

disciplinary process.⁷ The Commission has previously permitted SROs to agree, with Commission approval, with each other on how to allocate regulatory responsibilities. Rule 17d-2 under the Act permits SROs to establish joint plans for allocating the regulatory responsibilities imposed by the Act with respect to common members.⁸ An SRO participating in a regulatory plan is relieved of regulatory responsibilities with respect to a broker-dealer member of such SRO, if those regulatory responsibilities have been designated to another SRO under the regulatory plan. In addition, the Commission recognizes that an SRO can contract with other SROs, pursuant to a regulatory service agreement, to perform certain of these oversight activities. Nonetheless, an SRO retains ultimate responsibility for its self-regulatory responsibilities, even if it has contracted with another SRO to perform oversight activities.

B. Trading in NASDAQ Listed Securities

On April 14, 2003, Nasdaq submitted the Nasdaq Petition, requesting that the Commission address “unequal and inadequate regulation by some markets that trade securities listed on Nasdaq.”⁹ As discussed in Nasdaq’s Regulation White Paper,¹⁰ Nasdaq believes that as trading in Nasdaq securities spreads to a greater number of venues, it becomes increasingly difficult for the NASD or any other individual SRO to oversee adequately trading in those securities. Moreover, Nasdaq contends that this difficulty is particularly true with respect to broker-dealers that quote on one market while printing trades to another market or those that quote and trade the same security in more than one market. Nasdaq believes that it is often unclear which market is responsible for regulating such broker-dealers’ activities, and that no market is likely to have adequate information to effectively oversee that activity.¹¹

Until recently, most trading in Nasdaq-listed securities was regulated by the NASD. With guidance from the Commission, the NASD developed a regulatory framework to provide investor protection in an open trading environment with multiple market makers. Nasdaq claims that when trading in Nasdaq stocks was almost exclusively limited to the Nasdaq system, NASD was able to view trading in Nasdaq stocks and respond quickly and effectively to protect investors.

According to Nasdaq, the fragmentation of trading of securities listed on Nasdaq by various national and regional exchanges has caused the regulation of Nasdaq trading to become uncoordinated. Nasdaq states that there are harmful disparities in the markets’ abilities to regulate the trading of Nasdaq-listed securities: for instance, Nasdaq states that several exchanges do not have rules approved by the Commission for gathering the detailed trading data necessary for the detection of fraud, manipulation, insider trading, and other violations.

In addition, Nasdaq asserts that some markets are lowering their execution and reporting fees to compete for trades in Nasdaq-listed securities. Nasdaq also states that, to hold down costs, these markets avoid incurring new regulatory expenses, such as the costs of adapting their existing rules and surveillance systems to the unique structure and patterns of Nasdaq trading. According to Nasdaq, these markets use the savings from less regulation as an inducement to attract trading away from the NASD’s highly regulated markets to the detriment of investors.

Nasdaq initially raised many of these concerns in its Regulation White Paper prior to submitting its Petition. In response to the Regulation White Paper, The Cincinnati Stock Exchange, Inc. (“CSE”) asserted that “the current surveillance infrastructure provides an effective means for the ongoing regulation of the markets. This infrastructure, which has been in place for over 20 years, is organized in a manner that fairly distributes responsibilities and costs among the various self-regulatory organizations.”¹² CSE also noted that the Intermarket

Surveillance Group (“ISG”) was established for the purpose of coordinating regulatory efforts to address potential intermarket manipulations and trading abuses. As a result, CSE recommended, in part, that Nasdaq work with the ISG to address its concerns regarding intermarket surveillance methodologies and the allocation of intermarket responsibilities prior to abandoning the existing SRO and ISG infrastructure. In addition, CSE contended that Nasdaq is merely speculating about the adequacy of other markets’ surveillance programs, the adequacy of which is subject to Commission oversight and generally kept confidential between the Commission and the respective regulator. And lastly, CSE noted that if the regulatory concerns raised by Nasdaq exist, they exist for all securities, including exchange-listed securities.

III. Summary of the NASDAQ Petition

To address the regulatory issues identified by Nasdaq, Nasdaq requests that the Commission intercede in three ways. First, Nasdaq requests that the Commission exercise its authority under section 19(c) of the Act¹³ and Rule 192 of the Commission’s Rules of Practice¹⁴ to amend the rules of all markets that trade Nasdaq-listed securities to establish uniform trading rules, and to ensure equal surveillance and enforcement of those rules. Second, Nasdaq requests that the Commission exercise its authority under section 11A(a)(3)(B) of the Act,¹⁵ and Rule 11Aa3-2(b)(2)¹⁶ to immediately order that the exchanges’ costs of regulation—including audit trail collection, surveillance, and enforcement—be aggregated and deducted from the market data revenue collected pursuant to the UTP Plan.¹⁷ Finally, Nasdaq asks the Commission to identify markets that trade Nasdaq-listed securities without approved rules, order audit trails, surveillance, and examination programs that are sufficient to protect investors that buy and sell Nasdaq-listed securities on those markets. For those that do not, Nasdaq requests that the Commission exercise its authority under

⁷ See section 6(b)(6) of the Act, 15 U.S.C. 78f(b)(6); section 6(b)(7) of the Act, 15 U.S.C. 78f(b)(7); section 15A(b)(7), 15 U.S.C. 78o-3(b)(7); and section 15A(b)(8), 15 U.S.C. 78o-3(b)(8). While exchanges are required to enforce compliance by their members, and persons associated with their members, with applicable laws and rules, the Commission has used its authority under sections 17 and 19 of the Act to allocate to particular SROs oversight of broker-dealers that are members of more than one SRO. See 15 U.S.C. 78q and 78s. See also 17 CFR 240.17d-2; 17 CFR 240.19g2-1.

⁸ 17 CFR 240.17d-2.

⁹ See letter to Jonathan G. Katz, Secretary, Commission, from Edward Knight, Executive Vice President and General Counsel, Nasdaq, dated April 11, 2003 at 2 (File No. 4-479).

¹⁰ Nasdaq Regulation White Paper: A Call for a Fairer Allocation of Responsibilities and Costs in a Fragmented Market, dated January 24, 2003 (“Regulation White Paper”).

¹¹ See Regulation White Paper, *supra* note, at 1.

¹² See letter from Jeffrey T. Brown, Senior Vice President, Secretary and General Counsel, CSE, to Chairman Pitt, Commissioner Atkins, Commissioner Campos, Commissioner Glassman, and Commissioner Goldschmid, dated February 19, 2003, at 1 (“CSE Letter”). The CSE also stated that if “weaknesses exist in the system, CSE supports efforts by all markets to work together and improve intermarket coordination of securities regulation to ensure that our markets are fair, orderly and protect investors.” *Id.*

¹³ 15 U.S.C. 78s(c).

¹⁴ 17 CFR 201.192.

¹⁵ 15 U.S.C. 78k-1(a)(3)(B).

¹⁶ 17 CFR 240.11Aa3-2(b)(2).

¹⁷ The UTP Plan is the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis.