

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-45915; File No. SR-NASD-2001-44)

May 10, 2002

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. to Allow Electronic Communications Networks and Alternative Trading Systems to Participate in the Over-the-Counter Bulletin Board

I. Introduction

On July 12, 2001, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to allow electronic communications networks ("ECNs") and alternative trading systems ("ATs") to participate in the Over-the-Counter Bulletin Board ("OTCBB"). On August 28, 2001, the Commission published notice of the proposal in the Federal Register.<sup>3</sup> The Commission received seven comments on the proposal. On January 18, 2002, the NASD submitted Amendment No. 1 to the proposal.<sup>4</sup> This notice and order approves the proposed rule change, solicits comment from interested persons on Amendment No. 1, and approves Amendment No. 1 on an accelerated basis.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 44732 (August 22, 2001), 66 FR 45348.

<sup>4</sup> See Letter from Teri Nelson Jacoby, Office of General Counsel, Nasdaq, to Katherine A. England, Division of Market Regulation ("Division"), Commission, dated January 18, 2002 ("Amendment No. 1"). In Amendment No. 1, the NASD proposed additional rule text to clarify that an ATS or ECN that participates on the OTCBB must reflect non-subscriber access or post-transaction fees in its posted quote on the OTCBB.

## II. Description of the Proposal

The OTCBB is an automated quotation service that displays real-time quotes, last-sale prices, and volume information in over-the-counter ("OTC") equity securities.<sup>5</sup> The OTCBB, which began operating on a pilot basis in June 1990, is designed to facilitate the widespread publication of quotation and last-sale information for OTC equity securities. The Commission permanently approved the OTCBB in 1997.<sup>6</sup>

The OTCBB operates pursuant to NASD Rule 6500 et seq. These rules provide, among other things, that all securities quoted on the OTCBB must be sponsored by an NASD member that is a participating market maker. An OTC equity security not currently quoted on the OTCBB is considered "ineligible" until a market maker registers the security on NASD's Form 211.<sup>7</sup> The market maker also must provide certain additional information about the issuer of the security, for purposes of NASD Rule 6530, on a Form 211 Addendum. Under NASD Rule 6530, the issuer must be current in its

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<sup>5</sup> An OTC equity security generally is an equity security that is not listed or traded on Nasdaq or a national securities exchange. OTCBB securities include national, regional, and foreign equities, warrants, units, American Depositary Receipts, and direct participation programs securities.

<sup>6</sup> See Securities Exchange Act Release No. 38456 (March 31, 1997), 62 FR 16635 (April 7, 1997) (approving SR-NASD-92-7).

<sup>7</sup> In certain limited circumstances, a market maker is permitted to quote a security on the OTCBB by submitting a Rule 15c2-11 Exemption Form and/or a Form 211 Addendum, depending on the particular situation. For example, a market maker could be able to use a Rule 15c2-11 Exemption Form for certain securities that are already quoted on another quotation medium (e.g., the Pink Sheets) or are being delisted from Nasdaq. Telephone conversation between Teri Nelson Jacoby and Jeffrey Davis, Office of General Counsel, Nasdaq; Ken Worm, Market Regulation Department, NASD Regulation, Inc. ("NASDR"); Lisabeth Heese, Nasdaq Transaction Services; and Nancy Sanow and Michael Gaw, Division, Commission, on May 9, 2002 ("May 9 call").

filings with the Commission or other applicable regulatory authority for the security to be eligible for quotation on the OTCBB.

A market maker would submit the Form 211 and the Addendum to the NASDR OTC Compliance Unit. If the NASDR OTC Compliance Unit "clears" the security for quotation, Nasdaq's Market Data Integrity Unit would notify the market maker that it has been registered in the security and that it may enter a quote for that security on the OTCBB. Once cleared, the security would have "eligible" status. During the eligible period, Nasdaq administers a frequency-of-quotation test. The test must be satisfied before the security is identified as "active." To become active, the security must have been quoted on the OTCBB on at least 12 business days during the preceding 30 calendar days, with no more than four consecutive business days without quotations.<sup>8</sup> If the security is active, a market maker need not submit a Form 211 before quoting the security. However, a market maker must register with Nasdaq when it enters a quotation on the OTCBB for the first time; this registration may be completed on-line.

Proposed NASD Rule 6540(b) would permit an ATS or ECN to participate in the OTCBB in the same way that a market maker currently participates. If the security were not "active," the ATS or ECN would be required to provide the same information required by the Form 211 Addendum.<sup>9</sup> The first time that an ATS or ECN posted a quotation in an active security, it would be required to register on-line in the same manner as a market maker.

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<sup>8</sup> See NASD Rule 6540(b); 17 CFR 240.15c2-11(f)(3)(i).

<sup>9</sup> Nasdaq anticipates that ATSs and ECNs generally would submit quotations for those securities that do not require the filing of a Form 211 (i.e., "active" securities). See May 9 call.

In addition, ATSS and ECNs that wish to participate in the OTCBB would be required to comply with all other OTCBB rules applicable to market makers. For example, the OTCBB system does not permit a market maker to post a firm quote for less than the minimum size required by NASD Rule 6750.<sup>10</sup> Thus, an ATS or ECN would not be able to post in the OTCBB montage an order on behalf of a user for less than the minimum size required by NASD Rule 6750.<sup>11</sup>

### III. Comments Received, NASD Response, and Amendment No. 1

The Commission received seven comments from six commenters in response to the proposal.<sup>12</sup> Three commenters supported the proposal without qualification.<sup>13</sup> The fourth commenter, Knight, was generally supportive but raised concerns that the proposal did not set forth with sufficient particularity the requirements that would be imposed on ATSS and ECNs electing to participate in the OTCBB.<sup>14</sup> Knight was "particularly concerned with Nasdaq's failure to state unequivocally that ATSS participating in the

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<sup>10</sup> Telephone conversation between Teri Nelson Jacoby, Office of General Counsel, Nasdaq; Lisabeth Heese, Nasdaq Transaction Services; and Michael Gaw, Division, Commission, on April 23, 2002.

<sup>11</sup> See id.

<sup>12</sup> See e-mail from Malcolm Steed to rule-comments@sec.gov, dated September 9, 2001 ("Steed"); letter from K. Richard B. Niehoff to Margaret McFarland, Deputy Secretary, Commission, dated September 17, 2001 ("Niehoff"); letter from Kenneth Veneziano, Executive Vice President and General Counsel, GlobeNet Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 18, 2001; letter from Richard B. Levin, Assistant General Counsel and Regulatory Affairs Officer, Knight Securities, L.P., dated September 19, 2001 ("Knight"); e-mail from Gary Swancey to rule-comments@sec.gov, dated September 25, 2001 ("Swancey"); letter from Chris Concannon, Vice President, The Island ECN, Inc., dated September 26, 2001 ("Island"); letter from Kenneth Veneziano, Executive Vice President and General Counsel, GlobeNet Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated October 9, 2001 ("GlobeNet II").

<sup>13</sup> See Island; Steed; Swancey.

<sup>14</sup> See Knight.

OTCBB shall not be permitted to levy post transaction fees against non-subscribers." Knight further stated that ATSS and ECNs should be prohibited from levying fees on non-subscribers or be required to include non-subscriber fees in their quotes on the OTCBB. Furthermore, Knight believed that ATSS and ECNs that participate in the OTCBB should be required to comply with all rules applicable to other market maker participants, including, but not limited, to Rule 15c2-11.

The fifth commenter – GlobeNet, an ATS that currently operates a matching system for orders in OTCBB securities and that seeks to participate in the OTCBB – also advocated approval of the proposal. In GlobeNet's view, consolidating the quotes of market makers and ATSS on the OTCBB would facilitate the search by broker-dealers for the best price for their customers' orders. GlobeNet also stated that Nasdaq's proposal would enhance fair competition by allowing ATSS and market makers to compete on equal terms and would encourage dealers in OTCBB securities to compete with ATSS on price. GlobeNet cautioned, however, that it did not believe that the proposal was the ideal means to allow ATS and ECN participation on the OTCBB. GlobeNet noted that the NASD's proposal was structured to treat an ATS as a market maker, even though an ATS operates in a very different manner than a market maker.

In its second comment letter that responded to the views and concerns raised by other commenters, GlobeNet argued that its business model should not be undercut by precluding its ability to charge transaction fees. GlobeNet stated, nevertheless, that "the ability of GlobeNet to participate in the OTCBB is of such paramount importance to our ability to compete on a level playing field with market makers in the OTCBB that we reluctantly would acquiesce for the time being to a Nasdaq decision to reflect our

transaction fees in the GlobeNet quote on the OTCBB."<sup>15</sup> GlobeNet added that, when the Commission reaches a resolution on access fees in the Nasdaq market, it should apply the same approach to the OTCBB market.

The sixth commenter, Niehoff, was the only commenter who strongly opposed the NASD's proposal. Niehoff characterized the proposal as "clearly anti-competitive" and "a thinly disguised effort by Nasdaq to dictate the terms and conditions under which trading in OTCBB securities takes place."<sup>16</sup> Niehoff recommended that the Commission explore several issues – including whether an ATS or ECN desiring to participate in the OTCBB should be required to be an NASD member, to file Form 211, and to incur participation costs – and republish the proposal for additional comment.

On November 27, 2001, Nasdaq submitted a response to the comments noted above.<sup>17</sup> With respect to the application of Rule 15c2-11 to ATSS and ECNs, Nasdaq stated that it would apply NASD Rule 6740, Submission of Rule 15c2-11 Information on Non-Nasdaq Securities, to ATSS and ECNs in the same manner as it applies to market makers. Nasdaq noted, however, that the Commission has issued an exemption that permits broker-dealers to publish or submit quotations in quotation mediums – including quotation mediums that are not inter-dealer quotation systems – when they satisfy the requirements set forth in the exemption letter.<sup>18</sup> Nasdaq stated that it would adjust its

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<sup>15</sup> GlobeNet II.

<sup>16</sup> Niehoff.

<sup>17</sup> See letter from Mary M. Dunbar, Vice President, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated November 13, 2001.

<sup>18</sup> See letter from Larry E. Bergmann, Division, Commission, to Howard Kramer, Schiff Hardin & Waite, dated October 6, 2000.

administration of Rule 15c2-11 to be consistent with the Commission's interpretation of that rule, including with respect to GlobeNet and other similarly situated parties.

With respect to the comment submitted by Niehoff, Nasdaq stated that Niehoff did not offer specific reasons why he believes the proposal to be anti-competitive. Nasdaq believes, to the contrary, that the proposal is pro-competitive because it would broaden participation on the OTCBB while treating all participants equally. Also, Nasdaq believes that all ATSS and ECNs that seek to participate in the OTCBB must be NASD members; otherwise, the NASD would not have jurisdiction to regulate and oversee all participants. Nasdaq further stated that ATSS and ECNs would participate by posting quotes on the OTCBB through a Nasdaq Workstation II or an application program interface, as market makers currently do. According to Nasdaq, the costs to ATSS and ECNs of participation in the OTCBB would be the same as for market makers.

To address the issue of ATS and ECN fees, the NASD filed Amendment No. 1 to the proposal. As stated in Amendment No. 1, Nasdaq believes that, because market makers that enter quotes in the OTCBB are not permitted to charge access or post-transaction fees over and above their posted quotes, a participating ATS or ECN should be similarly prohibited from charging such fees, unless such fees were incorporated in its posted quote. Nasdaq indicated that the terms "access fee" and "post-transaction fee" both refer to fees charged by an ATS or ECN to participants with whom the ATS or ECN does not have a subscriber agreement. Typically, the fees are assessed on a per-share basis each time the non-subscriber accesses the posted quote of the ATS or ECN.

Nasdaq proposed to add new paragraph (c) to NASD Rule 6540 to reflect the foregoing. Paragraph (c) of the original proposal would become paragraph (d).

Paragraph (b) is unchanged from the original proposal. NASD Rule 6540 would therefore read as follows. New text is italicized:

**6540. Requirements Applicable to Market Makers**

- (a) No change.
- (b) An alternative trading system (ATS), as defined in Regulation ATS, Rule 300(a), or electronic communications network (ECN) as defined in SEC Rule 11Ac1-1(a)(8), shall be eligible to participate in the Service, provided however, that such ATS or ECN is an NASD member and otherwise meets the requirements for participation set forth in the OTC Bulletin Board Rules. Where used in the OTC Bulletin Board Rules, the term "market maker" shall be construed to include a participating ATS or ECN.
- (c) A participating ATS or ECN shall reflect non-subscriber access or post-transaction fees in the ATS's or ECN's posted quote in the OTC Bulletin Board montage.
- (d) No change.

IV. Discussion

A. The Proposal as Amended

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the regulations thereunder applicable to the NASD.<sup>19</sup> In particular, the Commission believes that the proposal is consistent with

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<sup>19</sup> In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

Section 15A(b)(6) of the Act.<sup>20</sup> Section 15A(b)(6) requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

The Commission finds that participation by ATSS and ECNs in the OTCBB will enhance competition in the marketplace for OTC equity securities. In the Commission's view, the proposal will foster competition because a greater number of market participants will be able to display their quotations on the OTCBB. Moreover, quotations for OTCBB securities will now be capable of being displayed in a single system, so that broker-dealers that execute orders in such securities can more readily ascertain the best prices.

As proposed in Amendment No. 1, an ATS or ECN that posts a quote for a security on the OTCBB may charge a fee to a non-subscriber for executing against that quote, provided that the fee is reflected in the quote. The Commission finds that Nasdaq's approach to ATS and ECN fees with respect to OTCBB participation is consistent with the Act.<sup>21</sup>

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<sup>20</sup> 15 U.S.C. 78o-3(b)(6).

<sup>21</sup> The Commission notes that, while Nasdaq for the sake of convenience uses the definition of "electronic communication network" set forth in Rule 11Ac1-1(a)(8), 17 CFR 240.11Ac1-1(a)(8), an ECN that participates in the OTCBB must independently satisfy the Commission's requirements in order to be considered an ECN for purposes of the Commission's Order Handling Rules.

In addition, the Commission expects that the NASD will address how transactions on the OTCBB that result from the posted quote of an ATS or ECN will be reported, cleared, and confirmed in light of the fact that such quote must include non-subscriber access or post-transaction fees, if any.

The Commission also believes that it is reasonable for the NASD to require ATSS and ECNs that wish to post quotes on the OTCBB to comply with the same obligations as a market maker. A broker-dealer is subject to Rule 15c2-11 whenever it places a quotation<sup>22</sup> in any quotation medium – including an ATS or ECN – unless it can rely on one of the exceptions set forth in Rule 15c2-11 or an exemption granted by the Commission.<sup>23</sup> The Commission has previously stated that Rule 15c2-11 would apply to an ATS or ECN if, as a registered broker-dealer, it displayed its own orders in the ATS or ECN.<sup>24</sup> However, if the ATS or ECN displayed the order of another broker-dealer, the requirements of Rule 15c2-11 would apply only to that broker-dealer and not to the ATS or ECN that functions as the quotation medium for such order.<sup>25</sup> Therefore, in a case in which an "ineligible" security is being quoted for the first time on the OTCBB through an ATS or ECN, the broker-dealer submitting the quote to the ATS or ECN would be required to submit a Form 211, rather than the ATS or ECN itself.

The Commission does not believe that the commenters raised any issue that would preclude approval of the proposed rule change. In particular, the Commission disagrees with one commenter's view that "the Commission should republish the proposal with a thorough analysis of the issues raised and seek further public comment."<sup>26</sup> The

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<sup>22</sup> "Quotation," as defined in Rule 15c2-11, means any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that he wishes to advertise his general interest in buying or selling a particular security. See 17 CFR 240.15c2-11(e)(3).

<sup>23</sup> See Securities Exchange Act Release No. 41110 (February 25, 1999), 64 FR 11124, 11135 (March 8, 1999) (reproposing amendments to Rule 15c2-11).

<sup>24</sup> See id.

<sup>25</sup> See id.

<sup>26</sup> Niehoff.

Commission believes that the issues raised by this commenter have been sufficiently addressed by Nasdaq, and that expanding the OTCBB to allow ATS and ECN participation has the potential to increase competition.

B. Accelerated Approval of Amendment No. 1

The Commission finds good cause for approving Amendment No. 1 to the proposal prior to the thirtieth day after the date of public notice in the Federal Register, pursuant to Section 19(b)(2) of the Act.<sup>27</sup> Amendment No. 1 clarified the obligations that would be imposed on ATSs and ECNs by the new provisions of NASD Rule 6540. One of these obligations is that an ATS or ECN participating in the OTCBB must reflect non-subscriber access or post-transaction fees in a quote that it posts in the OTCBB montage. The Commission understands that, presently, only one ATS – GlobeNet – has clearly expressed its intent to participate in the OTCBB, and GlobeNet in its second comment letter stated that it "would acquiesce for the time being to a Nasdaq decision to reflect [its] transaction fees in the GlobeNet quote on the OTCBB." GlobeNet also argued that the Commission should approve the proposed rule change "as quickly as possible."<sup>28</sup> Therefore, the Commission does not believe that an additional comment period for Amendment No. 1 is necessary, and that the proposed rule change, as amended, should be approved at this time.

VI. Solicitation of Comments on Amended Proposal

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the

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<sup>27</sup> 15 U.S.C. 78s(b)(2).

<sup>28</sup> GlobeNet II.

Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2001-44 and should be submitted by [insert date 21 days from the date of publication].

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>29</sup> that the proposed rule change (SR-NASD-2001-44) is approved and that Amendment No. 1 thereto is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>30</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>29</sup> Id.

<sup>30</sup> 17 CFR 200.30-3(a)(12).