

- Willingness to accept allocations as an e-DPM in options overlying 400 or more securities; and

- Willingness and ability to make competitive markets on CBOE and otherwise to promote CBOE in a manner that is likely to enhance the ability of CBOE to compete successfully for order flow in the options it trades.

The purpose of the final factor listed above is to permit the Exchange to take into consideration in the selection process which of the applicants will best be able to enhance the competitiveness of the Exchange. "Willingness to promote CBOE" includes assisting in meeting and educating market participants, maintaining communications with member firms in order to be responsive to suggestions and complaints, responding to suggestions and complaints, and other like activities. Further, this factor will not be applied by the Exchange to restrict, directly or indirectly, e-DPMs' activities as a market maker or specialist elsewhere, or to restrict how e-DPMs handle orders held by them in a fiduciary capacity to which they owe a duty of best execution.

The factor relating to the existence of order flow commitments would be used to evaluate existing order flow commitments between the applicant and order flow providers. A future change to, or termination of, any such commitments considered by the Exchange during the review process could not be used by the Exchange at any point in the future to terminate or take remedial action against an e-DPM. Further, the Exchange could not take remedial action solely because orders are not subsequently routed to the Exchange but elsewhere pursuant to any such commitments. Whether actual commitments result in orders being routed to the Exchange is a separate matter from the criteria for which an e-DPM's performance would be evaluated.

The proposed rules also provide that (i) as part of the approval of an e-DPM, the Exchange may place conditions on the approval based on the operations of the applicant and the number of option classes which may be allocated to the applicant; (ii) each e-DPM shall retain its approval unless such approval is removed by the Exchange pursuant to appropriate rules; and (iii) an e-DPM may not transfer its approval to act as an e-DPM unless allowed by the Exchange.

## 2. Statutory Basis

The Exchange believes that the proposed rule change, as amended, is

consistent with section 6(b) of the Act<sup>4</sup> in general and furthers the objectives of sections 6(b)(5)<sup>5</sup> of the Act in particular in that it serves to remove impediments to and perfect the mechanism of a free and open market because it will help the Exchange manage its proposed initial launch of e-DPM trading.

### *B. Self-Regulatory Organization's Statement on Burden on Competition*

The CBOE believes that the proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

No written comments were solicited or received with respect to the proposed rule change.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-CBOE-2004-17. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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 CBOE. All submissions should refer to File No. SR-CBOE-2004-17 and should be submitted by April 8, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49406; File No. SR-NASD-2003-173]

### **Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc., Through Its subsidiary, The Nasdaq Stock Market, Inc., Relating to the Nasdaq Closing Cross**

March 11, 2004.

## I. Introduction

On November 25, 2003, 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 establish a Nasdaq closing cross for certain Nasdaq national market securities ("Nasdaq Closing Cross").

The proposed rule change was published for comment in the **Federal Register** on December 11, 2003.<sup>3</sup> The Commission received two comment letters on the proposal.<sup>4</sup> Nasdaq

<sup>6</sup> 17 CFR 200.30-3(a)(12).

<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. 48878 (December 4, 2003), 68 FR 69098.

<sup>4</sup> See letter from Kim Bang, Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Commission,

Continued

<sup>4</sup> 15 U.S.C. 78f(b).

<sup>5</sup> 15 U.S.C. 78f(b)(5).

submitted two letters responding to the comment letters.<sup>5</sup> On February 11, 2004, Nasdaq amended the proposed rule change.<sup>6</sup> On March 4, 2004, Nasdaq again amended the proposed rule change.<sup>7</sup> This order approves the proposed rule change, as amended by Amendment Nos. 1 and 2.

## II. Description of Proposed Rule Change

The proposed rule change would establish the Nasdaq Closing Cross for certain Nasdaq national market securities. There would be three components of the Nasdaq Closing Cross: (1) The creation of on close and imbalance only order types; (2) the dissemination of an order imbalance indicator via electronic means; and (3) closing cross processing in SuperMontage at 4:00:00 that would execute the maximum number of shares at a single, representative price that would be the Nasdaq Official Closing Price.

## III. Comment Summary

The Bloomberg Letter raised an objection on several grounds to the requirement that trading interest be subject to automatic execution in order to take part in the Nasdaq Closing Cross. The Bloomberg Letter opined that, because the Nasdaq Closing Cross would exclude trades, and therefore liquidity, in Nasdaq securities that occur on electronic communications networks that have elected order delivery rather than auto-execution, the

closing price would likely be inaccurate, incomplete and misleading. The Bloomberg Letter commented further that the proposed rule change would violate Section 15A(b)(6) of the Act<sup>8</sup> which requires that the rules of a national securities association not be designed to permit unfair discrimination between customers, issuers, brokers or dealers. Finally, the Bloomberg Letter stated that the proposed rule change would constitute a constructive denial of access to ECNs, which would constitute, in turn, an unnecessary or inappropriate burden on competition in violation of Section 15A(b)(8) of the Act.<sup>9</sup>

The Amex Letter's primary comment was that the Nasdaq Closing Cross would provide Nasdaq officials with too much discretion and that the adjustment process for the "circuit breaker" amounts would allow for too much subjectivity. Specifically, the Amex Letter objected to: (1) The fact that, in its opinion, a crossing price could be selected in a manner that does not reflect true market forces; (2) the potential it sees for manipulation of the crossing price determination; and (3) the potential it sees for the crossing price determination to be influenced by certain Nasdaq member firms who may intervene for their own interests. The Amex Letter stated further that the "circuit breaker" procedures, including the benchmark values of the VWAP and the VWAI, were subjective and confusing.

In its response letters, Nasdaq spoke to the comments raised in the Bloomberg Letter, stating that Bloomberg's business decision to execute orders internally within Bloomberg's book rather than offering automatic execution on SuperMontage should not impede Nasdaq from proceeding with a market enhancement. Nasdaq suggested that there are multiple options that Bloomberg could pursue to satisfy its customers' interest in participating fully in the Nasdaq Closing Cross, such as (1) by participating in the Closing Cross on an automatic execution basis; (2) by routing standing limit orders through another participant that participates on an automatic execution basis, or (3) by discussing with Nasdaq the possibility of establishing a second market participant identifier for the entry of orders eligible to participate in the Closing Cross. Moreover, Nasdaq stated that the Closing Cross is inherently a "match" "matching interest of buyers and sellers at a single instant in time "and is not conducive

to an iterative order delivery process, which would create substantial technical difficulties for Nasdaq and unwarranted risk for other market participants.

Nasdaq's response letters also spoke to the concerns raised in the Amex Letter with respect to subjectivity, discretion of Nasdaq officials, and the circuit breaker. Nasdaq stated that the Closing Cross is designed to avoid ever triggering the circuit breaker and that the circuit breaker is intended as a prophylactic measure to protect investors. Nasdaq stated that the threshold percentage for the circuit breaker would be established well in advance and would be modified only in rare instances, such as index adjustments and options expirations. Moreover, rather than being subjective, the Closing Cross algorithm, including the threshold comparison, would be completely automated and closely tied to market values at the close of the trading day. In addition, in response to industry feedback, including the Amex Letter, Nasdaq amended the proposed rule change to establish the VWAP as the exclusive benchmark for determination of the threshold percentage, rather than rely on both the VWAP and the VWAI as initially proposed.

## IV. Discussion and Commission's Findings

After careful consideration of the proposed rule change, the comment letters, and Nasdaq's responses to the comment letters, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>10</sup> The Commission believes that the proposed rule change is consistent with Section 15A(b) of the Act,<sup>11</sup> in general, and furthers the objectives of Section 15A(b)(6),<sup>12</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation 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 open market and a national market system, and in

dated January 6, 2003 (sic) ("Bloomberg Letter"); and letter from Michael Ryan, Executive Vice President and General Counsel, American Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated January 6, 2004 ("Amex Letter").

<sup>5</sup> See letter from Jeffrey S. Davis, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated January 23, 2004; and letter from Edward S. Knight, Executive Vice President, Nasdaq, to The Honorable William H. Donaldson, Chairman, Commission, dated February 10, 2004.

<sup>6</sup> See letter from Jeffrey S. Davis, Nasdaq, to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated February 11, 2004 ("Amendment No. 1"). In Amendment No. 1, Nasdaq revised the proposed rule change to amend the "circuit breaker" for the Closing Cross to establish the Volume Weighted Average Price ("VWAP") as the exclusive benchmark for determination of the threshold percentage, rather than rely on both the VWAP and the Volume Weighted Average NASDAQ Inside ("VWAI"), as initially proposed. This was a technical amendment and is not subject to notice and comment.

<sup>7</sup> See letter from Jeffrey S. Davis, Nasdaq, to Katherine England, Assistant Director, Division, Commission, dated March 4, 2004 ("Amendment No. 2"). In Amendment No. 2, Nasdaq revised the text of the proposed rule change to make certain clarifying and technical changes. This was a technical amendment and is not subject to notice and comment. The language of the proposed rule change is attached as Exhibit A.

<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

<sup>9</sup> 15 U.S.C. 78o-3(b)(8).

<sup>10</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78o-3(b).

<sup>12</sup> 15 U.S.C. 78o-3(b)(6).

general, to protect investors and the public interest.

The Commission believes that Nasdaq has adequately addressed the comments raised in the comment letters. The Commission also believes that the proposed rule change may provide useful information to market participants and may minimize price volatility on the close. In addition, the Commission believes that the proposed rule change may result in the public dissemination of information that more accurately reflects the trading in a particular security at the close.

## V. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities association, and, in particular, Section 15A(b) of the Act.<sup>13</sup>

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>14</sup> that the proposed rule change (SR—NASD—2003–173) as amended by Amendment Nos. 1 and 2 is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

## Exhibit A

Proposed new language is in *italics*.

### Rule 4709 Nasdaq Closing Cross

(a) *Definitions. For the purposes of this rule the term:*

(1) *“Imbalance” shall mean the number of shares of buy or sell MOC or LOC orders that cannot be matched with other MOC or LOC or IO order shares at a particular price at any given time.*

(2) *“Imbalance Only Order” or “IO” shall mean an order to buy or sell at a specified price or better that may be executed only during the Nasdaq Closing Cross and only against MOC or LOC orders. IO orders can be entered between 9:30:01 a.m. and 3:59:59 p.m., but they cannot be cancelled or modified after 3:50:00 except to increase the number of shares or to increase (decrease) the buy (sell) limit price. IO sell (buy) orders will only execute at or above (below) the 4:00:00 SuperMontage offer (bid). All IO orders must be available for automatic execution.*

(3) *“Limit On Close Order” or “LOC” shall mean an order to buy or sell at a specified price or better that is to be executed only during the Nasdaq*

*Closing Cross. LOC orders can be entered, cancelled, and corrected between 9:30:01 a.m. and 3:50:00 p.m. and will execute only at the price determined by the Nasdaq Closing Cross. All LOC orders must be available for automatic execution.*

(4) *“Market on Close Order” shall mean an order to buy or sell at the market that is to be executed only during the Nasdaq Closing Cross. MOC orders can be entered, cancelled, and corrected between 9:30:01 a.m. and 3:50:00 p.m. and will execute only at the price determined by the Nasdaq Closing Cross. All MOC orders must be available for automatic execution.*

(5) *“Nasdaq Closing Cross” shall mean the process for determining the price at which orders shall be executed at the close and for executing those orders.*

(6) *“Order Imbalance Indicator” shall mean a message disseminated by electronic means containing information about MOC, LOC, and IO orders and the price at which those orders would execute at the time of dissemination.*

(b) *Order Imbalance Indicator. Beginning at 3:50 p.m., Nasdaq shall disseminate by electronic means an Order Imbalance Indicator every 30 seconds until 3:55, and then every 15 seconds until 3:58, and then every 5 seconds until 3:59, and then every second until market close. The Order Imbalance Indicator shall contain the following real time information:*

(1) *The number of shares represented by MOC, LOC, and IO orders that are paired at a single price that is at or within the current SuperMontage inside.*

(2) *The size of any Imbalance;*

(3) *The buy/sell direction of any Imbalance; and*

(4) *Indicative prices at which the Nasdaq Closing Cross would occur if the Nasdaq Closing Cross were to occur at that time and the percent by which the indicative prices are outside the then current SuperMontage best bid or best offer, whichever is closer. The indicative prices will be:*

(A) *The price at which the MOC, LOC, and IO orders in the Nasdaq Closing Book would execute, and*

(B) *The price at which both the MOC, LOC, and IO orders and all executable orders in SuperMontage (excluding volume that is available only by order delivery) would execute.*

(C) *If no price satisfies subparagraph (A) or (A) and (B) above, Nasdaq will disseminate the phrase “market buy” or “market sell”.*

(c) *Processing of Nasdaq Closing Cross.*

(1) *The Nasdaq Closing Cross will begin at 4:00:00, and after hours trading will commence when the Nasdaq Closing Cross concludes.*

(2) *The Nasdaq Closing Cross will occur at the price that*

(A) *Maximizes the number of shares executed. If more than one such price exists, the Nasdaq Closing Cross shall occur at the price that:*

(B) *Minimizes any Imbalance. If more than one such price exists, the Nasdaq Closing Cross shall occur at the price that:*

(C) *Minimizes the distance from the 4:00:00 SuperMontage bid-ask midpoint.*

(D) *If the Nasdaq Closing Cross price established by subparagraphs (A) through (C) above is outside the benchmarks established by Nasdaq by a threshold amount, the Nasdaq Closing Cross will occur at a price within the threshold amounts that best satisfies the conditions of subparagraphs (A) through (C) above. Nasdaq management shall set and modify such benchmarks and thresholds from time to time upon prior notice to market participants.*

(3) *If the Nasdaq Closing Cross price is selected and fewer than all MOC, LOC and IO orders and fewer than all continuous orders that are available for automatic execution in SuperMontage would be executed, orders will be executed at the Nasdaq Closing Cross price in the following priority:*

(A) *MOC orders, with time as the secondary priority;*

(B) *LOC orders, limit orders, IO orders, displayed quotes and reserve interest priced more aggressively than the Nasdaq Closing Cross price;*

(C) *LOC orders, IO Orders displayed interest of limit orders, and displayed interest of quotes at the Nasdaq Closing Cross price with time as the secondary priority;*

(D) *Reserve interest at the Nasdaq Closing Cross price with time as the secondary priority; and*

(E) *Unexecuted MOC, LOC, and IO orders will be canceled.*

(4) *All orders executed in the Nasdaq Closing Cross will be executed at the Nasdaq Closing Cross price, trade reported with SIZE as the contra party, and disseminated via the consolidated tape. The Nasdaq Closing Cross price will be the Nasdaq Official Closing Price for stocks that participate in the Nasdaq Closing Cross.*

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<sup>13</sup> 15 U.S.C. 78o–3(b).

<sup>14</sup> 15 U.S.C. 78s(b)(2).

<sup>15</sup> 17 CFR 200.30–3(a)(12).