

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47949; File No. SR-NASD-2001-75]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc., and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 To Make Permanent a Pilot Amendment to NASD Rule 4120 Relating to Nasdaq's Authority To Initiate and Continue Trading Halts

May 30, 2003.

I. Introduction

On October 18, 2001, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission" or "SEC"), 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 make permanent a pilot amendment to NASD Rule 4120 relating to Nasdaq's authority to initiate and continue trading halts in circumstances where Nasdaq believes that extraordinary market activity in a security listed on Nasdaq is caused by the misuse or malfunction of an electronic quotation, communication, reporting, or execution system. On January 28, 2002, Nasdaq amended the proposal.³ The proposed rule change, as modified by Amendment No. 1, was published for notice and comment in the **Federal Register** on February 5, 2002.⁴

The Commission received one comment letter on the proposed rule change.⁵ On April 14, 2003, Nasdaq

again amended the proposed rule change.⁶ This order approves the proposed rule change as modified by Amendment No. 1, and, simultaneously, the Commission provides notice of filing of Amendment No. 2 and grants accelerated approval of Amendment No. 2.

II. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change and the comment letters, and 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 association⁷ and, in particular, the

within the jurisdiction of other self-regulatory organizations." Amex Letter at 2. The Amex expressed no objection to Nasdaq's proposal if it is applied to situations that involve a Nasdaq system or the system of a broker-dealer or electronic communications network that is a Nasdaq member firm and over which Nasdaq has regulatory authority. *Id.* Nasdaq opposed the proposed rule change to the extent that Nasdaq wants to regulate the systems of UTP exchanges over which Nasdaq has no regulatory authority. *Id.* The Amex further stated that any authority for additional regulation of activity in Nasdaq securities having an inter-market impact should be exercised pursuant to the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis. *Id.*

The Commission notes that Instinet Corporation ("Instinet") filed a comment letter in response to SR-NASD-2001-37, the proposed rule change that established the pilot amendment to NASD Rule 4120. *See* July 27, 2001 letter from Jon Kroeper, First Vice President—Regulatory Policy/Strategy, Instinet, to Jonathan G. Katz, Secretary, Commission. Instinet stated that the proposed rule change (1) failed to properly define "extraordinary market activity;" (2) lacked objective standards for Nasdaq to make a determination to initiate and terminate trading halts; and (3) should be amended to allow NASD Regulation, Inc. to initiate and terminate trading halts based on extraordinary market activity instead of Nasdaq. Because Instinet's comment letter essentially addresses the same issues in the instant filing, the Commission has considered Instinet's letter in approving the instant proposed rule change.

⁶ *See* April 11, 2003 letter from John M. Yetter, Assistant General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, SEC, and attachments ("Amendment No. 2"). In Amendment No. 2, Nasdaq proposes changes to clarify the effect of a trading halt under the rule on exchanges trading Nasdaq securities on an unlisted trading privileges basis, as well as the NASD's Alternative Display Facility. Nasdaq filed Amendment No. 2 in response to concerns the Amex raised, and discussed the proposed rule change with members of the UTP Operating Committee on October 23, 2002. *See* Amendment No. 2 at 4. At that time, Nasdaq asked that members of the UTP Operating Committee inform Nasdaq of objections either to the permanent adoption of the proposed rule as amended, or to the conclusion that a trading halt initiated pursuant to the proposed rule would constitute a regulatory halt under the UTP Plan. At the time Nasdaq filed Amendment No. 2, Nasdaq had received no objections.

⁷ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

requirements of Section 15A of the Act,⁸ which requires, among other things, that a registered national securities association's rules be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and, in general, protect investors and the public interest.

The Commission believes that, in circumstances where the misuse or malfunction of electronic systems that trade Nasdaq-listed securities may impact the price and volume of transactions in such securities, Nasdaq should have the authority to halt trading in an affected security until the problem can be addressed. Such a decision to halt trading requires Nasdaq to make a determination that the action is necessary for the protection of investors and the public interest pursuant to NASD Rule 4120. Nasdaq has stated "the rule would not be invoked merely because a system malfunction rendered a particular venue for transactions in a security temporarily unavailable, nor would it be applied in other circumstances where the system problems of an individual firm or market center did not give rise to extraordinary market activity."⁹ Instead, Nasdaq states the rule is intended to address circumstances where there is "a market-wide regulatory concern that system misuse or malfunction is likely to harm investors by leading them to enter into transactions whose terms are materially influenced by the misuse or malfunction."¹⁰ Nasdaq also states that it will terminate trading halts initiated under the rule "as soon as Nasdaq can conclude that the system misuse or malfunction will no longer have a material effect on the market for the security that is the subject of the halt or that system misuse or malfunction is not the cause of an instance of extraordinary market activity."¹¹ The Commission believes that the proposed rule change is consistent with the Act, and believes that the proposed rule may assist Nasdaq in exercising its responsibility to maintain fair and orderly markets.

The Commission notes that Nasdaq, in Amendment No. 2, indicates that it believes that trading halts instituted by Nasdaq under the proposed rule would constitute "regulatory" trading halts under the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("Reporting Plan"). Under the Reporting

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ *See* January 25, 2002 letter from Mary M. Dunbar, Vice President, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), SEC, and attachments ("Amendment No. 1"). Amendment No. 1 completely replaced and superseded the original proposal.

⁴ *See* Securities Exchange Act Release No. 45355 (January 29, 2002), 67 FR 5351.

⁵ *See* October 2, 2002 letter from Richard T. Chase, Executive Vice President, Member Firm Regulation, The American Stock Exchange LLC ("Amex"), to Jonathan G. Katz, Secretary, SEC ("Amex Letter"). In its comment letter, the Amex expressed its support of Nasdaq's efforts to protect investors and the public interest through the use of trading halts. The Amex further stated that Nasdaq should clarify that Nasdaq's "authority to determine what is and what is not extraordinary market activity is limited to transactions within its jurisdiction and does not extend to transactions

⁸ 15 U.S.C. 78o-3.

⁹ Amendment No. 2 at 2-3.

¹⁰ *Id.* at 3.

¹¹ *Id.*