

and that Amendment No. 2 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48088; File No. SR-NASD-2003-85]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendments No. 1 and 2 Thereto Relating to a Post-Trade Anonymity Feature in SuperMontage

June 25, 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 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 ("Commission") the proposed rule change as described in Items I, II, and III below, which Nasdaq has prepared. 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 Commission is

publishing this notice, as amended, 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

Nasdaq is seeking to add a post-trade anonymity feature to its SuperMontage trading system.

The text of the proposed rule change is below. Proposed new text is *italicized* and proposed deleted text is [bracketed].

\* \* \* \* \*

#### 4712. *Obligation To Honor System Trades*

(a) If an NNMS Participant, or clearing member acting on his behalf, is reported by NNMS to clearing [at the close of any trading day], or shown by the activity reports generated by NNMS as constituting a side of a System trade, such NNMS Participant, or clearing member acting on his behalf, shall honor such trade on the scheduled settlement date.

(b) *Nasdaq shall have no liability if an NNMS Participant, or a clearing member acting on his behalf, fails to satisfy the obligations in paragraph (a).*

#### 4719. *Anonymity*

(a) *Transactions executed in NNMS in which at least one member submits a Non-Attributable Quote/Order will be processed anonymously. The transaction reports will indicate the details of the transactions, but will not reveal contra party identities.*

(b)(1) *The processing described in paragraph (a) shall not apply to transactions executed in NNMS when the member whose Quote/Order is decremented is an Order-Delivery ECN that charges an access fee.*

(2) *Except as required to comply with the request of a regulator, or as ordered by a court or arbitrator, Order-Delivery ECNs shall not disclose the identity of the member that submitted a Non-Attributable Quote/Order that decremented the Order-Delivery ECN's Quote/Order.*

(c)(1) *The Association may reveal a member's identity when the National Securities Clearing Corporation ("NSCC") ceases to act for a member, or the member's clearing firm, and NSCC determines not to guarantee the settlement of the member's trades.*

(2) *The Association may reveal a member's identity for regulatory*

identities of the members that execute anonymous trades through SuperMontage for six years in order to satisfy members' record keeping obligations under Securities Exchange Act Rules 17a-3(a)(1) and 17a-4(a).

*purposes or to comply with an order of an arbitrator or court.*

(3) *The Association may reveal a member's identity on risk management reports provided to the member's contra parties each day after 4 p.m., which disclose trading activity on an aggregate dollar value basis.*

\* \* \* \* \*

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

In its filing with the Commission, Nasdaq 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 IV below. Nasdaq 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

Nasdaq proposes to add a post-trade anonymity feature to SuperMontage in response to demand from members. Today, systems that provide automatic executions of orders for Nasdaq stocks are commonplace and often it is the additional features offered by a system that determines whether market participants send orders to that system or a competing system. One such feature valued by market participants today is the ability to trade anonymously. When a member seeks to trade anonymously, it wants to prevent its contra party from knowing its identity.

Anonymity is important to market participants because sometimes the identity of a party can reveal important "market intelligence" and complicate a member's ability to execute its customer orders. For example, if members see a pattern in which a particular member is actively buying a security, and it is commonly known that this member handles the orders of several very large institutional customers, such as pension funds or mutual funds, the other members can adjust their trading strategy for that security in anticipation of the strong demand that should develop as the member attempts to fill the order of one or more of its large institutional customers. In such a scenario, the natural result is that the price of the security increases and it becomes more expensive to fill the order. This result commonly is referred

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

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

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

<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"). In Amendment No. 1, the Nasdaq added rule language in paragraph (c) of NASD Rule 4719 that states that the Nasdaq staff can limit a member's ability to submit anonymous orders upon request of the member's firm. This provision was subsequently withdrawn in Amendment No. 2.

<sup>4</sup> See Letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Terri Evans, Assistant Director, Division of Market Regulation, dated June 20, 2003 ("Amendment No. 2"). In Amendment No. 2, the Nasdaq withdrew the provision to restrict a member's ability to submit anonymous orders upon request of the member's firm in paragraph (c) of NASD Rule 4719. Nasdaq also codified the proposal, through proposed paragraph (c) of NASD Rule 4719, to indicate that a member's identity may be revealed: (1) When the National Securities Clearing Corporation ("NSCC") ceases to act for a member or the member's clearing firm; (2) for regulatory purposes, or upon the order of a court or arbitrator; and (3) after 4 p.m. on trade date on an aggregate basis. Nasdaq also represented that it will retain the

to as "market impact." Nasdaq believes post-trade anonymity diminishes market impact, which can help members satisfy their duty of best execution.

Presently, SuperMontage only offers a pre-trade anonymity feature for certain trades, which means market participants do not know the identities of the members entering orders, but their identities are revealed to each other once a trade is executed.<sup>5</sup> The post-trade anonymity feature, or "full anonymity" feature, Nasdaq is proposing would reveal the members' identities to each other on a trade-by-trade basis in two circumstances: (1) if the member whose quote is hit (*i.e.*, the party providing the liquidity in the trade) is an ECN that participates in SuperMontage as an NNMS Order-Delivery ECN that charges an access fee;<sup>6</sup> or (2) the NSCC has ceased to act for the member involved in the trade, or for the clearing firm of the member involved in the trade, and the NSCC has decided not to guarantee the trades by the failed firm.<sup>7</sup> The reasons and process for revealing the members' identities in these circumstances is different and will be discussed in detail later. Nasdaq also proposes to provide members with additional risk management tools to complement the full anonymity feature.

Nasdaq's current pre-trade anonymity feature allows market makers, ECNs and Order Entry Firms to submit anonymous orders to SuperMontage for display under the "SIZE" market participant identifier ("MPID").<sup>8</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—meaning anonymity is lost.<sup>9</sup>

<sup>5</sup> Members seeking pre-trade anonymity submit "Non-Attributable Quotes/Orders" to SuperMontage. The term "Non-Attributable Quote/Order" is defined in Rule 4701(o) as "a bid or offer Quote/Order that is entered by a Nasdaq Quoting Market Participant or NNMS Order Entry Firm and is designated for display (price and size) on an anonymous basis in the Nasdaq Order Display Facility."

<sup>6</sup> The term "NNMS Order-Delivery ECN" is defined in Rule 4701(t)(2).

<sup>7</sup> A member's identity will be available to other members on certain compliance report cards issued by NASD's Market Regulation Department. However, the report cards normally are not issued until at least twenty-four days after trade date. In addition, NASD may reveal a member's identity to other members or others during a regulatory investigation or a routine oversight exam.

<sup>8</sup> Market makers and ECNs may also display Attributable Quotes/Orders under the market participant's MPID. However, Order Entry 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>9</sup> For the purpose of execution reports, Order Entry Firms have distinct MPIDs. Telephone

The new full anonymity feature Nasdaq is proposing builds upon the pre-trade anonymity feature available today using the Non-Attributable Quote/Order feature and extends the anonymity beyond the time of execution by masking the identities of the members executing the trade. As discussed above, currently a member's identity is revealed immediately when a Non-Attributable Quote/Order is executed. 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. Under the new proposal, when a member uses the Non-Attributable Quote/Order feature, instead of revealing the members' MPIDs, SuperMontage will substitute a four-letter identifier that indicates the trade is anonymous (*i.e.*, SIZE).<sup>10</sup> Therefore, instead of seeing its contra party's MPID on the reports, the reports will indicate SIZE as the contra party.<sup>11</sup> Replacing the members' MPIDs with SIZE does 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 will continue to receive immediate notification of trades executed by their correspondent firms,<sup>12</sup> and, except as described below, the new anonymity feature does not change how

conversation with Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Marc McKayle, Special Counsel, Division, Commission, on June 24, 2003.

<sup>10</sup> With one exception, trades will be processed anonymously if one of the parties submits a Non-Attributable Quote/Order. Thus, a member's trade can be processed anonymously even if it did not request anonymity. As discussed in detail later, the one exception is when the member whose quote is hit is an NNMS Order-Delivery ECN that charges a quote access fee.

<sup>11</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. Currently, members would contact each other and directly resolve disputed trades.

<sup>12</sup> When a correspondent firm executes an anonymous order in SuperMontage, its clearing firm will continue to receive a real-time SuperMontage 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 will be included in ACT's risk management tools. For example, anonymous trades will be included in the aggregate purchase and sales calculations performed by ACT and will be included in calculations for determining whether a correspondent firm is approaching the trading thresholds defined by the clearing firm.

trades will be processed and settled through the NSCC.<sup>13</sup>

The ACT reports that the NSCC receives from Nasdaq for anonymous trades will contain the identities of the parties to the trade. This measure will enable the NSCC to continue its normal risk management functions and settle anonymous trades just the same as those that are executed without the anonymity feature, with one exception. The ACT report sent to the NSCC will 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 will substitute SIZE for the MPID of the contra party, in effect masking from members the identities of their contra parties.<sup>14</sup> The purpose of this masking is to preserve anonymity through settlement. If the NSCC did not mask the contra party identities, the contract sheets would reveal the identities of the parties to the trade and thus eliminate the full anonymity feature. With this minor change, anonymity is preserved through settlement.

Nasdaq also proposes to offer additional risk management tools to members to assist them in monitoring their exposure to members they have traded with on an anonymous basis. Nasdaq has discussed its proposed full anonymity feature with several clearing firms in an attempt to balance members' competing desires to trade anonymously and monitor their exposure to other members. An execution system that reveals a contra party's identity immediately when a trade is executed provides the maximum amount of information for risk management, but, of course, such a system does not provide the degree of anonymity desired to lessen market impact. On the other hand, a system that does not provide any information with respect to the identity of contra parties, which is desirable for minimizing market impact, withholds useful risk management information. Ultimately, the information that provides market intelligence and creates market impact is one and the same as the information used in risk

<sup>13</sup> Nasdaq will not assume any responsibility to settle anonymous trades and the NSCC's settlement guarantee and close-out procedures for failed firms will not be affected by Nasdaq's anonymity proposal. Therefore, as required today by NASD Rules 4712 and 6160, members will 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. Nasdaq will provide members several tools to manage their exposure prior to the NSCC's settlement guarantee attaching. These tools are described in detail later.

<sup>14</sup> The NSCC issues contract sheets throughout the day.

management. Therefore, Nasdaq's proposal provides anonymity but also provides members with information that will allow members to continue to manage their risk.

Nasdaq is proposing to add four new measures that should help members monitor their exposure to other members and take action quickly if a contra party ceases operation. Nasdaq believes that the first and second measures will assist members directly in their efforts to assess the risk associated with their anonymous trading, whereas the third and fourth measures involve closer coordination between Nasdaq and the NSCC, which indirectly should benefit members trading anonymously.

First, Nasdaq will provide members with 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. This information will help members quantify their "worst case scenario," which would occur if one or all of their contra parties failed to settle all trades executed anonymously. With this information, members can determine whether any risk-limiting actions should be taken.

Second, Nasdaq will reveal after 4 p.m. Eastern Time the identities of the members listed on the intra-day concentration report.<sup>15</sup> With this information, members will know the exact dollar value of their aggregate purchases and sales with individual contra parties. This information then can be incorporated into a member's risk management system and analyzed on a contra party-by-contra party basis. If a member is concerned about trading with a particular member, the member will possess information that can help it assess whether any risk-limiting actions should be taken.

Third, Nasdaq will begin providing trade information to the NSCC in real time as trades are executed in SuperMontage. In comparison, today Nasdaq collects trade information and sends it to the NSCC at five pre-determined intervals throughout the day. With real time submission, the NSCC will possess trade information within seconds after a trade is executed and it can incorporate this information into its risk analysis of its participants. Ultimately, this could result in the NSCC reaching a decision earlier 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. Once the NSCC ceases to act for a participant, that firm, and any

other firm that clears through the participant, will not be able to continue trading.

Fourth, once the NSCC has ceased to act for a participant and determined not to guarantee the settlement of the participant's trades, Nasdaq will coordinate with the NSCC and promptly disclose to members each trade executed anonymously with the firm the NSCC ceased to act for and any firms that cleared through that the NSCC participant.<sup>16</sup> As described earlier, when the NSCC ceases to act for a participant is one of the two general scenarios in which Nasdaq will reveal contra party identities on a trade-by-trade basis. This measure will allow members to determine quickly their potential exposure from anonymous trades with the failed firm and its correspondents and take any necessary risk-reducing actions.

The second scenario in which Nasdaq will reveal contra party identities on a trade-by-trade basis is 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 cannot trade with complete anonymity when accessing liquidity provided by Order-Delivery ECNs that charge access fees. Trades executed with these 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 the ECN's quote access fee. Therefore, to provide fee-charging Order-Delivery ECNs with the opportunity to reject trades with certain members, Nasdaq must disclose each contra party's identity. Nasdaq believes that this process also will benefit members that execute trades with these ECNs because the members will be able to track the access fee charges accumulated with each ECN.

To preserve some degree of anonymity, while also accommodating the unique rights and needs of these ECNs, Nasdaq is proposing a rule that would prohibit fee-charging Order-Delivery ECNs from disclosing the identity of the member that submitted the Non-Attributable Quote/Order that decremented their Quote/Order.<sup>17</sup> 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. Based on conversations with ECNs, Nasdaq understands that ECNs do not normally disclose contra party identities for any trades executed through their systems because such a practice would diminish the anonymity features they provide. Therefore, Nasdaq believes the proposed rule prohibiting disclosure of this information is consistent with existing practices.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change, as amended, is consistent with the provisions of section 15A(b)(6) of the Act.<sup>18</sup> Section 15A(b)(6) requires the rules of the NASD to be designed 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. Nasdaq believes the proposal is consistent with this standard because it balances two competing needs with respect to disclosure of contra party information. Masking contra party identities will help members in obtaining the best execution for their customer orders by limiting the market intelligence that is obtained, and the market impact that results, when a seller's or buyer's identity is revealed. Recognizing, however, that this same information is helpful to members in assessing contra party risk, Nasdaq has responded by proposing additional risk management features that should help members in monitoring trades executed anonymously.

Nasdaq also believes that the proposal balances the need to provide an anonymity feature in SuperMontage and the unique needs of Order-Delivery ECNs that charge quote access fees. The proposal will continue to provide fee-charging Order-Delivery ECNs with the identities of their contra parties so that they have the information necessary to decide whether to trade with an individual member or reject an order because of a dispute regarding the payment of fees. However, to limit the effect of the special processing on the anonymity provided by SuperMontage, Nasdaq is proposing to prohibit these ECNs from disclosing the identities of their contra parties for anonymous trades, which Nasdaq understands is consistent with existing practices. Fee-charging Order-Delivery ECNs would be permitted to disclose this information if

<sup>16</sup> *Id.*

<sup>17</sup> Non-Attributable Quotes/Orders contain an indicator noting that the order is to be processed anonymously. As such, Order-Entry ECNs will be able to distinguish Non-Attributable Quotes/Orders from those orders for which the prohibition will not apply.

<sup>15</sup> See Amendment No. 2, *supra* note 4.

<sup>18</sup> 15 U.S.C. 78o-3(b)(6).

requested by a regulator or ordered by a court or arbitrator.

#### *B. Self-Regulatory Organization's Statement on Burden on Competition*

Nasdaq does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

#### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments were neither solicited nor received.

### **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 NASD consents, the Commission will:

(A) by order approve the 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 also will 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 July 23, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

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

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## **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-48093; File No. SR-NASD-2003-92]

### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. To Adopt NASD Rule 2370 To Govern Certain Lending Arrangements Between Registered Persons and Customers**

June 26, 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 June 11, 2003, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), 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 NASD. 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**

NASD proposes to adopt NASD Rule 2370 to govern lending arrangements between registered persons and customers. The text of the proposed rule change appears below. New text is in italics.

\* \* \* \* \*

#### *2370. Borrowing From or Lending to Customers*

*(a) No person associated with a member in any registered capacity may borrow money from or lend money to any customer of the member unless: (1) The member has written procedures allowing the borrowing and lending of money between such registered persons and customers of the member; (2) the lending or borrowing arrangement meets one of the following conditions: (A) the customer is a member of such person's immediate family; (B) the customer is a financial institution regularly engaged*

<sup>19</sup> 17 CFR 200.30-3(a)(12).

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

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

*in the business of providing credit, financing, or loans, or other entity or person that regularly arranges or extends credit in the ordinary course of business; (C) the customer and the registered person are both registered persons of the same member firm; (D) the lending arrangement is based on a personal relationship with the customer, such that the loan would not have been solicited, offered, or given had the customer and the associated person not maintained a relationship outside of the broker/customer relationship; or (E) the lending arrangement is based on a business relationship outside of the broker-customer relationship; and (3) the member has pre-approved in writing the lending or borrowing arrangement.*

*(b) The term immediate family shall include parents, grandparents, mother-in-law or father-in-law, husband or wife, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, children, grandchildren, cousin, aunt or uncle, or niece or nephew, and shall also include any other person whom the registered person supports, directly or indirectly, to a material extent.*

\* \* \* \* \*

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

In its filing with the Commission, NASD 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 IV below. NASD 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**

The purpose of the proposed rule change is to prohibit registered persons from borrowing money from or lending money to a customer unless the member has written procedures allowing such lending arrangements consistent with the rule, the loan falls within one of five permissible types of lending arrangements, and the member pre-approves the loan in writing. The five types of permissible lending arrangements are: The customer is a member of the registered person's immediate family (as defined in the proposed rule); the customer is in the business of lending money; the