

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54170; File No. SR-NASDAQ-2006-006)

July 18, 2006

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Granting Approval of Proposed Rule Change as Amended by Amendment No. 1 Regarding Restrictions on Affiliations between Nasdaq and its Members

I. Introduction

On April 5, 2006, The NASDAQ Stock Market LLC (“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 govern affiliations between Nasdaq and its members and to limit in certain respects Nasdaq’s regulatory authority with respect to members with which it is affiliated. On April 12, 2006, Nasdaq filed Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on April 28, 2006.³ The Commission received three comment letters on the proposal.⁴ On June 20, 2006, Nasdaq filed a response to comments.⁵ This order approves the proposed rule change, as amended.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 53697 (April 21, 2006) , 71 FR 25265.

⁴ See email from Richard Gold, Missoula, MT, dated April 28, 2006 (“Gold Email”); and letters to Nancy M. Morris, Secretary, Commission from George R. Kramer, Deputy General Counsel, Securities Industry Association, dated May 19, 2006 (“SIA Letter”), and Kim Bang, Bloomberg L.P., dated May 17, 2006 (“Bloomberg Letter”). One commenter expressed general concerns about already approved Nasdaq rules requiring members to be broker-dealers, and did not address the substance of the proposal. See Gold Email.

⁵ See letter to Nancy M. Morris, Secretary, Commission, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, dated June 20, 2006 (“Nasdaq Response Letter”).

II. Description of Proposal

Nasdaq Rule 2140 would prohibit Nasdaq or an entity with which it is affiliated from acquiring or maintaining an ownership interest in, or engaging in a business venture⁶ with, a Nasdaq member or an affiliate of a Nasdaq member in the absence of an effective filing with the Commission under Section 19(b) of the Act.⁷ Further, the rule would prohibit a Nasdaq member from becoming an affiliate⁸ of Nasdaq or an affiliate of an entity affiliated with Nasdaq in the absence of an effective filing under Section 19(b) of the Act.⁹ However, Nasdaq's rule excludes from this restriction two types of affiliations.

First, a Nasdaq member or an affiliate of a Nasdaq member could acquire or hold an equity interest in The Nasdaq Stock Market, Inc. that is permitted pursuant to Nasdaq Rule 2130 without filing such acquisition or holding under Section 19(b) of the Act.¹⁰ Second, Nasdaq or an entity affiliated with Nasdaq could acquire or maintain an ownership interest in, or engage in a business venture with, an affiliate of the Nasdaq member without filing such affiliation under Section 19(b) of the Act, if there were information barriers between the member and Nasdaq and

⁶ Nasdaq defines a "business venture" as an arrangement under which (A) Nasdaq or an entity with which it is affiliated and (B) a Nasdaq member or an affiliate of a Nasdaq member, engage in joint activities with the expectation of shared profit and a risk of shared loss from common entrepreneurial efforts.

⁷ 15 U.S.C. 78s(b).

⁸ Nasdaq defines the term "affiliate" under proposed Rule 2140 as having the meaning specified in Commission Rule 12b-2 under the Act; provided, however, that for purposes of Nasdaq Rule 2140, one entity shall not be deemed to be an affiliate of another entity solely by reason of having a common director

⁹ 15 U.S.C. 78s(b).

¹⁰ Nasdaq Rule 2130 provides that "[n]o member or person associated with a member shall be the beneficial owner of greater than twenty percent (20%) of the then-outstanding voting securities of The Nasdaq Stock Market, Inc."

its facilities. These information barriers would have to prevent the member from having an “informational advantage” concerning the operation of Nasdaq or its facilities or “knowledge in advance of other Nasdaq members” of any proposed changes to the operations of Nasdaq or its trading systems. Further, Nasdaq may only notify an affiliated member of any proposed changes to its operations or trading systems in the same manner as it notifies non-affiliated members. Nasdaq and its affiliated member may not share employees, office space, or data bases. Finally, the Nasdaq Regulatory Oversight Committee must certify, annually, that Nasdaq has taken all reasonable steps to implement, and comply with, the rule.

Finally, Nasdaq proposed to amend several of its disciplinary rules to provide that Nasdaq will not consider appeals of disciplinary actions by affiliated members. Instead, after an initial decision is rendered, the affiliated member could appeal directly to the Commission.

III. Summary of Comments

The Commission received three comments on the proposed rule change, as amended.¹¹ Two commenters believed that the rule was unclear and questioned whether it would be consistent with the requirements of Section 19(b) of the Act.¹² Specifically, one commenter believed that the rule would curtail the Commission’s ability to review Nasdaq rules and provide an exemption to a broad category of core Nasdaq facilities from Commission review.¹³ The other commenter believed that, by carving out many types of business arrangements (licensing agreements, provision of transactional services or data etc.) as outside of the definition of “business venture,” certain provisions of agreements “that today rise to the level of ‘SRO rules’

¹¹ See supra note 4.

¹² See SIA Letter supra note 4; Bloomberg Letter supra note 4.

¹³ See Bloomberg Letter supra note 4, at 1-2.

subject to Section 19(b) safeguards might potentially be avoided by simply shifting them to a new affiliate.”¹⁴

Both commenters also questioned why Nasdaq’s proposed exemptions from the general rule requiring a filing with the Commission did not include all of the conditions set forth in an earlier Commission order (the “FSI Order”),¹⁵ which allowed NASD and Nasdaq to develop trade analytics through a separate subsidiary without filing proposed rule changes on behalf of the subsidiary.¹⁶ The commenters noted that the Commission granted the relief at issue in the FSI Order on several conditions “designed to ensure that (a) the activities of FSI would not involve core functions of Nasdaq and (b) FSI would not obtain any informational benefit from Nasdaq that would give it a commercial advantage over its competitors.”¹⁷ By failing to cite the FSI Order and adhering to its conditions, one commenter believed that the proposal would allow business ventures involving affiliates to be executed without a filing with the Commission even where such agreements involved “fundamentally important or core services,” allowing the business venture to “benefit from Nasdaq’s monopoly powers” with respect to such services.¹⁸

Finally, one commenter raised concerns with the broad exception to the filing requirement when certain information barriers exist between Nasdaq and its member or affiliate, noting that “[i]t is not clear how, absent a filing explaining how such conditions would be met in

¹⁴ See SIA Letter supra note 4, at 3.

¹⁵ See Securities Exchange Act Release No. 42713 (April 24, 2000) (2000 SEC LEXIS 807).

¹⁶ See Bloomberg Letter supra note 4, at 2; SIA Letter supra note 4, at 3.

¹⁷ See Bloomberg Letter supra note 4, at 2. See also SIA Letter supra note 4, at 3.

¹⁸ See Bloomberg Letter supra note 4, at 3.

a particular business venture, anyone on the outside could determine in any given instance if Nasdaq and its venture partner in fact meet the requirements.”¹⁹

IV. Nasdaq’s Response to Comments

On June 20, 2006, Nasdaq responded to the issues raised by the commenters.²⁰ As a general preface, Nasdaq stated that it believed the concerns raised by the commenters reflected a “fundamental misunderstanding of the proposed rule change.”²¹ Nasdaq explained that it designed the proposal to stipulate that Nasdaq would be required to file a rule change regarding a proposed affiliation under the circumstances described in the rule “even if the Act does not require it to do so” to address a concern that there may be conditions under which the Commission would have a “strong policy interest in reviewing an affiliation between a self-regulatory organization . . . and one of its members.”²²

Nasdaq, citing the language of Rule 19b-4 referring to “facilities of the self-regulatory organization” and the definition of “facility” in Section 3(a)(2) of the Act,²³ explained that it was well-established that the rule filing obligations of Section 19(b) of the Act are triggered by changes to an SRO’s facilities.²⁴ Conversely, Nasdaq stated, “business ventures that do not constitute SRO facilities, such as the state-regulated insurance brokerages that Nasdaq owns, are not subject to Section 19 of the Act.”²⁵ At the same time, contrary to the concerns expressed in

¹⁹ See SIA Letter supra note 4, at 2.

²⁰ See Nasdaq Response Letter supra note 5.

²¹ See Nasdaq Response Letter supra note 5, at 1.

²² Id.

²³ 15 U.S.C. 78c(a)(2).

²⁴ See Nasdaq Response Letter supra note 5, at 1-2.

²⁵ Id. at 2.

the SIA Letter about Nasdaq avoiding the application of Section 19 by shifting certain operations to an affiliate, to the extent such activities constituted the operations of a facility, Section 19 would apply and require a filing, regardless of where the operations were located.²⁶

Nasdaq makes clear that it was neither the intent nor effect of the proposal to alter the Section 19 rule filing obligations applicable to Nasdaq. Rather, proposed Rule 2140(a) imposes a rule filing obligation where Nasdaq or one of its affiliates seeks to “acquire or maintain an ownership interest in, or engage in a business venture with, a Nasdaq member or an affiliate” and proposed Rule 2140(b) makes clear that “[n]othing in this rule shall prohibit, or require a filing” (emphasis added) in the circumstances described in that part of the rule.²⁷ Nasdaq explains that the rule does not purport to describe the circumstances under which Section 19 of the Act would require a filing, and that in any event, Nasdaq could not by rule “place limits on the requirements of Section 19 in the absence of an exercise of the Commission’s exemptive authority under Section 36 of the Act”²⁸ Nasdaq further states that the exceptions in Rule 2140(b) are exceptions only to the requirement in Rule 2140(a) and that “[w]hether Section 19 would require a filing in such circumstances would depend on the nature of the business venture, as it does today.”²⁹

Nasdaq provided a hypothetical example to illustrate its point. According to Nasdaq, if the Nasdaq Stock Market Inc. and a diversified financial services holding company that also owned a Nasdaq member established a joint venture for trading precious metals in the spot

²⁶ Id. at 2, n.3.

²⁷ Id. at 2.

²⁸ Id.

²⁹ Id. at 3.

market or for brokering commercial real estate in lower Manhattan, Nasdaq explained, the underlying activity would not be subject to a filing requirement under Section 19 because the joint venture would engage in activities not subject to Commission jurisdiction and would not be operated as a facility of Nasdaq. Although the joint venture would arguably result in an indirect affiliation between Nasdaq and one of its members, Nasdaq pointed out that its rule would not require a filing if the specified conditions of separation between the parties were in place. Nasdaq contrasted this scenario with a joint venture in which the hypothetical financial services holding company in question sold Nasdaq market data, in which case Section 19 of the Act would require a filing, regardless of its Rule 2140.

V. Discussion and Commission Findings

The Commission has carefully reviewed the proposed rule change, as amended, the comment letters, and the Nasdaq Response Letter, and finds that the proposed rule change, as amended, is consistent with the requirements of the Act³⁰ and the rules and regulations thereunder applicable to a national securities exchange.³¹ In particular, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b)(5) of the Act,³² which requires that the an exchange have rules designed, among other things, to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest.

³⁰ 15 U.S.C. 78f.

³¹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See U.S.C. 78c(f).

³² 15 U.S.C. 78f(b)(5).

The Commission recently stated that it “is concerned about [the] potential for unfair competition and conflicts of interest between an exchange’s self-regulatory obligations and its commercial interests that could exist if an exchange were to otherwise become affiliated with one of its members, as well as the potential for unfair competitive advantage that the affiliated member could have by virtue of informational or operational advantages, or the ability to receive preferential treatment.”³³ The Commission believes that Nasdaq’s proposed rule is designed to mitigate these concerns. Nasdaq’s rule makes it clear that affiliations between Nasdaq and its members must be filed with the Commission unless such affiliation is due to a member’s interest in The Nasdaq Stock Market, Inc. permitted under Rule 2130 or conforms to the specified information barrier requirements.

In its response letter, Nasdaq correctly noted that its rule does not, in any way, limit the Commission’s authority under the Act. If Nasdaq entered into an affiliation with a member (or any other party) that resulted in a change to a Nasdaq rule or the need to establish new Nasdaq rules, as defined under the Act, then such affiliation would be subject to the rule filing requirements of Section 19(b) of the Act. Nasdaq Rule 2140 would have no effect on this statutory rule filing requirement.

Finally, the Commission believes that Nasdaq’s revisions to certain disciplinary rules are consistent with the Act and are designed to protect the integrity of the disciplinary process. These modifications, which specify that Nasdaq may not be involved in certain disciplinary

³³ See Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006)(order approving the New York Stock Exchange’s merger with the Pacific Exchange).

actions involving members with which it is affiliated, insulate Nasdaq's role as an SRO from its commercial interests.

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁴ that the proposed rule change (SR-Nasdaq-2006-006) be, and hereby is, approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁵

Nancy M. Morris
Secretary

³⁴ 15 U.S.C. 78s(b)(2).

³⁵ 17 CFR 200.30-3(a)(12).