FINRA™
Financial Industry Regulatory Authority

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August 29, 2007

Via Email to rule-comments@sec.gov

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comment Letter on SR-NASDAQ-2007-001; Release No. 34-55937 – Notice of Filing of Proposed Rule Change as Modified by Amendment No. 2 to Amend Nasdaq's "Clearly Erroneous" Rule

Dear Ms. Morris:

FINRA staff[1] appreciates this opportunity to comment on the proposed rule change by The NASDAQ Stock Market LLC ("Nasdaq") to amend its "clearly erroneous" authority under Nasdaq Rule 11890, as published in the Federal Register on June 27, 2007 (the "Proposal").[2] The Proposal responds to recent suggestions by the staff of the Securities and Exchange Commission ("SEC") for self-regulatory organizations ("SROs") to adopt clear and consistent standards for applying rules such as Rule 11890, which cover breaking or adjusting trades determined to be clearly erroneous, to unauthorized trading activity or attempts to manipulate stock prices by illegally gaining access to legitimate accounts or opening new accounts using false information (often referred to as "account intrusions").

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1 The comments provided in this letter are solely those of the staff of FINRA; they have not been reviewed or endorsed by the Board of Governors of FINRA. For ease of reference, this letter may use "we," "FINRA," and "FINRA staff" interchangeably, but these terms refer only to the FINRA staff.

2 See Securities Exchange Act Release No. 55937 (June 21, 2007), 72 Fed. Reg. 35278 (June 27, 2007) (File No. SR-NASDAQ-2007-001).

FINRA strongly believes that coordinating with other SROs with the goal of having consistency and transparency regarding the clearly erroneous process is important to the marketplace and to investors. Investors and market professionals should be entitled to know that different regulators across markets are acting consistently to ensure the integrity of the overall market. Inconsistent rules and application of those rules can be damaging. However, FINRA staff has significant concerns with the Proposal, specifically, the proposed expansion of Nasdaq's clearly erroneous authority to address alleged account intrusion and other manipulative or fraudulent activities and the proposed numerical threshold levels.

FINRA believes that 'clearly erroneous' rules should protect the integrity of the market by ensuring that investors are not drawn into trading by misleading information resulting from errant transactions; the clearly erroneous rules should not be used to unwind trades resulting from alleged fraudulent activity. In addition, FINRA does not believe that the clearly erroneous rules should protect professionals from inadvertent errors that do not impact the integrity of the market. Such errors have taken place since trading began and have been absorbed by professionals as a cost of doing business throughout that time. There also is a contra party in each errant trade that entered into that transaction in good faith. Each time a clearly erroneous situation is declared, a contra party may be forced to forgo profits that should have accrued to its benefit. As a result, FINRA believes that the numerical thresholds in the clearly erroneous rules should be set high enough that they are invoked only when necessary to ensure market integrity and not as an everyday occurrence.

Use of Clearly Erroneous Authority for Account Intrusion Cases

With respect to Nasdaq's proposal to expand its use of clearly erroneous authority to include instances of account intrusion, FINRA believes that account intrusions are fundamentally a type of fraud that does not and should not fall within the scope of Rule 11890. Although account intrusion is a relatively new phenomenon that has developed with the increase of on-line trading, FINRA does not view it any differently than other types of frauds and manipulations and therefore does not believe it should prompt or receive any unique treatment with respect to the application of the clearly erroneous rules.[3]

FINRA recognizes the growing threat from these account intrusions and believes that appropriate efforts should be made to ensure that ill-gotten gains are forfeited and do not enrich the perpetrators. However, identifying account intrusion cases with certainty can be complex, and the marketplace moves quickly. As a result, FINRA believes that extending clearly erroneous authority to cover account intrusions may create more problems than it solves and that the primary emphasis in addressing account intrusion should be on prevention.

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3 See, e.g., SEC Press Release 2007-33 (March 7, 2007) ("*SEC Obtains Order Freezing $3 Million in Proceeds of Suspected Foreign-Based Account Intrusion Scheme.*")

FINRA's primary concern with expanding clearly erroneous authority to include account intrusions stems from the complex and fact-intensive nature of fraud and manipulation cases. As a general matter, it is often difficult and time-consuming to identify and verify with certainty the facts and circumstances surrounding any specific price movement in a security. On-line account intruders in particular generally leave little trace as to their real identities or the manner by which they intruded the account(s). The time needed to accurately determine the facts surrounding the trading is not possible in the context of making a clearly erroneous determination within the time frames set forth in Rule 11890. As a result of this tension, and as the Proposal contemplates, Nasdaq would be forced to rely solely on the written representation of the broker-dealer seeking to have a trade(s) broken that an account intrusion occurred and the surrounding facts and circumstances. Although reliance on representations of broker-dealers as to the basis of a clearly erroneous claim would not be unique to account intrusion, in the typical error or system malfunction situation for which clearly erroneous authority has historically been invoked, there are generally other objective factors that the SRO can look to and rely on within the timeframes prescribed by the clearly erroneous rules that corroborate the broker-dealer's representation. This is not the case with account intrusion.

Nasdaq also indicates that by requiring a statement of the factual basis for believing that the trade resulted from account intrusion and is, therefore, "clearly erroneous," FINRA will be able to evaluate after the fact whether a particular market participant is abusing the clearly erroneous process or employing poor internal controls. FINRA has concerns about relying on such an after-the-fact review, given that the trades in question will have already been broken, with the benefit already accrued to the claimant. Further, such a verification process will require significant resources and be extremely time-consuming. As is the case with proving most types of fraud or manipulation cases, the process will likely require months of analysis, testimony, and other investigative efforts. FINRA believes resolution of these types of situations, including account intrusion, should remain within the scope of enforcement efforts where all the facts and circumstances can be fully investigated and analyzed before action is taken, rather than resolved hastily via the clearly erroneous process and verified (if at all) months after the fact.

In addition, pursuant to the Proposal, trades would be broken only if they trigger certain numerical thresholds. As a result, in an account intrusion scenario, generally the first set of trades resulting from the unauthorized account access would not be broken as clearly erroneous because they would not trigger the numerical thresholds (i.e., transactions priced close to the inside market or other reference price would stand even if the transaction directly resulted from an account intrusion). Therefore, the transactions of the initial "victims" of the account intrusion fraud would not be voided or have a claim to clearly erroneous relief. As such, this will likely result in a disconnect between the broker-dealer that would have direct knowledge of the account intrusion and those broker-dealers that traded in the "after-market" of an account intrusion and are "eligible" for clearly erroneous relief because their trades are at prices that exceed the numerical threshold. FINRA believes that subsequent trades executed by purportedly innocent investors after the run up in price would be broken arbitrarily, based on the reference price established and the time frame reviewed. Not only would this not further a more orderly or fair market, it will likely result in confusion as to why some trades effected by an alleged account intrusion are being broken, while others are not.[4]

FINRA continues to be concerned about unauthorized or illegal activity such as account intrusion that could disrupt a fair and orderly market but believes that its clearly erroneous authority is not the appropriate way to address these types of fraudulent trading activities. Instead, members should routinely review the adequacy of their internal controls and ensure that appropriate system safeguards are in place to minimize or eliminate the potential for account intrusion. FINRA believes this will lead to greater long-term confidence by investors in the use of new technologies and in the marketplace generally. More importantly, it will create the proper incentives necessary to have firms prevent the vast majority of such frauds before they occur, rather than attempting to unwind portions of the effects of such frauds that happen to exceed pre-set numerical thresholds.

Numerical Thresholds

The core purpose of an SRO's clearly erroneous authority is to allow the SRO to review the status of transactions under its purview with a goal of maintaining market integrity by declaring a transaction to be null and void if the terms of the trade are clearly out of line with the objective market conditions for the security. This authority provides important safeguards against market disruptions caused by trader errors, system malfunctions, or other extraordinary events that result in executions affecting multiple market participants and/or securities.

FINRA considers a transaction to be clearly erroneous when the print is substantially inconsistent with the market price at the time of execution, there is no market or information based reason for the change in price, and there is a reported error. The goal is not to protect the individual who made the error. Rather, the intent in breaking these clearly erroneous transactions is to ensure market integrity and to protect other investors and market professionals from effecting additional trades based on the erroneous transaction.

With this in mind, FINRA believes that the numerical thresholds that can trigger a clearly erroneous determination should be set high enough to protect market integrity but not so low that the determination is most likely to primarily protect the individual who made the error. Under the Proposal, trades in Nasdaq securities executed during the regular trading session (defined in the Proposal to be trades between 9:30 a.m. and 4:00 p.m. Eastern Time), would be subject to review as clearly erroneous if the execution price deviates from the market price in a range from 3% to 10%; trades outside the regular trading session would be subject to review as clearly erroneous if the execution price deviates more than 6% to 20% from the market price. Certain transactions deemed to be "outlier transactions" would be subject to review as clearly erroneous only if they deviate 50% or more from the market price.

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4 Should the SEC approve the Proposal, FINRA suggests that the Proposal first be amended so that all trades resulting from an account intrusion are broken rather than just those trades that exceed certain numerical thresholds.

FINRA believes these proposed numerical thresholds are too low and will regularly encompass trading that does not threaten the integrity of the market, especially during periods of high market volatility. FINRA believes that only in unusual circumstances should regulators intervene in trades that are entered into in good faith. As a result, FINRA believes that thresholds of 10% to 20% are more appropriate because they will reduce the incidence of regulatory intervention in market transactions while still maintaining the integrity of the marketplace. These higher thresholds will reduce any incentives listed markets may have to break trades for broker-dealer firms with whom they have business relationships in order to protect their error accounts. They will also reduce the number of situations where an investor on the contra side of a trade that would fall within the guidelines recommended by Nasdaq would be disadvantaged by having its trades broken. Disputes arising between parties regarding trades executed below these thresholds may be resolved amicably between the parties (e.g., agreeing to break the trades in question) or arbitrated. FINRA understands that arbitration is a lengthier process, however it will allow for more detailed fact finding then can be done in the time frames allowed in Rule 11890 to determine whether a trade is clearly erroneous or not. These alternatives also ensure that both parties have a chance to be heard on what might otherwise be a legitimate trade.

Each month, FINRA reviews several hundred trades in the OTC market submitted by firms as possibly clearly erroneous transactions. The concern is that this volume continues to steadily grow over time.[5] FINRA believes that frequent use of clearly erroneous authority is harmful to investors and to the marketplace generally because the increasing use of this authority suggests that either errors are increasing without incentives being created to prevent them or this authority is being applied to a more expansive universe of transactions. FINRA believes that higher numerical thresholds would be fairer to the marketplace as a whole and will minimize opportunities for some market participants to abuse the clearly erroneous process or employ poor internal controls.

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[5] For example, in May, June, and July of 2007, FINRA received notification of 369, 539, and 595 trades, respectively, that were possibly clearly erroneous. In just the first three weeks of August 2007, that number has increased to over 800.

For the reasons set forth above, FINRA opposes Nasdaq's proposal to extend its clearly erroneous authority to account intrusion. Please contact Stephanie Dumont at (202) 728-8176 or Brant Brown at (202) 728-6927 if you would like to discuss our concerns or have any further questions.

Sincerely,

Barbara Z. Sweeney
Senior Vice President and
Corporate Secretary