

thereunder,<sup>15</sup> in that it establishes or changes a due, fee, or other charge imposed by NASD. The fee would become operative on March 8, 2004. At any time within 60 days of the filing of the proposed rule change, as amended, the Commission may summarily abrogate this proposed rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.<sup>16</sup>

#### 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. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR-NASD-2003-192. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2003-192 and should be submitted by March 11, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49220; File No. SR-NASD-2003-128]

#### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1, 2, and 3 Thereto by the National Association of Securities Dealers, Inc. Relating to the Establishment of a Maximum ECN Access Fee in SuperMontage and the Elimination of SuperMontage's Price/Time With Fee Consideration and Price/Size Execution Algorithms

February 11, 2004.

#### I. Introduction

On August 11, 2003, 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 amend NASD Rules 4623 and 4710 to: (1) Establish a maximum level of quote/order access fees for Electronic Communications Networks ("ECNs") that elect to participate in Nasdaq's National Market Execution System ("NNMS" or "SuperMontage"); (2) eliminate SuperMontage's Price/Time with access fee consideration execution algorithm; and (3) eliminate SuperMontage's Price/Size execution algorithm. On September 10, 2003 and September 15, 2003, Nasdaq filed Amendment Nos. 1<sup>3</sup> and 2<sup>4</sup> to the proposed rule change, respectively. The proposed rule change, as amended, was published for comment in the **Federal**

**Register** on September 30, 2003.<sup>5</sup> On January 20, 2004, Nasdaq filed Amendment No. 3 to the proposed rule change.<sup>6</sup> The Commission received seventeen comment letters on the proposal, as amended.<sup>7</sup> On December 15, 2003, Nasdaq filed a response to the comment letters.<sup>8</sup> This order approves the proposed rule change, as amended.

<sup>5</sup> See Securities Exchange Act Release No. 48501 (September 17, 2003), 68 FR 56358 ("Notice").

<sup>6</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated January 16, 2004 ("Amendment No. 3"). In Amendment No. 3, Nasdaq made technical changes to the rule text to reflect the approval of or the immediate effectiveness of other Nasdaq proposals. The Commission notes that this is a technical, non-substantive amendment and not subject to notice and comment.

<sup>7</sup> See letters to Jonathan G. Katz, Secretary, Commission, from Kim Bang, Bloomberg Tradebook LLC, dated October 21, 2003 ("Bloomberg Letter"); William O'Brien, Chief Operating Officer, BRUT, LLC, dated October 24, 2003 ("BRUT Letter"); Linda Lerner, General Counsel, Domestic Securities, Inc., dated October 24, 2003 ("Domestic Letter"); Gregg A. Dudzinski, Head of Equity Trading, Wm. V. Frankel & Co., dated, October 21, 2003 ("Dudzinski Letter"); Frederic Leslie, General Counsel, Hill, Thompson, Magid, L.P., dated November 7, 2003 ("Hill Thompson Letter"); Harvey Houtkin, Chief Executive Officer, dated October 22, 2003 ("Houtkin Letter"); Alex Goor, Executive Vice President, Instinet Corporation (on behalf of Instinet Corp. and the Island ECN, Inc.), dated October 22, 2003 ("Instinet/Island Letter"); Samuel F. Lek, Chief Executive Officer, Lek Securities Corp., dated December 16, 2003 ("LSC Letter"); Mark E. Yegge, Chief Executive Officer, NexTrade Holdings, Inc., dated October 13, 2003 ("NexTrade Letter"); Stephen Massocca, President & Director of Trading, Pacific Growth Equities, LLC, dated October 20, 2003 ("PGE Letter"); Josef Schaible, dated August 19, 2003 ("Schaible Letter"); Ann L. Vlcek, Vice President & Associate General Counsel, Securities Industry Association, dated October 31, 2003 ("SIA Letter"); John P. Hughes *et al.*, Chairman, Securities Traders Association, dated October 20, 2003 ("STA Letter"); Martin Cunningham, President, Security Traders Association of New York, Inc., dated October 21, 2003 ("STANY Letter"); Roderick Covlin, Executive Vice President, Track ECN, dated October 17, 2003 ("Track Letter"); and Scott W. Anderson, Director and Counsel, Region Americas Legal, UBS Securities LLC, dated October 16, 2003 ("UBS Letter"); and letter to Margaret H. McFarland, Deputy Secretary, Commission, from John H. Bluher, Executive Vice President & General Counsel, Knight Trading Group, Inc., dated, October 21, 2003 ("Knight Letter"). The Commission notes that several commenters raised issues, such as the elimination of access fees entirely, the payment and collection of access fees, and decrementation within SuperMontage, that are not at issue in the proposed rule change. At issue in the proposed rule change, in part, is whether the access fee cap being proposed is consistent with the Act. A more detailed summary of the comment letters received by the Commission is available for public inspection in the Public Reference Room at the Commission.

<sup>8</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Terri L. Evans, Assistant Director, Division, Commission, dated December 12, 2003 ("Nasdaq Response Letter").

<sup>15</sup> 17 CFR 240.19b-4(f)(2).

<sup>16</sup> For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change, as amended, under Section 19(b)(3)(C) of the Act, the Commission considers the period to commence on January 29, 2004, the date on which NASD filed Amendment No. 1. See 15 U.S.C. 78s(b)(3)(C).

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

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

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

<sup>3</sup> See letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated September 9, 2003, replacing Nasdaq's original Form 19b-4 filing in its entirety ("Amendment No. 1").

<sup>4</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated September 12, 2003 ("Amendment No. 2"). In Amendment No. 2, Nasdaq made technical corrections to its rule text.

## II. Description of the Proposed Rule Change

Currently, Nasdaq's SuperMontage system automates, in part, the matching of buy and sell trading interest using execution algorithms that limit the ability of users to select or anticipate who their counter-parties to a particular trade will be. Generally, market participants entering orders into SuperMontage are able to select between three execution algorithms by which orders that are not directed to a particular market participant may be executed. The three algorithms are based on price/time priority,<sup>9</sup> price/size/time priority,<sup>10</sup> and price/time priority that accounts for ECN quote access fees.<sup>11</sup> Once a market participant has entered a non-directed order in SuperMontage, the order is executed pursuant to the selected algorithm and SuperMontage rules. As a result, users

<sup>9</sup> Generally, in the price/time algorithm, non-directed orders are executed (within each price level) as follows: (1) Displayed quotes/orders of market makers, ECNs, non-attributable quotes/orders of NNMS Order Entry Firms, and non-attributable agency interest of UTP Exchanges, in time priority; (2) reserve size of market makers, NNMS Order Entry Firms, and ECNs, in time priority; and (3) principal quotes/orders of UTP Exchanges, in time priority. See NASD Rule 4710(b)(1)(B)(i).

<sup>10</sup> Generally, in the price/size/time algorithm, non-directed orders are executed (within each price level) as follows: (1) Displayed quotes/orders of market makers, ECNs, non-attributable quotes/orders of NNMS Order Entry Firms, and non-attributable agency interest of UTP Exchanges, in size/time priority; (2) reserve size of market makers, ECNs, and NNMS Order Entry Firms, in size/time priority, with size priority based on the size of the related displayed quote/order; and (3) principal quotes/orders of UTP Exchanges, in size/time priority. See NASD Rule 4710(b)(1)(B)(iii).

<sup>11</sup> Generally, in the price/time that accounts for ECN quote access fees algorithm, non-directed orders are executed (within each price level) as follows: (1) Displayed quotes/orders of market makers, ECNs that do not charge a separate quote access fee, non-attributable quotes/orders of NNMS Order Entry Firms, and non-attributable agency interest of UTP Exchanges, as well as quotes/orders of ECNs that charge a separate quote access fee where the ECN indicates that the price improvement offered by the quote/order is equal to or exceeds the quote access fee, in time priority; (2) displayed quotes/orders of ECNs that charge a separate quote access fee to non-subscribers that do not indicate that the price improvement offered by the specific quote/order is equal to or exceeds the access fee, in time priority; (3) reserve size of market makers, NNMS Order Entry Firms, and ECNs that do not charge a separate quote access fee to non-subscribers, as well as reserve size of quotes/orders from ECNs that charge a separate quote access fee to non-subscribers where the ECN entering such quote/order has indicated that the price improvement offered by the specific quote/order is equal to or exceeds the quote access fee, in time priority; (4) reserve size of ECNs that charge a separate quote access fee to non-subscribers that do not indicate that the price improvement offered by the specific quote/order is equal to or exceeds the quote access fee, in time priority; and (5) the principal interest of UTP Exchanges, in time priority. See NASD Rule 4710(b)(1)(B)(ii).

entering orders into SuperMontage may execute against a variety of market participants, including ECNs that charge a separate fee to other market participants that access their quotes/orders.

In the filing, Nasdaq proposes establishing a maximum permissible quote/order access fee for ECNs that elect to participate and execute transactions in SuperMontage. Under Nasdaq's proposal, the maximum SuperMontage ECN access fee would be capped at \$0.003 (three mils) per share. Participating ECNs would be free to charge quote/order access fees equal to or less than the \$0.003 maximum.

ECNs that desire to charge more than three mils for access to their quotes/orders would not be permitted to post liquidity in SuperMontage as NNMS ECNs. They would, however, be permitted to continue to participate in SuperMontage as NNMS Order Entry Firms.<sup>12</sup> As NNMS Order Entry Firms, those ECNs would have any quotes/orders entered into the system displayed and processed in the same manner as other NNMS Order Entry Firms. This would include having their quotes/orders represented only via the SIZE MMID and also making them subject to automatic execution.<sup>13</sup> As NNMS Order Entry Firms, these ECNs would not be allowed to impose any fee on a broker-dealer that accesses them through the SuperMontage system. As NNMS Order Entry Firms, such ECNs would be eligible for Nasdaq's liquidity provider rebate.<sup>14</sup>

In concert with establishing a maximum ECN quote access fee, Nasdaq proposes eliminating the Price/Size and the Price/Time with fee consideration execution algorithms currently available in SuperMontage.<sup>15</sup> Nasdaq proposes to

<sup>12</sup> An NNMS Order Entry Firm is defined in NASD Rule 4701(w) as a member of the NASD who is registered as an Order Entry Firm for purposes of participation in the NNMS. In its proposed rule change, Nasdaq is amending this definition to clarify that the term would also include ECNs or Alternative Trading Systems ("ATSS") that fail to meet the NASD Rule 4623 requirements for ATSS. Nasdaq is also amending the definition of NNMS Order Entry Firm to clarify that they cannot charge any fee to a broker-dealer that accesses its quote/order through NNMS.

<sup>13</sup> NNMS Order Entry Firms may enter orders that are displayed anonymously through SIZE. These displayed orders are subject to automatic execution. See NASD Rules 4701(g), 4707(b)(2), and 4710(b)(1)(A)(i).

<sup>14</sup> ECNs that participate as NNMS ECNs and charge a separate access fee are not entitled to receive a liquidity provider rebate. See NASD Rule 7010(i). Telephone conversation between Thomas P. Moran, Associate General Counsel, Nasdaq, and Sapna C. Patel, Special Counsel, Division, Commission, on January 27, 2004.

<sup>15</sup> Elimination of these two execution algorithms will leave only the Price/Time priority execution

implement all three changes simultaneously and within thirty days of any approval order issued by the Commission.<sup>16</sup>

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

The Commission received seventeen comment letters on the proposed rule change, as amended.<sup>17</sup> Three commenters supported the proposed rule change, although one of these commenters recommended modifying the proposed rule change.<sup>18</sup> Six commenters expressed general support for the NASD and Nasdaq's efforts to establish a maximum ECN access fee, but sought to have ECN access fees completely abolished.<sup>19</sup> Of those commenters, three commenters explicitly supported approving the Nasdaq proposal as an interim measure.<sup>20</sup> One commenter, the SIA, noted that its members had divergent views on the proposal, although there was support, albeit not unanimous support, for the proposal. According to the SIA, some firms viewed the cap as a fair compromise, while others considered it a good interim measure.<sup>21</sup> Seven commenters opposed the proposal.<sup>22</sup>

### A. ECN Access Fees

Several commenters generally supported Nasdaq's proposed maximum ECN access fee, because they believed that it would encourage more liquidity by easing fee concerns of various market

algorithm in SuperMontage. See *supra* notes 9 through 11.

<sup>16</sup> Telephone conversation between Thomas P. Moran, Associate General Counsel, Nasdaq, and Terri L. Evans, Assistant Director, Division, Commission, on February 2, 2004.

<sup>17</sup> See *supra* note 7.

<sup>18</sup> See BRUT Letter, Instinet/Island Letter, and Track Letter (strongly supporting the Nasdaq proposal, but recommending that Nasdaq amend the proposal to mandate that market participants pay the newly capped ECN access fees).

<sup>19</sup> See Dudzinski Letter, Hill Thompson Letter, Knight Letter, STA Letter, STANY Letter (noting that the majority of its membership applauded and supported the NASD's proposal), and UBS Letter.

<sup>20</sup> See Dudzinski Letter, Hill Thompson Letter, and Knight Letter.

<sup>21</sup> However, the SIA stated that its members believed that the Commission "must act without delay to develop a market-wide solution that levels the playing field for all market participants."

<sup>22</sup> See Bloomberg Letter, Domestic Letter, Houtkin Letter, LSC Letter, NexTrade Letter, PGE Letter, and Schaible Letter. Commenters opposed the proposal for several reasons, as more fully discussed herein. For example, Bloomberg believed that the Commission, not Nasdaq, should address the issue of access fees and PGE believed that the Nasdaq proposal would "only serve to confuse the issue" in light of the Commission's prior statements that it intended to address this issue. LSC believed that the Commission should withhold approval of the proposal and clarify that ECN access fees are anticompetitive and violate the securities laws.

participants,<sup>23</sup> or lower excessive burdens that are involuntarily imposed upon SuperMontage participants.<sup>24</sup> BRUT also believed that Nasdaq had done an admirable job reconciling the differences among SuperMontage participants, while utilizing its regulatory authority in a non-partisan fashion.

#### 1. Burden on Competition and Conflicts of Interest

BRUT believed that the current proposal represented a fair and balanced effort to “resolve an issue that has been the source of contention in the nation’s equity markets since the Commission’s adoption of the Order-Handling Rules in 1996.” Further, commenters opined that the availability of other trading venues, such as the NASD’s Alternative Display Facility (“ADF”) and exchanges, such as the Cincinnati Stock Exchange,<sup>25</sup> either removed concerns that Nasdaq was attempting to misuse its authority at the expense of ECNs<sup>26</sup> or provided alternatives for ECNs.<sup>27</sup>

However, several commenters believed that the proposed rule change was anti-competitive or an attempt by the NASD to set prices.<sup>28</sup> These commenters believed that the proposal was designed to eliminate competition,<sup>29</sup> require ECNs to change their business model of providing rebates,<sup>30</sup> or force ECNs to migrate away from SuperMontage and its order routing capabilities.<sup>31</sup> In addition, two commenters suggested that the proposed rule change reflected a conflict of interest between the NASD and Nasdaq because the NASD currently owns Nasdaq, and they believed that the NASD was overstepping its bounds by proposing a fee cap that, according to the two commenters, benefits Nasdaq, but hurts ECNs.<sup>32</sup>

Nasdaq responded to commenters’ concerns that Nasdaq proposed the

<sup>23</sup> See Track Letter; see also BRUT Letter.

<sup>24</sup> See UBS Letter (further stating that the Commission needs to act on this issue).

<sup>25</sup> The Commission notes the Cincinnati Stock Exchange recently changed its name to the National Stock Exchange. See Securities Exchange Act Release No. 48774 (November 12, 2003), 68 FR 65332 (November 19, 2003).

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

<sup>27</sup> See Instinet/Island Letter; see also Knight Letter.

<sup>28</sup> See Domestic Letter, Houtkin Letter, NexTrade Letter, and Schaible Letter.

<sup>29</sup> See Domestic Letter, Houtkin Letter, NexTrade Letter, and Schaible Letter.

<sup>30</sup> See Domestic Letter.

<sup>31</sup> See Domestic Letter, NexTrade Letter, and Schaible Letter.

<sup>32</sup> See Houtkin Letter and Schaible Letter; see also NexTrade Letter (stating that Nasdaq and the NASD have a financial incentive to eliminate ECNs from their marketplace).

access fee cap for anticompetitive reasons. Nasdaq asserted that the proposal was not anticompetitive because it selected a maximum ECN access fee cap that was closely linked to the rates charged by the most competitive and liquid ECNs and substantially similar to fees already in existence in the Nasdaq market. Nasdaq believed that this formed the best basis for determining an appropriate access fee cap in the absence of a uniform standard imposed by the Commission. Further, Nasdaq asserted that the Commission had repeatedly recognized that in some instances self-regulatory organizations (“SROs”) compete with their members, and that SuperMontage is a voluntary system and market participants that oppose the access fee cap have the option of posting trading interest in other market centers.

#### 2. Best Execution

Commenters asserted that because ECN access fees are hidden, an ECN’s quote does not reflect the true price available at an ECN, make best execution difficult, and cause distortions and lack of market transparency.<sup>33</sup> However, two commenters contended that as long as ECN fees remain below one cent, a customer would always receive the best execution, even including the ECN fee, provided that the ECN quotation is better than the next highest quote.<sup>34</sup> NexTrade also believed that the forced migration of ECNs to other market centers would exacerbate best execution concerns, increase fragmentation, remove liquidity and transparency, and widen spreads since fewer participants would be involved in providing liquidity to Nasdaq.

In response to the comments that the proposal would exacerbate best execution concerns, Nasdaq stated that the proposed rule change was an important step in re-focusing best-execution compliance on the actual price of a security rather than the current pre-occupation with transaction costs like ECN access fees. According to Nasdaq, such transaction costs are highly subjective and variable across the universe of ECNs and counter-parties. Nasdaq believed that its proposal enabled users to better predict the costs of trading for their customers and to take appropriate actions to meet their best execution obligations.

<sup>33</sup> See STA Letter and STANY Letter; see also Dudzinski Letter (stating that access fees can mire price discovery by masking a transactions true cost).

<sup>34</sup> See Houtkin Letter and NexTrade Letter.

#### 3. Basis for ECN Access Fee Cap

BRUT and Instinet/Island believed that Nasdaq had an appropriate basis for its access fee cap. BRUT believed that the proposal reflected a rate structure already in place for the vast majority of customers of ECNs and similar facilities on a volume-weighted basis, and preserved consistency with Nasdaq’s own access fee. Instinet/Island also emphasized that if the proposal was adopted, the maximum difference in total transaction fees in a SuperMontage transaction involving both non-access fee charging participants and fee charging ECNs would be reduced from the current \$0.007 per share to \$0.001 per share.

Further, Instinet/Island opined that “[c]ertain ECNs are charging access fees in SuperMontage that bear no relation to the market’s value of the service they are providing, as clearly evidenced by the fact that as a result of competition, the significant entities in the provision of this service (*i.e.*, Archipelago Exchange, BRUT, Instinet, Island, and NASDAQ) all charge access fees at a level equal to or below \$0.003 per share. In effect, certain ECNs on SuperMontage are taking advantage of SuperMontage’s order processing behavior to extract economic rents from other SuperMontage users.” According to Instinet/Island, SIA, and UBS, disparities are of particular concern in an automated system like SuperMontage that matches buying and selling interest through execution algorithms that limit the ability of users to select or anticipate their counter-parties to a particular trade.<sup>35</sup> Knight also stated that as a result of the disparity in ECN access fees, an ECN access fee could raise Knight’s execution cost in SuperMontage anywhere from 23 percent to 233 percent.<sup>36</sup>

Other commenters believed that Nasdaq failed to provide a basis for its proposal<sup>37</sup> and arbitrarily proposed a rate equal to the rate Nasdaq already charges.<sup>38</sup> NexTrade believed that the Commission permitted an access fee of \$0.009.<sup>39</sup> Further, NexTrade and Schaible believed that Nasdaq set the maximum ECN fee too low and that it would be impossible to charge \$0.003

<sup>35</sup> See also Hill Thompson Letter and Knight Letter (noting there is no competition with respect to access fees in SuperMontage).

<sup>36</sup> According to UBS, the “seemingly random manner of this assessment and the current wide disparity among the fees themselves, deprives non-ECN market participants of the ability to effectively forecast execution fees.”

<sup>37</sup> See Domestic Letter, Houtkin Letter and NexTrade Letter.

<sup>38</sup> See Bloomberg Letter and Houtkin Letter.

<sup>39</sup> See also Schaible Letter.

per share and remain profitable.<sup>40</sup> They also believed that Nasdaq's current fee schedule was inconsistent with the Nasdaq's proposed rule change to establish a maximum \$0.003 access fee because Nasdaq charged more than three-tenths of a cent for transactions occurring on SuperMontage. However, Knight, for example, distinguished between fees charged by market centers to which members or subscribers voluntarily route orders to, and fees charged by ECNs through SuperMontage for orders that may be involuntarily routed to the ECNs as a result of the SuperMontage execution algorithm.<sup>41</sup>

In response to these commenters, Nasdaq stated that it decided on the maximum \$0.003 access fee based on its understanding of the current, competitively-derived, fee structure and the need to allow further competition on fees. In Nasdaq's view, the lack of notice to counter-parties as to their expected costs because of the range in ECN access fees when utilizing SuperMontage impacts the willingness of market participants to use the system. Nasdaq disagreed with the assertion of one commenter that informing market participants of the highest possible fee, \$0.009, would solve this problem since such an approach would deter market participants that consider potential transaction costs from routing orders to SuperMontage. Nasdaq also distinguished between the fees it charges and the fees charged by ECNs. According to Nasdaq, its fees are public, equally applicable to all users, and subject to specific Commission review. In addition, Nasdaq believed that the access fees at the heart of its proposal are those that ECNs seek to impose, not on subscribers interacting directly using the ECN's systems, but counter-parties who interact with them only because of SuperMontage's neutral execution algorithms.

#### 4. Consistency With Sections 6(e) and 15A of the Act

Instinet/Island believed that the proposed ECN access fee cap was consistent with section 15A of the Act. Further, BRUT believed that the authority of SROs to police access fees in the facilities they operate was well established and cited to the Commission's releases approving the

<sup>40</sup> Several commenters recommended alternatives to Nasdaq's proposal. See Domestic Letter, Houtkin Letter, LSC Letter, and Schaible Letter. For example, Domestic and Houtkin suggested raising the maximum fee to \$0.005 or \$0.009, respectively.

<sup>41</sup> See also Dudzinski Letter and SIA Letter. Dudzinski believed that any system has a right to charge for the voluntary submission of orders, and that this would ensure innovation through competition.

Order Handling Rules and Regulation ATS as support.<sup>42</sup>

Bloomberg and LSC, however, believed that the Nasdaq proposal was inconsistent with section 6(e)(1) of the Act, which prohibits a national securities exchange from fixing rates of commissions, allowances, discounts or other fees.<sup>43</sup> In addition, PGE, which opposed the proposal, and Hill Thompson, which supported the proposal, both believed that it was inconsistent with section 15A of the Act to allow one group of market participants to charge access fees, while requiring other market participants to provide access to their quotes/orders free of charge. Additionally, Schaible believed that the proposal was inconsistent with the Order Handling Rules.

Nasdaq disagreed with commenters who asserted that the proposal was inconsistent with section 6(e) of the Act. With respect to section 6(e) of the Act, Nasdaq stated that because it is not yet registered as a national securities exchange, section 6(e) is currently inapplicable to the proposal. Nasdaq believed, however, that Regulation ATS specifically permits exchanges to establish access fee standards.

#### B. Elimination of SuperMontage Algorithms

Several commenters supported the elimination of the two algorithms, in particular the algorithm that takes into account fees.<sup>44</sup> Specifically, Track believed that the elimination of the Price/Time algorithm that took into account fees would benefit ECNs participating in SuperMontage by providing them with the same price/time priority as other participants and thus, leveling the playing field.<sup>45</sup> Further, BRUT and Instinet/Island opined that the algorithm taking into account ECN access fees could no longer be justified if the ECN access fee cap was adopted.

PGE, however, opposed the elimination of the Price/Time algorithm that takes into account fees until the market structure and associated legal

<sup>42</sup> See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release"); and Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules Release").

<sup>43</sup> LSC agreed with Nasdaq that ECNs imposing access fees on other participants as they see fit might constitute a fraudulent and manipulative act and violate just and equitable principals of trade for purposes of section 15A of the Act, but asserted that fixing commissions was also violative of section 6(e) of the Act and not the solution. See LSC Letter.

<sup>44</sup> See BRUT Letter, Instinet/Island Letter, and Track Letter.

<sup>45</sup> See also BRUT Letter.

issues surrounding ECN access fees were resolved to ensure a choice with regard to incurring such fees. The SIA stated that while some of its firms supported the complete elimination of both algorithms because they would no longer be necessary, other members supported retaining the algorithms.

In response, Nasdaq stated that it linked the establishment of the maximum ECN access fee with the elimination of the Price/Time with fee consideration algorithm to foster price/time priority within SuperMontage. Nasdaq believed that the establishment of a maximum access fee cap created the appropriate framework to eliminate the execution algorithm that considered ECN access fees.

#### IV. Discussion

The Commission has carefully reviewed the proposed rule change, the comment letters, and Nasdaq's response to comment letters, 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>46</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with section 15A(b)(6) of the Act because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members.<sup>47</sup> For the reasons discussed below, the Commission finds that Nasdaq's proposal to establish a maximum ECN access fee and to eliminate the two execution algorithms is consistent with the Act.<sup>48</sup>

<sup>46</sup> In approving this proposal, as amended, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>47</sup> 15 U.S.C. 78o-3(b)(6).

<sup>48</sup> In approving the proposed rule change pursuant to Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2), the Commission is not required to, and has not determined that, the proposed rule change is the only appropriate mechanism to achieve Nasdaq's goals.

### A. Nasdaq's Proposed Maximum ECN Access Fee

Rule 301(b)(4) of Regulation ATS provides, in relevant part, that an ATS<sup>49</sup> shall not charge any fee to broker-dealers that access the ATS through a national securities association that is inconsistent with equivalent access to the ATS.<sup>50</sup> In addition, if a national securities association establishes rules designed to assure consistency with standards for access to quotations displayed in the association, the ATS cannot charge any fee to members that is contrary to or inconsistent with any standard of equivalent access established by the rules. In the Regulation ATS Release, the Commission stated that fees charged by an ATS would be inconsistent with equivalent access if they had the effect of creating barriers to access for non-subscribers.<sup>51</sup> Further, the Commission believed that ECN fees should be similar to the communications or systems charges imposed by various markets<sup>52</sup> and that SROs should have the authority to assure that fees charged to non-subscribers were consistent with the fees typically charged by the members of the SRO for access to displayed orders.<sup>53</sup> For example, an association could establish a standard for what constitutes a fair and reasonable fee for non-subscriber access to an ATS, consistent with the effective operation of the SRO's market and the Commission's equivalent access requirement.<sup>54</sup> The Commission contemplated at the time that SROs could limit (or eliminate entirely) access fees, subject to Commission review.<sup>55</sup>

Specifically, the Commission stated that for a rule to be approved by the Commission, the rule must be necessary

to maintain consistency within the SRO's market, and be designed to promote just and equitable principles of trade, to promote fair competition, to facilitate transactions in securities, and in general, to protect investors and the public interest. The Commission believes that Nasdaq's proposal satisfies these requirements and is consistent with the Act.

The Commission recognizes that, over the years, certain ECNs have based their business models on charging access fees well above the access fees charged by other ECNs. The Commission agrees with commenters that such disparity in ECN access fees in a system like SuperMontage, which extensively automates the matching of buy and sell trading interest using execution algorithms, has had a detrimental impact on the system and its users. In particular, the Commission notes that the inability of system users to reasonably anticipate their trading costs due to hidden ECN access fees may discourage market participants from entering their quotes/orders into SuperMontage, thereby depriving all SuperMontage users of beneficial liquidity.<sup>56</sup> Consequently, the Commission believes that Nasdaq's proposal may attract new order flow to SuperMontage, increasing liquidity and promoting greater competition among market centers.

Furthermore, the Commission believes that Nasdaq's proposal to set a maximum ECN cap is necessary to maintain consistency within the Nasdaq market and with the equivalent access requirement. Some of the current ECN access fees for ECNs that elect to participate in SuperMontage are not consistent with the fees typically charged by other NASD members and, thus, may discourage non-subscriber broker-dealers from accessing ECN prices. In practice, some ECNs charge considerably more than other ECNs, and this may be due in part to the lack of competition with respect to access fees in SuperMontage.<sup>57</sup> As a result, the

Commission believes that some ECNs may rely on SuperMontage's order processing in order to charge higher fees to other SuperMontage users and still receive orders through SuperMontage. As indicated by Knight, differences in ECN access fees can add significant non-transparent costs to securities transactions. This may be inconsistent with the fair access standards imposed in the Order Handling Rules and Regulation ATS. Further, as noted by PGE and Hill Thompson, market makers, unlike ECNs, are prohibited from charging an access fee in addition to their posted quote.<sup>58</sup> Approval of the proposed rule change should help assure that no SuperMontage participant will be able to impose a fee that results in substantially higher execution costs to other participants, consistent with the equivalent access requirement.<sup>59</sup> As one commenter noted, the proposed rule change would effectively reduce the disparity in transaction costs between non-access fee charging participants and fee charging ECNs from \$0.007 to \$0.001 per share.<sup>60</sup> The Commission, therefore, believes that the proposed maximum access fee cap should promote fair competition and just and equitable principles of trade within the Nasdaq market and is consistent with the protection of investors and the public interest.

The Commission also believes that the Nasdaq proposal should encourage greater transparency by maintaining a closer relationship between displayed prices in the montage and effective execution prices obtained by market participants that interact with fee-charging ECNs. As a result, the maximum access fee cap may further facilitate transactions in securities by allowing market participants to rely on comparability of quotations across all participants within SuperMontage.

per share for each order matched on NexTrade's ECN." See <http://www.nextrade.com/company/overview.asp>. The Commission notes, however, that it has not expressed a view regarding the appropriateness of any specific access fee.

<sup>58</sup> Market makers are prohibited from charging access fees under the Quote Rule. See Rule 11Ac1-1(c)(2), 17 CFR 240.11Ac1-1(c)(2).

<sup>59</sup> See Regulation ATS Release, *supra* note 42, at 70870-70871.

<sup>60</sup> See NASD Rule 7010(i). Generally, Nasdaq participants are charged between \$0.0025 and \$0.003 for non-directed orders that access the quotes/orders of market participants that do not charge a fee, while Nasdaq participants that access the quotes/orders of market participants that charge a fee are charged \$0.001 plus the ECN fee. See Securities Exchange Act Release No. 48972 (December 22, 2003), 68 FR 75301 (December 30, 2003). With the approval of the proposed rule change and the maximum ECN access fee of \$0.003, the difference between accessing a fee charging participant and a non-fee charging participant is essentially \$0.001.

<sup>49</sup> An ECN is a subgroup of ATSS.

<sup>50</sup> 17 CFR 242.301(b)(4).

<sup>51</sup> See Regulation ATS Release, *supra* note 42, at 70871; See also Order Handling Rules Release, *supra* note 42, at note 272.

<sup>52</sup> See Regulation ATS Release, *supra* note 42, at 70871.

<sup>53</sup> See Regulation ATS Release, *supra* note 42, at 70871; See also "Interpretive Guidance on the Order Execution Rules," letter from Richard R. Lindsey, Director, Division, Commission, to Richard Grasso, Chairman and Chief Executive Officer, New York Stock Exchange, Inc., dated November 22, 1996 ("Interpretive Guide"), at 12. In the Interpretive Guidance, the Division stated that "an SRO may set reasonable conditions on whether an ECN should be allowed access to the SRO's market," and added that "an SRO may require that the prices displayed in its market by an ECN not include fees or other charges if the SRO believes this is necessary to make these prices consistent with other quotes in its market." See Interpretive Guide, at 11-12.

<sup>54</sup> See Regulation ATS Release, *supra* note 42, at 70871.

<sup>55</sup> See Regulation ATS Release, *supra* note 42, at 70872.

<sup>56</sup> See Notice, *supra* note 5 and Track Letter; See also BRUT Letter.

<sup>57</sup> See Instinet/Island Letter. The Commission notes that the following ECNs charge approximately three mils: BRUT's access fee for subscribers executing over 50,000 shares per day is currently \$0.0027 per share, while subscribers under this threshold are currently charged \$0.005 per share; INET charges \$0.003 for trades that remove liquidity from the INET book; and Track charges up to \$0.0029 for orders that remove liquidity from its book. See BRUT Letter (noting that BRUT anticipates modifying its rate structure upon approval of the proposed rule change); <http://www.island.com/prodsvr/bd/fee/fee.asp>; and <http://www.trackecn.com>. NexTrade, however, on its website, merely stated that the "SEC has authorized NexTrade to charge a rate up to \$0.009

Furthermore, the Commission believes that Nasdaq has adequately addressed concerns regarding the basis for its maximum access fee. The Commission believes that Nasdaq, in proposing this maximum ECN access fee, has attempted to accommodate the business models of ECNs with other SuperMontage users and the manner in which they participate in SuperMontage. As a result, the Commission believes that the maximum ECN access fee of \$0.003 should help to ensure a more level playing field for market participants that elect to participate in SuperMontage.

The Commission also believes that Nasdaq has adequately addressed concerns regarding Nasdaq's basis for the competitive impact of the proposed rule change and the conflict of interest between Nasdaq and the NASD. According to Nasdaq, the proposal was not anti-competitive because it selected a maximum ECN access fee cap that was closely linked to the rates charged by the most competitive and liquid ECNs and substantially similar to fees already in existence in the Nasdaq market. Further, Nasdaq asserted that the Commission had repeatedly recognized that in some instances SROs compete with their members, and that SuperMontage is a voluntary system and market participants that oppose the access fee cap have the option of posting trading interest in other market centers.

The Commission has previously recognized that conflicting roles are inherent in the SRO model since SROs act not only as regulators, but also as operators of markets.<sup>61</sup> The Commission does not believe that the proposed rule change is anti-competitive since Nasdaq has the authority (delegated by the NASD), consistent with Rule 301(b)(4), to establish rules designed to assure consistency with standards of access to quotations displayed on its facilities, subject to Commission approval. The Commission believes that the effect of the proposed rule change is not to limit competition with SuperMontage but to prevent ECNs from using SuperMontage to impose non-competitive fees on other SuperMontage participants. As discussed above, the Commission believes that the proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder. While NexTrade and Schaible contend that Nasdaq charges more than \$0.003, the Commission notes that Nasdaq does not charge for the entry or cancellation of non-directed

orders (other than the entry of orders preferenced to a particular market participant) into SuperMontage<sup>62</sup> and that Nasdaq only charges up to \$0.003 per share for orders executed within SuperMontage, which is consistent with the proposed rule change.<sup>63</sup> To the extent ECNs want to charge fees in excess of \$0.003, the Commission notes that participation on SuperMontage is voluntary and that ECNs are free to trade on other venues. In response to suggestions that the NASD has a conflict of interest relating to Nasdaq and is seeking to exclude ECNs that compete within SuperMontage, the Commission notes that the access fee cap is intended to encourage entry of orders into SuperMontage, and thereby encourage participation by market makers and ECNs.

The Commission also notes that some commenters believed that Nasdaq should not be allowed to set a maximum ECN access fee at all because doing so would be inconsistent with section 6(e) of the Act.<sup>64</sup> In particular, Bloomberg and LSC opined that the proposal was inconsistent with section 6(e)(1) of the Act because the proposal fixed the rates of fees charged by members of a national securities exchange.<sup>65</sup> According to Bloomberg, "[w]hile section 6(e)(1) was adopted to deal specifically with the rules of national securities exchanges that \* \* \* had fixed minimum brokerage commission rates, the section cuts more broadly than that and also prohibits fixed maximum rates of commissions, allowances, discounts or other fees."

Section 6(e)(1) was adopted by Congress in 1975 to statutorily prohibit the fixed minimum commission rate

<sup>62</sup> See NASD Rule 7010(i).

<sup>63</sup> See NASD Rule 7010(i) and note 58; see also Securities Exchange Act Release No. 48972 (December 22, 2003), 68 FR 75301 (December 30, 2003). The fees for entering or canceling directed or preferred orders are higher. However, in that instance, the market participant entering the order has voluntarily, using SuperMontage, sent the order to a particular market participant, and is aware of the applicable fees that will be charged in SuperMontage. See NASD Rule 7010(i). Market participants, however, can and do access other market participants outside of SuperMontage.

<sup>64</sup> See LSC Letter, PGE Letter, and Hill Thompson Letter. The Commission notes that, although Nasdaq is currently not a national securities exchange and that Section 6(e)(1) does not apply to it, Nasdaq does have an exchange application pending with the Commission. See Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001) (File No. 10-131). In addition, the Commission notes that Section 15A(b)(6) of the Act contains language similar to Section 6(e)(1).

<sup>65</sup> LSC further stated that "there can be no doubt about the fact that with the Securities Act Amendments of 1975 Congress banned a system of fixed regulated commissions in favor of competition."

system.<sup>66</sup> Congress prohibited any national securities exchange from fixing commissions and fees to be charged by its members unless they were first filed with the Commission pursuant to section 19(b) of the Act and were found by the Commission to be "reasonable in relation to the costs of providing the service and necessary to accomplish the purposes of the Exchange Act."<sup>67</sup> Section 6(e)(1) of the Act, in relevant part, provides that "no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members \* \* \*." <sup>68</sup> In addition, section 15A(b)(6) of the Act, in relevant part, provides that an association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that the rules of the association "are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees charged by its members \* \* \*." <sup>69</sup>

The Commission has considered the commenters' concerns regarding this issue and has determined that the provisions of sections 6(e)(1) and 15A(b)(6) of the Act regarding fixed commissions are not implicated by Nasdaq's proposal. As noted in the House Report, one of the purposes of the legislation was to "reverse the industry practice of charging fixed rates of commissions for transactions on the securities exchanges."<sup>70</sup> The fixed minimum commission rate system allowed exchanges to set minimum commission rates their members had to charge their customers, but allowed members to charge more. The House Report further noted that this practice had produced distortions in trading patterns, impacted unfairly on various classes of investors, and erected competitive impediments to the development of an efficient national market system, and stated that fully competitive commission rates are necessary to the efficient functioning of the securities markets.

The Commission does not believe that Nasdaq's proposal to establish a maximum ECN access fee of \$0.003 constitutes fixing commissions, allowances, discounts or other fees for purposes of sections 6(e)(1) and

<sup>66</sup> H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 42 (1975) ("House Report").

<sup>67</sup> S. Rep. No. 94-75, 94th Cong., 1st Sess. 61 (1975).

<sup>68</sup> 15 U.S.C. 78f(e)(1).

<sup>69</sup> 15 U.S.C. 78o-3(b)(6).

<sup>70</sup> See House Report, *supra* note 66.

<sup>61</sup> See Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001).

15A(b)(6) because Nasdaq's proposal allows ECNs participating in SuperMontage the ability to charge a range of other rates—anything from no fee to \$0.003.<sup>71</sup> In addition, the maximum ECN access fee applies only to ECNs that choose to participate in SuperMontage. Therefore, Nasdaq is not fixing fees generally; it is merely imposing a condition, consistent with the equivalent access requirement, for receiving executions through SuperMontage. ECNs that want to charge more than \$0.003 can send their quotes/orders to other venues, such as the ADF. Furthermore, ECNs that choose to charge more than \$0.003 would not be completely barred from participating in SuperMontage. Such ECNs could elect to participate in, for example, the ADF and charge more than \$0.003 per share, and would still be permitted to access and post liquidity in SuperMontage as an NNMS Order Entry Firm, but could not charge any access fee in SuperMontage.<sup>72</sup> As NNMS Order Entry Firms, those ECNs would have any quotes/orders entered into SuperMontage displayed and processed in the same manner as other NNMS Order Entry Firms and would be entitled to receive a liquidity provider rebate. Furthermore, the Commission agrees with BRUT and Nasdaq that an SRO's ability to establish access fee standards is specifically permitted by Regulation ATS. Accordingly, the Commission believes sections 6(e) and 15A(b)(6) of the Act are not implicated by Nasdaq's proposal and believes that Nasdaq has reasonably attempted to balance the divergent interests of SuperMontage users, including ECNs, in a manner consistent with the Act.

Two commenters stated that as long as ECN access fees remain below \$0.01, a customer will always receive best execution (even with the access fee included in the price), if the ECN's quote is better than the quote at the next

price level.<sup>73</sup> In addition, NexTrade believed that Nasdaq's proposal would force ECNs to other market centers, thereby exacerbating best execution concerns.<sup>74</sup>

The Commission notes that the argument raised by Houtkin and NexTrade is applicable only if ECNs that charge the highest access fees are the last trading interest to be accessed at a particular price level. Otherwise, their higher fees result in inferior executions at the same displayed price. Furthermore, to the extent that some ECNs charge higher access fees, these fees would substantially reduce the value of these quotes, so that the net price offered is at times minimally better than the next best displayed price. If the fee cap reduces the fees attached to these quotes, the resulting net price would be improved. Moreover, the Commission believes that the fee cap may encourage greater use of the system, which could encourage market makers and ECNs to offer better prices in the system, improving the execution of orders and thus, enhancing competition. Furthermore, Nasdaq is proposing to remove the algorithms that take into account size or access fees from SuperMontage.<sup>75</sup> As a result, the orders of ECNs would be accessed under the same Price/Time priority algorithm as other market participants, instead of potentially being accessed last as a result of the "Price/Time with fee consideration" algorithm.<sup>76</sup> To the extent there are concerns about increased fragmentation in the event ECNs migrate out of SuperMontage, the Commission notes that ECNs are currently able to and do participate in other markets.

The Commission believes that Nasdaq's proposal to establish a maximum ECN access fee should help to alleviate the concerns of market participants relating to their ability to obtain the best execution for customer orders. The Commission notes that some commenters raised best execution concerns related to hidden ECN access fees.<sup>77</sup> Currently, there is limited

incentive for ECNs within SuperMontage to reduce their access fees on their own. Therefore, the Commission believes that capping ECN access fees at \$0.003 per share should reduce fee disparities among ECNs within SuperMontage and enable market participants to ensure that their customers' orders receive best execution.

#### *B. Elimination of the Price/Time With Fee Consideration and Price/Size Algorithms*

The Commission believes that the elimination of the Price/Time with fee consideration execution algorithm in connection with Nasdaq's proposed maximum ECN access fee is reasonable. The Commission notes that, while several commenters supported eliminating the algorithm,<sup>78</sup> PGE and some members of the SIA opposed the elimination of the Price/Time with fees algorithm, even with the proposed fee cap. The Commission believes that Nasdaq's proposal balances the interests of its market participants and is reasonable in light of Nasdaq's proposed access fee cap. The Commission also believes that the elimination of the Price/Size algorithm, along with the Price/Time with fees algorithm, should allow Nasdaq to reduce system complexity within SuperMontage by eliminating two of three algorithms and promote greater price/time priority within the system.<sup>79</sup>

#### **V. Conclusion**

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>80</sup> that the proposed rule change (SR-NASD-2003-128), as amended, be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>81</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 04-3540 Filed 2-18-04; 8:45 am]

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<sup>71</sup> Currently, pursuant to a series of no-action letters issued by the Division, ECNs may charge fees to non-subscribers in amounts equal to those that they charge a "substantial proportion" of their active broker-dealers subscribers, but no more than \$0.009 per share. The Commission has not, however, expressed a view regarding the appropriateness of any specific access fee. No-action letters are posted to the Commission's Web site at <http://www.sec.gov/divisions/marketreg/mr-noaction.htm#ecns>.

<sup>72</sup> Telephone conversation between Thomas P. Moran, Associate General Counsel, Nasdaq, and Sapna C. Patel, Special Counsel, Division, Commission, on January 27, 2004.

<sup>73</sup> See Houtkin Letter and NexTrade Letter.

<sup>74</sup> NexTrade added that Nasdaq failed to study the impact of its proposal on best execution and investors.

<sup>75</sup> See *supra* note 15 and accompanying text.

<sup>76</sup> *Id.*; see also discussion in *supra* notes 57 through 58 and accompanying text.

<sup>77</sup> See STA Letter and STANY Letter; see also Dudzinski Letter.

<sup>78</sup> See BRUT Letter, Instinet/Island Letter, and Track Letter.

<sup>79</sup> According to Nasdaq, the Price/Size algorithm is rarely used in SuperMontage and accounts for less than seven percent of orders entered into the system. See Notice, *supra* note 5.

<sup>80</sup> 15 U.S.C. 78s(b)(2).

<sup>81</sup> 17 CFR 200.30-3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49218; File No. SR-NYSE-2003-31]

### Self-Regulatory Organizations; Notice of Filing of a Proposed Rule Change and Order Granting Accelerated Approval to the Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Minor Revisions to Sections 303A.08, 303.00, and 312.03 of the NYSE's Listed Company Manual

February 11, 2004.

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 October 9, 2003, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On February 9, 2004, the NYSE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposal and Amendment No. 1 on an accelerated basis.

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

The NYSE proposes to amend section 303.00 ("Corporate Governance Standards"), section 303A.08 ("Shareholder Approval of Equity Compensation Plans"), and section 312.03 ("Shareholder Approval") of the NYSE's Listed Company Manual. The NYSE represents that the proposed rule amendments reflect a need for minor clean-up revisions that became apparent following the addition of section 303A.08 to the NYSE's Listed Company Manual.

The text of the proposed rule change is available at the Office of the Secretary, the NYSE, and at the Commission.

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

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for,

the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

###### 1. Purpose

On August 16, 2002, the NYSE filed with the Commission amendments to its Listed Company Manual to implement significant changes to its listing standards aimed at helping to restore investor confidence by empowering and ensuring the independence of directors and strengthening corporate governance practices (the "Corporate Governance Proposals").<sup>4</sup> On October 7, 2002, the NYSE filed certain of the proposals included in the Corporate Governance Proposals, including section 303A.08 providing for shareholder approval of equity-compensation plans and amendments to NYSE Rule 452, "Broker No-Votes," to comply with a request from the Commission staff to address this issue separately from the remainder of the Corporate Governance proposals (the "October Proposals"). That filing was approved by the SEC on June 30, 2003.<sup>5</sup>

Following approval of the October Proposals, the NYSE's Listed Company Manual was updated to reflect the approved amendments. During that process, it became apparent to the NYSE that minor clean-up revisions were necessary. The amendments proposed in this filing reflect the need for these revisions. The NYSE proposes to revise Section 312.03(a) to clarify that the section applies to equity-compensation plans, and to include a cross-reference to section 303A.08. The NYSE proposes to clarify through these proposed amendments that shareholder approval is also required for equity-compensation plans under section 312.03, its shareholder approval policy. The NYSE also proposes to delete a provision of section 303.00 that was duplicated in different formats in both the October Proposals and the Corporate Governance Proposals. The format approved in the

Corporate Governance Proposals will be retained in section 303.00.

In addition, the NYSE proposes to delete two paragraphs in section 303A.08 that relate to broker voting. These paragraphs relate to amendments approved to NYSE Rule 452 regarding broker voting and were inadvertently included in the rule text relating to equity-compensation plans, rather than in NYSE Rule 452 itself. One of these paragraphs relates to a 90-day transition period regarding a prohibition on broker voting on equity-compensation plans, which expired as of September 29, 2003. The other paragraph relates to the NYSE's intention to establish a working group to advise with respect to the need for, and design of, mechanisms to facilitate implementation of the requirement that brokers may not vote on equity-compensation plans presented to shareholders without instructions from the beneficial owners. Since September 29, 2003, the date the rule change went into effect, the working group has been monitoring stockholder meetings of companies at which equity-compensation plans were subject to shareholder approval. The NYSE represents that there have been 65 such situations to date. To the NYSE's knowledge, only one equity-compensation plan failed to receive shareholder approval; that plan also would have required that brokers not vote under the former rule due to the fact that the number of shares reserved for the plan exceeded 5% of the company's outstanding shares. The NYSE has also solicited feedback from Automatic Data Processing, Inc. ("ADP") and the proxy solicitor community on whether difficulties were being encountered with respect to the amended rule. No problems were reported for listed companies. In addition, the NYSE represents that the working group has not received any complaints directly from listed companies following effectiveness of the amended rule. The NYSE further represents that the working group will continue to monitor this issue throughout the 2004 proxy season.<sup>6</sup>

###### 2. Statutory Basis

The Exchange believes that the proposed rule change, as amended, is consistent with section 6 of the Act<sup>7</sup> in general and furthers the objectives of section 6(b)(5)<sup>8</sup> in particular in that it is

<sup>4</sup> See File No. SR-NYSE-2002-33. This filing was approved on November 4, 2003. See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003).

<sup>5</sup> See Securities Exchange Act Release No. 48108 (June 30, 2003), 68 FR 39995 (July 3, 2003) (SR-NYSE-2002-46).

<sup>6</sup> The Commission notes that the paragraph on the working group that the NYSE is proposing to delete only refers to the intention to establish a working group.

<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

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

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

<sup>3</sup> Amendment No. 1 replaces the NYSE's original 19b-4 filing in its entirety.