

to as "market impact." Nasdaq believes post-trade anonymity diminishes market impact, which can help members satisfy their duty of best execution.

Presently, SuperMontage only offers a pre-trade anonymity feature for certain trades, which means market participants do not know the identities of the members entering orders, but their identities are revealed to each other once a trade is executed.<sup>5</sup> The post-trade anonymity feature, or "full anonymity" feature, Nasdaq is proposing would reveal the members' identities to each other on a trade-by-trade basis in two circumstances: (1) if the member whose quote is hit (*i.e.*, the party providing the liquidity in the trade) is an ECN that participates in SuperMontage as an NNMS Order-Delivery ECN that charges an access fee;<sup>6</sup> or (2) the NSCC has ceased to act for the member involved in the trade, or for the clearing firm of the member involved in the trade, and the NSCC has decided not to guarantee the trades by the failed firm.<sup>7</sup> The reasons and process for revealing the members' identities in these circumstances is different and will be discussed in detail later. Nasdaq also proposes to provide members with additional risk management tools to complement the full anonymity feature.

Nasdaq's current pre-trade anonymity feature allows market makers, ECNs and Order Entry Firms to submit anonymous orders to SuperMontage for display under the "SIZE" market participant identifier ("MPID").<sup>8</sup> When a trade is executed with an order that resides under the SIZE MPID, the identity of the member that anonymously submitted the order is revealed immediately to the other member involved in the trade—meaning anonymity is lost.<sup>9</sup>

The new full anonymity feature Nasdaq is proposing builds upon the pre-trade anonymity feature available today using the Non-Attributable Quote/Order feature and extends the anonymity beyond the time of execution by masking the identities of the members executing the trade. As discussed above, currently a member's identity is revealed immediately when a Non-Attributable Quote/Order is executed. SuperMontage produces an execution report that is sent to the parties to the trade and also creates a report in Nasdaq's Automated Confirmation Transaction Service ("ACT"). These reports contain the MPIDs for the members that executed the trade. Under the new proposal, when a member uses the Non-Attributable Quote/Order feature, instead of revealing the members' MPIDs, SuperMontage will substitute a four-letter identifier that indicates the trade is anonymous (*i.e.*, SIZE).<sup>10</sup> Therefore, instead of seeing its contra party's MPID on the reports, the reports will indicate SIZE as the contra party.<sup>11</sup> Replacing the members' MPIDs with SIZE does not alter how information is reported to the consolidated tape or Nasdaq's surveillance systems or the type of information reported to the consolidated tape or Nasdaq's surveillance systems. In addition, clearing firms will continue to receive immediate notification of trades executed by their correspondent firms,<sup>12</sup> and, except as described below, the new anonymity feature does not change how

conversation with Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, and Marc McKayle, Special Counsel, Division, Commission, on June 24, 2003.

<sup>10</sup> With one exception, trades will be processed anonymously if one of the parties submits a Non-Attributable Quote/Order. Thus, a member's trade can be processed anonymously even if it did not request anonymity. As discussed in detail later, the one exception is when the member whose quote is hit is an NNMS Order-Delivery ECN that charges a quote access fee.

<sup>11</sup> Nasdaq will know the identities of the members executing an anonymous trade and will provide a "help desk" that members can call to assist them in resolving disputed anonymous trades. Currently, members would contact each other and directly resolve disputed trades.

<sup>12</sup> When a correspondent firm executes an anonymous order in SuperMontage, its clearing firm will continue to receive a real-time SuperMontage report and ACT report containing all the trade details (*e.g.*, the number of shares and the price of the trade), except the identity of the correspondent's contra party. The details of anonymous trades also will be included in ACT's risk management tools. For example, anonymous trades will be included in the aggregate purchase and sales calculations performed by ACT and will be included in calculations for determining whether a correspondent firm is approaching the trading thresholds defined by the clearing firm.

trades will be processed and settled through the NSCC.<sup>13</sup>

The ACT reports that the NSCC receives from Nasdaq for anonymous trades will contain the identities of the parties to the trade. This measure will enable the NSCC to continue its normal risk management functions and settle anonymous trades just the same as those that are executed without the anonymity feature, with one exception. The ACT report sent to the NSCC will contain an indicator noting that the trade is anonymous. The effect of this indicator is that, on the contract sheets the NSCC issues to its participants, the NSCC will substitute SIZE for the MPID of the contra party, in effect masking from members the identities of their contra parties.<sup>14</sup> The purpose of this masking is to preserve anonymity through settlement. If the NSCC did not mask the contra party identities, the contract sheets would reveal the identities of the parties to the trade and thus eliminate the full anonymity feature. With this minor change, anonymity is preserved through settlement.

Nasdaq also proposes to offer additional risk management tools to members to assist them in monitoring their exposure to members they have traded with on an anonymous basis. Nasdaq has discussed its proposed full anonymity feature with several clearing firms in an attempt to balance members' competing desires to trade anonymously and monitor their exposure to other members. An execution system that reveals a contra party's identity immediately when a trade is executed provides the maximum amount of information for risk management, but, of course, such a system does not provide the degree of anonymity desired to lessen market impact. On the other hand, a system that does not provide any information with respect to the identity of contra parties, which is desirable for minimizing market impact, withholds useful risk management information. Ultimately, the information that provides market intelligence and creates market impact is one and the same as the information used in risk

<sup>13</sup> Nasdaq will not assume any responsibility to settle anonymous trades and the NSCC's settlement guarantee and close-out procedures for failed firms will not be affected by Nasdaq's anonymity proposal. Therefore, as required today by NASD Rules 4712 and 6160, members will be obligated to settle matched trades reported to the NSCC, including trades executed anonymously that have been matched and reported to the NSCC, but not yet guaranteed by the NSCC. Nasdaq will provide members several tools to manage their exposure prior to the NSCC's settlement guarantee attaching. These tools are described in detail later.

<sup>14</sup> The NSCC issues contract sheets throughout the day.

<sup>5</sup> Members seeking pre-trade anonymity submit "Non-Attributable Quotes/Orders" to SuperMontage. The term "Non-Attributable Quote/Order" is defined in Rule 4701(o) as "a bid or offer Quote/Order that is entered by a Nasdaq Quoting Market Participant or NNMS Order Entry Firm and is designated for display (price and size) on an anonymous basis in the Nasdaq Order Display Facility."

<sup>6</sup> The term "NNMS Order-Delivery ECN" is defined in Rule 4701(t)(2).

<sup>7</sup> A member's identity 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. In addition, NASD may reveal a member's identity to other members or others during a regulatory investigation or a routine oversight exam.

<sup>8</sup> Market makers and ECNs may also display Attributable Quotes/Orders under the market participant's MPID. However, Order Entry Firms can only post Non-Attributable Quotes/Orders for display in SuperMontage. See Securities Exchange Act Release No. 47830 (May 12, 2003), 68 FR 27126 (May 19, 2003).

<sup>9</sup> For the purpose of execution reports, Order Entry Firms have distinct MPIDs. Telephone