NASDAQ®

January 24, 2005

Catherine McGuire
Associate Director and Chief Counsel
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth St., N.W.
Washington, DC 20549

> **Re: Request for No-Action Relief from Paragraph (a)(2) of Rule 10b-10 under the Securities Exchange Act of 1934 by The Nasdaq Stock Market, Inc.**

Dear Ms. McGuire:

The Nasdaq Stock Market, Inc. respectfully requests your assurance that the staff of the Division of Market Regulation ("Staff") will not recommend that the Securities and Exchange Commission ("Commission") take any enforcement action under paragraph (a) of Rule 10b-10 under the Securities Exchange Act of 1934 ("Exchange Act") if an NASD member that executes orders for its customers in the Nasdaq Market Center execution system (formerly known as SuperMontage) indicates on a customer confirmation that the member acted as agent in those circumstances in which the member has acted as agent in submitting a customer's order to the Nasdaq Market Center, and the order is executed in the Nasdaq Market Center by matching against principal (including proprietary) trading interest of the same member (using either the same four-letter market participant identifier ("MPID") or another MPID of the member), provided that the member complies with all other requirements of Rule 10b-10 in confirming the customer's order, including paragraph (a)(2)(i) thereof.

This request for no-action relief is limited to those situations in which: (1) the party submitting principal orders does not have knowledge about the agency orders submitted by the member, and the party submitting agency orders does not have knowledge about the principal orders submitted by the member ("No Knowledge Requirement"); and (2) the member does not determine or influence the selection of the trading interest against which the agency order will be executed, including through the use of functionality of the Nasdaq Market Center designed for that purpose ("Randomness Requirement").

Background

Nasdaq's market structure is designed to provide members the greatest degree of flexibility in executing their customer orders. In this regard, Nasdaq does not require

members to use any specific execution system. Instead, members have the choice to use Nasdaq's execution system or they can internalize orders. Internalization generally means that the broker-dealer to which the order is delivered fills the order by purchasing shares from, or selling shares to, the customer on a proprietary basis. In addition, an order is considered internalized when a broker-dealer matches one customer's buy order with another customer's order to sell. Orders can be internalized using Nasdaq's system or through a broker-dealer's own system.

The Market Center is Nasdaq's system for, among other things, collecting bids, offers, and orders, and providing automatic executions against those bids, offers, and orders. NASD members that are registered as Nasdaq market makers are required to display a bid and an offer in the Market Center for each security in which they are registered.[1] In addition, electronic communications networks ("ECNs")[2] are required to provide a bid and an offer that reflect the best priced orders to buy and sell in their systems, to the extent that an ECN has such orders in its system for a particular security and has chosen to display those orders in Nasdaq.[3] Each market maker's and ECN's bid and offer are displayed under an MPID.[4] In addition to displaying trading interest under their own MPID, market makers and ECNs also can display orders anonymously under the MPID "SIZE."[5]

The Market Center also aggregates trading interest at price levels to show the depth of the market for a security. Specifically, for the top five bid and offer prices, the Market Center collects the individual bids and offers submitted by market makers and ECNs under their own MPIDs and combines them with the trading interest submitted under the SIZE MPID to show the total number of shares displayed and available at each of the five price levels.[6] The aggregate number of shares displayed is updated in real time as

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[1]   See NASD Rule 4613.

[2]   See Exchange Act Rule 11Ac1-1(a)(8).

[3]   See NASD Rule 4623.

[4]   Nasdaq presently is offering a pilot program, which expires on March 1, 2005, that allows market makers and ECNs to obtain a second MPID under which they can display trading interest in a security. Nasdaq intends to seek Commission approval to make this program permanent.

[5]   Members that are not registered as market makers or ECNs in a particular security (i.e., order entry firms) also can submit trading interest anonymously using the SIZE functionality. When displayed in the Market Center, SIZE shows the aggregate trading interest at a particular price submitted by market makers, ECNs, and order entry firms.

[6]   Exchanges that trade Nasdaq securities also can choose to participate in the Market Center. Generally, exchanges that participate in the Market Center are treated the same as NASD members, except when the quote/order submitted by the exchange is principal trading interest of an exchange member. See NASD Rule 4710(e).

trades are executed and members cancel orders or change their bids and offers.[7]

The Market Center also provides a means for members to submit orders to execute against the bids and offers displayed in the system.[8] Generally, the system will execute an order by matching it against bids and offers in price/time priority, meaning an order will execute against the member who was first at the best price. The execution of the order, and thus the member's contra party, will be determined by what other orders, bids, or offers are present in the Market Center and the priority of those orders, bids, and offers.[9]

The aggregate number of shares displayed does not include the number of shares that may be available in reserve at a price level. For example, a market maker can submit to the Market Center an offer to sell 1000 shares, but also indicate that it only wants to display 100 shares under its MPID. The remaining 900 shares are held in reserve and are available for execution when all other displayed shares at that price level have been executed. When the Market Center displays the aggregate trading interest at a price level, the number of shares held in reserve is not included.

[7] The Market Center also aggregates the number of shares available beyond the top five price levels, but the calculation is not updated and displayed in real time.

[8] In addition to the order processing discussed above and in footnote 9, Nasdaq recently introduced a closing cross and an opening cross for the Nasdaq Market Center. *See* Securities Exchange Act Release No. 49406 (Mar. 11, 2004), 69 FR 12879 (Mar. 18, 2004) (order approving the closing cross); and Securities Exchange Act Release No. 50405 (Sep. 16, 2004), 69 FR 57118 (Sep. 23, 2004) (order approving the opening cross).

[9] The Market Center executes orders using several different processes, based upon the process chosen by the member submitting the order. Orders can be submitted to the "Non-Directed Order process" or the "Directed Order process."

A "Preferenced Order" is a type of Non-Directed Order that permits the member submitting the order to choose a "preferred" contra party (including the member itself), if the preferred contra party is at the best price. Preferenced Orders are included in the same execution queue as Non-Directed Orders, but when the Preferenced Order is next in time to be processed, the order will execute only if the preferred contra party is at the best price. If the preferred contra party is not at the best price, the order will be returned to the member that submitted the order.

A "Directed Order" also allows the member submitting the order to specify their contra party, but the order will be considered a liability order, and thus subject to the requirements of the Commission's Firm Quote Rule (Rule 11Ac1-1), only if the order is sent to a market maker or ECN that has agreed to accept Directed Orders as liability orders. In contrast to Preferenced Orders, Directed Orders are not processed in the same queue as Non-Directed Orders. In addition, Directed Orders are not automatically executed against the market maker or ECN to whom the order is delivered; the market maker or ECN must affirmatively accept the order. Furthermore, the market maker or ECN can respond with a counteroffer. The Directed Order process replaced Nasdaq's SelectNet service when the Market Center execution system was implemented. Anonymity is not available when using Directed Orders.

To allow internalization through the Market Center, there is, however, an exception to time priority for Non-Directed Orders. If a Non-Directed Order is not qualified as anti-internalization, or AIQ, the Market Center will internalize the order when the member submitting the order is at the best price under the same MPID as the Non-Directed Order. For example, when a market maker submits an order to sell without the AIQ modifier, the system will determine whether the market maker has a bid that is at the best bid price for the security under the same MPID as the order to sell, and will execute the order to sell against the market maker's bid, even if the market maker is not first at the best price under the same MPID. If the member submitting the order is not at the best price, the order will be executed in time priority at the best price.

When an order is marked with the AIQ qualifier, the Market Center will process the Non-Directed Order in one of two ways, as chosen by the member.[10] In one instance the system will never execute the order against the member that submitted the order ("Y Value AIQ").[11] In the other instance, the system will not deviate from price/time priority (*i.e.*, the internalization processing exception to the execution algorithm will not operate) and the order will execute against the member submitting the order if it is the next party against whom an order should be executed in accordance with price/time priority ("I Value AIQ").[12]

Members also have the choice to trade anonymously in the Market Center. Members can trade on a fully anonymous basis or remain anonymous on a pre-trade basis only. The Market Center provides contra party anonymity through settlement (*i.e.*, full anonymity) by replacing, on certain reports, the MPID of the contra party with the SIZE MPID. For each trade executed in the system, the Market Center produces an execution report that is sent to the parties to the trade and it also creates a report in the Market Center's trade reporting system (formerly know as the Automated Confirmation Transaction Service, or "ACT"). Among other things, these reports contain the MPIDs of the members that executed the trade. When an order is executed on a fully anonymous basis, instead of revealing the members' MPIDs on the reports, the Market Center substitutes the SIZE MPID.[13] Replacing the members' MPIDs with SIZE provides anonymity through settlement.

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[10] The AIQ functionality only prevents an order from executing against the same MPID under which the AIQ order was submitted. As such, if a market maker or ECN uses more than one MPID, it is possible for an order to be internalized by executing against an MPID of the firm that is different from the MPID under which the order was submitted, but there is no exception to time priority across MPIDs of the same member. In other words, the system will not deviate from price/time priority to internalize orders across MPIDs of the same firm.

[11] *See* NASD Rule 4710.

[12] *Id.*

[13] Generally, trades will be processed on a fully anonymous basis if one of the members submits a fully anonymous order. Thus, a member's trade can be processed on a fully anonymous basis even if it did not request anonymity.

For the pre-trade anonymity option, the identities of the members involved in the trade are revealed in the Market Center reports immediately upon execution. However, an order seeking pre-trade anonymity will be processed on a fully anonymous basis when it executes against an order seeking full anonymity. This exception accommodates the desire of a member seeking full anonymity to have its identity masked through settlement.

Request for No-Action Relief

Rule 10b-10 – Identifying Capacity

Paragraph (a)(2) of Rule 10b-10 requires a broker-dealer to disclose on a confirmation to a customer the capacity in which it handled the customer's order (*i.e.*, as agent or principal), and whether the broker-dealer acted as agent for some other person, or as agent for both the customer and some other person (the "Capacity Requirement"). The Capacity Requirement, in conjunction with the other requirements of paragraph (a)(2) of

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There are two routine exceptions to the full anonymity processing, however. The exceptions occur when either one of the following circumstances exist: (1) the member whose quote is hit is a Market Center Order-Delivery ECN that charges a quote access fee, or (2) the order is internalized through the Market Center. In the first situation, a member's identity will be revealed to an Order-Delivery ECN when the order is delivered to the ECN; the member submitting the order will be informed of the ECN's identity upon receipt of the execution and ACT reports. This process allows ECNs to determine whether they will trade with the contra party or reject the trade because of an access fee dispute. In addition, this process helps ECN contra parties to monitor the fees they are accumulating with ECNs.

In the second situation, a member will be informed, either at the time of execution or at the end of the day, that it executed a trade against itself. The time at which the member will be informed varies based on whether the order is executed against the same MPID under which it was submitted or against another MPID of the member. When an order submitted to the Market Center is matched against other trading interest of the member under the same MPID under which the order was submitted, the Market Center will reveal the MPID on the execution and ACT reports immediately upon execution. However, when an order is executed in the Market Center by matching against a different MPID of the firm, Nasdaq will provide the member a list of these trades on a trade-by-trade basis at the end of the day. Nasdaq also is exploring the feasibility of providing members immediate notification of "across MPID executions."

A member's identity also will be disclosed if necessary for regulatory purposes. For example, a member's identity will be revealed to its contra parties if the National Securities Clearing Corporation ("NSCC") has ceased to act for a member involved in the trade or for the clearing firm of the member involved in the trade, and NSCC has decided not to guarantee the trades by the member.

In addition, a member's identity also 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.

Rule 10b-10, is designed to provide customers with information that could alert them to potential conflicts of interest their broker-dealer may have had when handling their orders.

Nasdaq is requesting assurance that the Staff will not recommend enforcement action to the Commission under paragraph (a) of Rule 10b-10 if an NASD member indicates on confirmations to its customers that the member acted as agent on a customer's behalf when the member has acted as agent in submitting a customer's order to the Nasdaq Market Center execution system, and the order is executed in the system by matching against principal trading interest on the opposite side of the market submitted by the same member (using either the same MPID or another MPID of the member), provided that the member complies with all other requirements of Rule 10b-10 in confirming the customer's order, including paragraph (a)(2)(i) thereof.

This request for no-action relief is limited to those circumstances in which the member complies with the No Knowledge and Randomness Requirements, discussed below.

No Knowledge Requirement

This request for no-action relief is limited to those situations in which the party submitting principal orders does not have knowledge about the agency orders submitted by the member, and the party submitting agency orders does not have knowledge about the principal orders submitted by the member. The No Knowledge Requirement is similar to an interpretation in the context of the NASD's rule prohibiting market makers from trading ahead of their customer limit orders.[14] A member will be able to satisfy the No

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[14]   In NASD *Special Notice to Members 95-43* (June 5, 1995) and *Notice to Members 03-74* (Nov. 2003), NASD issued an interpretation of Interpretive Material 2110-2, Trading Ahead of Customer Limit Orders (commonly referred to as the "Manning Rule"), that clarified the extent to which the Manning obligations apply when a market maker has other desks that conduct proprietary trading.

The Manning Rule generally prohibits a market maker from trading for its own account at prices that would satisfy a customer's limit order in NASDAQ securities, unless the market maker immediately thereafter executes the customer limit order. The NASD's interpretation addressed the question of whether proprietary transactions by desks other than the market making desk would "trigger" the Manning obligation and require the firm to fill the customer limit orders held by the market-making desk. Specifically, the 1995 Notice stated that "[a]s long as a firm implements and utilizes an effective system of internal controls, such as appropriate 'Chinese walls,' that operate to prevent the non-market-making desk from obtaining knowledge of customers' limit orders, those other desks may continue to trade at prices the same as or inferior to the customers' limit orders."

The 2003 Notice clarified that the no knowledge interpretation is applicable when a non-market-making desk uses an MPID that is distinct from the MPID of the market making desk.

Knowledge Requirement if it implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent the party submitting principal orders from obtaining knowledge about the agency orders submitted by the member, and the party submitting agency orders from obtaining knowledge about the principal orders submitted by the member. To be effective, such a system of internal controls must include specific policies and procedures that prevent each principal order submitter separated by the information barriers from obtaining knowledge regarding agency orders submitted by the member, and each agency order submitter separated by the information barriers from obtaining knowledge regarding principal orders submitted by the member. In addition, in order to satisfy the No Knowledge Requirement, all agency and principal orders of the member must be submitted on an anonymous basis (either with pre-trade anonymity or full anonymity). However, in order to enable market makers to satisfy their continuous, two-sided quote obligation, a member is not required to meet the anonymity requirement with respect to the principal interest reflected in the member's two-sided quotes in securities in which it is a market maker, provided that the member maintains an effective system of internal controls and submits all agency and all other principal orders on an anonymous basis (either with pre-trade anonymity or full anonymity).

Randomness Requirement

In addition to the No Knowledge Requirement, this request for no-action relief is limited to those situations in which the member does not determine or influence the selection of the trading interest against which the agency order will be executed. The agency order submitters may not use the Nasdaq Market Center functions that allow members to select or influence against whom their orders are executed. This requirement thus eliminates from the request for no-action situations in which a member sends Directed Orders or Preferenced Orders to itself (either to the same MPID or another MPID of the member). In addition, as described above, the Nasdaq Market Center's execution algorithm is designed to deviate from time priority at the best price when it can match a buy order and sell order submitted under the same MPID of a member. Therefore, to qualify for the no-action relief, a member must suppress this feature by utilizing the I Value AIQ.

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Nasdaq believes it is appropriate in the situation described above for a member to indicate it executed a customer's order as agent. By acting as agent in submitting an order to the Nasdaq Market Center and marking the order as agent, the member has evidenced its intent to act in an agency capacity. In addition, the No Knowledge and Randomness Requirements are designed to ensure that this intent to act as agent and indeed the actual handling and execution of the order as agent are not compromised. Given these precautions, if a customer's agency order is executed against the member's principal trading interest, it is not due to any actions by the member to influence who it executes against. To the contrary, the matching of the agency and principal trading

interest occurs at the best price available and the contra party is determined randomly based upon multiple factors not controlled by the member. Further, statistics measuring the degree of order interaction among the participants in the Nasdaq Market Center suggest that the probability of a customer's agency order utilizing the I Value AIQ executing against the member's principal trading interest is low.[15] As a result, a member will not know that it executed the order against itself until after the order is executed and reported to the tape.

Moreover, the proposed no-action relief would not diminish investor protection because it does not relieve a member of its duty of best execution.[16] It should also be noted that the failure by a member to seek the most advantageous terms reasonably available under the circumstance for a customer's order may be a violation of NASD rules.[17] In these circumstances, the conflicts that can arise when an order is handled and executed as principal are not present, and therefore it is not inconsistent with the purposes of the Capacity Requirement to allow members to indicate they executed the customer's order on an agency basis.

In view of the foregoing, Nasdaq respectfully requests assurance that the Staff will not recommend enforcement action to the Commission under paragraph (a) of Rule 10b-10 if an NASD member that executes orders for its customers in the Nasdaq Market Center

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[15] For example, in a recent month, natural internalization in Nasdaq-listed stocks executed in the Nasdaq Market Center execution system (i.e., internalization that results from market participants utilizing the I Value AIQ) amounted to 0.01 percent of the total volume of Nasdaq-listed stocks executed in the system. For Nasdaq's most liquid stocks, natural internalization only amounted to 0.02 percent, and there was no natural internalization in the least liquid stocks. Even if market participants increase utilization of the I Value AIQ as a result of the proposed no-action relief, significantly higher rates of natural internalization are not likely to occur. This is evident from the fact that structured internalization in Nasdaq-listed stocks executed in the Nasdaq Market Center (i.e., internalization that results from market participants not utilizing the AIQ functionality) in a recent month amounted to less than three percent of the total volume of Nasdaq-listed stocks executed in the system, with the highest observed internalization rate being approximately ten percent in any group of fifty stocks ranked by average volume. In addition, when reviewing the trading activity of those participants that do internalize orders through the Market Center execution system (both natural and structured internalization), Nasdaq found that 96.8 percent of their overall volume in the system resulted from other market participants hitting their quotes. For Nasdaq stocks with the fewest number of quoting market participants, 60.7 percent of the internalizing market participants' volume was the result of interaction with other market participants, whereas this number rises to 96.9 percent for stocks with the greatest number of quoting market participants.

[16] See Regulation NMS, Exchange Act Rel. No. 49325 (February 26, 2004), 69 Fed. Reg. 11126, 11137 (March 9, 2004) ("A broker-dealer still must seek the most advantageous terms reasonably available under the circumstances for all customer orders. A broker-dealer must carry out a regular and rigorous review of the quality of market centers to evaluate its best execution policies, including the determination as to which markets it routes customer order flow.").

[17] See NASD Rule 2320.

execution system indicates on a customer confirmation that the member acted as agent when the member has acted as agent in submitting a customer's order to the Nasdaq Market Center, and the order is executed in the Nasdaq Market Center by matching against principal trading interest of the same member (using either the same MPID or another MPID of the member), provided that the member complies with all other requirements of Rule 10b-10 in confirming the customer's order, including paragraph (a)(2)(i) thereof. This request for no-action relief is limited, however, to those order handling and execution scenarios that comply with the No Knowledge and Randomness Requirements, discussed above.

If you have any questions, I can be reached at 301.978.8480, or you can call Peter R. Geraghty, Associate Vice President and Associate General Counsel, at 301.978.8486.

Sincerely,

Edward S. Knight

cc: Brian A. Bussey
        Assistant Chief Counsel

        Matthew A. Daigler
        Staff Attorney