if NSCC determines that the anonymous trade or trades should be exited from trade processing, the SRO providing the anonymous trading system will be responsible for identifying to other members which of their trades are with the member for which NSCC has ceased to act.

In connection with this filing, the National Association of Securities Dealers, Inc. ("NASD") filed and the Commission approved a proposed rule change that allows the NASD to add an anonymity feature to the Nasdaq Stock Market's SuperMontage trading system.<sup>5</sup>

#### I. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>6</sup> The trade anonymity feature is a valued service that trading

systems like the Nasdaq want to be able to provide to their members. The Commission finds that by amending its rules to provide for the clearance and settlement of anonymous trades, NSCC's proposed rule change should help to promote the prompt and accurate clearance and settlement of such transactions.

#### IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-NSCC-2003-14) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48533; File No. SR-PCX-2003-4]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Posting Period for Membership Applications

September 24, 2003.

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 August 26, 2003, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Pacific Exchange, Inc. ("PCX" or "Exchange") is proposing to amend its rules to modify the period during which

<sup>1</sup> 17 CFR 200.30-3(a)(12).

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> 17 CFR 240.19b-4.

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

<sup>2</sup> Securities Exchange Act Release No. 48122 (July 2, 2003), 68 FR 41410.

<sup>3</sup> NSCC recently added a new Section II.C.1 to its rules. Securities Exchange Act Release No. 48141 (July 8, 2003), 68 FR 42153 (July 16, 2003) [File No. SR-NSCC-2003-12].

<sup>4</sup> In a trading system that provides trade anonymity, the identity of at least one side of a trade is not revealed to the other side at the time of the trade.

<sup>5</sup> Securities Exchange Act Release Nos. 48088 (June 25, 2003), 68 FR 39605 (July 2, 2003) [File No. SR-NASD-2003-85] and 48526 (September 23, 2003).

<sup>6</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>61</sup> 15 U.S.C. 78s(b)(2).

<sup>62</sup> Nasdaq intends to implement the proposed rule change on September 29, 2003. Telephone conversation between Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Marc McKayle, Special Counsel, Division, Commission, on September 23, 2003.

<sup>63</sup> 17 CFR 200.30-3(a)(12).