

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57826; File No. SR-NASDAQ-2007-001)

May 15, 2008

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 3 to and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 2 and 3 Thereto, to Amend Nasdaq's Clearly Erroneous Rule

I. Introduction

On January 22, 2007, The NASDAQ Stock Market LLC ("Nasdaq") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend Rule 11890, Nasdaq's "Clearly Erroneous Rule," and related Interpretive Material. Nasdaq filed Amendment Nos. 1 and 2 to the proposal on June 1, 2007 and June 12, 2007, respectively.³ The proposed rule change, as modified by Amendment No. 2, was published for comment in the Federal Register on June 27, 2007.⁴ The Commission received two comment letters regarding the proposed rule change.⁵ On May 15, 2008, Nasdaq filed Amendment No. 3 to the proposal.⁶ The Commission is publishing this notice to solicit comments on the proposed rule change, as modified

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced the proposed rule change in its entirety and was withdrawn by Nasdaq on June 14, 2007. Amendment No. 2 replaced the proposed rule change in its entirety.

⁴ See Securities Exchange Act Release No. 55937 (June 21, 2007), 72 FR 35279.

⁵ See letter from Michael T. Dorsey, Managing Director, Trading Services & Compliance, Pink Sheets LLC ("Pink Sheets"), dated July 18, 2007 ("Pink Sheets Letter"), and letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, Financial Industry Regulatory Authority ("FINRA"), dated August 29, 2007 ("FINRA Letter").

⁶ Amendment No. 3 deleted the proposed revisions to the Clearly Erroneous Rule relating to the submission of unauthorized orders and use of an account for manipulative purposes and clarified the manner in which a request for review can be submitted.

by Amendment Nos. 2 and 3 and simultaneously is approving the proposed rule change, as modified by Amendment Nos. 2 and 3, on an accelerated basis.

II. Description of the Proposal

Nasdaq proposes several changes to its Clearly Erroneous Rule and related Interpretative Material. Specifically, Nasdaq proposes to: (i) set forth price-based standards and provide guidance on the application of those standards when Nasdaq considers whether one or more transactions are clearly erroneous under Rule 11890; (ii) modify the numerical threshold as applied to trades occurring outside of the Regular Session;⁷ (iii) amend the time limits for market participants to file for review under Rule 11890(a) in cases where the price of the transaction is significantly different from the applicable inside price; and (iii) make several procedural modifications to the rule.

Nasdaq proposes to amend IM-11890-4 and IM-11890-5 to incorporate objective price-based standards and provide guidance regarding the application of those standards under Rule 11890. Under Rule 11890, Nasdaq is authorized to break trades when the execution price is more than a specified percentage (i.e., a Numerical Threshold) away from a “Reference Price” that is indicative of prior market conditions. The Reference Price generally used under Rule 11890 would be, for Nasdaq securities, the best bid/best offer (“BBO”) in Nasdaq at the time the disputed transactions were first executed (or the national BBO for non-Nasdaq securities) for trading during the Regular Session, and the closing price for the security on its Primary Market for trades outside the Regular Session. Nasdaq, however, may use a different Reference Price in

⁷ Regular Session means the primary trading session for a particular security on its Primary Market, which is generally 9:30 a.m. through 4:00 or 4:15 p.m. Primary Market means: (i) for a Nasdaq security, the Nasdaq Market Center; and (ii) for a non-Nasdaq security, the market designated as the primary market under the Consolidated Tape Association Plan.

unusual circumstances. Thus, in a case where material news about a security was released after the market close for the security and a trade occurred outside of the Regular Session, Nasdaq may use a Reference Price derived from after-hours trading activity rather than the closing price of the security. Similarly, in the case of several large orders that execute at multiple prices, a Reference Price based on a weighted average of the BBO at relevant times may be used rather than a Reference Price based solely on the BBO immediately prior to the execution of the first share of the order. Nasdaq proposes to amend the Interpretive Material to add examples of cases where Nasdaq may apply alternative Numerical Thresholds in determining which trades to break. Nasdaq also may use different Numerical Thresholds in events that involve other markets in order to coordinate a point beyond which trades would be adjusted or broken that is consistent across markets.

The Interpretive Material would provide that Nasdaq could break or modify all trades in a security if a pervasive mistake resulted in trading that should not have occurred. For example, trades in a security that was incorrectly authorized for trading prior to the date of its actual initial public offering could all be broken. Similarly, if Nasdaq systems executed orders in the Nasdaq opening cross or closing cross at a price that was inconsistent with the rules governing the operation of the crosses, either due to a Nasdaq system error or because an underlying erroneous order resulted in an erroneous opening or closing price, Nasdaq could break or adjust all of the affected trades.

Nasdaq also proposes to amend the Numerical Thresholds under IM-11890-4 for trading outside the Regular Session, to establish wider ranges within which trades would stand. According to Nasdaq, this proposed change reflects the diminished depth of the market during after-hours and pre-market trading sessions. Accordingly, Nasdaq proposes to double the

Numerical Thresholds for transactions occurring during these times. For example, a trade at \$40 per share could be broken if more than 10% away from the Reference Price during the Regular Session, but could not be broken during the pre-market or after-hours sessions unless it was more than 20% away from the Reference Price.

In addition, Nasdaq proposes to amend the language of Rule 11890(a)(2)(B) to set forth that persons seeking review of transactions must present a factual basis for believing that the trade is clearly erroneous. Nasdaq states that it cannot, within the context of an adjudication that must be conducted within a short period of time, determine all of the factual circumstances associated with a particular trade or set of trades. Nasdaq believes that it is generally incumbent on persons seeking review actually to allege a human or system error, rather than merely stating that the order was “filled away” or at “a bad price.” Requiring the statement of a factual basis also would allow FINRA to evaluate, after the fact, whether a particular market participant is abusing the clearly erroneous process or employing poor internal controls.⁸ According to Nasdaq, individuals and firms found to have misled Nasdaq about the cause of the alleged error would be subject to disciplinary action for misleading a self-regulatory organization.

Further, Nasdaq proposes to amend the time limits for market participants to file for an adjudication under Rule 11890(a) in cases where the price of the transaction at issue is more than 50% away from the applicable inside price (or the closing price, for trading outside Nasdaq’s Regular Session or before the primary market has posted its first two-sided quote), provided that the value of the transactions at issue is more than \$10,000. If these criteria are met, the

⁸ FINRA performs certain regulatory functions for Nasdaq, including a review, in certain circumstances, of clearly erroneous transactions submitted by member firms. Telephone conversation between John Zecca, Vice President MarketWatch, Nasdaq and David Michehl, Special Counsel, Division of Trading and Markets, Commission on May 14, 2008.

transaction is defined as an “Outlier Transaction,” and the parties to the trade are given an extra hour to petition for review, if the trade occurred during the Regular Session or during pre-market hours, or until 9:30 a.m. the next trading day if the trade occurred after hours. The reason for this change is to provide greater assurance that trades that are egregiously out of line with prevailing market prices are not permitted to stand, provided that the dollar value of the trades is significant and the request for review is made within the proposed timeframe.

Finally, Nasdaq proposes to make several procedural modifications to Rule 11890 and the Interpretative Material to: (i) allow Nasdaq to notify the counterparty to a trade about an erroneous event by telephone or other means consistent with the communications provisions of Rule 11890(d); (ii) specify that requests for review must be submitted to Nasdaq in writing, using an online complaint form, facsimile, or such other communications procedures specified by Nasdaq; (iii) rather than specifying that Nasdaq must act within 30 minutes, Nasdaq would be permitted to act as soon as possible, in circumstances when Nasdaq acts on its own motion under Rule 11890(b), except in extraordinary circumstances, in which case the time limit for a determination would be 9:30 a.m. the next trading day; (iv) replace references to Nasdaq “officer” with Nasdaq “official” throughout the Rule; (v) add a section listing definitions of terms used in the rule; and (vi) delete obsolete references to transactions entered into by a member of a national securities exchange with unlisted trading privileges in Nasdaq securities.

III. Commission’s Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁹

⁹ In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

and, in particular, the requirements of Section 6(b) of the Act¹⁰ and the rules and regulations thereunder. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹¹ in that the proposal is designed to promote just and equitable principles of trade, prevent fraudulent and manipulative acts, remove impediments to and perfects the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.

The Commission considers that, except in extraordinary circumstances, trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an obvious error may exist, suggesting that it is unrealistic to expect that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction and therefore that a clearly erroneous transaction may have taken place. In the Commission's view, the determination of whether a clearly erroneous trade has occurred should be based on specific and objective criteria and subject to specific and objective procedures.

Nasdaq proposes to modify certain price-based parameters that it uses for review of transactions alleged to be clearly erroneous under Rule 11890 and related Interpretive Material. The proposed numerical thresholds in the Interpretative Material set forth a clear and objective methodology for use in determining whether a transaction or transactions executed on Nasdaq are clearly erroneous. The proposed amendments also establish specific and objective criteria governing the review of such trades.

The Pink Sheets expressed general support for the proposal and stated that similar authority with respect to unauthorized use of accounts should be included in NASD Rule

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

11890.¹² FINRA expressed its view that account intrusions are fundamentally a type of fraud that does not and should not fall within the scope of the Clearly Erroneous Rule.¹³ FINRA believed that the Clearly Erroneous Rule is not the appropriate way to address unauthorized or illegal activity such as account intrusions.¹⁴ In Amendment No. 3, Nasdaq proposes to delete the provisions relating to unauthorized use of an account and use of an account for manipulative activity. Given the fact that the Clearly Erroneous Rule is designed to address trades made in error and the more difficult factual analysis presented by expanding the rule's application beyond obvious errors, the Commission believes that it is appropriate for Nasdaq to retain the original scope of the rule.

In addition, FINRA believed that numerical thresholds that can trigger a clearly erroneous determination should be set high enough to protect market integrity but not so low that the determination is most likely to primarily protect the individual who made the error.¹⁵ FINRA noted its view that thresholds of 10% to 20% are more appropriate because they will reduce the incidence of regulatory intervention in market transactions while still maintaining the integrity of the marketplace.¹⁶ The Commission believes that Nasdaq's proposed Reference Price thresholds are commensurate with the manner in which Nasdaq currently applies its Clearly Erroneous Rule and are not unreasonable.

The Commission finds good cause for approving the proposed rule change, as modified by Amendment Nos. 2 and 3 thereto, before the thirtieth day after the date of publication of

¹² Pink Sheets Letter, supra note 5. The Commission notes that revisions to NASD Rule 11890 are outside of the scope of the proposal before it.

¹³ FINRA Letter, supra note 5.

¹⁴ Id.

¹⁵ Id.

¹⁶ Id.

notice of filing thereof in the Federal Register. Accelerating approval of this proposal should benefit investors by creating, without undue delay, greater certainty in the application of Nasdaq's Clearly Erroneous Rule because the proposal establishes objective standards to be applied by Nasdaq in reviewing clearly erroneous transactions. Therefore, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,¹⁷ to approve the proposed rule change, as modified by Amendment Nos. 2 and 3, on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASDAQ-2007-001 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2007-001. 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, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the

¹⁷ 15 U.S.C. 78s(b)(2).

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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2007-001 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NASDAQ-2007-001), as modified by Amendment Nos. 2 and 3, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Florence E. Harmon
Deputy Secretary

¹⁸ 17 CFR 200.30-3(a)(12).