

(b) No Change.

(c)(1) [(A)] Unless excused by operation of paragraphs [(c)(1)(B)] (c)(2) or (d) below an ITS/CAES Market Maker that makes a bid or offer and in so doing creates a locked or crossed market with an ITS Participant Exchange or another ITS/CAES Market Maker and that receives a complaint through ITS/CAES or CAES from the party whose bid (offer) was locked or crossed (the "aggrieved party"), the ITS/CAES Market Maker responsible for the locking offer (bid) shall, as specified in the complaint, either promptly "ship" (i.e., satisfy through ITS/CAES or CAES the locked bid (offer) up to the size of his locking offer (bid)) or "unlock" (i.e., adjust his locking offer (bid) so as not to cause a locked market). If the complaint specifies "unlock," it may nevertheless ship instead.

[(B)2] If there is an error in a locking bid or offer that relieves the locking ITS/CAES Market Maker from its obligations under paragraph (c)(2) of Rule 11Ac1-1 and if the ITS/CAES Market Maker receives a "ship" complaint through ITS/CAES or CAES from the aggrieved party, the locking ITS/CAES Market Maker shall promptly cause the quotation to be corrected and, except as provided in paragraph (d) below, it shall notify the aggrieved party through ITS/CAES or CAES of the error within two minutes of receipt of the complaint. If the locking ITS/CAES Market Maker fails to so notify the aggrieved party, he shall promptly ship.

[(2) An ITS/CAES Market Maker that makes a bid or offer and in so doing creates a locked or crossed market with another ITS/CAES Market Maker shall promptly send to such other ITS/CAES Market Maker an order seeking either the bid or offer which was locked or crossed, unless excused by operation of paragraph (d) below. Such order shall be for either the number of shares he has bid for (offered) or the number of shares offered (bid for) by the ITS/CAES Market Maker, whichever is less.]

(d) No Change.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in sections A, B,

and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

The Nasdaq InterMarket is a quotation, communication, and execution system that allows NASD members to trade stocks listed on the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex").⁴ The InterMarket competes with regional exchanges like the Chicago Stock Exchange ("CHX") and the Cincinnati Stock Exchange ("CSE") for retail order flow in stocks listed on the NYSE and the Amex. InterMarket comprises CAES, a system that facilitates the execution of trades in listed securities between NASD members that participate in InterMarket, and ITS, a system that permits trades between NASD members and specialists on the floors of national securities exchanges that trade listed securities.

The national market system plan governing the Intermarket Trading System ("ITS Plan") requires national securities exchanges and the NASD to adopt a model rule governing locked and crossed markets in ITS-eligible securities. The current wording of the NASD rule differs slightly from that required by the ITS Plan, in that it treats locks and crosses that occur completely within the Nasdaq InterMarket differently than it treats locks and crosses that occur between InterMarket participants and ITS participant exchanges. Nasdaq believes that this difference increases the regulatory and compliance burdens of NASD members that participate in CAES and in ITS, as well as increasing the regulatory burdens on the NASD itself, without any offsetting benefits to the InterMarket or its members.

NASD Rule 5263 currently requires ITS/CAES Market Makers that create locked or crossed markets with another ITS Participant to comply with the precisely defined procedure expressed in the ITS Plan, which requires that a locking participant respond only after a locked market complaint has been properly registered. In contrast, the rule requires that ITS/CAES Market Makers that lock other ITS/CAES Market Makers within CAES promptly send the locked or crossed Market Maker an order seeking the number of shares of

the locked/crossed bid or offer without waiting for the locked or crossed Market Maker to complain. Nasdaq believes that the more stringent requirement within the InterMarket can cause CAES Market Makers to prematurely send an order to trade without having the input or an understanding of the locked party's intentions to trade. Nasdaq also believes that it forces ITS/CAES Market Makers to be familiar with and engage in two different procedures in response to the same behavior, creating unnecessary confusion and cost.

To eliminate this disparity vis-à-vis other markets, Nasdaq proposes to simply mirror the language of the ITS Plan and to remove the more restrictive language with respect to locks or crosses that occur between ITS/CAES Market Makers. Nasdaq believes that although locking and crossing behavior can provide valuable price discovery information to market participants, regulatory incentives help minimize the extent to which such locks and crosses interfere with the smooth operation of the InterMarket and with ITS/CAES Market Makers' internal systems.

According to Nasdaq, applying the same locked and crossed rule to both ITS and CAES will also improve Nasdaq's ability to effectively enforce Section 8(d) of the ITS Plan. In a June 13, 2003 letter from Lori Richards, Director of the Office of Compliance Inspections and Examinations to Robert Glauber, Chairman and Chief Executive Officer of the NASD, Ms. Richards recommended that the NASD improve its regulatory program for detecting and disciplining InterMarket participants that violate the lock/cross provisions of the ITS Plan and NASD Rule 5263. Nasdaq is working diligently to respond to that recommendation. This proposal is one of several steps the NASD and Nasdaq will take in response to Ms. Richards' recommendation.

2. Statutory Basis

Nasdaq believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A of the Act,⁵ in general and with Section 15A(b)(6) of the Act,⁶ in particular, in that the proposal is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster competition and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and

⁴ Nasdaq's InterMarket formerly was referred to as Nasdaq's Third Market. See Securities Exchange Act Release No. 42907 (June 7, 2000); 65 FR 37445 (June 14, 2000) (SR-NASD-00-32).

⁵ 15 U.S.C. 78o-3.

⁶ 15 U.S.C. 78o-3(6).