

pilot, many of which challenged the CSE's statistics.<sup>14</sup> Some of the commenters proffered statistics to support their contention that the CSE merely serves as a means for firms to internalize order flow. Among other things, commenters alleged that (1) over 94% of preferencing dealers' executions are paired order trades; (2) only 4.8% of CSE trades can be characterized as trades between CSE dealers; and (3) CSE quotes are inaccessible to other ITS participants.

The Commission has examined the data provided by the CSE and commenters and believes it would be useful to analyze additional data before making a definitive determination on the pilot. To allow further evaluation of the market structure implications of permanently approving the CSE's preferencing program, the Commission requests that the CSE continue to submit the quarterly reports described in the Commission's previous orders approving extensions of the pilot. The Commission also will collect relevant data on its own to evaluate the pilot.

More importantly, the Commission is interested in exploring whether broader market structure initiatives can address the commenters' concerns regarding order interaction and the effects of preferencing on the NMS in general, and on order execution quality in particular. In this regard, the Commission recently proposed rules that attempt to address, among other things, the order interaction and best execution issues presented by preferencing of order flow.<sup>15</sup> Extension of the CSE pilot will allow the Commission an opportunity to study the implications of the proposals for the CSE's preferencing pilot during the pendency of the rulemaking process.

The Commission finds good cause for approving the proposed rule change, as amended, prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. The Commission believes that accelerated approval of the proposal is appropriate in order to avoid an interruption to the existing pilot while the Commission continues to collect data and consider broader market structure rules to address internalization.

<sup>14</sup> The Commission received negative comment letters from, among others, the New York Stock Exchange, American Stock Exchange, and Boston Stock Exchange. These and other correspondence received regarding the CSE's request for permanent approval of the pilot program are available to the public in File No. SR-CSE-95-03.

<sup>15</sup> See Securities Exchange Act Release No. 36310 (September 29, 1995).

## VI. Conclusion

It Is Therefore Ordered, pursuant to Section 19(b)(2)<sup>16</sup> that the proposed rule change, as amended, is hereby approved on an accelerated basis, and the preferencing pilot is extended through March 29, 1996.

By the Commission.

Jonathan G. Katz,

Secretary.

[FR Doc. 95-24908 Filed 10-5-95; 8:45 am]

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[Release No. 34-36311; File No. SR-NASD-95-34]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Temporary Approval of Proposed Rule Change to Extend Certain SOES Rules Through January 31, 1996

#### I. Introduction

On August 11, 1995, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change 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> The NASD proposes to extend through January 31, 1996 certain changes to its Small Order Execution System ("SOES") that were originally implemented in January 1994 for a one-year pilot period ("January 1994 Amended SOES Rules").<sup>3</sup> These rules subsequently were modified in January 1995 ("January 1995 Amended SOES Rules")<sup>4</sup> and further modified in March 1995 ("March 1995 Amended SOES Rules").<sup>5</sup> The March 1995

<sup>16</sup> 15 U.S.C. § 78s(b)(2) (1988).

<sup>1</sup> 15 U.S.C. § 78s(b)(1) (1988).

<sup>2</sup> 17 CFR 240.19b-4 (1994).

<sup>3</sup> Securities Exchange Act Release No. 33377 (Dec. 23, 1993), 58 FR 69419 (Dec. 30, 1993) (approving the Interim SOES Rules on a one-year pilot basis effective January 7, 1994). See also Securities Exchange Act Release No. 33424 (Jan. 5, 1994) (order denying stay and granting interim stay through January 25, 1994) and Securities Exchange Act Release No. 33635 (Feb. 17, 1994) (order denying renewed application for stay).

<sup>4</sup> Securities Exchange Act Release No. 35275 (Jan. 25, 1995), 60 FR 6327 (Feb. 1, 1995).

<sup>5</sup> Securities Exchange Act Release No. 35535 (Mar. 27, 1995), 60 FR 16690 (Mar. 31, 1995).

The March 1995 Amended SOES Rules did not include the two features found in the January 1994 Amended SOES Rules that:

(1) Reduced the maximum size order eligible for SOES execution from 1,000 shares to 500 shares; and

(2) Prohibited short sale transactions through SOES.

The January 1995 Amended SOES Rules continued all of the January 1994 Amended SOES Rules, except for the short sale prohibition and, as

Amended SOES Rules are scheduled to expire on October 2, 1995, and the NASD seeks to extend these until January 31, 1996. Without further Commission action, the SOES rules would revert to those in effect prior to January 1994.

Notice of the proposed rule change appeared in the Federal Register on August 31, 1995.<sup>6</sup> Eleven comments were received in response to the Commission release. For the reasons discussed below, this order approves the proposed rule change until January 31, 1996.

#### II. Description of the Current and Prior Proposals

The NASD proposes to extend until January 31, 1996 the March 1995 Amended SOES Rules. Specifically, the NASD proposes to extend until January 31, 1996 changes that:

- (1) Reduce the minimum exposure limit for "unpreferenced" SOES orders from five times the maximum order size to two times the maximum order size, and eliminate the exposure limits for "preferenced" SOES orders; and
- (2) Maintain the availability of an automated function for updating market maker quotations when the market maker's exposure limit has been exhausted (market makers using this update function may establish an exposure limit equal to the maximum order size for that security).

#### III. Comments

The current proposal attracted eleven comments, eight supporting the proposal and three opposing it. The comments raised issues similar to those raised in connection with previous amendments to the SOES Rules.

Generally, commenters supporting the proposals have argued that the various amendments to the SOES Rules have been necessary to limit the exposure of market makers to multiple SOES executions, which benefits retail investors by producing narrower spreads and more liquid markets. Some commenters supporting the proposal also argued for additional limits on market makers' SOES exposure, such as a reduction in the SOES maximum order size to 500 shares.

Commenters opposed to the proposals have argued that the statistical and market quality data cited by the NASD<sup>7</sup> in support of the various amendments to the SOES Rules are not sufficient to

noted, the March 1995 Amended SOES Rules continued only the first two January 1994 Amended SOES Rules.

<sup>6</sup> Securities Exchange Act Release No. 36154 (Aug. 25, 1995), 60 FR 45502 (Aug. 31, 1995).

<sup>7</sup> See *infra* notes 16-20 and accompanying text.

support the NASD's position. They contend that the studies on which the NASD relies fail to demonstrate any increase in market quality as a result of the various amendments to the rules and that market makers have ample opportunity to update their quotes in order to avoid multiple SOES executions.

#### IV. Discussion

The Commission must approve a proposed NASD rule change if it finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that govern the NASD.<sup>8</sup> In evaluating a given proposal, the Commission examines the record before it and relevant factors and information.<sup>9</sup> The Commission believes that approval of the proposal through January 31, 1996 meet the above standards. Specifically, the Commission believes that the current minimum exposure limit and automated quotation update feature are appropriate while the NASD considers other methods for handling small orders from retail customers.<sup>10</sup>

The Commission believes that a sufficient basis exists for approving the NASD's proposal to continue the current operation of SOES. The system provided and continues to provide retail investors enhanced opportunity to obtain execution of orders in size up to 1,000 shares and, accordingly, has improved access to the Nasdaq market.

In addition, the March 1995 Amended SOES Rules resulted in an increase in the SOES minimum exposure limit from 1,000 shares to 2,000 shares. Moreover, the March 1995 Amended SOES Rules continued the methodology for calculating a market maker's

outstanding exposure limit that excluded orders executed pursuant to a preferencing arrangement. Under the SOES Rules prior to the January 1994 Amended SOES Rules, both preferred and unpreferred orders were considered when calculating a market maker's remaining exposure limit. Thus, in relative terms, the 2,000 share exposure limit potentially provides greater liquidity under certain conditions compared to the pre-January 1994 Amended SOES Rules' 5,000 share minimum exposure limit.

The Commission continues to believe that the current operation of SOES has eliminated the economically significant restrictions imposed on order entry firms by the January 1994 Amended SOES Rules. The Commission believes that while the proposal does not restore the pre-January 1994 Amended SOES Rules minimum exposure limit, it provides customers fair access to the Nasdaq market and reasonable assurance of timely executions. In this regard, the maximum order size equals the size requirement prescribed under the Firm Quote Rule and NASD rules governing the character of market maker quotations.<sup>11</sup> Moreover, market maker's minimum exposure limit for unpreferred orders is double its minimum size requirement prescribed under these rules.<sup>12</sup>

The Commission also believes that extending the automated update function is consistent with the Firm Quote Rule.<sup>13</sup> The update function provides market makers the opportunity to update their quotations automatically after executions through SOES;<sup>14</sup> under the Commission's Firm Quote Rule,

market makers are entitled to update their quotations following an execution and prior to accepting a second order at their published quotes.<sup>15</sup>

In connection with its proposal, the NASD submitted data it believes supports extending the current minimum exposure limit and the automated quotation update feature.<sup>16</sup> In addition, in connection with the Commission's consideration of the NASD's proposal, the Commission requested that the NASD provide any industry-wide or firm-specific data that market maker firms have provided the NASD concerning the effect SOES has had on profitability or the market making function.<sup>17</sup> According to the NASD, since the restoration in March 1995 of the maximum order size of 1,000 shares, the volume of trading through SOES has increased both in absolute terms and relative to overall Nasdaq volume. As a result, the NASD believes, some market makers have withdrawn from making a market in certain Nasdaq securities. The NASD argues that failure to extend the March 1995 Amended SOES Rules would exacerbate this withdrawal.

The Commission is not convinced, however, that the data submitted by the NASD demonstrates a casual relationship between the change in the operation of SOES as a result of the March 1995 Interim SOES Rules and the decline in the number of market makers in the selected securities. Rather, the Commission believes the NASD's data demonstrates, at best, a correlation between the two. The NASD did not control for other factors that may have affected the number of market makers in the securities covered by their study (e.g., decreased spreads; increased volatility; seasonality; and increased capital requirements associated with increased prices). Such factors could potentially explain the decline in the number of market makers independent of SOES activity. In addition, the NASD

<sup>11</sup> *NASD Manual*, Schedules to the By-Laws, Schedule D, Part V, Sec. 2(a), (CCH) ¶ 1819.

<sup>12</sup> 17 CFR 240.11Ac1-1(c). Nonetheless, the Commission is concerned about the potential for delayed and/or inferior executions. In this regard, the Commission expects the NASD to monitor the extent to which exposure limits are exhausted, the extent to which the automated quotation update feature is used, and the effects these two aspects have on liquidity. Moreover, the Commission expects the NASD to consider the possibility of enhancements to eliminate the potential for delayed and/or inferior executions. The Commission expects the NASD to report back to the Commission on these issues by December 1, 1995.

<sup>13</sup> The SOES automated update function is also consistent with the NASD's autoquote policy which generally prohibits autoquote systems, but allows automatic updating of quotations "when the update is in response to an execution in the security by the firm." *NASD Manual*, Schedules to the By-Laws, Schedule D, Part V, Sec. 2 (CCH ¶ 1819).

<sup>14</sup> The NASD has indicated that 21 percent of market makers in Nasdaq National Market securities use the automated quotation update feature for 38 percent of all market making positions in Nasdaq National Market securities. Letter from Richard Ketchum, Executive Vice President and Chief Operating Officer, NASD, to Jonathan G. Katz, Secretary, SEC (Mar. 22, 1995).

<sup>15</sup> The Firm Quote Rule requires market makers to execute orders at prices at least as favorable as their quoted prices. The Rule also allows market makers a reasonable period of time to update their quotations following an execution, allows market makers to reject an order if they have communicated a quotation update to their exchange or association, and provides for a size limitation on liability at given quote. 17 CFR 240.11Ac1-1(c)(2). See also, Securities Exchange Act Release No. 14415 (Jan. 26, 1978), 43 FR 4342 (Feb. 1, 1978).

<sup>16</sup> Letter from Richard G. Ketchum, Executive Vice President and Chief Operating Officer, NASD, to Brandon Becker, Director, Division of Market Regulation, SEC (Aug. 1, 1995).

<sup>17</sup> Letter to Richard G. Ketchum, Executive Vice President and Chief Operating Officer, NASD, from Brandon Becker, Director, Division of Market Regulation, SEC (Aug. 25, 1995). As of the issuance of this order, the NASD has not provided any data in response to this request.

<sup>8</sup> 25 U.S.C. 78s(b). The Commission's statutory role is limited to evaluating the rules as proposed against the statutory standards. See S. Rep. No. 75, 94th Cong., 1st Sess., at 13 (1975).

<sup>9</sup> In the Securities Acts Amendments of 1975, Congress directed the Commission to use its authority under the Act, including its authority to approve SRO rule changes, to foster the establishment of a national market system and promote the goals of economically efficient securities transactions, fair competition, and best execution. Congress granted the Commission "broad, discretionary powers" and "maximum flexibility" to develop a national market system and to carry out these objectives. Furthermore, Congress gave the Commission "the power to classify markets, firms, and securities in any manner it deems necessary or appropriate in the public interest or for the protection of investors and to facilitate the development of subsystems within the national market system." S. Rep. No. 75, 94th Cong., 1st Sess., at 7 (1975).

<sup>10</sup> See letter from Joan C. Conley, Secretary, NASD, to Mark Barracca, Branch Chief, Division of Market Regulation, SEC (Sept. 22, 1995) (submission of File No. SR-NASD-95-42, the NASD's NAqess proposal which is designed to replace SOES).

selected securities with the largest decline in the number of market makers. From an economic and statistical basis, this introduces severe statistical problems and a bias toward those securities with the largest number of market makers. This selection, under any circumstance, would find the largest absolute changes in the number of market makers.

In further support of its proposal, the NASD continues to rely on studies previously submitted to the Commission in support of the amendments to SOES.<sup>18</sup> In its order approving both the January 1995 and March 1995 Amended SOES Rules, however, the Commission expressed its belief that this data submitted by the NASD demonstrated neither significant improvement to nor serious deterioration in the quality of the Nasdaq market subsequent to the adoption of the January 1994 Amended SOES Rules.<sup>19</sup> The information submitted since does not alter the Commission's original assessment. The Commission, therefore, continues to believe that the data submitted by the NASD demonstrates neither a significant improvement to nor serious deterioration in the quality of the Nasdaq market subsequent to the adoption of the January 1994 Amended SOES Rules.<sup>20</sup> Moreover, the Commission believes this is true whether the amended SOES rules are viewed collectively or individually. Thus, the Commission's evaluation of the data submitted by the NASD does not change its determination to approve the proposal to extend the March 1995 Amended SOES Rules through January 31, 1996.

## V. Conclusion

As indicated above, the Commission has determined to approve the October 1995 Amended SOES Rules through January 31, 1996. In light of the balance of factors described above and the limited duration of the current proposal, the Commission believes extension of the reduction in the minimum exposure limit, the limitation of the exposure limit to unpreferenced orders, and the

<sup>18</sup> Securities Exchange Act Release No. 35080 (Dec. 9, 1994), 59 FR 65109 (Dec. 16, 1994) and letter from John F. Olson, Counsel for the NASD, Gibson, Dunn & Crutcher, to Jonathan Katz, Secretary, SEC (Dec. 30, 1994) (submitting in connection with File No. SR-NASD-94-68 analysis entitled *The Association Between the Interim SOES Rules and Nasdaq Market Quality* prepared by Dean Furbush, Ph.D., Economists Incorporated (Dec. 30, 1994)).

<sup>19</sup> Securities Exchange Act Release No. 35275 (Jan. 25, 1995), 60 FR 6327 (Feb. 1, 1995).

<sup>20</sup> Nonetheless, the Commission continues to be interested in data and studies demonstrating the effect, if any, of the SOES rule changes on the Nasdaq market.

addition of an automatic quotation update feature is consistent with the Act.

The Commission, in the exercise of the authority delegated to it by Congress, and in light of its experience regulating securities markets and market participants, has determined that approval of these temporary changes to the SOES Rules until January 31, 1996 is consistent with maintaining investor protection and fair and orderly markets, and that these goals, on balance, outweigh possible anti-competitive effects on order entry firms and their customers.

Accordingly, the Commission finds that the rule change is consistent with the Act and the rules and regulations thereunder applicable to the NASD and, in particular, Sections 15A(b)(6), 15A(b)(9), and 15A(b)(11). In addition, the Commission finds that the rule change is consistent with the Congressional objectives for the equity markets, set out in Section 11A, of achieving more efficient and effective market operations, fair competition among brokers and dealers, and the economically efficient execution of investor orders in the best market.

It is Therefore Ordered, pursuant to Section 19(b)(2) of the Act, that the instant rule change SR-NASD-95-34 be, and hereby is, approved, effective October 3, 1995 through January 31, 1996.

By the Commission.  
Jonathan G. Katz,  
Secretary.  
[FR Doc. 95-24909 Filed 10-5-95; 8:45 am]  
BILLING CODE 8010-01-M

[Release No. 34-36323; File No. SR-BSE-95-14]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Boston Stock Exchange, Inc., Relating to its Competing Specialist Pilot Program

September 29, 1995.

#### I. Introduction

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> notice is hereby given that on September 25, 1995, the Boston Stock Exchange, Inc. ("BSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change, and on

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988).

<sup>2</sup> 17 CFR 240.19b-4 (1994).

September 27, 1995, Amendment No. 1 thereto,<sup>3</sup> as described in Items II and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### II. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The BSE seeks to extend the current pilot program for competing specialists on its floor until March 29, 1996, and to adopt clarifying language for limit order execution under the pilot. The Exchange also proposes to expand the program to four competing specialists that may trade up to 100 stocks each.

#### III. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

The purpose of the proposed rule change is to extend the current pilot program for competing specialists until March 29, 1996 and to clarify the priority rule regarding the execution of limit orders on the central limit book.<sup>4</sup>

<sup>3</sup> See letter from Karen Aluisse, Assistant Vice President, BSE, to Glen Barentine, Senior Counsel, SEC, dated September 27, 1995. Amendment No. 1 amended the request for an extension through June 28, 1996, to an extension through March 29, 1996.

<sup>4</sup> The language of the proposed rule change is as follows, with additions to the current rule in italics and deletions in brackets:

*Because there is only one Exchange market in a security subject to competition, all limit [Limit] orders sent to the Exchange will be maintained by the BEACON System's central limit book and will be [entrusted to each competing specialist are to be represented and] executed strictly according to time priority as to receipt of the order in the BEACON System, irrespective of firm order routing procedures.*

This rule change previously was published for public comment in Securities Exchange Act Release No. 36100 (August 14, 1995), 60 FR 43628 (August 22, 1995), as an amendment to a BSE request for permanent approval of the competing specialist program. See File No. SR-BSE-95-02.