

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-48239; File No. SR-NASD-2003-98)

July 28, 2003

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by National Association of Securities Dealers, Inc., Through Its Subsidiary, The Nasdaq Stock Market, Inc., Regarding Reporting of Transactions Conducted through Electronic Communications Networks to the Automated Confirmation Transaction Service

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 19, 2003, 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 Items have been prepared by Nasdaq. The Exchange submitted an amendment to the proposed rule change on January 27, 2003.³ 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 the Substance of the Proposed Rule Change

Nasdaq proposes to clarify the reporting requirements applicable to transactions conducted through electronic communications networks (“ECNs”) and reported to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from John Yetter, Associate General Counsel, Nasdaq, to Kathy England, Assistant Director, Division of Market Regulation, Commission, dated July 10, 2003 (“Amendment No. 1”). Amendment No. 1 deletes the reference in NASD Rule 6130(c)(6) to subparagraph (3) because this provision would not apply to ECNs.

Automated Confirmation Transaction Service (“ACT”). ECNs would be required to file notice of their methods for trade reporting under the proposed rule change within 30 calendar days after the date of Commission approval.

The text of the proposed rule change is below. Proposed new language is in italics; proposed deletions are in brackets.

5400. NASDAQ STOCK MARKET AND ALTERNATIVE DISPLAY FACILITY
TRADE REPORTING

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5430. Transaction Reporting

(a) No change.

(b) Which Party Reports Transaction and to Which Facility

(1) In transactions between two Registered Reporting Nasdaq Market Makers, the member representing the sell side shall report the trade using ACT.

(2) In transactions between a Registered Reporting Nasdaq Market Maker and a Non-Registered Reporting Member, the Registered Reporting Nasdaq Market Maker shall report the trade using ACT.

(3) In transactions between two Non-Registered Reporting Members, the member representing the sell side shall report the trade using ACT or TRACS.

(4) In transactions between a member and a customer, the member shall report as follows:

(A) A Registered Reporting Nasdaq Market Maker shall report the trade using ACT;

(B) A Registered Reporting ADF Market Maker shall report the trade using TRACS; and

(C) A Non-Registered Reporting Member shall report the trade using ACT or TRACS.

(5) In transactions between two Registered Reporting ADF Market Makers, the member representing the sell side shall report the trade using TRACS.

(6) In transactions between a Registered Reporting ADF Market Maker and a Non-Registered Reporting Member, the Registered Reporting ADF Market Maker shall report the trade using TRACS.

(7) In transactions between a Registered Reporting Nasdaq Market Maker and a Registered Reporting ADF Market Maker, the member representing the sell side shall report as follows:

(A) A Registered Reporting Nasdaq Market Maker shall report the trade using ACT; and

(B) A Registered Reporting ADF Market Maker shall report the trade using TRACS.

(8) If a member simultaneously is a Registered Reporting Nasdaq Market Maker and a Registered Reporting ADF Market Maker, and has the trade reporting obligation pursuant to paragraphs (1), (2), (4), (5), (6), or (7), the member can report the trade using either ACT or TRACS, unless the trade is executed using ACES; the Nasdaq National Market Execution System (“NNMS”); [the SelectNet Service; the SmallCap Small Order Execution System (“SOES”);] or the Primex Auction System (“Primex”). A trade executed using

ACES must be reported using ACT, and trades executed using NNMS[, SelectNet, SOES,] or Primex will be reported to ACT automatically.

(9) In transactions conducted through an ACT ECN (as defined in Rule 6110) that are reported to ACT, the ACT ECN shall ensure that transactions are reported in accordance with Rule 6130(c). If an ACT ECN is also a Registered Reporting ADF ECN (as defined in Rule 4200A), Rule 6130(c) shall apply only to transactions conducted through the ECN for which trade reports are submitted to ACT.

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6100. AUTOMATED CONFIRMATION TRANSACTION SERVICE (ACT)

6110. Definitions

(a) – (p) No change.

(q) The term “ACT ECN” shall mean a member of the Association that is an electronic communications network that is a member of a registered clearing agency for clearing or comparison purposes or has a clearing arrangement with such a member, to the extent that transactions executed through it are reported to ACT.

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6130. Trade Report Input

(a) – (b) No change.

(c) Which Party Inputs Trade Reports to ACT

ACT Participants shall, subject to the input requirements below, either input trade reports into the ACT system or utilize the Browse feature to accept or decline a trade

within the applicable time-frames as specified in paragraph (b) of this Rule. Trade data input obligations are as follows:

(1) in transactions between a Market Maker and an Order Entry Firm, the Market Maker shall be required to submit a trade report to ACT;

(2) in transactions between two Market Makers, the member representing the sell side shall be required to submit a trade report to ACT;

(3) in transactions between two Order Entry Firms, the member representing the sell side shall be required to submit a trade report to ACT[.];

(4) in transactions between a member and a customer, the member shall be required to submit a trade report to ACT;

(5) in transactions conducted through an ACT ECN that are reported to ACT, the ACT ECN shall ensure that transactions are reported in accordance with one of the following methods:

(A) the ACT ECN shall submit the trade reports to ACT and identify itself as the reporting party;

(B) the ACT ECN shall submit the trade reports to ACT on behalf of the reporting party and identify the reporting party in accordance with the rules for determining reporting parties reflected in paragraphs (1), (2), (3), and (4) above; or

(C) the ACT ECN shall require one of the parties, determined in accordance with the rules for determining reporting parties reflected in paragraphs (1), (2), (3), and (4) above, to submit the trade reports to ACT.

When an ACT ECN reports transactions in accordance with subparagraph (A), the ACT ECN shall be responsible for ensuring that the trade reports are accurate and contain all information required by subsection (d) of this rule for both the ACT ECN and the identified non-reporting party. When an ACT ECN reports transactions in accordance with subparagraph (B), both the ACT ECN and the party identified as the reporting party shall be responsible for ensuring that the trade reports are accurate and contain all information required by subsection (d) of this rule for both the ACT ECN and the identified reporting party. When an ACT ECN requires reporting of transactions in accordance with subparagraph (C), the reporting party shall be responsible for ensuring the accuracy and completeness of the trade report.

An ACT ECN shall provide written notice to the Association of the method of trade reporting used by the ACT ECN for each of its subscribers, and may change the method of trade reporting used for a subscriber by providing advance written notice of the change to the Association;

(6) in transactions conducted through two ACT ECNs or an ACT ECN and an ECN that is not an ACT ECN, an ACT ECN shall be responsible for complying with the requirements of paragraph (5) above for reporting a transaction executed through its facilities, and an ECN that routed an order to it for execution shall be deemed to be a Market Maker and a member for purposes of the rules for determining reporting parties reflected in paragraphs (1), (2), and (4) above; and

(7) in transactions conducted through an ACT ECN in which neither of the parties is a member, the ACT ECN shall report the transaction in accordance with the requirements of subparagraph (5)(A) above.

(d) – (e) No change.

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6400. REPORTING TRANSACTIONS IN LISTED SECURITIES

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6420. Transaction Reporting

(a) No change.

(b) Which Party Reports Transaction

(1) Transactions executed on an exchange are reported by the exchange and shall not be reported by members.

(2) In transactions between two Registered Reporting Members, only the member representing the sell side shall report.

(3) In transactions between a Registered Reporting Member and a Non-Registered Reporting Member, only the Registered Reporting Member shall report.

(4) In transactions between Non-Registered Reporting Members, only the member representing the sell side shall report.

(5) In transactions conducted through an ACT ECN (as defined in Rule 6110), the ACT ECN shall ensure that the transactions are reported in accordance with Rule 6130(c).

(c) - (e) No change.

IM-6420. Transactions in Eligible Securities

SUMMARY OF PROVISIONS GOVERNING MEMBERS' REQUIREMENTS TO
REPORT TRANSACTIONS IN ELIGIBLE SECURITIES

Chart 1--General Reporting Requirements Under Rule 6420(b)

Member	Transaction	Member Reports When Contra-Party Is			
		[Designated] <u>Registered</u> Reporting Member	Non- [Designated] <u>Registered</u> Reporting Member	Exchange	Customer
[Designated] <u>Registered</u> Reporting Member	buys from:	No	Yes	No	Yes
Non- [Designated]	buys from:	No	No	No	Yes
Member	sells to:	Yes	Yes	No	Yes

Registered

Reporting

Member sells to: No Yes No Yes

ACT ECN See 6130(c) See 6130(c) No See 6130(c)

Chart II -- Reporting Requirements for “Riskless” Transactions
as Defined in Rule 6420(d)(4)

Member	Transaction	Member Reports When Contra-Party Is			
		[Designated] <u>Registered</u> Reporting Member	Non- [Designated] <u>Registered</u> Reporting Member	Exchange	Customer
[Designated] <u>Registered</u>	buys from customer				
Reporting	and sells to:	Yes	Yes	No	Yes
Member	sells to customer				
	and buys from:	No	Yes	No	Yes

Non-	buys from customer				
[Designated]	and sells to:	No	Yes	No	Yes
<u>Registered</u>					
Reporting					
Member	sells to customer				
	and buys from:	No	No	No	Yes

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6600. REPORTING TRANSACTIONS IN OVER-THE-COUNTER SECURITIES

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6620. Transaction Reporting

(a) No change.

(b) Which Party Reports Transaction

(1) In transactions between two OTC Market Makers, only the member representing the sell side shall report.

(2) In transactions between an OTC Market Maker and a Non-Market Maker, only the OTC Market Maker shall report.

(3) In transactions between two Non-Market Makers, only the member representing the sell side shall report.

(4) In transactions between a member and a customer, the member shall report.

(5) In transactions conducted through an ACT ECN (as defined in Rule 6110), the ACT ECN shall ensure that the transactions are reported in accordance with Rule 6130(c), and the term “Market Maker” as used in such rule shall be construed to include an OTC Market Maker.

(c) - (e) No change.

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6900. REPORTING TRANSACTIONS IN DIRECT PARTICIPATION PROGRAMS

6920. Transaction Reporting.

(a) No change.

(b) Which Party Reports Transactions

(1) In transactions between two members, only the member representing the sell side shall report.

(2) In transactions between a member and a customer, the member shall report.

(3) In transactions conducted through an ACT ECN (as defined in Rule 6110), the ACT ECN shall ensure that the transactions are reported in accordance with Rule 6130(c); provided that for purposes of Rule 6130(c)(5) (B) and (C), the party with the reporting obligation shall be as set forth in Rule 6130(c)(3) and the term “Order Entry Firm” as used in such rule shall be construed to refer to any member.

(c) – (e) No change.

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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 is proposing to adopt rules to define with greater clarity the reporting obligations applicable to transactions executed through ECNs that are reported to ACT. The proposal is based on Nasdaq's understanding of the different methods used by ECNs today to report trades, and in general, the rule filing is not intended to require ECNs to modify their current trade reporting practices. Rather, the purpose of the filing is to codify these practices in the form of clear, enforceable rules that will provide greater guidance to market participants.⁴ The proposed rule change would apply to transactions in all securities that are executed through an ECN and reported to ACT.

Reporting of transactions executed through ECNs is complex because ECNs conduct transactions on an "agency" basis, with the ECN standing as a central contra party to two offsetting transactions with ECN subscribers. However, the substance of the

⁴ The proposed rules are intended to provide greater certainty while Nasdaq remains a subsidiary of the NASD, and do not impact the trade reporting rules filed by Nasdaq in its application to register as an exchange, which are different from the current proposal.

transaction is the transference of shares from one ECN subscriber to another, and therefore only one transaction is reported to the tape for public dissemination.

Current practices of ECN trade reporting have developed over time in conjunction with the growth of the number of ECNs. As each new ECN entered the market, it registered with Nasdaq under NASD Rule 4623 and informed Nasdaq and NASD of its planned method for reporting transactions. Although Nasdaq believes that the use of different reporting methodologies by different ECNs has generally allowed ECNs to fulfill reporting obligations while tailoring their methodology to their own business needs and those of their subscribers, the absence of clearly defined rules has, in some circumstances, created confusion as to the trade reporting responsibilities of ECNs and their subscribers. Nasdaq believes that the proposed rule change will provide members greater certainty concerning their trade reporting responsibilities, while allowing ECNs to continue using the various methods of trade reporting that have developed over time.

The proposed rule change permits ECNs to use any of three methods for reporting transactions.⁵ Each ECN would inform NASD which method it would use for reporting trades to ACT for each of its subscribers, but it could change its method at any time by providing advance notice to NASD.⁶ First, an ECN may assume sole responsibility for

⁵ As discussed earlier, the three methods are based on current ECN trade reporting practices. Nasdaq also understands that, at any given time, an ECN may utilize more than one of these methods and the choice of the method varies depending on the needs of particular subscribers. For example, ECN A may use one method for subscriber B and another method for subscriber C. This proposal is not intended to limit this flexibility. Accordingly, an ECN will be permitted to use more than one of the methods described in Rule 6130(c), as long as it provides NASD written notice concerning the methods that it will use for each subscriber.

⁶ Notices must be filed with Nasdaq's MarketWatch Department and NASD's Market Regulation Department.

reporting transactions executed through its facilities and identify itself as the reporting party. Second, an ECN may assume sole responsibility for transaction reporting, but identify a subscriber as the reporting party. In that case, the identified reporting party would be determined in accordance with the existing rules for allocating trade reporting responsibility. Thus, if the subscribers conducting a transaction through the ECN were both market makers or both order entry firms, the selling party would be identified as the reporting party; if the transaction were between a market maker and an order entry firm, the market maker would be identified as the reporting party; and if the transaction were between a member (i.e., a broker-dealer) and a non-member (such as an institutional investor), the member would be identified as the reporting party.

Third, the ECN may impose some or all of the responsibility for reporting on its subscribers. In that case, the ECN would notify the appropriate reporting party, determined in accordance with the existing rules of priority for trade reporting, that it had an obligation to submit a report concerning the trade.

In each case, the party submitting a trade report is responsible for ensuring its accuracy and completeness.⁷ In addition, when an ECN submits a trade report identifying another party as the reporting party, both the ECN and the identified reporting party are responsible for ensuring the accuracy and completeness of the report.

The proposed rule change also addresses procedures for reporting transactions in several unique circumstances associated with ECNs. First, the rule provides that when the parties to a transaction executed through an ECN are both non-members, the ECN must submit all required trade reports and identify itself as the reporting party. This is

⁷ Rule 6130(d) specifies the information that is required to be included in each ACT report.

the case because as non-members, the parties to the transaction would not be eligible to report trades through ACT. Second, in circumstance where one ECN routes an order to another ECN that executes the order, the ECN that executes the order would be responsible for reporting the transaction, or requiring a subscriber to report the transaction, in accordance with one of the three basic methods for trade reporting described above. For purposes of the rules for allocating trade reporting responsibility between ECN subscribers, the routing ECN would be deemed to be a market maker. Thus, if the executing ECN uses the second method of trade reporting, and it receives an order from a routing ECN that is matched against the order of an order entry firm or a non-member customer, the routing ECN would be identified as the reporting party. If the executing ECN matched the routed order against the order of a market maker or another ECN, however, the sell side would be identified as the reporting party.

Finally, it should be noted that the proposed rule change applies only to transactions that are reported to ACT, since Nasdaq does not have authority to establish rules governing the reporting of trades to non-Nasdaq systems. Thus, in circumstances where an ECN has the option to report trades to ACT or to another trade reporting system, such as the NASD's TRACS system, the rule does not mandate that the ECN use ACT for trade reporting. However, to the extent that the ECN or its subscribers opt to use ACT to report a particular transaction, all provisions of the proposed rule change would apply to that transaction.⁸ In addition to the above changes, Nasdaq is also

⁸ The proposed rule change also corrects several typographical errors in IM-6420.

removing references to “Select Net Service” and the “SmallCap Small Order Execution System” from NASD Rule 5430(b)(8) because these systems are no longer in place.⁹

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,¹⁰ in general, and with Section 15A(b)(6) of the Act,¹¹ in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and to protect investors and the public interest. Nasdaq purports that the proposed rule change will clarify the trade reporting obligations associated with transactions conducted through ECNs. Nasdaq believes that the adoption of clear, enforceable rules will provide guidance to market participants and thereby provide greater assurance of comprehensive reporting of ECN transactions.

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.

⁹ Telephone call between John Polise, Senior Special Counsel, Sonia Trocchio, Special Counsel, and Leah Mesfin, Attorney, Division, Commission, and John Yetter, Assistant General Counsel, and Peter Geraghty, Associate Vice President and Associate General Counsel, Office of the General Counsel, Nasdaq on July 9, 2003.

¹⁰ 15 U.S.C. 78o-3.

¹¹ 15 U.S.C. 78o-3(6).

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 such proposed rule change, or

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

IV. Solicitation of Comments

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

submissions should refer to file number SR-NASD-2003-98, and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland
Deputy Secretary

Action as set forth or recommended herein
APPROVED pursuant to authority delegated by
the Commission under Public Law 87-592.

For the Division of Market Regulation

by: _____

(DATE)

¹² 17 CFR 200.30-3(a)(12).