

**Nasdaq Exchange Registration
Member and Issuer Transition Issues**

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Nasdaq Exchange Registration Member and Issuer Transition Issues

On January 13, 2006, the Securities and Exchange Commission (“SEC”) approved the Nasdaq Stock Market LLC (“Nasdaq”) as a registered national securities exchange.¹ Under the SEC’s order, Nasdaq will be able to begin operating as a national securities exchange after a number of legal and operational conditions have been satisfied.

Nasdaq’s transaction execution services, such as the Nasdaq Market Center, Brut, and INET, will be operated under Nasdaq’s exchange registration. NASD members that currently operate as order-entry firms, market-making firms or electronic communications networks in the Nasdaq Market Center will need to become members of the Nasdaq Exchange in order to use the Nasdaq Market Center trading system and other Nasdaq services. All NASD member firms will be eligible to become members of the Nasdaq Exchange by completing a “waive in” form.

When Nasdaq begins operating as a national securities exchange, member firms of the Nasdaq Exchange and the issuers of securities listed on the Nasdaq Exchange will become subject to certain additional obligations and exemptions under the Securities Act of 1933 (“Securities Act”), the Securities Exchange Act of 1934 (“Exchange Act”), and the rules thereunder.

I. Transition Issues for Members of the Nasdaq Exchange

A. Application of Section 11(a) of the Exchange Act to Trading by Nasdaq Exchange Members.

Members of the Nasdaq Exchange will be subject to Section 11(a) of the Exchange Act, which applies specifically to members of national securities exchanges. Section 11(a) generally provides that an exchange member may not effect transactions on that exchange for its own account, the accounts of its associated persons, or any account over which the member or any of its associated persons exercise investment discretion (“covered accounts”).²

The SEC has adopted Rule 11a2-2(T) under the Exchange Act, which is known as the “effect vs. execute” rule. Under the effect vs. execute rule, an exchange member is permitted to effect transactions on the exchange for covered accounts if it arranges for an unaffiliated exchange member to execute the transactions on the exchange floor. Members of floor-based securities exchanges can use floor brokers to execute transactions pursuant to the effect vs. execute rule, but the Nasdaq Exchange will be fully electronic and will not have a floor. As a result, the strict application of Section 11(a) would restrict Nasdaq Exchange members’ trading ability solely because the exchange is electronic.

However, the SEC indicated in its approval order that Nasdaq Exchange members entering orders into the Nasdaq Execution Systems would satisfy the conditions of the effect vs. execute

¹ Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550.

² In addition, Rule 11a-1 under the Exchange Act effectively provides that the Section 11(a) prohibitions on trading in covered accounts apply to trading on the floor of an exchange. However, Rule 11a-1 should not apply with respect to the Nasdaq Exchange because the exchange will not have a floor.

rule. In particular, the SEC noted that Nasdaq Exchange members would be entering orders directly through anonymous electronic Exchange facilities without the participation of an unaffiliated exchange member.³ However, the SEC also noted that, in cases where a member effects transactions for a covered account for which it exercises investment discretion, the member must be authorized by a written agreement that refers to Section 11(a) in order to retain any compensation in connection with the transaction.⁴

B. Short Sales.

Short sales in Nasdaq National Market securities are governed by NASD Rule 3350, which provides that broker-dealers may not effect short sales in Nasdaq-traded securities at or below the current best bid when that bid is below the preceding best bid in the security. Rule 3350 does not apply to short sales in Nasdaq Capital Market (formerly, Nasdaq Small Cap Market) securities. Short sales in exchange-traded securities, however, are governed by Rule 10a-1 under the Exchange Act, which provides that a person may not effect a short sale at or below the price of the last sale when that price is below the next preceding sale price. Pursuant to Rule 202(T) of Regulation SHO under the Exchange Act, all short sale pricing tests have been suspended for a pilot group of securities.

In its approval order of Nasdaq's exchange registration, the SEC granted an exemption from Rule 10a-1 that permits Nasdaq to apply Rule 3350 to short sales in Nasdaq National Market securities and to allow Nasdaq Capital Market securities to be exempt from application of Rule 10a-1. The securities subject to the pilot under Rule 202(T) of Regulation SHO will continue to be excluded from the pricing test under Rule 3350.

C. Transaction Confirmations.

Rule 10b-10 under the Exchange Act, which governs confirmation disclosure requirements, does not distinguish between transactions on exchanges and on Nasdaq or other OTC markets. However, pursuant to NYSE Rule 409, NYSE members that effect customer transactions on the Nasdaq Exchange will have to note Nasdaq as the market of execution on confirmations of those transactions. Confirmations for transactions in Nasdaq Exchange securities that are not executed on the exchange and are reported to the Trade Reporting Facility will have to note OTC as the market of execution.

³ The staff of the SEC's Division of Market Regulation has previously issued interpretive guidance under the effect vs. execute rule to ease the restrictions of Section 11(a) on electronic securities exchanges. *See, e.g.*, Securities Exchange Act Release No. 44983 (Oct. 25, 2001), 66 FR 55225 (Nov. 1, 2001) (approving Archipelago Exchange), citing Letter from Paula R. Jensen, Deputy Chief Counsel, Division of Market Regulation, SEC, to Kathryn L. Beck, Senior Vice President, Special Counsel and Antitrust Compliance Officer, Pacific Exchange, Inc. ("PCX") (October 25, 2001); Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Edith Hallahan, Associate General Counsel, Philadelphia Stock Exchange, Inc. ("Phlx") (March 24, 1999); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to David E. Rosedahl, PCX (November 30, 1998) (regarding PCX application of OptiMark); Letter from Brandon Becker, Director, Division of Market Regulation, SEC, to George T. Simon, Partner, Foley & Lardner (November 30, 1994); Securities Exchange Act Release No. 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (approving the New York Stock Exchange's Off-Hours Trading Facility).

⁴ *See* Rule 11a2-2(T)(a)(2)(iv) under the Exchange Act.

D. Regulation M.

Regulation M under the Exchange Act governs the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities, and is intended to preclude manipulative conduct by persons with an interest in the outcome of an offering. Rule 103 of Regulation M provides an exception from the trading restrictions for “passive market making” in Nasdaq securities. Because Nasdaq will continue to use market makers rather than specialists when it begins operating as a national securities exchange, Nasdaq’s registration as an exchange should not affect the application of Regulation M.

E. Short-Swing Profits.

Section 16 of the Exchange Act provides that profits resulting from the purchase and sale (or sale and purchase) of a security within six months by a director, officer, or principal stockholder of the issuer may be recovered by the issuer. Section 16(d) provides an exclusion from this basic provision for dealers engaged in certain market-making activities in non-exchange markets. This exclusion will no longer be applicable once Nasdaq begins operating as a national securities exchange.

F. Determination of Beneficial Ownership.

Rule 13d-3(d)(2) under the Exchange Act provides that an exchange member is not deemed to be a beneficial owner of securities that it holds for another person solely because the member is the record holder and is able to direct the vote of such securities, without instructions, on uncontested matters or matters that do not affect the rights and privileges of the holders of the securities voted. When Nasdaq begins operating as a national securities exchange, Rule 13d-3(d)(2) will become applicable to members of the Nasdaq Exchange.

G. Filing of Audited Financial Statements.

Rule 17a-5(d)(1)(iii) provides that the requirement for a broker-dealer to file audited financial statements with the SEC does not apply to an exchange member that trades only with other exchange members and does not carry any customer accounts. When Nasdaq begins operating as a national securities exchange, members of the Nasdaq Exchange that meet the requirements of Rule 17a-5(d)(1)(iii) will be able to take advantage of this exception.

H. Lost and Stolen Securities.

Rule 17f-1(b)(1) provides that an exchange member that trades through the facilities of the exchange and has not received or held customer securities within the last six months is not required to register with the SEC’s Lost and Stolen Securities Program. When Nasdaq begins operating as a national securities exchange, members of the Nasdaq Exchange that meet the requirements of Rule 17f-1(b)(1) will be able to take advantage of this exception.

I. Exemption from Registration for Certain Members of National Securities Exchanges.

Rule 15a-4 provides a forty-five day exemption from broker-dealer registration for natural persons who are members of a national securities exchange for purposes of continuing to effect

transactions on the floor of the exchange. When Nasdaq begins operating as a national securities exchange, members of the Nasdaq Exchange that meet the requirements of Rule 15a-4 will be able to take advantage of the exemption from registration.

II. Transition Issues for Issuers of Securities Listed on the Nasdaq Exchange

A. **Registration under Section 12 of the Exchange Act.**

Nasdaq-traded securities are currently registered under Section 12(g) of the Exchange Act, which generally requires registration of securities that are held by at least 500 shareholders and whose issuers have more than \$10,000,000 in assets.⁵ Under Section 12(a) of the Exchange Act, a security may not be traded on a national securities exchange unless the security is registered with the SEC and the exchange as provided in Section 12(b). All issuers of securities registered pursuant to Section 12 are subject to the requirements to file periodic reports (*e.g.*, annual and quarterly reports) pursuant to Section 13 of the Exchange Act.

When Nasdaq begins operating as a national securities exchange, Nasdaq-traded securities will be required to be registered under Section 12(b) of the Exchange Act. In order to accommodate its issuers' transition from Section 12(g) to Section 12(b) registration, Nasdaq has adopted Rule 4130, which allows Nasdaq to file a single application for Section 12(b) registration on behalf of all of its issuers.⁶ Under Rule 4130, Nasdaq will provide notice to each issuer regarding the Section 12(b) registration process and will provide issuers that do not wish to register under Section 12(b) the ability to opt out of the registration process.

B. **Exemptions from Section 12 Registration.**

Nasdaq Exchange securities will be eligible for certain exemptions from Section 12 registration that are available only to exchange-traded securities.

- ***Exemption of Warrants.*** Rule 12a-4 under the Exchange Act exempts from Section 12 registration certain warrants granted to the holders of securities traded on a national securities exchange.
- ***Temporary Exemption of Substituted or Additional Securities.*** Rule 12a-5 under the Exchange Act exempts from Section 12 registration certain securities obtained by holders of securities traded on a national securities exchange.
- ***Exemption of Stock Contained in Standardized Market Baskets.*** Rule 12a-7 under the Exchange Act exempts from Section 12 registration certain component stocks of a standardized market basket for purposes of listing the basket on a national securities exchange.

⁵ See Section 12(g)(1)(B) of the Exchange Act (requiring registration of securities whose issuers have more than \$1,000,000 in total assets) and Rule 12g-1 under the Exchange Act (exempting issuers from 12(g) registration if their total assets do not exceed \$10,000,000).

⁶ See Securities Exchange Act Release No. 53606 (April 6, 2006), 71 FR 18790 (order approving proposed rule change); Securities Exchange Act Release No. 53362 (February 24, 2006), 71 FR 10734 (notice of proposed rule change).

C. Exemption from Securities Act Registration for Certain Sales of Restricted Securities.

Rule 144 under the Securities Act provides an exemption from Securities Act registration for certain sales of restricted securities. Rule 144(h) provides that if the amount of securities to be sold in reliance on Rule 144 during any period of three months exceeds 500 shares or other units or has an aggregate sale price in excess of \$10,000, three copies of a notice on Form 144 must be filed with the SEC. If the securities are traded on a national securities exchange, one copy of the notice must be filed with the “principal” exchange on which the securities are traded.

Accordingly, Form 144 will be required to be filed with respect to sales of Nasdaq Exchange listed securities that are subject to Rule 144(h).

D. Delisting of Securities.

Rule 12d2-2(c) provides that an issuer of securities listed on an exchange must file Form 25 with the SEC to delist those securities and to withdraw the securities from registration under Section 12(b) of the Exchange Act. When Nasdaq begins operating as a national securities exchange, issuers of securities listed on the Nasdaq Exchange will become subject to Rule 12d2-2(c).

For more information on these issues, contact any one of the following Morgan Lewis attorneys:

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