June 20, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: SEC Release No. 34-47849 (File No. S7-11-03)

Dear Mr. Katz:

National Association of Securities Dealers, Inc. ("NASD") appreciates the opportunity to respond to the Securities and Exchange Commission's ("SEC" or "Commission") Concept Release requesting comment on The Nasdaq Stock Market, Inc.'s ("Nasdaq") petition relating to the regulation of Nasdaq-listed securities ("Concept Release").[1] Specifically, Nasdaq has petitioned the SEC to use its authority to amend the rules of all markets that trade Nasdaq-listed securities to establish uniform trading rules and ensure equal surveillance and enforcement of those rules; order that the exchanges' costs of regulation, including costs associated with proper data collection, surveillance and enforcement, be aggregated and deducted from the market data revenue collected pursuant to the Nasdaq Unlisted Trading Privileges plan ("UTP Plan");[2] and prohibit the

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1 NASD, the world's largest securities self-regulatory organization ("SRO"), was established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934 ("Exchange Act"). Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD also is the parent organization of Nasdaq and the American Stock Exchange, LLC ("Amex"). Amex is registered as a national securities exchange and also is a SRO. NASD is the SRO for Nasdaq and in this capacity, monitors all the trading on Nasdaq. NASD also operates the Alternative Display Facility ("ADF"), which is a securities quotation, collection, trade reporting and comparison facility. The opinions provided in this letter only reflect the views of NASD staff. It has not been reviewed or endorsed by Amex or Nasdaq.

2 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. Currently, UTP Plan participants are NASD, Amex, the Boston Stock Exchange, Inc. ("BSE"), the Chicago Stock Exchange, Inc. ("CHX"), the Cincinnati Stock Exchange, Inc. ("CSE"), the Pacific Exchange, Inc. ("PCX"), and the Philadelphia Stock Exchange, Inc. ("PHLX").

launch or continuation of trading in Nasdaq issues by any market that fails to protect investors as required under the Exchange Act.

NASD believes that the significant changes in the trading of Nasdaq-listed securities support a reexamination of the current regulatory structure. In this regard, NASD welcomes the SEC's focus on these and other issues relating to market structure. NASD also agrees with many of the underlying assertions in Nasdaq's petition relating to the negative impact on regulation resulting from the fragmentation of trading in Nasdaq-listed securities, although it takes no view on the competitive aspects of these market developments.

Our primary objective in responding to the Concept Release is to emphasize the need to address the regulatory gaps that exist as a result of disparities between markets that trade Nasdaq-listed securities, such as inconsistent rules and regulatory data collection requirements, and resulting surveillance activities. We believe that these disparities, as well as jurisdictional issues relating to SRO oversight responsibilities, limit the effectiveness of the current state of coordinated regulation and that regulatory gaps will continue to exist unless there is enhanced cooperative regulation across markets, including the collection of a market-wide comprehensive order and transaction audit trail. In this regard, we have provided both our general views of the issues raised in the Concept Release, as well as specific responses to many of the questions posed in the Release.

I. Introduction –Transition from Consolidated to Fragmented Market

As noted in the Concept Release, over the past several years, both the display of quotations and the reporting of trades in Nasdaq securities have become increasingly dispersed across multiple markets. Not only can the quoting and trading of Nasdaq securities occur in multiple venues, broker/dealers generally can quote the same security in one or more markets, while trade reporting to others. The fragmentation in the trading of Nasdaq-listed securities has been driven somewhat by competition between market centers to capture trading volume, which, from the perspective of market participants, has had a positive impact on efficiencies within markets and costs.

Fragmentation has had a negative impact on NASD's ability to conduct regulation of quoting and trading activities in Nasdaq-listed securities. When the vast majority of trading in Nasdaq-listed securities occurred on or through Nasdaq, NASD had direct and automated access to regulatory data representing substantially all of the marketplace. With trading now occurring on multiple markets, no single SRO is able to capture a complete picture of all the trading in Nasdaq-listed securities,[3] and, under certain circumstances, even all the trading by one broker/dealer. This fragmentation of data has

[3] NASD recognizes that, although fragmentation is a fairly recent development in the trading in Nasdaq-listed securities, it has existed for some time in the trading of NYSE-listed securities.

degraded regulation from both the perspective of NASD's obligations to regulate Nasdaq-specific activity, as well as the overall regulation of trading in Nasdaq securities by all markets.

With respect to NASD's regulatory responsibilities, the ability to allocate quotes and trades to various markets results in gaps in the regulatory data provided to NASD and the surveillance of that trading activity. As a result, certain unlawful trading activity may go undetected, while the number of "false positive" alerts increases because mitigating activity may have occurred on another market. This affects the overall integrity and effectiveness of NASD's regulatory program.

With respect to regulation of activities across all markets that quote and trade Nasdaq-listed securities, the ability to allocate quotes and trades to various markets that have differing rules, regulatory data submission requirements, and surveillance systems results in regulatory data and surveillance gaps, providing firms the ability to engage in regulatory arbitrage and purposefully implement certain quoting and trading strategies to have misconduct remain undetected. It also raises important jurisdictional issues regarding which regulatory body should be responsible for activities conducted on or through each market, including the collection and maintenance of order audit trail data. These problems can be compounded by reductions in fees and revenue sharing with participants, potentially at the expense of regulation.

II. Data Submission and Other Disparities Between Markets

Each market eligible to quote and trade Nasdaq securities promulgates, with SEC approval, its own rules relating to the quoting and trading of Nasdaq securities.[4] As such, for a variety of reasons, many rules and interpretations are not consistent across markets. These differences can provide incentives for market participants to quote or trade report to a particular venue that may have fewer regulatory "hurdles" and can undermine the effectiveness of coordinated regulation. It also can result in potential operational and compliance difficulties for broker/dealers that must ensure compliance with varying rules depending on the particular market center. Provided below are examples of rules that vary across markets, including regulatory data submissions requirements and restrictions on short sales.

Regulatory Data Submission Requirements

To ensure NASD maintains a comprehensive order and transaction audit trail for surveillance and oversight purposes, NASD imposes specific data submission requirements on its members with respect to order and transaction reporting. Through the

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4 The UTP Plan obligates each Plan participant to enforce compliance by its members with certain requirements, such as restrictions on autoquoting, intermarket transaction reporting and regulatory halts.

combination of data received from NASD's Order Audit Trail System ("OATS"), Nasdaq's Automated Confirmation Transaction ("ACT") system, ADF's Transaction Reporting and Comparison System ("TRACS") and Nasdaq order delivery and execution systems, NASD is able to compile an audit trail that tracks the lifecycle of an order that is executed on Nasdaq or the ADF from the time of receipt by the firm to the time it is reported to the tape. Although these data submission requirements may be more comprehensive (and expensive) than that required by other markets, NASD believes this information is critical to the effectiveness of its regulatory program, in particular, the regulatory and surveillance systems that use this data to conduct automated surveillance of trading in the Nasdaq market.

OATS. NASD's OATS rules (NASD Rules 6950 through 6957) require that NASD members record and report any oral, written or electronic instruction to effect a transaction in a Nasdaq security received by a member or originated by a department of a member for execution by the same or another member, except those proprietary orders originated by the trading desk in the ordinary course of market making.[5] Detailed information is submitted to NASD with respect to each of these orders, including, among other things, the time of receipt of the order by the member, whether the order was received from a customer or another broker/dealer, the account type code, limit order display indicator, sixteen special handling codes and an order identifier used to link the order to subsequent order events and/or ACT or TRACS trade reports.[6] In addition, NASD OATS rules require that all reported times be captured by computer system clocks and/or mechanical time-stamping devices that are synchronized to within three seconds of the National Institute of Standards and Technology (NIST) standard.

To ensure the integrity of the data submitted, over 110 separate OATS data validations are performed, which can result in OATS data submissions being rejected and generating an error message. Members are required by rule to repair and resubmit rejected OATS data. NASD also has dedicated a staff of six employees to OATS compliance to ensure the accuracy, completeness and timeliness of the OATS data. Since 2001, NASD has initiated approximately 190 formal and informal disciplinary actions for non-compliance with the OATS rules.

Transaction Reporting Requirements. Nasdaq and ADF trade reporting rules require that detailed transaction-related information be reported to NASD as part of the

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5 See Exchange Act Release No. 39729 (March 6, 1998). The final phase of OATS, Phase III, which applies the OATS requirements to manual orders, has been delayed pending SEC approval of a rule proposal (SR-NASD-00-23) that would change certain OATS requirements relating to Phase III.

6 Detailed information relating to subsequent events associated with the order, such as cancel/replaces, routes to another broker/dealer or exchange, or the execution of the order, also must be recorded and reported to OATS. For most executions on Nasdaq or ADF, NASD matches an OATS Execution Report with its corresponding ACT or TRACS trade report, as applicable, to obtain additional information about the execution, including price and capacity information, as well as to complete the lifecycle of the order by linking it to its media report.

trade report. NASD rules specify what information must be inputted when reporting a trade. In addition to quantity, price and report time, required information includes, among other things, execution time for any OATS reportable transaction or any transaction not reported within 90 seconds of execution, a symbol indicating whether the transaction is a buy, sell, sell short, sell short exempt or cross, a symbol indicating whether the trade is reported as principal, riskless principal or agent, the reporting and contra side clearing and executing brokers, indicators for late trade reports or executions, and OATS order identifying information. NASD Market Regulation staff ensures the integrity of trade reporting data through several automated and off-line compliance reviews.

NASD is not aware of any other market that currently trades Nasdaq-listed securities that has an order audit trail comparable to NASD's OATS.[7] Similarly, other markets may not impose comparable data requirements for trade report submissions. The collection by other markets of less comprehensive order and transaction data can contribute to the potential for regulatory gaps between markets and may provide incentives for market participants to conduct their activities where less regulatory data is required to be submitted. Moreover, NASD believes that the Commission should not strive merely for comparability on the issue of data submission, but uniformity. NASD believes that while competition benefits most areas in terms of attracting liquidity, the level and detail of regulatory data, which serves as the backbone of any self-regulatory program, is not one of those areas.

Short Sale Rule

NASD Rule 3350 (the "Short Sale Rule"), which applies to trades in Nasdaq National Market (NNM) securities reported to Nasdaq and ADF, requires that no member effect a short sale for the account of a customer or for its own account at or below the current best inside bid when the current best inside bid is below the preceding best inside bid. Similar to SEC Rule 10a-1, the Short Sale Rule, among other things, is designed to prevent fraudulent and manipulative acts, further the orderly operation of securities markets and reduce the potential for short-term volatility and inaccurate pricing often associated with short selling.

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7 On January 24, 2003, Nasdaq submitted to the Commission a white paper relating to the allocation of regulatory responsibilities and costs in a fragmented market ("Nasdaq white paper"). In its white paper, Nasdaq discusses NASD's regulatory process, including the primary regulatory systems and reviews implemented by NASD. Nasdaq noted that it did not appear that any other market currently executing trades in Nasdaq-listed securities had an SEC-approved order audit trail. The CSE responded to Nasdaq's white paper in a letter to SEC Commissioners dated February 19, 2003 ("CSE Response Letter"). Among other issues raised in the letter, the CSE responded that the CSE did have an SEC-approved order audit trail, its Firm Order Submission ("FOS") system, which it claims predates and contains more information than NASD's OATS. NASD strongly believes the CSE's assertion that FOS contains more information than NASD's OATS is incorrect and that NASD's OATS captures more data for a larger universe of orders than CSE's FOS.

Other markets that trade Nasdaq-listed securities do not impose similar restrictions on short sales executed in their markets. As such, market participants have advised NASD staff that they are contemplating sending order flow, possibly just short sale orders, to other markets based solely on the fact that they would not need to comply with the Short Sale Rule for those orders. Moreover, they question whether they are obligated pursuant to their best execution requirements to send short sales to these other markets to ensure a timely execution.

III. Disparities in Regulatory Oversight and Surveillance

Different levels of regulatory surveillance and enforcement between markets not only result in regulatory gaps and inefficiencies, but can create incentives for market participants to quote or trade in one venue over another. As a general matter, individual SROs are not in a position to evaluate the overall integrity and effectiveness of regulatory programs of other SROs. In this regard, NASD assiduously has avoided making such an assessment through the statements made herein. Rather, as the SEC considers whether the current state of coordinated regulation is the appropriate regulatory structure in a fragmented market, NASD believes it is important to provide some background on its regulatory and surveillance program and the factors that it believes contribute most to the effectiveness of its regulatory program.

Through significant investments in staffing and technology, NASD's Market Regulation Department has developed and implemented automated surveillance and detection systems and has established a comprehensive off-line investigative and examination program. NASD Market Regulation has a staff of 150 dedicated to analyzing and investigating trading activity on Nasdaq for potential misconduct. In 2002, the Department initiated approximately 250 formal disciplinary actions for trading-related conduct.

With respect to automated surveillance, NASD has developed several system applications that process and integrate order, quotation, trade report data, Nasdaq system data and other external sources of information for regulatory surveillance and oversight purposes. In the 1st quarter of 2003, for example, our systems processed approximately 6.2 billion orders, quotes, and trades in performing this analysis. These key regulatory systems include:[8] Advanced Detection System ("ADS"),[9] Securities Observation, News

[8] The Nasdaq white paper discussed NASD's regulatory process, including the primary regulatory systems and reviews implemented by NASD. The CSE Response Letter stated that Nasdaq speculates as to the adequacy of other markets' surveillance programs when it has no actual knowledge of those programs. The CSE notes that this is because it is a matter of Commission policy that surveillance programs and procedures be kept confidential between the Commission and the regulator. While we agree that certain surveillance procedures, such as specific break detection algorithms and thresholds, should not be made public, we disagree that the general scope and breadth of a regulatory program should remain confidential. In fact, given the comprehensiveness of NASD's regulatory programs, we

Analysis and Regulation ("SONAR") system,[10] View for Internal Surveillance and Trading Analysis ("VISTA"),[11] Enhanced Audit Trail ("EAT"),[12] Statistical Analysis Software ("SAS"),[13] and Quality of Market Report Cards ("QMRC").[14]

NASD uses its automated systems to review, analyze and detect a large number of potential violations. For example, with respect to order handling activities, NASD systems analyze member activities for potential violations such as trading outside the inside, untimely executions of market orders and limit order display. With respect to quoting activities by members, NASD systems analyze member activities for compliance with, among other things, the firm quote rule, "trade or move" requirements, locked/crossed markets, ECN display activities and autoqutoing restrictions. With respect to reviews for manipulative activities, NASD systems conduct automated reviews for patterns relating to marking-the-open and marking-the-close, both trade based and quote based, and other patterns of potential market manipulation associated with various trading systems such as ECNs and Alternative Trading Systems. With respect to insider trading and other fraudulent activities, NASD systems analyze trading activity, news stories and issuer filings and generate alerts on a daily basis.

NASD Market Regulation staff also conducts extensive, in-depth non-automated reviews and on-site examinations in a variety of areas including issuer, broker/dealer and customer complaints, books and records and supervision. NASD also implemented the Trading and Market Making Surveillance ("TMMS") program in late 1995, which conducts in-depth, on-site reviews of member firms for compliance with trading-related requirements including, but not limited to:

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believe this information is useful in evaluating the overall regulatory oversight of trading in Nasdaq-listed securities.

9 ADS compiles detailed trade and quote data, inside quotes and order information and integrates the information for use in automated and manual surveillance. ADS is used in several areas within Market Regulation including Trading Practices, Trade Reporting, Firm Quote Compliance, Trading Analysis, Short Sales, Market Integrity, Best Execution and Order Handling.

10 SONAR analyzes trading activity, news stories and issuer filings for Nasdaq securities for potential insider trading, fraudulent or manipulative activity and unusual trading activity surrounding the publication of research reports.

11 VISTA collects trades, quotes, dividend information, market maker registrations and Nasdaq system order activity. Market Regulation staff uses VISTA information to identify potential violative activities, as well as determining whether breaks or other suspicious trading activity merit further review.

12 EAT integrates ADS data and provides NASD Market Regulation staff the ability to obtain ADS data upon request and view the integrated quote, order and transaction data to recreate and analyze market activities.

13 SAS is used to conduct analysis and sweeps on an as needed basis.

14 QMRC review and analyze member compliance in areas such as trade reporting, best execution, firm quote and short sales.

- Order handling obligations (including limit order protection and display);
- Best execution obligations (including price and time for limit and market orders);
- Disclosure of order execution and order routing information;
- Recordkeeping obligations for short sales;
- OATS reporting and general record keeping obligations; and
- Supervisory obligations related to trading and market making activities.

Much of the surveillance described above relies upon the detail, accuracy and timeliness of the underlying data. For transactions executed on Nasdaq or ADF, the systems above receive transaction and quotation data on a real-time or T+1 basis. For quoting and trading activities occurring on other markets, NASD generally uses information obtained from the InterMarket Surveillance Group ("ISG") Audit Trail for surveillance purposes.

The information available from the ISG Audit Trail is less detailed than that obtained for Nasdaq and ADF transactions and lacks a number of key pieces of information. For example, the ISG Audit Trail identifies trades at the clearing firm level, not at the executing firm level. The ISG Audit Trail also does not provide information on whether the trade was a short sale, the capacity in which it was reported, and generally does not provide the actual execution time. Only media reported trades are provided on the ISG Audit Trail, such that NASD would not have access to clearing only reports to other exchanges, which are used frequently by ECNs to maintain anonymity. Further, the time entries made in the ISG Audit Trail are not required to be captured pursuant to a synchronized clock, as are NASD OATS and transaction information. In addition, the ISG Audit Trail data is not received until T+4 and manual processing of the data typically is necessary to obtain all the relevant information needed about a trade.[15]

The ISG Audit Trail only provides information relating to reported trades and does not provide any specific order information, such as the type of order, when and where the order originated or if it was routed. Moreover, because NASD's access to trade information for an order executed on another market generally is limited to the ISG Audit Trail, which does not capture the executing broker or any OATS order identifier information, NASD is not able to link systematically transaction information with the OATS routing or execution information it currently receives for trades executed in Nasdaq-listed securities on other markets.[16]

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15 The ISG Audit Trail works effectively, given its intent and design. It was not created to support real-time surveillance or to effectively consolidate data for automated detection purposes. It is a tool to facilitate coordinated investigations, as ISG is an organization created to ensure coordination, once investigations have begun.

16 The specific OATS requirements with respect to orders that are executed on an exchange vary depending on whether the order is routed to the exchange for handling and execution or if the order is executed by the member and only trade reported to the exchange. Under the first scenario, the member would provide OATS information relating to the new order and the route of the order to a non-member

Further, although, as noted above, NASD does obtain certain OATS data relating to executions on other exchanges, which can assist NASD staff in its review of certain conduct by its members, the receipt and analysis of such information raises important jurisdictional and cost issues relating to whether NASD should be capturing this data and whether it should be responsible for the conduct associated with this activity under the current structure of coordinated regulation.

IV. Ability to Regulate – Flaws in the Current Coordination Model

The current model of coordinated regulation can result in regulatory gaps and inefficiencies such that potential misconduct occurring across markets may go undetected. Further, jurisdictional issues relating to which SRO is responsible for detecting potential misconduct and enforcing compliance with applicable rules also can exacerbate those gaps, as well as encourage "regulatory freeriding," whereby a market receives revenue for a transaction without bearing the regulatory cost associated with that transaction. Even with consistent rules, data and surveillance systems, the coordination model may continue to result in gaps due to the inequitable allocation of regulatory responsibilities and costs relating to the surveillance of certain inter-market activities.

Inadequate Levels of Coordination

NASD believes that differing rules, regulatory data submission requirements and surveillance systems and programs across markets result in the increased potential for gaps in the regulation of trading in Nasdaq-listed securities and for certain misconduct to go undetected. These gaps can degrade both the regulatory program of each SRO and the coordinated efforts of all the markets. Examples of areas in which potential regulatory gaps can result from the lack of consistent data or consolidated regulation include best execution, firm quote compliance, limit order protection, fraud, manipulation, insider trading, wash sales, short sales, trade reporting, and Regulation M.[17] As such, NASD believes that enhanced coordination or some level of consolidation is the most effective approach to eliminate these potential gaps in the regulation of trading in Nasdaq-listed securities.

Jurisdictional Issues

Jurisdictional issues, in particular the manner in which regulatory responsibilities and costs are allocated, significantly impact the effectiveness of coordinated regulation. As a general matter, it is NASD's experience that the SROs, unsurprisingly, view their

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exchange. With respect to an order that is executed by a member and then reported to an exchange, the member would be required to record and report to OATS new order and execution information.

[17] NASD does not believe it is advisable to discuss in a public document how the current level of coordination permits such conduct to remain undetected.

primary regulatory oversight responsibilities to be that of activities by their own members and not the activities of non-member broker/dealers that actually may underlie the members' activities. At the current time, the types of market participants that have moved their trading away from Nasdaq to other venues primarily are ECNs. The ECN activity represented on exchanges typically is the display of quotes and orders and trading on behalf of broker/dealers that are not exchange members.

As a result, NASD receives a significant number of referrals from other exchanges relating to transactions reported to other exchanges. For example, since April 2002, NASD has received approximately five hundred referrals from one regional exchange for manipulation and insider trading relating to executions that occurred on the regional exchange market. In these situations, it is NASD's regulatory program that ultimately reviews the underlying activity of transactions that occurred on another market and for which that market has received market data or other transaction-based revenue. However, the markets supporting NASD's regulatory program, Nasdaq or ADF, have not received revenue for the transaction.

Coordinated regulation through the use of referrals under the current jurisdictional structure has other shortcomings. As outlined above, with each market reviewing the trading of only its member, the identification of trends by a single broker/dealer who may quote directly and/or enter orders through multiple markets will be much more difficult to detect. Further, because other markets may not collect comparable data or perform equivalent surveillance, gaps in regulation may occur. Even when potential violations are detected and referred to another SRO, the referral process can result in significant delays in the review of suspicious trading. First, the originating SRO must identify suspicious trading, determine that it involves a non-member broker/dealer, and then refer the activity to the appropriate SRO. The SRO receiving the referral then must begin collecting and analyzing its own data about the transaction.

V. Specific Responses to Request for Comment

In addition to the general views described above, provided below are specific responses to several of the questions posed in the Concept Release.

Need for Uniform Trading Rules and Surveillance:

Q1. Do commenters agree with Nasdaq that there is unequal regulation of trading in Nasdaq securities?

Response: As previously noted, NASD and other SROs are not in a position to evaluate the overall integrity and effectiveness of the regulatory programs of other SROs. However, we believe that certain elements of an SRO's regulatory program, such as the rules that apply to regulatory data submission requirements, can be compared and evaluated objectively. To that end, NASD believes that no other market that currently trades Nasdaq-listed securities has an order and transaction audit trail comparable to NASD's audit trail (created for both Nasdaq and ADF). The lack of uniformity of order and transaction data contributes to the potential for regulatory gaps between markets and may provide incentives for market participants to conduct activities where less regulatory data is collected on an automated basis.

Further, when a market does not impose certain trading rules that are beneficial to the integrity of the market, such as a short sale rule, unequal regulation can exist and can create market advantages in the form of regulatory arbitrage. Finally, even assuming that each individual SRO did impose identical regulatory and data collection requirements, unequal regulation would still exist with respect to inter-market activities because of the weaknesses inherent in the current model of coordinated regulation.

Q2. Should all exchanges and associations trading Nasdaq securities have rules requiring detailed audit trail information?

Response: Yes. An SRO that does not require the submission of detailed audit trail information not only degrades the quality of regulation in the overall market, it provides a competitive advantage to that particular SRO through lower regulatory costs and fewer regulatory burdens on market participants.

Q3. Should all exchanges and associations trading Nasdaq securities be required to automate their surveillance and examination of Nasdaq trading on their markets?

Response: This is a determination that must be made by each SRO and the SEC to ensure that the SRO is complying with its requirements under the Exchange Act. However, NASD would find it extremely difficult, if not impossible, to regulate the trading on Nasdaq and ADF entirely through non-automated means.

Q4. Should all exchanges and associations trading Nasdaq securities have similar rules to regulate short selling?

Response: Yes. As noted previously, by not requiring that all markets trading Nasdaq securities impose similar short sale rules, markets without such rules create opportunities for regulatory arbitrage. Market participants have advised NASD staff that they are contemplating sending order flow, possibly just short sale orders, to other markets based solely on the fact that they would not need to comply with the Short Sale Rule for those orders. Moreover, they question whether they are obligated pursuant to their best execution requirements to send short sales to these other markets to ensure a timely execution.

Q5. What other trading rules should be uniform across all markets?

Response: As a general matter, we believe that most trading rules that further investor protection and market integrity should be uniform, or at least consistent, across markets, particularly if by allowing a market not to impose such a rule provides that market a competitive advantage. These rules would include pre-trade and post-trade transparency rules such as firm quote rule, locked and crossed markets rules, and order and transaction reporting requirements, and market conduct rules such as limit order protection, best execution and frontrunning restrictions.

Q6. How should the Commission address any regulatory gaps that can arise when trading in the same security is fragmented across different SROs?

Response: NASD believes that there are a variety of potential solutions to address these issues, including enhanced levels of data collection and consolidation, partial consolidation of surveillance functions, or complete consolidation of surveillance functions. NASD would suggest analyzing whether these approaches would address the regulatory gaps that currently exist. For example, with respect to compliance with the limit order protection rule, regulatory gaps may exist when a firm bifurcates its customer and proprietary trades across markets. Consolidation of data in this area would resolve any gaps because one regulator would have the data necessary to analyze the entire universe of orders and trades across markets. Another regulatory area that would benefit from consolidation is surveillance of potential insider trading. Not only do inefficiencies result from multiple programs reviewing for the same misconduct, potential violative trading can be spread across markets, making is less likely that it will be detected by any one SRO. Certain functions, however, such as rules relating to specific conduct by floor brokers, may not benefit from consolidated regulation.

Q7. To what extent is ISG a useful mechanism for coordinating intermarket regulatory efforts? Does ISG fully address the regulatory gaps Nasdaq contends exist? Does the fact that the Commission does not have direct oversight of ISG limit the sufficiency of the ISG framework in ensuring adequate regulation of violative conduct in the trading of Nasdaq securities that can occur across markets, such as insider trading or certain market manipulations?

Response: ISG was created to facilitate information sharing and to assist in coordinating inquiries and investigations across SROs. Although ISG certainly has been beneficial in coordinating the exchange of information between SROs relating to intermarket activities, it is not, and was never intended to be, the equivalent of having an SRO or other SEC-regulated entity directly responsible for oversight of all intermarket activities. In addition, as noted previously, the ISG Audit Trail, which was created by ISG as a surveillance tool for intermarket investigations, is not comparable to the audit trail information collected by NASD and other markets for their own surveillance purposes. However, ISG could play an important role in any decision to enhance the levels of data consolidation and surveillance coordination.

Q8. Are there models sufficient to address potential concerns raised by fragmentation of regulation by multiple SROs trading Nasdaq securities?

Response: As noted, a hybrid model that consolidates data and some cross-market functions while continuing to coordinate others would address the concerns raised by fragmentation of regulation by multiple SROs. We also believe that these concerns would be addressed through consolidated regulation.

Q9. Are there advantages or disadvantages to a single market regulator with regulatory oversight across all markets trading Nasdaq securities?

Response: As described in this letter, NASD believes a single market regulator would alleviate many of the regulatory gaps associated with coordinated regulation. It also would address jurisdictional issues that arise when members of one SRO are trading through members of other SROs and the associated regulatory freeriding that can result. However, it is not the only alternative to address the current gaps in surveillance and oversight.

Q10. Should a competitive bidding process be required to determine which entity will serve as the single regulator?

Response: NASD does not have a specific view on the appropriate process to choose an entity. Although cost efficiency is extremely important, NASD believes that cost alone should not be the determinative factor. The most important factor is the qualifications of the potential candidate, which we believe must be determined through a vigorous and thorough review by the SEC.

Allocation of Regulatory Costs:

Q4. Should the NASD be required, as suggested by the CSE, to alter its systems to include more data from inter-market trading to improve inter-market surveillance? If so, who should pay for this enhancement?

Response: Although NASD agrees that access to more inter-market data may assist NASD in its ability to conduct inter-market surveillance, such a requirement raises important jurisdictional and cost issues relating to whether NASD should be capturing this data under the current regulatory structure of coordinated regulation and/or whether it should even be responsible for the conduct associated with the activity. Because often this "inter-market" activity is occurring on another market that receives revenue for the transaction, NASD incurs regulatory costs for that activity, while the markets for which it conducts regulation may not receive revenue for the associated trade under the current market structure.

Application of Nasdaq's Recommendations to Exchange Listed Securities:

Q1. Do commenters believe that there is unequal regulation of exchange-listed securities among the markets trading such securities? If so, do commenters believe that the proposals made by Nasdaq with respect to Nasdaq securities would address such unequal regulation in the listed markets? If not, what other approaches do commenters recommend?

Response: To the extent that rules, regulatory data and oversight and surveillance are fragmented in the exchange-listed markets, regulatory gaps will exist, which would benefit from the approaches and discussions contained herein.

Q2. Should the Commission require an intermarket consolidated order audit trial system for Nasdaq-listed and exchange-listed securities, other than options?

Response: We believe the collection of a market-wide comprehensive order and transaction audit trail for any market would be an extremely useful tool and would assist in addressing potential regulatory gaps from fragmented trading.

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Thank you again for the opportunity to comment on these critical issues relating to regulatory structure. As the only national securities association in the U.S. and SRO to both Nasdaq and the ADF, we believe we are uniquely qualified to provide input on the issues raised in the Concept Release, and would be pleased to provide greater detail to the Commission staff as appropriate.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary