

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-36310; File No. S7-30-95]

RIN 3235-AG66

### Order Execution Obligations

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rules.

**SUMMARY:** The Securities and Exchange Commission ("Commission") today is proposing two rules and amendments to a rule to improve the handling and execution of customer orders. In light of the availability of improvements in order handling technology and the proliferation of ancillary order handling arrangements, including payment for order flow, directed order handling and internalization, the Commission is proposing rules that are intended to improve the opportunity of investors to obtain the best execution possible for their orders. At the same time, the proposals are designed to preserve the benefits of a competitive market structure that has greatly enhanced market liquidity, transparency and efficiency.

**DATES:** Comments should be submitted on or before January 16, 1996.

**ADDRESSES:** Interested persons should submit three copies of their written data, views and opinions to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549, and should refer to File No. S7-30-95. All submissions will be made available for public inspection and copying at the Commission's Public Reference Room, Room 1024, 450 Fifth Street NW., Washington, DC 20549.

**FOR FURTHER INFORMATION CONTACT:** David Oestreicher regarding Rules 11Ac1-4 and 11Ac1-5, Ethan Corey regarding best execution obligations, and Gautam S. Gujral, Elizabeth Prout Lefler or Gail A. Marshall regarding amendments to Rule 11Ac1-1 at (202) 942-0158, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Commission proposes to amend Rule 11Ac1-1 ("Quote Rule")<sup>1</sup> under the Securities Exchange Act of 1934 ("Exchange Act")<sup>2</sup> to require exchanges and over-the-counter ("OTC") market

makers in listed securities to publish quotations for listed securities where the exchange or OTC market maker trades more than 1% of the aggregate trading volume for that security. The Commission also proposes to amend the Quote Rule to require exchange specialists and OTC market makers to quote to the public any better prices that they privately quote through certain electronic communications networks. Further, the Commission proposes to require specialists and OTC market makers to display customer limit orders priced better than the specialist's or OTC market maker's quote. Finally, the Commission proposes to require that specialists and OTC market makers provide customer market orders some opportunity for price improvement before executing the order. The rule provides for order exposure procedures that, if followed, would be deemed to satisfy the requirement that a specialist or OTC market maker provide an opportunity for price improvement. These procedures are not, however, intended to be the only method by which OTC market makers and specialists may offer the opportunity for price improvement.

### I. Introduction

#### A. Background

The vision of a "national market system" ("NMS"), which Congress adopted in the Securities Acts Amendments of 1975 ("1975 Amendments"),<sup>3</sup> has served our markets well, fostering a market system that by any measure is the fairest and most efficient in the world. The idea of an integrated system in which competition among linked markets would make the best prices universally available, transparent disclosure of quotes and trades would promote best execution, and broker-dealers would place the interests of customers first, represented a significant step forward for our markets. The costs and dislocations associated with implementing the systems required were substantial and concerns that liquidity would be impaired were pervasive. The undertaking primarily was placed on the shoulders of the securities industry: the Commission took seriously the Congressional mandate that it "facilitate" these goals while allowing maximum flexibility in the design.

The last 20 years have seen continued progress toward an NMS. Major infrastructure developments such as the Consolidated Quotation System ("CQS"), the consolidated transaction

tape, last-sale reporting for OTC securities, and the Intermarket Trading System ("ITS") have made information about trading interest, volume, and prices widely available to market participants. The technological innovations of the last two decades have made it possible to display, route, and execute orders in volumes unheard of even a few years ago. Communication among markets and market participants, once slow and costly, is now instantaneous and economical. Now more than ever, investors can expect that their orders will be executed at the best prices available across a spectrum of markets. In a very real sense, investors have benefited directly from the NMS initiatives, as increased transparency has contributed to greater liquidity and better enabled investors to monitor the quality of their executions, and technology has allowed better, quicker, and cheaper access to the markets.

Notwithstanding these positive developments, improved technology also has made possible market practices and structures that raise the issue of whether customers are consistently afforded the enhanced opportunities for better prices made possible by innovations in price dissemination and order handling. Questions have been raised about whether increasingly commonplace practices such as the routing of customer order flow to market makers and specialists in return for payment and the internalization of customer orders by integrated firms may reduce competition based on published quotes. In addition, customers' limit orders are not always displayed in all markets. At a minimum, those customers whose orders are not displayed lose the opportunity to have their orders interact with the market.

There are also concerns about whether quotations fully convey the quality of information intended by the 1975 Amendments. The development of electronic trading systems that allow market makers to display different prices to different customers has created the potential for two-tiered markets in which market makers quote one price to public investors while quoting better prices in private systems. As a result, investors without access to these "hidden" quotes may not obtain the benefit of the best available prices. Similarly, investors may not receive the best available prices when other customers' limit orders are not represented in the quotes. When specialists and OTC market makers fail to display limit orders that improve the inside quotes, the quotes do not convey the real quotation spread and may

<sup>1</sup> 17 CFR 240.11Ac1-1.

<sup>2</sup> 15 U.S.C. 78a to 78ll (1988).

<sup>3</sup> Pub. L. No. 94-29, 89 Stat. 97 (1975).

present an inaccurate picture of trading interest.

In many respects, these structures and practices have neither kept pace with investors' needs nor advanced Congress' mandate for an NMS. Some investors have sufficient market power, sophistication and access to information and markets necessary to ensure best execution of their orders. Retail customers, however, typically depend on their brokers for information and access to the market. Regardless of whether the execution occurs in an exchange market or OTC, investors expect prompt executions at the best prices reasonably obtainable. Investors should be able to rely on published quotations for an accurate picture of the market. Investors should receive fair treatment for their orders and should not have to compete with their own brokers for quality executions.

Ultimately, if market structures and practices work to their disadvantage, investors will lose confidence in the fairness of the market. The tremendous success of our markets over the last 20 years has been due in large part to investor confidence in their fairness, integrity, and efficiency. To the extent that practices and structures such as hidden limit orders, payment for order flow, internalization, and two-tiered markets may not satisfy investor needs and diminish transparency, these practices threaten to undermine investor confidence and market efficiency.

Congress saw competition as the primary source of change and innovation in achieving an NMS and directed the Commission to use its rulemaking authority to remove impediments to competition and facilitate the development of an NMS. To the extent that order flow increasingly is routed on a basis other than quote competition, the transparency and competitiveness of our markets may suffer. Similarly, the continued fragmentation of quotations erodes the value of the quote. Accordingly, the Commission believes that it is time to propose action to ensure the future confidence of investors and the competitiveness of American markets.

The Commission today is proposing a series of initiatives that would enhance transparency in our markets and improve the handling and interaction of customer orders. The proposed rules stress that markets and dealers should disclose as much information about supply and demand as is practicable. Transparency of customer orders ensures that prices fully reflect overall supply and demand and prevents market fragmentation. The proposed

rules assure the continued availability of quality information with respect to quotations. In addition, the proposed rules seek to improve opportunities in auction and dealer markets for market orders to interact directly with other market orders and public limit orders, consistent with the goals of a national market system.

The proposed rules reinforce the importance of fair competition among markets and market participants. The Commission believes that the introduction of new technologies during the past 20 years has been largely a product of competition in our markets. In recognition of the importance of fostering continued innovation through competitive market forces, as well as Congress's mandate to facilitate-but-not-design, the proposals do not require any particular system or market structure. Rather, they attempt to achieve their intended effect by establishing minimum standards for the handling of customer orders. The intent is to further the goals of an NMS while preserving an atmosphere in which innovation is welcome and rewarded.

#### *B. The Duty To Seek Best Execution of Customer Orders*

Even absent the rule proposals being issued for comment today, the duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.<sup>4</sup> Although the duty of best execution is longstanding, the specific obligations of broker-dealers in fulfilling that duty have evolved over time. As developments in market structure and technology create new opportunities to achieve better execution of customer orders, it is incumbent on the Commission and the markets to take full advantage of those developments.

Historically, with the development of sophisticated price dissemination and order routing systems, broker-dealers gained better, more economical means to determine the best price for a security trading in multiple markets. For example, before the advent of the Nasdaq automated quotation system, broker-dealers manually routed their customer orders to OTC market makers, and were viewed as having made reasonable efforts if they contacted three market makers to find the best available price. The development of Nasdaq enabled broker-dealers to check the quotations of all Nasdaq market makers

<sup>4</sup> See Securities Exchange Act Release No. 30920 (July 14, 1992), 57 FR 32587 (July 22, 1992); Division of Market Regulation, *Market 2000: An Examination of Current Equity Market Developments* (Jan. 1994) ("Market 2000"), Study V.

at once, thus expanding the range of OTC quotes to be taken into account in seeking best execution.<sup>5</sup> In the listed markets, the CQS provided broker-dealers for the first time with the currently reported bids, offers, and quotation sizes of brokers and dealers trading listed securities both on exchanges and in the OTC market.<sup>6</sup> In approving the CQS, the Commission stressed that it would expect broker-dealers to take into account the pricing information made available through the system in fulfilling their best execution obligations.<sup>7</sup>

Over time, exchanges and broker-dealers also have developed automated order routing systems to process small trades. The Commission concluded in response that an automated order routing environment was not necessarily inconsistent with the achievement of best execution.<sup>8</sup> Indeed, the Commission recognized that it could be impractical, both in terms of time and expense, for a broker that handled a large volume of orders to determine individually where to route each order it received. The Commission therefore stated that broker-dealers routing orders for automated execution could satisfy their best execution obligations by assessing periodically the quality of competing markets to assure that aggregated order flow was directed to markets providing the most advantageous terms for their customers' orders.<sup>9</sup>

In this regard, the Commission recently cited a staff position warning broker-dealers against presuming that routing order flow to a market providing quote-based executions always would satisfy the duty of best execution for small orders in listed securities; at the same time, the Commission noted the role of price improvement as a factor in best execution, speaking in the context of aggregate order routing decisions for

<sup>5</sup> Market 2000, *supra* note 4, at II-11.

<sup>6</sup> Securities Exchange Act Release No. 15009 (July 28, 1978), 43 FR 34851 (Aug. 7, 1978) (first declaring temporarily effective CQS Plan); Securities Exchange Act Release No. 16518 (Jan. 22, 1980), 45 FR 6521 (Jan. 28, 1980) (permanently approving CQS Plan).

<sup>7</sup> *Id.*

<sup>8</sup> Securities Exchange Act Release No. 15671 (Mar. 22, 1979), 44 FR 20360 (Apr. 4, 1979); Securities Exchange Act Release No. 15926 (June 15, 1979), 44 FR 36912, 36923 n. 118 (June 22, 1979); Securities Exchange Act Release No. 17583 (Feb. 27, 1981), 46 FR 15713, 15715 n. 16 (Mar. 9, 1981); Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963, 23973 n. 127 (June 5, 1989); Market 2000, *supra* note 4, Study V at V-1 n. 8; Securities Exchange Act Release No. 34902 (Oct. 27, 1994), 59 FR 55006, 55009 n. 30 (Nov. 2, 1994) ("Payment for Order Flow Release").

<sup>9</sup> See sources cited *supra* note 8.

listed and OTC stocks.<sup>10</sup> For example, trades in listed securities that are routed to an exchange typically are exposed to other public orders or interest in the trading crowd that exists on the trading floor.<sup>11</sup> Such order exposure brings with it the possibility for price improvement, *i.e.*, an execution at a price that is better than the existing quotes. In addition, with the development of sophisticated order handling systems, some OTC market makers are now providing an opportunity for price improvement for their customer orders.

As technology has advanced, certain order handling routines that may not have been economical or even possible several years ago have become available. Using internal automated systems, some broker-dealers now are able to route orders automatically to the dealer market or automated system offering the best price, or alternatively, match the best price themselves and execute the order as principal. It now is possible for some broker-dealers to seek better prices for their customers' orders not only on the CQS and Nasdaq, but also on other market systems, such as SelectNet. More importantly, the availability of sophisticated order handling systems has made it possible for some broker-dealers and market centers to provide an opportunity for price improvement for their customer orders. The use of these efficient routing and execution facilities by firms and exchanges suggests that price improvement procedures and other best execution safeguards in an automated environment are increasingly practicable and are setting new standards for the industry.

In the past, quote based executions in OTC securities were generally recognized as satisfying best execution obligations.<sup>12</sup> The development of efficient new facilities, however, alters what broker-dealers must consider in seeking best execution of customer orders. In determining the parameters of what is reasonable in particular circumstances, the Commission believes that in light of recent developments broker-dealers must now consider not

only their customers' expectations, but also ways of obtaining improved executions for customers using the range of available new technologies as they evolve. While not all markets and trading systems are equally accessible to large and small broker-dealers, and not all order handling technologies are equally affordable to all broker-dealers, when efficient and cost effective systems are readily accessible, broker-dealers must evaluate carefully whether they can be used in fulfilling their duty of best execution.

### C. Overview of the Proposed Rules

The rules proposed today will increase the opportunities for investors to receive best execution for their orders and promote market efficiency. Moreover, by stressing the importance of transparency and price improvement, the proposed rules should reinforce competition among markets and market participants. The rules proposed today, however, are not intended to alter or displace the well-established duty under the antifraud principles for market participants to provide customers with best execution. Broker-dealers remain obligated to seek the most favorable terms possible under the circumstances for their customers.

The first of these rule proposals involves amendments to the Quote Rule that would improve information about the significant market makers in a security and the prices they are quoting. The proposals would require exchanges and OTC market makers that account for more than 1% of the volume in a listed security to publish their quotations for that security. In addition, the amendments would require exchange specialists and OTC market makers who submit priced orders to certain electronic communications networks to include those orders in their published quotes.

Second, the Commission is proposing a minimum standard for all markets that would require the display of customer limit orders under certain circumstances. The proposed rule would promote best execution of customer limit orders, and would increase market transparency and efficiency by ensuring that prices fully reflect overall supply and demand.

Finally, the Commission has previously stated in other contexts that broker-dealers have a duty to consider opportunities for price improvement when deciding where to route customer orders for execution.<sup>13</sup> In support of this duty, the rules would require OTC

market makers and specialists to provide their customer orders with an opportunity for price improvement. Recognizing that OTC market makers and specialists currently employ a variety of systems and procedures to provide price improvement opportunities, the proposed rule does not impose any one formula or mechanism for achieving price improvement. Nonetheless, to provide guidance to dealers as to one set of conditions under which they would satisfy their obligation under the rule, the Commission is proposing a non-exclusive safe harbor. The safe harbor sets out a procedure that would satisfy the price improvement obligation while allowing for the duty to be satisfied by alternative means. The Commission also seeks comment on alternative safe harbors.

While the legislative history of the 1975 Amendments recognized that order exposure and interaction may not be appropriate for some securities, Congress intended that for as many securities as feasible, the NMS should ensure that public investors receive the benefits and protections associated with transparency and order interaction. Accordingly, the rules proposed today are designed to comply with the principle that a broker-dealer will seek the same quality of execution regardless of whether the broker-dealer is acting as principal or agent, and regardless of whether the transaction is effected in an exchange or OTC market.

## II. Proposals

### A. Amendments to the Quote Rule

#### 1. Background

The proposed amendments to the Quote Rule are designed to: (1) expand the coverage of existing broker-dealer quotation requirements to include substantial market makers in non-Rule 19c-3 securities,<sup>14</sup> and (2) ensure that OTC market makers and exchange specialists reflect in their public quotes the best prices they have published in certain electronic communications networks.

The Commission believes these amendments are important to enhance competition in publicly disseminated

<sup>10</sup> See Payment for Order Flow Release, *supra* note 8, at text accompanying nn. 31-33.

<sup>11</sup> See Payment for Order Flow Release, *supra* note 8. In addition, most regional exchanges have incorporated order exposure features into their small order routing and execution systems so that price improvement may be offered. Most regional exchanges program their automated execution systems to ensure that customer orders receive a price at the national best bid or best offer ("NBBO") or better, and the specialist is provided an opportunity to improve the price. Payment for Order Flow Release, *supra* note 8, at n. 32 and sources cited therein. This feature by itself, however, rarely provides an execution between the spread.

<sup>12</sup> Market 2000, *supra* note 4, Study V at V-4.

<sup>13</sup> See Payment for Order Flow Release, *supra* note 8.

<sup>14</sup> See 17 CFR 240.19c-3. Exchange Act Rule 19c-3 prohibits the application of off-board trading restrictions to securities that: (1) were not traded on an exchange before April 26, 1979; or (2) were traded on an exchange on April 26, 1979, but ceased to be traded on an exchange for any period of time thereafter. Accordingly, exchange-traded securities not subject to off-board trading restrictions are referred to as Rule 19c-3 securities, and exchange-traded securities subject to off-board trading restrictions are referred to as non-Rule 19c-3 securities.

quotes. Furthermore, these amendments are intended to improve published quotation information by ensuring that OTC market makers and exchanges publicly disseminate quotations in the exchange-listed securities they actively trade, and by ensuring that the best bid and offer prices are made available to public investors.

The legislative history of the 1975 Amendments makes it clear that a prompt, accurate and reliable composite quotation reporting system is an essential element of the NMS.<sup>15</sup> Congress believed it essential that the composite quotation reporting system include quotations from all market centers.<sup>16</sup> Those Amendments also granted the Commission "pervasive rulemaking power to regulate securities communications systems."<sup>17</sup>

#### a. Dissemination of Quotes Under the Rule

Public quote reporting for equity securities is governed by Section 11A of the Exchange Act,<sup>18</sup> the Quote Rule<sup>19</sup> and Rule 11Aa3-2 (the "Plan Rule"),<sup>20</sup> as well as exchange and NASD rules. These rules require registered exchanges and securities associations<sup>21</sup> to file quotation reporting plans with the Commission that provide for the collection and transmission of quotation information on a real-time basis.<sup>22</sup> Specialists and OTC market makers communicate their quotes to the exchange and to the NASD pursuant to these plans and the SROs in turn make this information available to vendors for dissemination to the public.<sup>23</sup> The Quote Rule requires public dissemination of the best bid, best offer, and size for each market trading the security as well as the consolidated best bid and offer.<sup>24</sup> Quotations provided to vendors must be firm, and a specialist or OTC market maker generally is

obligated to execute any order at a price at least as good as its published bid or offer.<sup>25</sup> Brokers and dealers covered by the Rule, including dealers trading listed securities in the OTC market (*i.e.*, third market makers), must supply quotations to their exchange or association for dissemination to quotation vendors.

#### b. Mandatory and Voluntary Quotes Under the Rule

When the Commission first proposed the Quote Rule, it noted that a lack of reliable quotation information from the various markets was hampering private and self-regulatory efforts to establish a viable composite quotation system which consequently was impeding the development of an NMS.<sup>26</sup> Accordingly, the Quote Rule, as originally adopted, mandated that specialists and OTC market makers subject to the Rule's provisions communicate their quotations promptly to their relevant exchange or association and that such quotations be "firm."

Shortly after the rule was adopted, the Commission granted exemptive relief to exchanges and OTC market makers<sup>27</sup> responsible for less than 1% of the aggregate trading volume in a reported security, primarily because the costs of compliance with the mandatory Quote Rule for such exchanges and OTC market makers with *de minimis* market share were substantially disproportionate to any reasonably anticipated competitive benefits.<sup>28</sup>

In 1982, the Commission amended the rule to make quote dissemination voluntary rather than mandatory for

those OTC market makers and exchanges with less than 1% of the volume in Rule 19c-3 securities. For non-Rule 19c-3 securities, the amendment required OTC market makers and exchanges to communicate quotes only when they qualified as the principal market for the security. Market makers could voluntarily quote if they elected to do so in accordance with the Rule. Thus, under the Quote Rule presently, unless an OTC market maker or exchange is responsible for such a significant share of the trading volume that it can be considered the principal market for an exchange-traded security, its decision to register to communicate its quotes in non-Rule 19c-3 securities is purely voluntary.<sup>29</sup>

The Commission noted that many of the quotations provided by dealers to comply with the mandatory rule had been inaccurate and stale or produced by systems designed to track the primary market automatically.<sup>30</sup> Processing and dissemination of the resulting quotation information, some of which was deemed unreliable, had been a strain on vendor systems. The Commission also believed that the operation of the ITS,<sup>31</sup> through which third market makers who disseminate quotes may effect transactions with other markets in Rule 19c-3 securities, would create an economic incentive to quote competitively in the affected securities in the absence of a mandate.

However, after the adoption of the voluntary quote rule, regional exchanges continued to quote the securities they traded using automated quotation devices that tracked the national best bid and offer.<sup>32</sup> Today, although many

<sup>25</sup> See Rule 11Ac1-1(c)(1), 17 CFR 240.11Ac1-1(c)(1).

<sup>26</sup> See Securities Exchange Act Release No. 12670 (July 29, 1976), 41 FR 32856 (Aug. 5, 1976) ("Quote Rule Proposing Release").

<sup>27</sup> See *e.g.* Securities Exchange Act Release No. 15747 (Apr. 19, 1979), 17 S.E.C. Doc. 304, granting Amwiss International Corporation exemptive relief from paragraph (c)(1) of the Quote Rule, pursuant to paragraph (d) of the rule, ("Amwiss exemption"). The Commission also granted exemptive relief to certain exchanges which accounted for a *de minimis* share of the consolidated volume in any reported security. See Securities Exchange Act Release No. 15012 (July 28, 1978), 43 FR 33978 (Aug. 2, 1978) (Intermountain Stock Exchange); Securities Exchange Act Release No. 15011 (July 28, 1978), 43 FR 33983 (Aug. 2, 1978) (Spokane Stock Exchange); Securities Exchange Act Release No. 15010 (July 28, 1978), 43 FR 33976 (Aug. 2, 1978) (Cincinnati Stock Exchange); Securities Exchange Act Release No. 15013 (July 28, 1978), 43 FR 33981 (Aug. 2, 1978) (Philadelphia Stock Exchange).

<sup>28</sup> See Securities Exchange Act Release No. 15771 (Apr. 26, 1979), 44 FR 26067 (May 4, 1979). See also Securities Exchange Act Release No. 18482 (Feb. 11, 1982), 47 FR 7399, 7405 (Feb. 19, 1982) (stating that the Commission has followed an established policy of granting exemptive relief to OTC market makers with a *de minimis* share of the order flow in a particular security).

<sup>29</sup> An OTC market maker in reported securities may effectively elect to disseminate quotations under proposed paragraph (a)(25)(ii)(B) by registering as a NASD market maker and "communicating" its best bids and offers to the association by entering two-sided quotations in the Nasdaq System. See NASD By-Laws, Schedule D, Part V, § 1 (CCH) ¶ 1816D.

Similarly, an exchange that is not the principal market for a reported security may voluntarily elect to disseminate quotes for the security pursuant to proposed paragraph (a)(25)(i)(B).

<sup>30</sup> See Securities Exchange Act Release No. 17583 (Feb. 27, 1981), 46 FR 15713 (Mar. 9, 1981).

<sup>31</sup> The ITS commenced operation on a pilot basis on April 17, 1978. The ITS is an intermarket order routing facility which permits orders for the purchase and sale of multiply-traded securities to be sent directly from one market center to another. OTC market makers do not have access to ITS for non-Rule 19c-3 securities.

<sup>32</sup> In this regard, the ITS Plan provides:

each Participant that furnishes to other Participants bid-asked quotations that are generated by an automated quotation tracking system (such as the Autoquote or the Centramart system currently employed by certain Participants) agrees that no such quotation shall be for more than 100 shares.

<sup>15</sup> S. Rep. No. 75, 94th Cong., 1st Sess. 9-10 (1975) ("Senate Report"). Cf. H.R. Rep. No. 229, 94th Cong. 1st Sess. 29 (1975) ("House Report") (noting that conference committee adopted the Senate's provisions on the NMS with minor revisions).

<sup>16</sup> Senate Report, *supra* note 15 at 101.

<sup>17</sup> *Id.* at 93.

<sup>18</sup> 15 U.S.C. 78k-1.

<sup>19</sup> 17 CFR 240.11Ac1-1 (1993). See Securities Exchange Act Release No. 14415 (Jan. 26, 1978), 43 FR 4342 (Feb. 1, 1978).

<sup>20</sup> 17 CFR 240.11Aa3-2 (1993).

<sup>21</sup> The NASD is the only registered national securities association.

<sup>22</sup> See Rule 11Ac1-1(b)(1), 17 CFR 240.11Ac1-1(b)(1) (dissemination requirements for exchanges and associations).

<sup>23</sup> Rule 11Ac1-2, 17 CFR 240.11Ac1-2 ("Vendor Display Rule") requires vendors of market information to display quotation information in a non-discriminatory manner.

<sup>24</sup> See Rule 11Ac1-1(b)(1), 17 CFR 240.11Ac1-1(b)(1).

third market makers quote competitively, some do so selectively, choosing not to display quotes for securities that are subject only to voluntary quote provisions. In fact, several active third market makers maintain continuous, two-sided quotations but do not disseminate them to the investing public because they are not obligated to do so. This has left a significant gap in the quotation information which is available to all investors, contrary to an essential goal of the NMS.

While the Commission believes that the 1% threshold for mandatory quotes continues to be appropriate, the Commission believes the disparate treatment of Rule 19c-3 and non-Rule 19c-3 securities now should be revisited.<sup>33</sup> Since the Quote Rule initially was promulgated, and thereafter amended, trading under the regulatory scheme has evolved and market participants and the Commission have gained substantial experience under Rule 19c-3 and the Quote Rule. For example, as more securities have become subject to Rule 19c-3, trading volume in the third market has grown.<sup>34</sup> Thus, off-board trading in Rule 19c-3 securities now accounts for a greater number of stocks and a more substantial percentage of U.S. trading volume than it did when the Commission initially established the disparate treatment for quotations in Rule 19c-3 and non-Rule 19c-3 securities under the Quote Rule.

In view of the growth of third market trading volume, much of which is executed by automated systems at prices derived from the principal markets, the Commission questions whether this trading should continue to be conducted on the basis of voluntary quotations, or whether it should be subject to standards similar to those for trading Rule 19c-3 securities. Under the Quote

<sup>33</sup> *ITS Plan*, 8(d)(ii). Thus, it is not unusual for exchanges to disseminate quotations, presumably generated by computers, that are bid at 1/8 below the best national bid and offered at 1/8 above the best national offer, for 100 shares on each side.

<sup>34</sup> Firms that trade non-Rule 19c-3 securities off an exchange are not subject to the same requirements as third market makers that meet the 1% threshold for Rule 19c-3 securities. For example, a third market maker required to quote in a Rule 19c-3 security must register as a CQS market maker with the NASD. *NASD Manual*, Schedule D to the By-Laws, Part VI, § 1, (CCH) ¶ 1828. CQS market makers are subject to the NASD's CQS market maker rules, which include firm and continuous two-sided quote obligations and mandatory participation in Nasdaq's Computer Assisted Execution System ("CAES"), and in the *ITS*. *NASD Manual*, Schedule D to the By-Laws, Part IV, § 1, 2, (CCH) ¶ 1828, 9.

<sup>35</sup> See *Fragmentation vs. Consolidation of Securities Trading: Evidence from the Operation of Rule 19c-3*, Office of Economic Analysis, SEC, pp. 4-5 (Mar. 29, 1995).

Rule presently, executing market makers are subject to disparate quotation requirements for non-Rule 19c-3 and Rule 19c-3 securities. The Commission questions whether there are sufficient distinctions between trading in Rule 19c-3 securities and other listed securities to justify different quotation standards. Requiring OTC market makers and exchanges that account for more than 1% of the volume in a listed security to disseminate quotations for that security would provide greater information about significant market makers in the security, and the prices at which they are willing to trade.

The proposed uniform application of the Quote Rule to all exchange-listed securities, if adopted, raises the issue of the disparate treatment of Rule 19c-3 and non-Rule 19c-3 securities under the *ITS Plan*. Currently, the *ITS Plan* provides access to any participant in any Rule 19c-3 security in which the participant disseminates continuous two-sided quotations, but excludes OTC market makers from *ITS* access for non-Rule 19c-3 securities. The proposed amendments to the Quote Rule would subject OTC market makers and exchanges to the same quotation requirements for all exchange-listed securities. Accordingly, the Commission believes it is appropriate to reconsider the issue of *ITS* access by third market makers. The Commission requests comment on whether the amendments should be accompanied by an expansion of the linkage between *ITS* and the NASD's CAES to provide *ITS* access to and from any market maker for any exchange-listed security in which that market maker disseminates continuous two-sided quotations.

Requiring active third market makers to quote also raises the issue of whether revisions to a current NASD rule that restricts certain computer generated quotations are necessary.<sup>35</sup> Regional exchange specialists currently may use automated mechanisms to track the NBBO in a security if they maintain a quotation size of no more than 100 shares. OTC market makers, however, are prohibited, by NASD requirements, from using similar automated quotation tracking systems. The NASD requirements are designed to prevent the multiplication of non-competitive quotes, with their attendant burden on

<sup>36</sup> *NASD Manual*, Schedules to the By-Laws, Schedule D, Part IV, Sec. 2, (CCH) ¶ 1829. The NASD, however, provides an automated quotation update capability (auto-refresh) which market makers may elect to use. Specifically, the quote of a market maker using auto-refresh will be automatically updated when the market maker exhausts its exposure limit in the NASD's Small Order Execution System.

system capacity. In the absence of an amendment to the NASD rule, market makers in effect often would be required to maintain firm, continuous two-sided markets without using computers to generate those quotes. The Commission requests comment on whether computer generated quotations should be permitted if active third market makers are required to quote in non-Rule 19c-3 securities, and if so, under what conditions.

The Commission also notes that the proposed amendments to the Quote Rule would extend the coverage of the rule to all Nasdaq securities (including SmallCap securities) where previously the rule applied only to Nasdaq/National Market securities. The Commission preliminarily believes that this element of the proposal should not impose new costs on market participants because the NASD rules concerning quotations already treat Nasdaq/National Market and SmallCap securities similarly. The Commission believes that this aspect of the proposed Quote Rule amendment, therefore, simply extends Exchange Act rule coverage to the same range of securities as existing NASD rules.

#### c. Dissemination of Quotes Through Electronic Communications Networks

Since the Quote Rule's adoption in 1978, electronic communications networks have been developed that allow participants to enter priced orders which are widely disseminated to third parties and which permit such orders to be executed in whole or in part. Participants may include investors (retail and institutional), broker-dealers, and market makers. The sponsors of these systems may be regulated as broker-dealers even though the manner of operation of the systems may differ from the activities of traditional broker-dealers.<sup>36</sup>

The Commission traditionally has been concerned with the creation of so-called "hidden markets" whereby an OTC market maker or specialist publishes quotations in some market centers at prices superior to the quotation information disseminated broadly by such OTC market maker or specialist.<sup>37</sup> Due to an increasing number of electronic communications networks being developed by market participants and market centers, quotation information is becoming splintered, with OTC market makers and specialists publishing different

<sup>36</sup> See Market 2000, *supra* note 4, at III-12. See also 17 CFR 240.17a-23 regarding regulation of Broker Dealer Trading Systems.

<sup>37</sup> See Securities Exchange Act Release No. 17583, *supra* note 30.

proposed trading prices in different quotation systems, some with limited access. As a result, smaller retail customers do not always obtain the benefit of the best available price.

While these systems may have increased intermarket competition, the Commission believes that consolidated quotations and their dissemination to the public continue to be important elements of the NMS. Moreover, while competition is an important goal of the NMS, competition based on fragmented quotations may reduce efficient pricing of publicly disseminated bids and offers, thereby impeding the NMS goal of consolidated quotations. More importantly, the availability of accurate quotation information enables investors to police the efforts of their brokerage firms to obtain the best price possible for their orders.

Over 20 years ago, the Commission noted that an essential purpose for the establishment of an NMS "is to make information on prices, volume, and quotes for securities in *all* markets available to *all* investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell, or not sell for less than the highest price a buyer is prepared to offer."<sup>38</sup> In adopting the 1975 Amendments, Congress embraced the Commission's position by specifying in Section 11A(a)(1)(C)(iii) of the Exchange Act that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure "the availability to brokers, dealers and investors, of information with respect to quotations for and transactions in securities."<sup>39</sup>

The proposed amendments to the Quote Rule are intended to improve the quality and expand the scope of published quotation information from OTC market makers and specialists by requiring them to reflect in their public quotes the bid and offer prices (*e.g.*, priced orders) they disseminate through electronic communications networks that provide the ability to execute against these priced orders. The amendments are designed specifically to address what the Commission believes

to be the potential for market makers to quote one price to public investors but to publish firm quotes in private systems at better prices.

## 2. Proposed Amendments

### a. Definition of Subject Security

Coverage of the Quote Rule would be expanded pursuant to proposed subparagraph (a)(6), which defines a "covered security." As proposed, a covered security would mean any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Exchange Act.<sup>40</sup> This expansion of coverage would bring Nasdaq SmallCap securities within the scope of the Quote Rule.<sup>41</sup> Thus, market makers in those securities would be obligated under the Rule, as well as NASD rules, to provide quotes and to honor those quotes in trading with the public.<sup>42</sup>

### b. Market Makers That Trade More Than 1% of a Security in a Quarter

The proposed amendments to the Quote Rule would expand the definition of a subject security to include non-Rule 19c-3 securities as well as Rule 19c-3 securities. As a result, firms that hold themselves out as willing to buy and sell non-Rule 19c-3 securities on a regular or continuous basis, even if they

<sup>40</sup> 15 U.S.C. § 78c(a)(51)(A)(ii).

<sup>41</sup> Section 11A(c)(1) grants the Commission the authority to prescribe, among other matters, rules and regulations to assure accurate and reliable quotations "with respect to any security other than an exempted security." The Commission believes that extending the requirements of the Quote Rule to Nasdaq SmallCap securities will further these interests.

<sup>42</sup> In addition to the changes discussed in greater detail herein, the Commission is proposing to make technical, non-substantive changes to the Quote Rule. The terms "association," "revised bid or offer," and "revised quotation size" will be separately defined in the rule. The definition of "exchange-traded security" has been revised to exclude OTC securities traded on an exchange pursuant to unlisted trading privileges. The definition of "plan processor" has been amended to reflect the appropriate cross-reference. The definition of "principal market" has been removed from the Quote Rule because it is no longer applicable. In addition, the definitions have been rearranged in alphabetical order.

Paragraph (b)(1)(i) of the rule has been reorganized to separately set forth the exclusions in subparagraphs (A) and (B). Paragraph (b)(1)(iii) has been eliminated and the substance of the provision has been incorporated into paragraphs (b)(1)(i) and (b)(1)(ii).

The Commission is also proposing to amend the definition of the term "reported security" as it appears in Rule 11Aa3-1(a)(4). The amendment alters the form but not the meaning of the term or its application. The amendment will make the term consistent with the definition of "reported security" in the Quote Rule.

have not elected to register as market makers with the NASD, would be subject to the rule, contingent upon meeting the 1% threshold. Exchanges that trade more than 1% of either a Rule 19c-3 or a non-Rule 19c-3 security would also be required to make continuous two-sided quotes available to the public.

The practical implication of this amendment is that the most active market makers in non-Rule 19c-3 securities, who currently have no obligations to report quotations, would be required to register as CQS market makers and disseminate continuous two-sided quotations publicly.

The Commission also is proposing an amendment to the definition of "OTC market maker" to include a market maker that holds itself out as willing to buy from and sell to its customers, if it does so on a regular or continuous basis. This would apply even if the market maker does not hold itself out as willing to buy and sell to the market in general. Dealers that internalize customer order flow in particular stocks, and dealers that hold themselves out to particular firms as willing to execute their customer order flow, and who execute these orders on a regular or continuous basis, would be considered market makers under the proposed amendment. As in the past, broker-dealers would not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer's request. Moreover, the proposed definition does not encompass block positioning.

### c. Use of Electronic Communications Networks

The Commission is proposing to include prospectively within the definition of "bid" or "offer" under the Quote Rule priced orders that market makers enter into widely disseminated electronic communications networks, thereby requiring market makers to include such orders in the bids and offers they communicate to their exchange or association for reflection in their published quotations.<sup>43</sup> New paragraph (c)(5)(i)(A) would deem, prospectively, dissemination of a priced order by an exchange market maker, defined to include specialists, and an

<sup>43</sup> Paragraph (a)(3) of the amended Quote Rule defines the terms "best bid" and "best offer" to mean the highest priced bid and lowest priced offer.

Conforming amendments to the definition of "bid" and "offer" and paragraph (c)(1) are proposed to, in effect, require brokers and dealers to report their "best bids" and "best offers" rather than their "most recently" communicated bids and offers. This represents a change from the existing rule's reliance on a temporal standard to a price standard.

<sup>38</sup> Securities and Exchange Commission, *Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets* (Feb. 2, 1972) ("Future Structure Statement") at 9-10, 37 FR 5286, 5287 (Feb. 4, 1972) (emphasis added). See also SEC, *Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System* (1973) at 25-28.

<sup>39</sup> 15 U.S.C. § 78k-1(a)(i)(c)(iii).

OTC market maker in an electronic communications network to be a publication of a bid or offer.<sup>44</sup> The rule would not require the OTC market maker or specialist to publish in its publicly disseminated quote the full size of the priced order included in the electronic communications network. Rather, the OTC market maker or specialist would be required to disseminate publicly the price of the order and the minimum size set by the exchange or association.

The term "electronic communications network" would include continuous auction systems, but is not intended to include crossing systems or broker-dealer internal order routing systems. The term "priced order" within the rule refers to orders at a specified price, not indications of interest. Thus, the Commission intends the scope of this proposal to include disseminated commitments to buy or sell a security at a particular price for a particular number of shares (which may be effected in whole or in part). The Commission does not intend the scope of the amendments to include disseminated interest to buy or sell a security where price or the number of shares is not included as part of the dissemination. Furthermore, the rule does not apply to odd-lot orders. Unlike the other proposals, these proposed amendments do not include exceptions for block orders or orders for which an OTC market maker's or specialist's customer has expressly requested that the order not be displayed. However, the Commission requests comment on whether the rule should exclude orders where an OTC market maker or specialist is acting as agent if its customer requests that the order not be displayed.

The Commission recognizes that the exchanges and the NASD impose minimum price variations for securities traded or quoted by their members. For example, currently most exchange-listed securities are quoted and traded with a minimum price variation of  $\frac{1}{8}$  point or, in some instances,  $\frac{1}{16}$  point. Nasdaq securities may be traded and reported in variations as low as  $\frac{1}{256}$ , and may be quoted in minimum variations of  $\frac{1}{16}$ . Some existing electronic communications networks allow for trading variations as low as  $\frac{1}{256}$ , and

some systems also provide for decimal variations as low as a penny. The fact that systems allow for different minimum variations in the quote may cause conflicts for OTC market makers and specialists attempting to comply with the proposed amendments to the Quote Rule. For example, a market maker may submit an order in an electronic communications network at a price of  $20\frac{5}{16}$ , but only have the facility to post a quote in the primary market in minimum variations of  $\frac{1}{8}$ . The Commission does not intend to create incentives for OTC market makers or specialists to increase the size of the fractions they would quote in electronic communications networks or in any other market. As such, the proposed amendment to the quote rule, if adopted, may necessitate simultaneous changes to the minimum price variations across markets.

The proposed amendments would ensure that OTC market makers and specialists in a stock reflect in their quotes superior priced quotation information including buy and sell orders in that stock that they have entered into electronic communications networks, as described. As a result, an OTC market maker or specialist that was making a continuous market in a stock, but was not previously publishing quotes in that stock, would obligate itself by making quotes available to electronic communications networks to publish two-sided quotes in that stock. While this obligation to publish quotations resulting from entry of a priced order in an electronic communications network would end once the order is removed from the network, as a practical matter, immediate withdrawal of public quotations could result in the OTC market maker or specialist being unable to re-enter quotations for that security for a subsequent period.

### 3. Request for Comments

The Commission requests comment on issues raised by the proposed amendments to the Quote Rule. Concerning the proposed addition of quotations in non-Rule 19c-3 securities in the existing mandatory and voluntary Quote Rule requirements, commenters are encouraged specifically to address the following questions:

(1) The primary effect of this amendment is that the most active market makers in non-Rule 19c-3 securities (generally, those trading more than 1% of the consolidated volume in the securities), who currently are not required to disseminate quotes in the securities, would be required to register as "CQS market makers," pursuant to

NASD rules. The Quote Rule and NASD rules currently require CQS market makers, among other matters, to maintain firm, continuous two-sided markets in the securities they trade. The Commission seeks comment on whether the proposed amendment would result in more accurate and useful quotations. The Commission also seeks comment on whether market makers required to register as CQS market makers, and thereby maintain two-sided quotes, should be granted greater ITS access.

(2) In view of the various ITS and NASD restrictions on computer generated quotations, the Commission seeks comment on the costs and benefits to market participants and the markets in general that would be associated with the proposed amendments. The Commission also invites comment on whether amendments to SRO rules are necessary to achieve the Commission's objectives.

Concerning the proposed amendment for inclusion of best bids and offers that are disseminated through electronic communications networks, the Commission specifically seeks comment on the following issues:

(1) The proposed amendments are designed to deter fragmented markets and to promote improved quotations. The Commission seeks comment on whether the proposed amendments achieve this goal, and invites suggestions for alternatives to the rule that would better achieve this goal. The Commission also requests comment generally as to whether there are business justifications or economic rationale for permitting market makers to publish bid and offer prices for execution in electronic communications networks which differ from their quotations in public markets. The Commission requests comment on whether market participants utilize electronic communications networks to quote in finer increments because such finer increments are not possible on an exchange or Nasdaq.

(2) The Commission notes that the proposed rule will have the effect of prohibiting market makers that do not currently publish quotes in a covered security from placing an order, bid or offer into an electronic communications network, unless they elect to publish quotations for such orders in that security. The Commission seeks comment on whether this result is appropriate.

(3) The Commission seeks comment on the types of electronic communications networks that would be subject to the rule. The Commission solicits comment on whether the definition of the term "electronic

<sup>44</sup> Pursuant to proposed subparagraph (c)(4)(i), no exchange or OTC market maker would be able to make available, disseminate or otherwise communicate to any quotation vendor, directly or indirectly, for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any covered security which is not a subject security with respect to such exchange or OTC market maker.

communications network” unintentionally captures crossing systems or broker-dealer internal order routing systems or any other systems inconsistent with the Commission’s objectives. The Commission also seeks comment on whether the proposal should apply to crossing systems or broker-dealer internal systems in some manner. Finally, the Commission seeks comment on the competitive effects of the proposal on existing electronic communications networks, their subscribers and users, and whether there are alternatives to the proposal that would minimize any negative competitive effects while achieving the Commission’s goals. For example, should the Commission require these systems to furnish these prices to the applicable exchange or association for further dissemination, and provide some access, such as a linkage, to the prices in their electronic network?

(4) As indicated in the discussion, differences in the minimum trading variation across markets and electronic communication networks raise concerns about how the proposed amendment to the Quote Rule would apply across all systems. The Commission seeks comment on the steps necessary to ensure that differential minimum variation requirements do not frustrate the purposes of the rule. What modifications to SRO member firm facilities are required?

Would an acceptable alternative be to require an OTC market maker or specialist that enters a priced order at a smaller price variation than is used by the exchange or association’s quotation system, to display a quotation at a price that is rounded to the next quotation increment used in that market? While this approach would not provide full public disclosure of the better price available in the electronic communications network, it also would not require changes to existing quotation systems.

(5) As discussed above, the proposed amendments would not apply to any firm that occasionally executes customer orders as principal, but does not generally hold itself out as willing to buy and sell the security. The Commission seeks comment on whether the proposed amendments should be modified to include these firms in the definition of OTC market maker. In addition, the Commission requests suggestions for alternative language to achieve the Commission’s stated goals.

(6) The Commission requests comments on whether there should be exceptions under the rule, and if so, under what circumstances. Specifically, the Commission seeks views on whether

the rule should exclude orders where a market maker is acting as agent if its customer expressly requests that the order not be displayed. In particular, should an exception be provided for customer limit orders entered into an electronic communications network if the customer has requested, pursuant to the exception from the limit order display rule, that its limit order not be displayed?

(7) The proposed rule would only require OTC market makers and specialists to display the minimum quotation size established by an exchange or association for an order displayed in an electronic communications network. Should the OTC market maker or specialist be required to display publicly the full size of the order? Alternatively, should the rule require the public display of the full size unless the customer requests otherwise?

#### 4. Consideration of the Proposed Rule’s Costs and Benefits

The proposed amendments would require some market participants to modify their current quotation dissemination systems. Although the Commission believes that these amendments would not impose significant implementation costs, it seeks comment on the order of magnitude of the costs. The Commission believes that the proposed amendments would provide several benefits to the markets and to investors in those markets, including improved price discovery, liquidity and competition between market makers. In addition, the proposed amendments would improve execution prices of customer market orders that are priced off the consolidated best bids and offers. These benefits are distributed across a wide constituency, so the Commission seeks guidance on how best to evaluate the benefits associated with the proposed amendments.

The Commission seeks detailed comment on the following specific questions regarding the costs and benefits of amendments to the Quote Rule:

(1) What system changes and costs under the proposed amendments to the Quote Rule would be necessary?

(2) If the amendments were adopted, what would be the likely impact on OTC market makers, specialists, and electronic communications networks?

(3) Currently, some market makers receive the benefits associated with OTC market maker or specialist designation (*e.g.*, favorable margin treatment, short-sale trading exemptions, and enhanced market access) without being required to

disseminate continuous two-sided quotes. How should the Commission quantify the benefits derived from OTC market maker or specialist status? How should the Commission quantify the costs associated with disseminating continuous two-sided quotes? In particular, how should the Commission quantify the costs associated with disseminating such quotes manually, rather than through computer generated mechanisms?

(4) How should the Commission assess the potential benefits associated with public access to the best prices in the market and how should those benefits be quantified?

(5) How would the proposed amendments contribute to transparency in the market and how should the improvements in transparency be quantified?

(6) To the extent that OTC market makers and specialists maintain superior bids (offers) in electronic communications networks, those bids (offers) would be reflected in the consolidated quotes that are available to the public. How should the Commission quantify the savings to customers associated with the concomitant narrowing of publicly disseminated spreads?

#### B. Display of Customer Limit Orders

##### 1. Background

The failure to display limit orders that are priced better than current quotes raises at least three regulatory concerns. First, the failure to display limit orders can produce an artificial widening of spreads, raising the concern that investors may not have access to optimum prices. Second, there are concerns about fair competition. If the quotes from a market or market maker do not fully represent the buying and selling interest in a given security, quote competition is less keen, and the price discovery process may be impaired. Third, because many markets and market makers offer automatic executions of small orders at the best displayed quotes, a failure to display limit orders that improve the best displayed quotes can result in inferior executions for these orders.

In connection with Market 2000,<sup>45</sup> the Commission received comments

<sup>45</sup> Market 2000 recommended that the securities exchanges consider whether to encourage the display of all limit orders (*i.e.*, orders to buy or sell at a specified price) in listed stocks priced better than the best intermarket quotes, unless the ultimate customer requests that the order not be displayed. Market 2000 also recommended that the NASD consider whether to encourage the display of limit orders in Nasdaq stocks when the orders are

concerning whether the optimal degree of pre-trade disclosure of limit orders was being achieved within a given market. Some commentators alleged that specialists and third market dealers sometimes fail to display limit orders priced better than the displayed quotation.<sup>46</sup> Questions were also raised about the lack of limit order exposure on Nasdaq. Although the OTC market recently has made improvements in the manner in which customer limit orders are handled, there is no requirement that limit orders be displayed.<sup>47</sup>

Section 11A(a)(1)(C)(v) of the Exchange Act expresses Congress' goal that, consistent with the other objectives of the NMS, investor orders, including limit orders, should be permitted to interact without the participation of a dealer.<sup>48</sup> Congress envisioned that the NMS would make all specialists and market makers aware of public customer limit orders held anywhere in the system, and provide enhanced protection and priority for those orders.<sup>49</sup>

at prices better than the best Nasdaq quotes, unless the customer requests that the order not be displayed. See Market 2000, *supra* note 4 at IV-6.

<sup>46</sup> See Thomas H. McInish & Robert A. Wood, "Hidden Limit Orders on the NYSE", 21 *J. Portfolio Mgmt* 19 (No. 3, Spring 1995). The authors assert that New York Stock Exchange ("NYSE") specialists only display about 50% of limit orders that better existing quotes. In their opinion, this practice represents a serious policy issue because it places both public investors and regional exchanges at a disadvantage. They assert that hiding limit orders impedes strategic decisions on order placement; results in publicly submitted market orders receiving inferior prices; hampers the monitoring of order executions; reduces the probability of a limit order being executed; results in a delay in reporting limit order executions; interferes with the ability of the regional exchanges to execute public orders; and artificially improves NYSE performance relative to the regional exchanges using a common benchmark. The authors also claim that NYSE Rule 60 is ambiguous in that the specialists may have some leeway in choosing what to disclose in their quotes. The NYSE, in Information Memo 93-12, *infra* note 51-52 and accompanying text, reminded members of the duty to represent limit orders at their limit prices when requested to do so. Some traders, however, have continued to accuse NYSE specialists of hiding limit orders. See *Traders Accuse Specialists of Holding Back Limit Orders*, Investment Dealers' Digest, 8, (Feb. 14, 1994).

In its comment letter to Market 2000, however, the NYSE asserted that its publicly disseminated best bid or offer includes all firm trading interest announced on the floor as required by the exchange's rules. See Letter from William H. Donaldson, Chairman and Chief Executive Officer, NYSE, to Jonathan G. Katz, Secretary, SEC at 25-26 (Nov. 24, 1992) ("NYSE Letter"). In addition, as discussed later, a recently issued NYSE policy statement indicates that specialists have an obligation to reflect in their quotes certain limit orders received manually or via the Designated Order Turnaround System ("SuperDot"). See *infra* note 54-55 and accompanying text.

<sup>47</sup> See *infra* note 56-60 and accompanying text.

<sup>48</sup> 15 U.S.C. § 78k-1(a)(1)(C)(v) (1988).

<sup>49</sup> Senate Report, *supra* note 15 at 18 ("The Committee is satisfied that [the legislation] grants

The Commission does not believe that the differences between dealer and auction markets compel different results in the degree of investor protection afforded in competing markets. Accordingly, the Commission believes it is appropriate at this time, and consistent with investor expectations, to propose the uniform disclosure of customer limit orders across all markets. The increased transparency of customer limit orders in all markets could produce, among other benefits, spreads that more fully represent buying and selling interest in the market and enhance an investor's ability to monitor execution quality. This, in turn, should increase competition among dealers based on their respective quotations.

The Commission also believes that the proposed rule will benefit orders routed to automated execution systems. Execution on these systems is often tied to the best displayed quotation for a particular security. The display requirement should result in executions at prices that more accurately reflect buying and selling interest in the market, thus resulting in better executions for orders priced through automated execution systems.

## 2. Discussion

Limit orders currently are handled differently in the various auction and dealer markets. Generally, exchange rules require that a limit order be displayed in the quotation for a security when it improves the best bid or offer. NYSE specialists, for example, must reflect a customer limit order in their quotations at the limit price when requested to do so.<sup>50</sup> In addition, the NYSE's order handling procedures assume that all limit orders routed to a specialist through SuperDot implicitly contain a display request.<sup>51</sup> Therefore, except in the unusual and infrequent circumstance where a specialist believes market conditions suggest the likelihood of imminent price improvement, a limit

the Commission complete and effective authority to implement a system for the satisfaction of public limit orders.").

<sup>50</sup> See NYSE Rule 79A.10 (when a limit order is presented to the specialist by a floor broker, the floor broker must affirmatively request that the specialist display the limit order; failure to so request leaves the decision whether to display the limit order to the discretion of the specialist); see also NYSE Rule 60 (requiring specialists to promptly report, *inter alia*, the best bid and offer in the trading crowd in each reported security in which the specialist is registered).

Of course, adoption of the Commission's proposal would supersede any exchange or association rule regarding the display of customer limit orders to the extent such exchange or association rule is inconsistent with the Commission's proposal.

<sup>51</sup> NYSE Information Memo 93-12 (Mar. 30, 1993).

order received by a specialist through SuperDot should be reflected in the specialist's quote as soon as practicable following receipt of the order.<sup>52</sup> According to the NYSE, 93% of all limit orders that improve the best bid or offer displayed are reflected in the specialist's quote within two minutes of receipt, while 98% of such limit orders are reflected within five minutes of receipt.<sup>53</sup>

The Commission recently approved a proposed rule change by the NYSE that clarifies the exchange's policy with respect to the display of limit orders received by a specialist.<sup>54</sup> This policy requires specialists to display the full size of all orders received through SuperDot as well as orders received by specialists manually which are subsequently entered into the electronic book. This requirement includes increasing the size of a quotation for orders at the same price as the current bid or offer; when a member requests that less than the full size of the order be shown, the specialist is obligated to show the size requested. Specialists must display as soon as practicable any order which, in relation to current market conditions in a particular security, represents a material change in the supply or demand for that security. If the quotation already reflects significant supply or demand, and the specialist receives an order that is *de minimis* in relation to such supply or demand, the specialist may take a reasonable time (generally not more than two minutes) before updating the size of the quotation.<sup>55</sup>

<sup>52</sup> *Id.*

<sup>53</sup> Telephone Conference between Edward A. Kwalwasser, Executive Vice President, NYSE, and Holly Smith, Associate Director, Division of Market Regulation, SEC, January 9, 1995.

Other exchanges also have rules regarding dissemination of bids and offers. Generally, these rules either cite, in whole or in part, language from the Quote Rule, or are drafted in such a manner as to allow for broad interpretation with respect to the display of limit orders. See, e.g., Boston Stock Exchange Guide, Rules of the Board of Governors, Chapter II, Sec. 7, (CCH) ¶ 2020; Pacific Stock Exchange Guide, Rules of the Board of Governors, Rule 5.6(f), (CCH) ¶ 3979; American Stock Exchange Guide, General and Floor Rules, Rule 115, (CCH) ¶ 9265; Chicago Stock Exchange Guide, Article XX, Rule 7, (CCH) ¶ 1688; Philadelphia Stock Exchange Guide, Rules 105 and 229 (CCH) ¶ 2105 and 2229.

<sup>54</sup> See Securities Exchange Act Release No. 35687 (May 8, 1995), 60 FR 25751 (May 12, 1995) (notice of the proposal), and Securities Exchange Act Release No. 36231 (Sept. 14, 1995), 60 FR 48736 (Sept. 20, 1995) (approval order).

<sup>55</sup> The NYSE provides the following example of when a specialist may take a reasonable time to update the size of the quotation: If the market in XYZ security is 20 (5000) - 20¼ (50,000), and the specialist receives an order to sell 200 shares at 20¾, such order would be considered *de minimis* and the specialist would be permitted to wait a reasonable period of time (but not more than two

The OTC market operates as a dealer market, in which the quote for any security represents a dealer's own bid and offer. The rules of the NASD currently do not require market makers to display customer limit orders that better the best bid or offer for the security.<sup>56</sup> Generally, customer limit orders in OTC securities either will be routed to a broker-dealer's market making desk or to a non-affiliated market maker for execution if the firm does not make a market in the security.<sup>57</sup> In the past, market makers typically did not execute limit orders until the best bid or offer displayed on Nasdaq equaled the limit price. This practice has changed, however, over the course of the past year. In June 1994, the Commission approved a proposed rule change filed by the NASD that prohibits broker-dealers from trading ahead of their customers' limit orders.<sup>58</sup> The Commission further expanded this prohibition in May 1995, when it approved another NASD proposed rule change that prohibits broker-dealers from trading ahead of customer limit orders they accept from other brokers.<sup>59</sup> The Commission also has published for comment a proposed rule change filed by the NASD that would require, in certain circumstances, the display of customer limit orders for exchange-listed securities traded OTC.<sup>60</sup>

The exchanges and the NASD use automated trading systems to route and, in some instances, execute orders of predetermined size. Some of these systems accept limit orders. Each system, however, may differ in its handling of limit orders that are not executed immediately upon receipt. For example, the NYSE's SuperDot system

minutes) before changing the size of the offer to 50,200. The Commission requests comment on whether, in the context of its rule proposal, a discretionary *de minimis* threshold is appropriate; whether an alternative standard (e. g., 5% of the outstanding size) is appropriate; or whether there should be no exception for *de minimis* size orders. See Part 4, Request for Comments (No. 3).

<sup>56</sup> See *NASD Manual*, Schedule D to the By-Laws, Part V, Section 2 (CCH) ¶ 1819.

<sup>57</sup> *Market 2000*, *supra* note 4 at V-5.

<sup>58</sup> See Securities Exchange Act Release No. 34279 (June 29, 1994), 59 FR 34883 (July 7, 1994).

<sup>59</sup> See Securities Exchange Act Release No. 35751 (May 22, 1995), 60 FR 27997 (May 26, 1995).

<sup>60</sup> See Securities Exchange Act Release No. 35471 (Mar. 10, 1995), 60 FR 14310 (Mar. 16, 1995). The proposed rule, applicable to exchange listed securities traded OTC, generally would require a market maker either to execute immediately a limit order of 500 shares or less priced better than the market maker's quotation, or display the order in its quotation with a minimum quotation size of 500 shares. Limit orders greater than 500 shares would be required to be displayed in the market maker's quotation but the quotation size need not equal the size of the limit order. Any portion of the order not displayed, however, would have to be executed at a price at least as favorable as the displayed price.

routes limit orders to the specialists' posts where they are handled in accordance with NYSE rules governing specialist representation of such orders. The American Stock Exchange's ("Amex") PER system routes limit orders in the same manner as SuperDot and the orders are handled in accordance with Amex rules. The NASD's Small Order Execution System ("SOES") treats limit orders priced at the current inside market as market orders that are immediately executed.<sup>61</sup> All other limit orders reside in a limit order file that can be reviewed by market makers.<sup>62</sup> The NASD has filed for Commission approval a proposed system, "NAqcess," that would replace SOES and include a limit order file designed to improve the handling of customer limit orders.<sup>63</sup>

The Commission is proposing new Rule 11Ac1-4 to require the uniform display of customer limit orders that improve a specialist's or OTC market maker's best bid or offer for a particular security as well as the size of such orders. In addition, the rule would require the display of the size of certain limit orders priced at the NBBO. The Commission has considered and is building upon the special role played by market makers and specialists in discovering prices and providing liquidity to the securities markets. While the proposed rule generally mandates display of limit orders, market makers and specialists still would retain some flexibility in handling limit orders accepted for execution.

Specifically, the rule would allow an OTC market maker or specialist, immediately upon receipt of the limit order, to: (1) Change its quote and the size associated with its quote to reflect the limit order; (2) execute the limit order; (3) place the limit order in a limit order book in its own market or another market that complies with the requirements of the rule; or (4) send the limit order to another market maker or specialist who complies with the

<sup>61</sup> Preferred orders (*i.e.*, orders routed to a specific market maker pursuant to a pre-existing agreement) are executed immediately at the inside quote. Unpreferred orders are executed against market makers in a security in rotation. SOES, however, does not execute an unpreferred order against a single market maker more than once every 15 seconds.

<sup>62</sup> The current SOES rules have been extended, with certain changes that do not affect the handling of limit orders, through October 2, 1995. See Securities Exchange Act Release No. 35535 (Mar. 27, 1995), 60 FR 16690 (Mar. 31, 1995). The NASD has requested that the Commission grant a further extension through January 31, 1996. Securities Exchange Act Release No. 36154 (Aug. 25, 1995), 60 FR 45502 (Aug. 31, 1995).

<sup>63</sup> See File No. SR-NASD-95-42, submitted on September 22, 1995.

requirements of the rule. The proposed rule prescribes the duty of a specialist or OTC market maker to display a customer limit order when the order is "held" by the specialist or OTC market maker. If the specialist or OTC market maker immediately sends the order to a limit order book or another specialist or OTC market maker that would display the order in compliance with the rule, the specialist or OTC market maker that routes the order would have no duty to display. The Commission believes that these alternatives will provide all market makers, specialists, and market centers an opportunity to continue to provide their valuable services while offering customers the best available execution opportunities.

### 3. Proposed Rule

Proposed Rule 11Ac1-4 applies to "customer limit orders" in "covered securities." A covered security is defined as any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system that is sponsored by a registered securities association. This definition is designed to encompass all exchange-listed securities, Nasdaq National Market securities and Nasdaq SmallCap securities.<sup>64</sup>

A customer limit order includes any order to buy or sell a covered security at a specified price not for the account of a broker or dealer. Limit orders transmitted for execution by a broker or dealer on behalf of a customer are included in the definition.<sup>65</sup> The size of any limit order that improves the NBBO would be displayed in full. The size of a limit order priced at the NBBO would be displayed when it represents more than a *de minimis* change in relation to the size displayed by the specialist or OTC market maker.

<sup>64</sup> Regionally listed securities that do not substantially meet NYSE or Amex original listing criteria do not satisfy the definition of "covered security." Such securities are not "reported securities" as that term is defined, nor do they meet the other elements of the definition of covered security. OTC Bulletin Board ("OTCBB") securities also do not satisfy the definition of covered security. The Commission has determined not to extend the display requirement to such securities at the present time. The Commission requests comment, however, on the appropriate scope of the rule. See Part 4, Request for Comments (No.5).

<sup>65</sup> SRO rules typically provide some time and price priority for orders submitted by non-broker-dealer customers, in recognition of the time and price advantages associated with professional orders. *But see* Securities Exchange Act Release No. 35751, *supra* note 59, in which the Commission discussed the appropriateness of excluding options market makers from the customer class protected by the NASD prohibition against "trading ahead."

The proposed rule would apply to: (i) Every member of an exchange that is registered by that exchange as a specialist or has been authorized by an exchange to perform functions substantially similar to that of a specialist (collectively "specialist");<sup>66</sup> (ii) third market makers;<sup>67</sup> (iii) members of an association that are OTC market makers;<sup>68</sup> and (iv) exchange members that trade an OTC security pursuant to UTP.<sup>69</sup> These persons would be required to reflect immediately in their bid or offer the price and size of each customer limit order they hold at a price that would improve their bid or offer in the security.<sup>70</sup> For example, in the case where a person covered by the rule is quoting 10-10½ when it receives a customer limit order in a covered security to buy at 10¾, it must change its bid to 10¾ immediately to reflect the limit order. The size of the order also must be included in the quote. Where the order betters the NBBO, the person would be required to change the price and size of its quote regardless of the size of the limit order, except in the case of an odd-lot or block size order. Nasdaq market makers, however, are subject to minimum quotation size requirements which depend on the characteristics of the security. The proposed rule would require that the size of the customer limit order be displayed. The Commission recognizes, therefore, that the NASD may need to amend its quote size rules to allow display of small customer limit orders.<sup>71</sup>

All persons covered by the rule also would be obligated to reflect in their quotes the size of a customer limit order that: (1) Is priced equal to their bid or offer; (2) is priced equal to the national best bid or offer for the security; and (3) represents more than a *de minimis* change in relation to the size associated with their bid or offer.<sup>72</sup> For example, assume a regional specialist's quote is 10 (1000)-10½ (1000), when the specialist receives a customer limit order to buy 2000 shares at 10. Assume further that the NBBO is 10-10¾. Under the rule, the specialist would be

obligated to change immediately its bid to 10 (3000).

As noted above, the rule would require the "immediate" display of certain customer limit orders. To satisfy this requirement, a specialist or OTC market maker must display the limit order immediately upon receipt unless there exists an applicable exception to the display requirement.

There are six exceptions to the general requirements of the proposed rule. The first exception applies to any customer limit order that is executed upon receipt of the order.<sup>73</sup> If the order is executed upon receipt, then no duty arises under the proposed rule.

The second exception applies to any limit order that is placed by a customer who expressly requests that the order not be displayed.<sup>74</sup> This exception is included because there may be instances where a customer may prefer to exclude its order from public display. This exception will permit customers to negotiate individually execution parameters for the handling of their orders with their broker-dealers either on an order-by-order basis or prospectively. Standardized disclaimers or contractual language by a firm would not be deemed to be a request by a customer that its order not be displayed. For example, a customer with a large limit order may wish to let its broker work the order rather than display the entire order. This exception gives the customer the right to decide if the order should be displayed in total, in part, or not at all. The rule would require a customer to expressly request that an order *not* be displayed. A customer request that an order be placed in a particular non-public trading system would not, by itself, be deemed to come within the exception. The Commission expects that most retail customers will want their limit orders displayed pursuant to the rule. Thus, the Commission has crafted the rule to require specialists and OTC market makers to assume that retail customers wish to have their orders displayed.

The third exception applies to odd-lot orders.<sup>75</sup> The rule does not require the display of an order for less than a unit of trading pursuant to the rules of the exchange or association. In the event that a round-lot limit order represented in the quote is partially filled and, as a result, would then be deemed an odd-lot order, the exchange or association may treat the remainder of the order as an odd-lot for purposes of this rule.

The fourth exception applies to block size orders.<sup>76</sup> Orders of at least 10,000 shares or for a quantity of stock having a market value of at least \$200,000 need not be displayed in accordance with the rule.<sup>77</sup> Customers placing block orders, however, may request that the order be displayed in accordance with the requirements of the rule. The specialist or OTC market maker would be obligated to honor such a request.

The fifth exception applies to a limit order that is delivered immediately to an exchange or association sponsored system that displays limit orders and complies with the requirements of the rule with respect to that order.<sup>78</sup> This exception, however, does not relieve a specialist or OTC market maker from its display obligation for orders it receives through exchange or association facilities, unless the system itself displays the order.

The sixth exception applies to a limit order that is delivered to another exchange member or OTC market maker that complies with the display requirements of the rule with respect to that order.<sup>79</sup> For example, a market maker that receives a limit order subject to the display requirement under the rule may immediately send the order to another market maker in the security if it reasonably believes that the other market maker will display the order in accordance with this rule.

#### 4. Request for Comments

The Commission requests comment on issues raised by this proposal, including the following matters:

(1) The proposed rule is designed to increase transparency of customer limit orders. The Commission seeks comment on whether the rule promotes transparency consistent with customers' agency expectations.

(2) As discussed earlier, some commenters believe that specialists sometimes fail to display limit orders entered at prices better than the displayed quotation. The present rule proposal is designed, in part, to address this concern. Accordingly, the Commission seeks comment on the extent to which specialists currently fail to reflect immediately in their quotes limit orders that improve the best bid or offer; whether the rule addresses legitimate concerns that limit orders are not presently displayed in a consistent manner in all auction markets; and whether there may be situations where,

<sup>66</sup> Proposed § 240.11Ac1-4(b)(1)(i).

<sup>67</sup> Proposed § 240.11Ac1-4(b)(1)(ii).

<sup>68</sup> Proposed § 240.11Ac1-4(b)(2)(i). If an OTC market maker is not quoting publicly, it still must publish a quotation that identifies the limit order, or avail itself of one of the exceptions.

<sup>69</sup> Proposed § 240.11Ac1-4(b)(2)(iii).

<sup>70</sup> See Proposed § 240.11Ac1-4(b)(1)(i)(A), (b)(1)(ii)(A), (b)(2)(i)(A) and (b)(2)(ii)(A). The Commission notes that the rule does not provide for any discretion in the timing of the display of the limit order.

<sup>71</sup> See also Section I.I.C.2. (regarding proposed price improvement rule).

<sup>72</sup> See Proposed § 240.11Ac1-4(b)(1)(i)(B), (b)(1)(ii)(B), (b)(2)(i)(B) and (b)(2)(ii)(B).

<sup>73</sup> Proposed § 240.11Ac1-4(c)(1).

<sup>74</sup> Proposed § 240.11Ac1-4(c)(2).

<sup>75</sup> Proposed § 240.11Ac1-4(c)(3).

<sup>76</sup> Proposed § 240.11Ac1-4(c)(4).

<sup>77</sup> This block definition is consistent with the current definition used in NYSE Rule 127.10.

<sup>78</sup> Proposed § 240.11Ac1-4(c)(5).

<sup>79</sup> Proposed § 240.11Ac1-4(c)(6).

in the interest of best execution, a specialist should have the discretion not to announce some or all of a customer's order on the floor.<sup>80</sup>

(3) In certain circumstances, the rule would require that the size of a customer limit order be reflected where the limit order is priced equal to the NBBO and represents more than a *de minimis* change in relation to the size displayed by the specialist or OTC market maker. The Commission seeks comment on whether it is appropriate to base the display requirement on a *de minimis* threshold; whether this threshold should be quantified (e.g., 5% of current quote size); or whether the size of all orders priced equal to the NBBO should be displayed.

(4) The Commission seeks comment on whether the scope of the definition of "block size" is appropriate, particularly whether the definition should be changed to apply to orders of greater size or market value (e.g., 25,000 shares as in NYSE Rule 72(b)). Alternatively, the Commission requests comment on whether orders of block size should be subject to the display requirement.

(5) The proposed rule would apply to exchange listed securities, Nasdaq National Market securities and Nasdaq SmallCap securities. The Commission seeks comment on the scope of the rule.

(6) The Commission seeks comment on the rule's interaction with other initiatives, such as the NASD's proposal to create a new small order execution system;<sup>81</sup> the NASD's proposal to impose display requirements on market makers holding limit orders for exchange-listed securities traded over-the-counter;<sup>82</sup> and the NASD's trading ahead prohibitions.<sup>83</sup>

(7) The Commission requests comment on whether the exception to the display requirement for limit orders delivered immediately upon receipt to an exchange- or association-sponsored system that displays those limit orders in accordance with the rule should be extended to electronic communications networks or other proprietary trading systems. If so, the Commission seeks comment on whether the extension of such exception should be predicated on the level of accessibility and transparency afforded by these systems.

<sup>80</sup> See NYSE Letter, *supra* note 46 at 26 (specialist allowed to use professional judgment as an agent on how best to serve the customer). *But see* NYSE Information Memo 93-12, *supra* note 51 (except in unusual and infrequent circumstances, a limit order received through SuperDot will be reflected in the specialist's quote).

<sup>81</sup> See File No. SR-NASD-95-42, *supra* note 63.

<sup>82</sup> See Securities Exchange Act Release No. 35471, *supra* note 60.

<sup>83</sup> See, *supra* note 58-59.

(8) The Commission seeks comment on whether it would be appropriate to include within the definition of limit orders those orders, however defined by a particular exchange or association, as to which a specialist, market maker or system sponsor has some discretion over the price at which the order is executed. For example, the Commission is interested in the potential costs and benefits of including CAP orders within the scope of the rule.<sup>84</sup>

(9) The Commission seeks comment on the effect of the rule on passive market making activities pursuant to Rule 10b-6A of the Exchange Act (17 CFR 240.10b-6A).

(10) The Commission seeks comment on whether a market maker should be required to obtain some form of assurance that a customer limit order it sends to another market maker will be displayed in accordance with this rule, before the market maker would be allowed to send the limit order pursuant to paragraph (c)(6) of the rule.

#### 5. Consideration of the Proposed Rule's Costs and Benefits

To evaluate fully the impact of the proposed rule, the Commission requests commenters to provide their views on the costs and benefits associated with the proposed rule, and any data that may support those views.

The proposed limit order display rule would require market makers and specialists to display customer limit orders that either narrow their own spread or increase the size associated with the NBBO. This rule is intended to encourage quote competition between markets and market participants; to enhance customer-to-customer interaction without the intervention of a specialist or OTC market maker; to increase opportunities for the execution of limit orders; and to improve transparency in all markets.

The Commission acknowledges that the display obligations would require some market participants to modify their current order handling and display practices. The Commission notes that market makers may continue to receive or demand compensation for executing customer limit orders, such as by charging a commission for handling the order. The Commission believes that the implementation cost of the proposed rule is minor, but seeks comment on the order of magnitude of such costs.

The Commission envisions that this rule would have significant benefits for

<sup>84</sup> Such orders are percentage orders entered with a "convert and participate" instruction, and are executed based on the execution of other orders. For a discussion of percentage orders, see NYSE Rule 123A.

the financial markets and investors in those markets. Investors are expected to benefit from enhanced transparency, improved price competition and the interaction of customer orders without the intervention of a market maker or specialist, all of which should lower the cost for investors to trade in the market. The financial markets as a whole should benefit from the proposed rule because the price discovery process will be enhanced, market transparency will be improved and price competition will be promoted. By their very nature, these benefits are broad-based and pervasive. Because incremental amounts on a trade-by-trade basis produce significant cumulative amounts for the market as a whole, the Commission seeks guidance on how to represent accurately the savings associated with the implementation of this rule.

The Commission seeks further comment on the following specific questions:

(1) What would be the necessary system changes and costs associated with implementation of the limit order display rule?

(2) If the rule were adopted, what would be the likely impact on OTC market makers and specialists? Would these effects on the commitment of capital be influenced by the trading characteristics of particular securities, e.g., high volume vs. limited volume?

(3) The Commission recognizes that subsequent to adoption of the rule, market makers may need to charge commissions for the handling and display of public limit orders. What would be the anticipated level of commissions for a limit order and what would be the overall cost to the customer?

(4) How should the Commission assess the potential benefits associated with the narrowing of spreads?

(5) What would be the likely impact of the proposed rule on the depth of the market and how should that impact be quantified?

(6) What would be the likely impact of the rule on the liquidity of the market and how should that impact be quantified?

(7) How would the proposed rule contribute to transparency in the market and how should the improvements in transparency be quantified?

(8) What degree of customer-to-customer interaction could be expected if the rule is adopted and what are the savings to those customers?

### C. Price Improvement for Customer Market Orders

#### 1. Background

The Commission today seeks comment on a market-wide price improvement rule for customer market orders. The rule would apply across exchange and OTC markets to promote best execution for all securities covered by the rule. The Commission also is proposing a non-exclusive safe harbor as one means by which a specialist or OTC market maker can be assured that an order has received a sufficient opportunity for price improvement for purposes of the rule.

The Commission believes this rule will encourage market participants to take advantage of current technologies and provide customer market orders with improved access to price improvement opportunities, regardless of where such orders are routed for execution. Although the proposed rule speaks to OTC market makers and specialists, if adopted it would have clear implications for the best execution obligations of broker-dealers generally. The Commission does not intend for the proposed rule to displace the existing best execution obligation;<sup>85</sup> rather, the Commission believes that the rule would complement the long-standing duties of broker-dealers to seek to obtain best execution of their customer orders. Moreover, the rule is intended to foster competition among markets and market makers on the basis of price improvement opportunities.

Although the rule proposed today would require OTC market makers and specialists to provide price improvement opportunities for customer orders, the Commission is not prescribing any particular method of achieving price improvement in recognition of the fact that competition can produce innovative price improvement mechanisms. However, to provide certainty regarding one alternative by which a specialist or OTC market maker will be deemed to have provided price improvement opportunities to customer market orders, the Commission is proposing a non-exclusive safe harbor. A specialist or OTC market maker that executes a customer market order in accordance with the conditions of the safe harbor would be deemed to have satisfied its price improvement obligation.

The Commission wishes to stress, however, that the order exposure procedures set out in the proposed safe harbor are not mandatory, nor are they

the exclusive means by which to satisfy the obligation to provide an opportunity for price improvement. The Commission believes that methods other than the exposure of customer orders can satisfy the obligation. The Commission is interested in receiving comment regarding alternative methods by which price improvement opportunities may be provided. For example, some specialists and OTC market makers utilize systems based on algorithms that automatically provide an opportunity for price improvement. Orders that are processed manually also can be provided enhanced opportunities to achieve better executions. The Commission requests comment on an alternative safe harbor procedure, described *infra*.<sup>86</sup>

Under the safe harbor proposed today, a specialist or market maker would expose in its quote a customer order at an improved price and provide the customer with a guaranteed execution at the "stop" price. This procedure is designed to promote the interaction of exposed orders at prices better than the displayed NBBO with orders or trading interest in other markets. The safe harbor also could lead to increased competition by encouraging OTC market makers and specialists to compete more actively for order flow on the basis of their published quotations.

The 1975 Amendments were designed to facilitate the creation of a "market characterized by economically efficient executions, fair competition, broad dissemination of basic market information and the maximum interplay of auction market principles."<sup>87</sup> One of the "paramount objectives" Congress established for the NMS was "the centralization of all buying and selling interest so that each investor will have the opportunity for the best possible execution of his order."<sup>88</sup> Congress made it clear that the Commission has broad discretion how best to facilitate the development of an NMS.<sup>89</sup>

The proposed safe harbor is based, in part, on the order exposure proposals considered by the Commission in 1982.<sup>90</sup> In August 1983, the Commission postponed further action on these initiatives, due, in part, to then existing market structure and practices.<sup>91</sup> The

largest market maker trading Rule 19c-3 securities had ceased operations earlier that year and the Commission believed that, due to the low level of OTC trading in Rule 19c-3 securities and certain technological impediments, the costs associated with the rule would outweigh the benefits that could be achieved at that time.

The utility of an order exposure requirement was debated again in response to Market 2000,<sup>92</sup> with comment divided on the need for such a rule.<sup>93</sup> The NYSE suggested that the Commission reconsider an order exposure rule to provide for greater interaction and enhance best execution of customer orders. The regional exchanges believed that an order exposure rule could restore the incentive of market makers and exchanges to compete on the basis of their displayed quotations.<sup>94</sup> The U.S. General Accounting Office suggested that order exposure rules be considered in connection with any new proposals to further repeal off-board trading restrictions.<sup>95</sup> Other commenters to Market 2000 were ambivalent; for example, the Securities Industry Association noted that "currently there is no compromise or consensus between those who would advocate a uniform public order exposure rule for listed securities and those who believe transparency requirements should be determined by customer demand and not mandated."<sup>96</sup> The National Specialists Association, commenting on prior Commission NMS initiatives, stated that the Association was "aware of nothing that should persuade the Commission to revisit any of these proposals, except, perhaps, the order exposure rule."<sup>97</sup> The NASD stated that a new order exposure rule was unnecessary, but that if one were to be

<sup>92</sup> See Market 2000, *supra* note 4 at IV-10.

Because some SROs supported an order exposure rule, Market 2000 suggested that all interested SROs coordinate the development of an order exposure rule for Commission consideration. See, e.g., NYSE Letter, *supra* note 46; Letter from William G. Morton, Jr., Boston Stock Exchange, John L. Fletcher, Midwest Stock Exchange, Leopold Korins, Pacific Stock Exchange, and Nicholas A. Giordano, Philadelphia Stock Exchange, to Jonathan G. Katz, Secretary, SEC (Dec. 11, 1992) ("Regional Letter"). Since the publication of Market 2000, however, no efforts have been initiated toward this end.

<sup>93</sup> See NYSE Letter, *supra* note 46.

<sup>94</sup> See Regional Letter, *supra* note 92.

<sup>95</sup> See GAO, *Securities Markets: SEC Actions Needed to Address Market Fragmentation Issues* (June 1993).

<sup>96</sup> See Letter from Thomas M. O'Donnell, Chairman, and Marc E. Lackritz, President, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC (July 1, 1993).

<sup>97</sup> See Letter from David Humphreville, National Specialists Association, to Jonathan Katz, Secretary, SEC (Dec. 11, 1992).

<sup>86</sup> See Part 3, Request for Comments (No. 15).

<sup>87</sup> Senate Report, *supra* note 15 at 101.

<sup>88</sup> *Id.* at 100.

<sup>89</sup> *Id.* at 18, 19; accord H.R. Rep. No. 229, 94th Cong., 1st Sess. 29 (1975).

<sup>90</sup> See Securities Exchange Act Release No. 18738 (May 13, 1982), 47 FR 22376 (May 24, 1982); Securities Exchange Act Release No. 19372 (Dec. 23, 1982), 47 FR 58287 (Dec. 30, 1982).

<sup>91</sup> See Securities Exchange Act Release No. 20074 (Aug. 12, 1983), 48 FR 38250 (Aug. 23, 1983).

<sup>85</sup> See Payment for Order Flow Release, *supra* note 8.

developed it should apply to all markets equally.<sup>98</sup>

## 2. Proposed Rule

Proposed Rule 11Ac1-5 would require each specialist or OTC market maker<sup>99</sup> in a covered security that accepts a customer market order to provide that order with an opportunity for price improvement.<sup>100</sup> The term "price improvement" is defined as the execution of an order at a price that is better than the existing NBBO.<sup>101</sup> A covered security is defined as any reported security and any other security for which a transaction report, last sale data, or quotation information is disseminated through an automated quotation system that is sponsored by a registered securities association. Therefore, the definition of covered security includes exchange-listed securities, and those Nasdaq securities that satisfy a threshold requirement based on average daily volume.<sup>102</sup> The threshold for inclusion of Nasdaq securities has been proposed to include the 250 Nasdaq stocks with the highest average daily trading volume over the previous quarter. The Commission preliminarily believes that customer market orders for certain Nasdaq securities are not presently received with sufficient regularity to provide a substantial likelihood of price improvement. Therefore, at the present time, the Commission questions whether the potential costs associated with providing the opportunity for price improvement are justified for these securities. Accordingly, the Commission has set a threshold in an attempt to identify the securities for which price improvement opportunities are appropriate. The Commission would consider, at a later date, whether to

extend the rule with respect to Nasdaq securities falling below the threshold.

The proposed rule applies to all customer market orders, defined to include any order to buy or sell a covered security at the best available price that is not for the account of either a broker or a dealer. Further, the proposed rule applies in those instances where the spread between the NBBO is greater than the minimum variation. The "minimum variation" is defined as the minimum increment by which a covered security may be quoted on the primary market for the security.<sup>103</sup>

The proposed rule does not specify the extent to which an opportunity for price improvement must be provided, or what method must be used to provide this opportunity. To clarify one acceptable means of satisfying the rule's requirement, however, the rule includes a safe harbor that describes order exposure procedures that would be deemed to provide sufficient price improvement opportunities under the rule.<sup>104</sup> Under these procedures, prior to executing a customer market order in a covered security, the specialist or market maker would be required to stop the customer order at the NBBO,<sup>105</sup> and publish, and maintain for 30 seconds, a bid or offer on behalf of the customer. The specialist or market maker's quote must be for at least the size of the customer order, at a price one minimum variation away from the stop price on the opposite side of the market.<sup>106</sup> If the exposed order is not executed at the new quote, the specialist or market maker would fill the customer order at the stop price for the lesser of: (1) the full number of shares of the order; or (2) the size associated with the NBBO at the time the order was stopped. The exposure procedures would not apply in circumstances where the order is for a security with a spread between the NBBO greater than four times the minimum variation to avoid excessive quotation volatility resulting from the exposure requirement in markets with a wide spread.<sup>107</sup>

The following example illustrates the operation of the safe harbor. Assume

that an exchange specialist is quoting 20 (500)—20 $\frac{3}{8}$  (1,000), the NBBO for XYZ security. Assume further that a customer market order to sell 1000 shares of XYZ security is received by that exchange specialist. Pursuant to the safe harbor, the exchange specialist would stop the order at 20 for 500 shares, and expose the entire 1,000 share order on the offer at an increment  $\frac{1}{8}$  higher than the stop price for 30 seconds. The new inside quote, therefore, would be 20 (500)—20 $\frac{1}{8}$  (1000) for 30 seconds. The size associated with the exposed order may be reduced to the extent of any partial execution during the exposure period.<sup>108</sup>

Although the exposure procedures require a market maker or specialist to expose a customer market order at a price that is one minimum variation better than the stop price, the Commission considered alternative approaches. For example, the Commission considered whether to require exposure of the order at one minimum variation better than the bid (for a buy order) or the offer (for a sell order). To illustrate, assume that the NBBO is 20—20 $\frac{3}{8}$ , and a customer market order to sell is received. The proposed exposure procedures would require that the order be stopped at 20 (up to the size associated with the NBBO) and exposed as an offer at 20 $\frac{1}{8}$ . The Commission considered whether the exposure procedures should, instead, require the specialist to stop the order at 20 and expose it as an offer at 20 $\frac{1}{4}$  ( $\frac{1}{8}$  better than the best offer). Although the alternative potentially would result in a better execution price for an exposed order where the spread between the NBBO was greater than  $\frac{1}{4}$ , it appears that there would be less likelihood that the order would receive price improvement because it would be displayed at a price less likely to draw contra-side orders.<sup>109</sup> Nevertheless, the Commission seeks comment on whether this alternative would be preferable.

It should be noted that because exposure of orders under the proposed safe harbor would result in the dissemination of a new NBBO during the exposure period, the price improvement opportunity for other customer market orders received during

<sup>98</sup> See Letter from Joseph R. Hardiman, President, NASD, to Jonathan G. Katz, Secretary, SEC (Nov. 20, 1992).

<sup>99</sup> See Proposed § 240.11Ac1-5(a)(9). The term *OTC market maker* has the same meaning provided in § 240.11Ac1-1. This definition is not coextensive with the definition found at 15 U.S.C. 78c(a)(38). See *supra* section II.A.2.b. regarding the amendments to the Quote Rule.

<sup>100</sup> Proposed § 240.11Ac1-5(b).

<sup>101</sup> Proposed § 240.11Ac1-5(a)(10).

<sup>102</sup> Proposed § 11Ac1-5(a)(3). In addition, regionally listed securities that do not substantially meet NYSE or Amex original listing criteria do not satisfy the definition of "covered security." Such securities are not "reported securities" as that term is defined in the proposed rule, nor do they meet the other elements of the definition of covered security. OTC Bulletin Board securities also do not satisfy the definition. The Commission has determined not to extend the requirements of the rule to such securities at the present time. The Commission has, however, requested comment on the appropriate scope of the rule. See Part 3, Request for Comments (Nos. 11 and 17).

<sup>103</sup> Proposed § 240.11Ac1-5(a)(6).

<sup>104</sup> Proposed § 240.11Ac1-5(c).

<sup>105</sup> Proposed § 240.11Ac1-5(d)(1)(i).

<sup>106</sup> Proposed § 11Ac1-5(d)(1)(ii). When a specialist or market maker "stops" an order, such specialist or market maker guarantees the execution or partial execution of the order at a specified price. Proposed § 240.11Ac1-5(a)(12). The specified price is defined as the "stop price." Proposed § 240.11Ac1-5(a)(13).

<sup>107</sup> Proposed § 240.11Ac1-5(d)(5)(i). For example, a customer market order for an NYSE listed security with a current bid of 20 and an offer of 20 $\frac{3}{8}$  would not be subject to the exposure requirements of the safe harbor.

<sup>108</sup> Proposed § 240.11Ac1-5(d)(4).

<sup>109</sup> For example, if the NBBO is 20—20 $\frac{3}{8}$  when a customer sell order is received, the new NBBO under the proposal would be 20—20 $\frac{1}{8}$  and 20—20 $\frac{1}{4}$  under the alternative. If a buy market order was received, the current proposal could result in execution at 20 $\frac{1}{8}$  and the alternative could result in an execution at 20 $\frac{1}{4}$ . However, the buy market order would be more likely to be executed on the offer of 20 $\frac{1}{8}$  because it is more advantageous for buy orders and so would be more likely to be executed at the exposure price.

the exposure period will be determined on the basis of the new NBBO. For example, if the NBBO is 20—20½ and thereafter is reduced to 20—20⅓ because of the exposure of a customer sell order, customer market orders sent to other markets during the exposure period would not be entitled to price improvement under the rule because the new NBBO (during the exposure period) has been narrowed to the minimum variation, although the Commission is seeking comment on whether the safe harbor should be extended to minimum increment markets. But, under best execution principles, other customer orders presumably would be required to be executed at prices at least as favorable as the new NBBO during the period it existed.

The order exposure procedures contain provisions designed to facilitate efficient order execution during periods in which orders are received in rapid succession. For example, the order exposure procedures provide that if the specialist or market maker receives a subsequent customer market order on the same side of the market during the exposure period, the specialist or market maker may immediately execute the exposed order at the stop price and must stop and expose the subsequent customer market order.<sup>110</sup> This means that in the example stated above, the specialist could execute immediately the exposed order at the stop price of 20 (up to the amount of the order that has been stopped), stop the subsequent sell-side customer market order at 20, and expose the subsequent order at 20⅓ for 30 seconds (assuming the NBBO remains the same).

The order exposure procedures also provide an exception for order execution where another specialist or market maker executes a transaction at a price equal or inferior to the stop price on the same side of the market.<sup>111</sup> In the example given above, if the XYZ specialist in another market executes an order at 20, the specialist who currently is exposing an order at 20⅓ could immediately execute the exposed order at 20 rather than continue to expose the order for the full 30 seconds.

In addition, the order exposure procedures provide for the execution of an exposed order prior to the expiration of the exposure period where the market for a particular security moves away from the stop price.<sup>112</sup> This exception is meant to reduce the risk associated with stopping an order during a substantial market move. If another specialist or

market maker changes its bid (in the case of a stopped buy order) or offer (in the case of a stopped sell order) to the stop price, then the specialist or market maker exposing the order may execute that exposed order at the stop price prior to the expiration of the exposure period. For example, if a specialist on another exchange changes its offer to the stop price in response to market conditions, the specialist that has been exposing the customer market order at 20⅓ also may change its offer and immediately execute the customer order at the stop price of 20 rather than expose the order for the full 30 second period at 20⅓.

The order exposure procedures would not apply in certain circumstances. The procedures contain an exception for any order of block size.<sup>113</sup> The safe harbor also contains an exception for orders of non-block size that are effected in conjunction with a block trade effected outside of the NBBO.<sup>114</sup> For example, if a customer order to sell is stopped at 20 and exposed on the offer at 20⅓, and a block transaction is effected at 20¼, the exposed order may be executed in accordance with exchange practices.

The final two exceptions to the safe harbor apply to odd-lot orders and orders received within 5 minutes of the opening and closing of the trading day. The latter exception is intended to allow for the efficient opening and closing of all markets.

The rule, as a whole, contains an exception for "fast market" conditions.<sup>115</sup> Specifically, the requirement to provide an opportunity for price improvement would not apply to transactions where firm quotations on an exchange or by the association are not required based on unusual market conditions. In addition, the proposed rule contains an exception that permits a specialist or market maker to send a customer market order to another market or market maker if those markets or market makers are in compliance with the rule.<sup>116</sup>

### 3. Request for Comments

The Commission requests comment on issues raised by this proposal, including the following matters:

(1) The proposed rule would require that market makers or specialists provide an opportunity for price improvement before executing customer orders, and sets forth non-exclusive procedures that would satisfy that requirement. The Commission requests

comment on whether the rule should set forth the specific degree or manner by which the price improvement opportunity must be provided.

(2) The Commission recognizes that some automated execution systems operated by markets do not currently provide an opportunity for price improvement for market orders, but include the possibility of interaction with limit orders entered into the system. The Commission seeks comment on whether these systems should be adapted to allow market makers to provide opportunities for price improvement, or whether they should be deemed to satisfy the rule's requirement as currently operated.

(3) The payment for order flow rules require broker-dealers that receive payment for order flow in a security to disclose their order routing practices to their customers, including the availability of price improvement opportunities. The Commission seeks comment on whether an extension of these disclosure rules to all covered securities, irrespective of whether payment for order flow is received, would provide sufficient additional incentive for market makers and specialists to provide price improvement opportunities, without the adoption of a specific price improvement rule.

(4) Under the order exposure procedures, the quote exposing the order would become the NBBO for the length of time that the order is exposed (e.g., up to 30 seconds). After execution of the order or expiration of the exposure period, the spread for the NBBO would widen. The Commission seeks comment on what effect, if any, rapid quote changes may have on system capacity, autoquote systems, automated execution systems that execute customer orders at the NBBO, and the expectations of investors with respect to the execution prices of market orders.

(5) Under the safe harbor, the Commission has proposed an exposure period of 30 seconds. The Commission seeks comment on the effect of a 30-second exposure period on the functions of specialists or market makers, and whether a longer (e.g., 45 or 60 seconds) or shorter (e.g., 15 seconds) period is appropriate.

(6) As noted above, the proposed rule is designed to ensure that price improvement opportunities will be more widely available for customer orders. Such a rule should promote the interaction of exposed orders with orders or trading interest in other markets. The Commission seeks comment on whether exposure of orders

<sup>110</sup> Proposed § 240.11Ac1-5(d)(2).

<sup>111</sup> Proposed § 240.11Ac1-5(b)(3)(i).

<sup>112</sup> Proposed § 240.11Ac1-5(b)(3)(ii).

<sup>113</sup> Proposed § 240.11Ac1-5(d)(5)(ii).

<sup>114</sup> Proposed § 240.11Ac1-5(d)(5)(v).

<sup>115</sup> Proposed § 11Ac1-5(e) (1), (2) and (3).

<sup>116</sup> Proposed § 11Ac1-5(e)(4).

in non-Rule 19c-3 listed securities would be fully effective without extension of the ITS interface, which links Nasdaq with the registered securities exchanges for trading in Rule 19c-3 securities, to all listed securities.<sup>117</sup>

(7) The Commission has proposed several exceptions to the order exposure procedures for situations where a specialist or market maker receives orders in rapid succession. While alleviating the problems associated with queuing, the exceptions may affect the overall utility of the rule. The Commission seeks comment on alternative methods for addressing potential order queues and rapidly moving markets.

(8) As proposed, the requirement to provide an opportunity for price improvement would apply to situations where the spread between the NBBO is greater than the minimum variation. The Commission seeks comment on whether application of the rule should be extended to situations where the spread between the NBBO is equal to the minimum variation. If extended, under the exposure procedures a specialist or market maker would be required to stop a customer buy order at the national best offer and expose it at the national best bid; a sell order would be stopped at the national best bid and exposed at the national best offer.

(9) If the exposure procedures were extended to minimum variation markets, the Commission seeks comment on whether the rule should contain an exception to the exposure procedures in situations where a specialist or market maker receives an order that would be executed against a limit order represented in the quote. The effect of the exception is illustrated in the following example: assume that the NBBO is 20-20<sup>1</sup>/<sub>8</sub> and that the offer price represents a customer limit order. If a market order to buy is received, the exception would allow the trade to be executed immediately at 20<sup>1</sup>/<sub>8</sub>. Alternatively, if there were no exception for agency orders represented in the quote, the market order would be stopped at 20<sup>1</sup>/<sub>8</sub> and exposed at 20 for 30 seconds. Comment is requested on both approaches. Further, the Commission seeks comment on whether the rule should contain an exception to the exposure procedures in situations where a specialist or market maker receives an order that would be executed against a limit order represented in the quote, where the

spread between the NBBO is greater than the minimum variation.

(10) The Commission seeks comment on whether the order exposure procedures should apply to agency cross transactions, *e.g.*, the execution of a buy and sell order for the same security by an entity acting as agent for both orders.

(11) The proposed rule would apply to exchange listed securities, and those OTC securities that satisfy the threshold requirement. The Commission seeks comment on whether the scope of the rule is appropriate.

(12) The Commission seeks comment on how the rule would interact with other initiatives, such as the Commission's proposed amendments to the Quote Rule and the Commission's proposed Limit Order Display Rule.

(13) In light of the activity that takes place at the beginning and the end of the trading day, the proposed safe harbor includes an exception from the exposure requirement during the first five minutes of trading, as well as the last five minutes of the trading day. The Commission seeks comment on whether this exception is appropriate.

(14) Some SROs maintain rules regarding excess spread parameters.<sup>118</sup> The Commission seeks comment on the impact of the proposed rule on such excess spread parameters.

(15) The Commission seeks comment on alternative methods by which price improvement opportunities for customer market orders may be achieved, and on alternative safe harbor procedures, including reliance on internal order crossing and intermarket print protection systems. For example, an alternative may be to permit a specialist or market maker to stop a customer market order at its proposed execution price for a short period of time (*e.g.*, 1 minute). If during this time period the specialist or market maker received a customer market order on the opposite side of the market from the stopped order, the specialist or market maker would cross the orders at a price better than the proposed execution price. In addition, if during this time period a trade in the stock is reported in another market at a price better than the proposed execution price, the specialist or market maker would also be required to execute the customer order at a price better than the proposed execution price.

The Commission requests comment on whether this alternative would provide sufficient opportunity for price improvement to be included as a safe harbor under the rule. Unlike the order

exposure safe harbor, it would not require publication of a quotation reflecting the order, and may, therefore, provide a simpler process with less impact on quote variations, while still providing customer orders an opportunity for better prices based on other internal orders and superior reported trade prices. At the same time, because the customer order would not be publicly displayed, this procedure would not result in narrower quotes or provide an opportunity for greater intermarket order interaction.

The Commission also requests comment on the mechanics of how the alternate safe harbor should function. First, in the event of an intervening trade away from the specialist, market maker, or dealer, should protection be offered at the print price or at a price that is better than the minimum price variation? Second, how should subsequent orders received during the period the stop is in effect be handled; should they be immediately executed at the stop price or should a new time period be created? Finally, should price protection be offered only up to the size of the intervening trade (if it is less than the size of the order) or for the full size of the order?

(16) The Commission seeks comment on alternative procedures under the proposed safe harbor:

(a) The first alternative would require a specialist or OTC market maker that receives a customer market order to stop the order at the price at which it was quoting when the order was received, or if it was not publicly quoting, at its proposed execution price. Under this scenario, if the NBBO was 20-20<sup>1</sup>/<sub>4</sub>, and the market maker was quoting 20-20<sup>1</sup>/<sub>2</sub> when it received a customer market order to buy, the market maker would be allowed to stop the order at 20<sup>1</sup>/<sub>2</sub>. If, however, the best offer remained 20<sup>1</sup>/<sub>4</sub> at the time of execution, execution at an inferior stop price would be constrained by best execution principles.

(b) The second alternative would require a specialist or market maker that receives a customer market order to stop the order if the bid (for a sell order) or offer (for a buy order) is the specialist's or market maker's principal quotation. If, however, the bid or offer represents an agency order, the specialist or market maker would not be required to stop the incoming market order.

(17) The Commission seeks comment on the liquidity threshold, specifically:

(a) Whether a selection based on average daily trading volume is appropriate and, if not, alternative selection criterion that would be appropriate given the Commission's stated goals;

<sup>117</sup> See *supra* section II.A.1.b. regarding the amendments to the Quote Rule.

<sup>118</sup> See, *e.g.*, *NASD Manual*, Schedule D to the By-Laws, Part V, Section 2(d), (CCH) ¶ 1819.

(b) Whether the 250 issue cutoff is appropriate<sup>119</sup> and, if not, a more appropriate cutoff and the basis for that selection; and

(c) Whether an average daily trading volume threshold should be applied only to Nasdaq securities or all securities.

(18) In addition, for all markets, the Commission recognizes that the proposed safe harbor may not be appropriate for stocks which trade with significant spreads. For example, when a market order to sell is received for a stock that trades with a bid of 330 and an offer of 334, it may not be appropriate to narrow the spread to 330–330 $\frac{1}{8}$ . For this reason, the Commission is proposing an exemption to the safe harbor for stocks whose spread is greater than four times the minimum variation in the stock.<sup>120</sup> The Commission seeks comment with respect to this spread threshold, specifically:

(a) Whether a spread threshold should be applied, or whether all market makers and specialists, regardless of the spread, should offer price improvement under the proposed safe harbor for all stocks; and

(b) Whether the proposed spread threshold of greater than four times the minimum variation should be higher or lower.

(19) The proposed rules are designed to enhance opportunities for price improvement of customer orders in light of the existing  $\frac{1}{8}$  point minimum trading variation that exists for most stocks in the market. The Commission understands that, to some extent, the minimum variation itself may serve as an impediment to quote based competition and price improvement opportunities. Under the existing scheme, market participants must pay up the entire  $\frac{1}{8}$  point to obtain price priority. A reduction in the minimum trading variation would lower this cost and provide additional opportunities for customer limit orders and market maker quotes to narrow spreads not only in those stocks where the minimum variation is  $\frac{1}{8}$  of a point, but in all stocks.

The Commission recognizes that there are many issues related to a change in the minimum variation—including,

<sup>119</sup> For the quarter beginning April 1995 and ending June 1995, the 250 stocks with the highest average daily volume on Nasdaq had an average daily trading volume of 731,000 shares per stock per day.

<sup>120</sup> This exemption would exclude approximately 6% of NYSE listed stocks and 5% of AMEX listed stocks but no stocks in the 250 Nasdaq stocks that meet the liquidity threshold. If applied to all Nasdaq securities, this exemption would exclude approximately 7% of Nasdaq stocks.

among others, the effect that a reduction in the  $\frac{1}{8}$  point increment might have on the priority of orders and the liquidity of the markets more generally. In this regard, the Commission's Division of Market Regulation previously requested that SROs study these potential costs, as well as the benefits that might be associated with a system of decimal pricing. The ultimate goal of such a study would be to determine whether such a shift would strengthen the competitive posture of the U.S. equity markets as they position themselves in a global marketplace.<sup>121</sup>

Notwithstanding the lack of a comprehensive study by the SROs, the Commission continues to believe that decimal pricing is the next logical step for the markets to pursue to improve transparency and provide opportunities for narrower spreads.<sup>122</sup> Although the Commission is not prepared to mandate such a change in the minimum increment at this time, comment is requested on the costs and benefits of a change in the minimum variation either relative, or as a supplement to, the rules being proposed today. Comment is also requested on whether any reduction in the minimum increment should be in a finer increment of fractions (e.g.,  $\frac{1}{16}$  or  $\frac{1}{32}$ ) or decimals (e.g., \$0.10, or \$0.05).

#### 4. Consideration of Proposed Rule's Costs and Benefits

To evaluate fully the impact of the proposed rule, the Commission requests commenters to provide their views on the costs and benefits associated with the rule, and any data that may support those views.

The proposed rule would require each OTC market maker or specialist that accepts a customer market order to provide that order with an opportunity to receive price improvement when the difference between the NBBO for the security is greater than the minimum variation by which the security may be quoted on the principal market for such security. This rule is intended to enhance best execution opportunities for customer market orders in all markets. The rule is intended to encourage quote competition between markets and market participants; to enhance customer-to-customer order interaction without the intervention of a specialist or market maker; to improve transparency in all markets; and provide more opportunities for broker-dealers to satisfy their best execution obligations.

The Commission acknowledges that the price improvement obligations would require some market participants

to modify their current order handling and display practices. The Commission seeks comment on the magnitude of such costs. Further, the Commission recognizes that the price improvement requirement and direct interaction between customers may reduce the profitability associated with market making activities. To the extent that this can be quantified, the Commission seeks comment as to how much profit market makers would forego if the proposed rule is adopted.

The Commission envisions that this rule would have significant benefits for the financial markets and investors in those markets. Investors are expected to benefit from the enhanced transparency, improved price competition, the interaction of customer orders without the intervention of an OTC market maker or specialist, and improved opportunities to receive better executions, all of which should lower the cost for investors to trade in the market. Additionally, the financial markets as a whole should benefit from the proposed rule since the price discovery process will be enhanced, transparency will be improved and price competition will be promoted. By their very nature, these benefits are broad-based and pervasive. Because incremental amounts on a trade-by-trade basis produce significant cumulative amounts for the market as a whole, the Commission seeks guidance on how to represent accurately the savings associated with the implementation of this rule.

The Commission seeks detailed comment on the following specific questions:

(1) What would be the necessary system changes and costs associated with implementation of the proposed rule?

(2) If the proposed rule were to be adopted, what effect would the interaction of customer orders have on market makers and specialists?

(3) The Commission recognizes that subsequent to the adoption of the proposed rule, market makers may need to charge commissions for the handling of market orders. What would be the anticipated level of commissions for a market order and what would be the overall cost to the customer?

(4) How should the Commission assess the potential benefits associated with the narrowing of spreads?

(5) What would be the likely impact of the proposed rule on the depth of the market and how should it be quantified?

(6) What would be the likely impact on the liquidity of the market and how should that impact be quantified?

<sup>121</sup> See Market 2000, *supra* note 4 at 18.

<sup>122</sup> Payment for Order Flow Release, *supra* note 8.

(7) What degree of customer-to-customer interaction could be expected if the proposed rule is adopted and what are the savings to those customers?

### III. Statutory Basis

The amendments to Rule 11Ac1-1 and adoption of Rules 11Ac1-4 and 11Ac1-5 are being proposed pursuant to 15 U.S.C. 78 *et seq.*, particularly sections 11A, 6, 10(b), 11(a)(2), 11(b), 15A, 15(c) and 23(a)(1); 15 U.S.C. 78k-1, 78f, 78j(b), 78k(a)(2), 78k(b), 78o-3, 78o(c) and 78w(a)(1) (1988).

### IV. Summary of the Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with 5 U.S.C. Section 603 regarding proposed Rule 11Ac1-4, Rule 11Ac1-5, and amended Rule 11Ac1-1. The following summarizes the conclusions of the IRFA.

The IRFA uses certain definitions of "small entities" adopted by the Commission for purposes of the Regulatory Flexibility Act. In the IRFA, the Commission states that regulatory action is proposed to ensure the display of customer limit orders that are priced better than the current inside quotes, and to ensure the exposure of customer market orders when the spread between the NBBO is greater than the minimum increment by which a security may be quoted. Specifically, by requiring display, Rule 11Ac1-4 would narrow spreads, increase competition, and improve the price discovery process. Likewise, by providing for order exposure, Rule 11Ac1-5 would enhance best execution opportunities, increase competition, and improve the price discovery process.

In the IRFA, the Commission states that the amendment to the Quote Rule is proposed to ensure that market makers in reported securities and other securities adhere to firm quote reporting obligations. Specifically, requiring both 19c-3 and non-19c-3 market makers to communicate quotes if they trade more than 1% of the aggregate trading volume, and requiring OTC market makers and specialists to display in their quote orders placed into an electronic communications network will contribute to price discovery, promote liquidity, enhance competition among market makers and facilitate the best execution of customer orders.

The Commission is unable to quantify reasonably the impact that the proposed rules and amendments would have on small brokers or dealers. The Commission does not believe it would be practicable to exempt small entities

from the proposed rules and amendments because to do so would be inconsistent with the Commission's statutory mandate.

A copy of the IRFA analysis may be obtained by contacting Mignon McLemore, Division of Market Regulation, SEC, 450 Fifth Street NW., Washington, DC 20549, (202) 942-0158.

### V. Paperwork Reduction Act

Certain provisions of proposed Rule 11Ac1-4 and the proposed amendments to Rule 11Ac1-1 may contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*), and the Commission has submitted them to the Office of Management and Budget for review in accordance with 44 U.S.C. 3507(d). The title for the collection of information is: "Proposed Amendments to Rule 11Ac1-1; Proposed Rule 11Ac1-4."

The proposed amendments to Rule 11Ac1-1, and in particular the definition of "subject security" under paragraph (a)(25), would increase the number of OTC market makers who are required under paragraph (c)(1) of the Quote Rule to communicate their bids, offers, and quotation sizes to their association which, in turn, disseminate the information in the form of public quotations pursuant to paragraph (b); it would also require an exchange that meets the threshold to disseminate the information in the form of public quotations pursuant to paragraph (b). This collection of information will be used to ensure public dissemination of quotations in accordance with the Quote Rule. The collection of information is necessary to expand the coverage of existing broker-dealer quotation requirements to include substantial market makers in non-Rule 19c-3 securities and to improve public information about the prices they are quoting. The likely respondents to the proposed collection of information will be the 10 or less third market makers not already subject to the Quote Rule. They will respond to the collection of information each time they initially enter and then update their quotations, estimated to be 120-200 times per trading day per respondent. The Commission anticipates the collection of information will result in a negligible additional burden to the NASD (the association to which the 10 or so market makers would be required to communicate their bids, offers, and quotation sizes). The collection of information would require the 10 or so respondents to access Nasdaq Work Station Level III (the media through

which market makers update their quotations). Because the respondents should already subscribe to Nasdaq Work Station Level II, and because there is no additional fee for Level III, the 10 or so respondents would not incur any additional expense to comply with the collection of information. To the extent that updating quotations for reporting purposes requires manual entry on Level III, the Commission estimates an additional clerical burden of approximately 25.2-42 hours per year for each respondent (based on an estimated average of 3 seconds for each update). The estimated total annual reporting burden for a total of 10 respondents combined is 252-420 hours per year.

In addition, the Commission notes that specialists and OTC market makers who currently publish quotations for non-Rule 19c-3 securities pursuant to the voluntary election provisions of the Rule would be required to do so under the proposed amendments. Because these specialists and market makers are already publishing quotations, no additional burden should result from the collection of information. Similarly, because OTC market makers in Nasdaq SmallCap securities are already required to publish quotations in accordance with NASD rules, no additional burden should result to such market makers from the proposed collection of information.

The Commission is also proposing new Rule 11Ac1-4 which, with certain exceptions and in certain circumstances, would require specialists and OTC market makers to change their published quotation to reflect the price and/or size of a customer limit order which would improve their published bid or offer. This collection of information will be used to require generally that market makers reflect immediately in their bid or offer the price and size of each customer limit order they hold at a price that would improve their bid or offer in the security. The collection of information is necessary to provide a minimum standard for all markets that would require the display of customer limit orders under certain circumstances.

The likely respondents to the collection of information will be approximately 500-600 OTC market makers. They will respond to the collection of information each time they update their quotations in response to the customer limit orders described above, estimated to average 30-60 times per trading day per respondent. The Commission estimates on average for each OTC market maker that the additional clerical burden for updating

quotations based on customer limit orders would be 7–13 hours per year per respondent (based on an estimated average of 3 seconds for each update). The Commission does not anticipate any significant additional burden on exchange specialists in light of current exchange order handling practices. The estimated total annual reporting burden for all respondents combined is 5,530 hours per year.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to—

(i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility;

(ii) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information;

(iii) Enhance the quality, utility, and clarity of the information to be collected;

(iv) Minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments directly to the Commission. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

## VI. Effects on Competition

Section 23(a)(2) of the Exchange Act<sup>123</sup> requires the Commission, in adopting rules under the Exchange Act, to consider any anti-competitive effects of such rules and to balance these effects against the regulatory benefits gained in furthering the purposes of the Exchange Act.

The Commission preliminarily views the proposed amendments to Rule 11Ac1–1 and proposed Rules 11Ac1–4 and 11Ac1–5 as causing no burden on competition unnecessary or inappropriate in furtherance of the purposes of the Exchange Act. The Commission believes that the proposed rules are consistent with the principles for the development of the national

market system that Congress specified in the Exchange Act. The Commission also believes that any burden on competition that the proposed rules and amendments may impose on the exchanges, Nasdaq and their members, and applicable proprietary trading systems is necessary and appropriate.

As noted above, the Commission has asked for comments on the costs and benefits of each of the proposed rules and amendments. In addressing those issues, the Commission also requests comment on any competitive burdens that might result from adoption of the proposed rules described in this release. In particular (but without limitation), the Commission requests comment on the effect adoption of the proposed rules would have on competition among primary exchanges, regional exchanges and third market makers; among integrated broker-dealers, wholesale market makers, and specialists; between integrated broker-dealers and order entry firms; among Nasdaq, exchanges and proprietary trading systems; and between U.S. broker-dealers, exchanges and associations and overseas broker-dealers and exchanges.

## Text of the Proposed Rules

### List of Subjects in 17 CFR Part 240

Confidential business information, Registration of securities information processors, Securities.

For the reasons set out in the preamble, the Commission proposes to amend Part 240 of Chapter II of Title 17 of the *Code of Federal Regulations* as follows:

## PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for part 240 is revised to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

\* \* \* \* \*

2. Section 240.11Aa3–1 is amended by revising paragraph (a)(4) to read as follows:

### § 240.11Aa3–1 Dissemination of transaction reports and last sale data with respect to transactions in reported securities.

(a) *Definitions.* \* \* \*

(4) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available

pursuant to an effective transaction reporting plan.

\* \* \* \* \*

3. Section 240.11Ac1–1 is revised to read as follows:

### § 240.11Ac1–1 Dissemination of quotations.

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

(1) The term *aggregate quotation size* shall mean the sum of the quotation sizes of all responsible brokers or dealers who have communicated on any exchange bids or offers for a covered security at the same price.

(2) The term *association* shall mean any association of brokers and dealers registered pursuant to section 15A of the Act (15 U.S.C. 78o–3).

(3) The terms *best bid* and *best offer* shall mean the highest priced bid and the lowest priced offer.

(4) The terms *bid* and *offer* shall mean the bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, but shall not include indications of interest.

(5) The term *consolidated system* shall mean the consolidated transaction reporting system.

(6) The term *covered security* shall mean any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)).

(7) The term *effective transaction reporting plan* shall have the meaning provided in § 240.11Aa3–1.

(8) The term *exchange market maker* shall mean any member of a national securities exchange (“exchange”) who is registered as a specialist or market maker pursuant to the rules of such exchange.

(9) The term *exchange-traded security* shall mean any covered security or class of covered securities listed and registered, or admitted to unlisted trading privileges, on an exchange, provided, however, that securities not listed on any exchange that are traded pursuant to unlisted trading privileges are excluded.

(10) The term *make available*, when used with respect to bids, offers, quotation sizes and aggregate quotation sizes supplied to quotation vendors by an exchange or association, shall mean to provide circuit connections at the premises of the exchange or association supplying such data, or at a common

<sup>123</sup> 15 U.S.C. 78w(a)(2) (1988).

location determined by mutual agreement of the exchanges and associations, for the delivery of such data to quotation vendors.

(11) The term *odd-lot* shall mean an order for the purchase or sale of a covered security in an amount less than a round lot.

(12) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to a customer, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size.

(13) The term *plan processor* shall have the meaning provided in § 240.11Aa3-2.

(14) The term *published aggregate quotation size* shall mean the aggregate quotation size calculated by an exchange and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to a responsible broker or dealer.

(15) The terms *published bid* and *published offer* shall mean the bid or offer of a responsible broker or dealer for a covered security communicated by it to its exchange or association pursuant to this section and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(16) The term *published quotation size* shall mean the quotation size of a responsible broker or dealer communicated by it to its exchange or association pursuant to this section and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(17) The term *quotation size*, when used with respect to a responsible broker's or dealer's bid or offer for a covered security, shall mean:

(i) The number of shares (or units of trading) of that covered security which such responsible broker or dealer has specified, for purposes of dissemination to quotation vendors, that it is willing to buy at the bid price or sell at the offer price comprising its bid or offer, as either principal or agent; or

(ii) In the event such responsible broker or dealer has not so specified, a normal unit of trading for that covered security.

(18) The term *quotation vendor* shall mean any securities information processor engaged in the business of disseminating to brokers, dealers or investors on a real-time basis, bids and offers made available pursuant to this section, whether distributed through an

electronic communications network or displayed on a terminal or other display device.

(19) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.

(20) The term *responsible broker or dealer* shall mean:

(i) When used with respect to bids or offers communicated on an exchange, any member of such exchange who communicates to another member on such exchange, at the location (or locations) designated by such exchange for trading in a covered security, a bid or offer for such covered security, as either principal or agent; provided, however, that, in the event two or more members of an exchange have communicated on such exchange bids or offers for a covered security at the same price, each such member shall be considered a "responsible broker or dealer" for that bid or offer, subject to the rules of priority and precedence then in effect on that exchange; and further provided, that for a bid or offer which is transmitted from one member of an exchange to another member who undertakes to represent such bid or offer on such exchange as agent, only the last member who undertakes to represent such bid or offer as agent shall be considered the "responsible broker or dealer" for that bid or offer; and

(ii) When used with respect to bids and offers communicated by a member of an association to another broker or dealer or to a customer otherwise than on an exchange, the member communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

(21) The term *revised bid or offer* shall mean a market maker's bid or offer which supersedes its published bid or published offer.

(22) The term *revised quotation size* shall mean a market maker's quotation size which supersedes its published quotation size.

(23) The term *specified persons*, when used in connection with any notification required to be provided pursuant to paragraph (b)(3) of this section and any election (or withdrawal thereof) permitted under paragraph (b)(5) of this section, shall mean:

(i) Each quotation vendor;

(ii) Each plan processor; and

(iii) The processor for the Options Price Reporting Authority (in the case of a notification for a subject security which is a class of securities underlying

options admitted to trading on any exchange).

(24) The term *subject security* shall mean:

(i) With respect to an exchange:

(A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and

(B) Any other covered security for which such exchange has in effect an election, pursuant to paragraph (b)(5)(i) of this section, to collect, process, and make available to quotation vendors, bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of an association:

(A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and

(B) Any other covered security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to paragraph (b)(5)(ii) of this section, to communicate to its association bids, offers and quotation sizes for the purpose of making such bids, offers and quotation sizes available to quotation vendors.

(b) *Dissemination requirements for exchanges and associations.* (1) Every exchange and association shall establish and maintain procedures and mechanisms for collecting bids, offers, quotation sizes and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association, processing such bids, offers and sizes, and making such bids, offers and sizes available to quotation vendors, as follows:

(i) Each exchange shall at all times such exchange is open for trading, collect, process and make available to quotation vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any exchange by any responsible broker or dealer, but shall not include:

(A) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is

cancelled or withdrawn if not executed immediately after communication; and

(B) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange;

(ii) Each association shall, at all times that last sale information with respect to reported securities is reported pursuant to an effective transaction reporting plan, collect, process and make available to quotation vendors the best bid, best offer, and quotation sizes communicated otherwise than on an exchange by each member of such association acting in the capacity of an OTC market maker for each subject security and the identity of that member (excluding any bid or offer executed immediately after communication), except during any period when over-the-counter trading in that security has been suspended; and

(2) Each exchange shall, with respect to each published bid and published offer representing a bid or offer of a member for a subject security, establish and maintain procedures for ascertaining and disclosing to other members of that exchange, upon presentation of orders sought to be executed by them in reliance upon paragraph (c)(2) of this section, the identity of the responsible broker or dealer who made such bid or offer and the quotation size associated with it.

(3) (i) If, at any time an exchange is open for trading, such exchange determines, pursuant to rules approved by the Securities and Exchange Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that the level of trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting, processing, and making available to quotation vendors the data for a subject security required to be made available pursuant to paragraph (b)(1) of this section in a manner that accurately reflects the current state of the market on such exchange, such exchange shall immediately notify all specified persons of that determination. Upon such notification, responsible brokers or dealers that are members of that exchange shall be relieved of their obligation under paragraph (c)(2) of this section and such exchange shall be relieved of its obligations under paragraphs (b)(1) and (2) of this section for that security: *Provided, however*, That such exchange will continue, to the maximum extent practicable under the circumstances, to collect, process, and make available to quotation vendors

data for that security in accordance with paragraph (b)(1) of this section.

(ii) During any period an exchange, or any responsible broker or dealer that is a member of that exchange, is relieved of any obligation imposed by this section for any subject security by virtue of a notification made pursuant to paragraph (b)(3)(i) of this section, such exchange shall monitor the activity or conditions which formed the basis for such notification and shall immediately renotify all specified persons when that exchange is once again capable of collecting, processing, and making available to quotation vendors the data for that security required to be made available pursuant to paragraph (b)(1) of this section in a manner that accurately reflects the current state of the market on such exchange. Upon such renotification, any exchange or responsible broker or dealer which had been relieved of any obligation imposed by this section as a consequence of the prior notification shall again be subject to such obligation.

(4) Nothing in this section shall preclude any exchange or association from making available to quotation vendors indications of interest or bids and offers for a subject security at any time such exchange or association is not required to do so pursuant to paragraph (b)(1) of this section.

(5) (i) Any exchange may make an election for purposes of paragraph (a)(24)(i)(B) of this section for any covered security, by collecting, processing, and making available bids, offers, quotation sizes, and aggregate quotation sizes in that security; except that for any covered security previously listed or admitted to unlisted trading privileges on only one exchange and not traded by any OTC market maker, such election shall be made by notifying all specified persons, and shall be effective at the opening of trading on the business day following notification.

(ii) Any member of an association acting in the capacity of an OTC market maker may make an election for purposes of paragraph (a)(24)(ii)(B) of this section for any covered security, by communicating to its association bids, offers, and quotation sizes in that security; except that for any other covered security listed or admitted to unlisted trading privileges on only one exchange and not traded by any other OTC market maker, such election shall be made by notifying its association and all specified persons, and shall be effective at the opening of trading on the business day following notification.

(iii) The election of an exchange or member of an association for any covered security pursuant to this

paragraph shall cease to be in effect if such exchange or member ceases to make available or communicate bids, offers, and quotation sizes in such security.

(c) *Obligations of responsible brokers and dealers.* (1) Each responsible broker or dealer shall promptly communicate to its exchange or association, pursuant to the procedures established by that exchange or association, its best bids, best offers, and quotation sizes for any subject security.

(2) Subject to the provisions of paragraph (c)(3) of this section, each responsible broker or dealer shall be obligated to execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or published offer (exclusive of any commission, commission equivalent or differential customarily charged by such responsible broker or dealer in connection with execution of any such order) in any amount up to its published quotation size.

(3)(i) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (c)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation if:

(A) Prior to the presentation of an order for the purchase or sale of a subject security, a responsible broker or dealer has communicated to its exchange or association, pursuant to paragraph (c)(1) of this section, a revised quotation size; or

(B) At the time an order for the purchase or sale of a subject security is presented, a responsible broker or dealer is in the process of effecting a transaction in such subject security, and immediately after the completion of such transaction, it communicates to its exchange or association a revised quotation size, such responsible broker or dealer shall not be obligated by paragraph (c)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation size.

(ii) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (c)(2) of this section if:

(A) Before the order sought to be executed is presented, such responsible broker or dealer has communicated to

its exchange or association pursuant to paragraph (c)(1) of this section, a revised bid or offer; or

(B) At the time the order sought to be executed is presented, such responsible broker or dealer is in the process of effecting a transaction in such subject security, and, immediately after the completion of such transaction, such responsible broker or dealer communicates to its exchange or association pursuant to paragraph (c)(1) of this section, a revised bid or offer:

*Provided, however,* That such responsible broker or dealer shall nonetheless be obligated to execute any such order in such subject security as provided in paragraph (c)(2) of this section at its revised bid or offer in any amount up to its published quotation size or revised quotation size.

(4) Subject to the provisions of paragraph (b)(4) of this section:

(i) No exchange or OTC market maker may make available, disseminate or otherwise communicate to any quotation vendor, directly or indirectly, for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any covered security which is not a subject security with respect to such exchange or OTC market maker; and

(ii) No quotation vendor may disseminate or display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size from any exchange or OTC market maker for any covered security which is not a subject security with respect to such exchange or OTC market maker.

(5)(i) Entry of any priced order for a covered security by an exchange market maker or OTC market maker in that security into an electronic communications network that widely disseminates such orders to third parties and permits such orders to be executed against in whole or in part shall be deemed to be:

(A) A bid or offer under this section, to be communicated to the market maker's exchange or association pursuant to paragraph (c) of this section for at least the minimum quotation size that is required by the rules of the market maker's exchange or association; and

(B) A communication of a bid or offer to a quotation vendor for display on a display device for purposes of paragraph (c)(4)(i) of this section.

(ii) Paragraph (c)(5)(i) of this section shall not apply to any odd-lot order.

(d) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, exchange,

or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

4. Sections 240.11Ac1-4 and 240.11Ac1-5 are added to read as follows:

**§ 240.11Ac1-4 Display of customer limit orders.**

(a) *Definitions.* For purposes of this section:

(1) The term *association* shall mean any association of brokers and dealers registered pursuant to Section 15A of the Act (15 U.S.C. § 78o-3).

(2) The terms *best bid* and *best offer* shall mean the highest priced bid and lowest priced offer.

(3) The terms *bid* and *offer* shall mean the bid price and the offer price communicated by a broker-dealer to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent.

(4) The term *block size* shall mean any order:

(i) Of at least 10,000 shares; or

(ii) For a quantity of stock having a market value of at least \$200,000.

(5) The term *covered security* shall mean any "reported security" and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in 15 U.S.C. 78c(a)(51)(A)(ii).

(6) The term *customer limit order* shall mean an order to buy or sell a covered security at a specified price that is not for the account of either a broker or dealer; *Provided, however,* that the term customer limit order shall include an order transmitted by a broker or dealer on behalf of a customer.

(7) The term *exchange-traded security* shall have the meaning provided in § 240.11Ac1-1.

(8) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(9) The term *reported security* shall have the meaning provided in § 240.11Aa3-1.

(b) *Specialists and OTC market makers.* (1) For covered securities that are exchange-traded securities:

(i) Each member of an exchange that is registered by that exchange as a specialist, or is authorized by that exchange to perform functions

substantially similar to that of a specialist, shall publish immediately a bid or offer that reflects:

(A) The price and size of each customer limit order held by such member that is at a price that would improve the best bid or offer of such member in such security; and

(B) The size of each customer limit order that:

(1) Is priced equal to the bid or offer of such specialist for such security;

(2) Is priced equal to the national best bid or offer; and

(3) Represents more than a *de minimis* change in relation to the size associated with the specialist's bid or offer.

(ii) Each registered broker or dealer that acts as a OTC market maker shall publish immediately a bid or offer that reflects:

(A) The price and size of each customer limit order held by the broker or dealer for execution otherwise than on the floor of an exchange that is at a price that would improve the bid or offer of such broker or dealer in such security; and

(B) The size of each customer limit order held by the broker or dealer for execution otherwise than on the floor of an exchange that:

(1) Is priced equal to the bid or offer of such broker or dealer for such security;

(2) Is priced equal to the national best bid or offer; and

(3) Represents more than a *de minimis* change in relation to the size associated with the broker or dealer's bid or offer.

(2) For covered securities that are not exchange-traded securities:

(i) Each member of an association that is an OTC market maker shall publish immediately a bid or offer that reflects:

(A) The price and size of each customer limit order held by the OTC market maker when the customer limit order is at a price that would improve the bid or offer of such OTC market maker in such security; and

(B) The size of each customer limit order held by the OTC market maker that:

(1) Is priced equal to the bid or offer of such OTC market maker for such security;

(2) Is priced equal to the national best bid or offer; and

(3) Represents more than a *de minimis* change in relation to the size associated with the OTC market maker's bid or offer.

(ii) Each exchange member shall publish immediately a bid or offer that reflects:

(A) The price and size of each customer limit order held by the exchange member when the customer

limit order is at a price that would improve the bid or offer of such exchange member in such security; and

(B) The size of each customer limit order held by the exchange member that:

(1) Is priced equal to the bid or offer of such exchange member for such security;

(2) Is priced equal to the national best bid or offer; and

(3) Represents more than a *de minimis* change in relation to the size associated with the member's bid or offer.

(c) *Exceptions.* The requirements in paragraph (b) of this section shall not apply to any customer limit order:

(1) That is executed upon receipt of the order.

(2) That is placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed.

(3) That is an odd-lot order.

(4) That is a block size order, unless a customer placing such order requests that the order be displayed in compliance with this section.

(5) That is delivered immediately upon receipt to an exchange or association-sponsored system that displays those limit orders, and complies with the requirements of this section with respect to that order.

(6) That is delivered immediately upon receipt to another exchange member or OTC market maker that complies with the requirements of this section with respect to that order.

**§ 240.11Ac1-5 Price improvement for customer market orders.**

(a) *Definitions.* For purposes of this section:

(1) The term *association* shall mean any association of brokers and dealers registered pursuant to section 15A of the Act (15 U.S.C. 78o-3).

(2) The term *block size* shall mean any order:

(i) Of at least 10,000 shares; or

(ii) For a quantity of stock having a market value of at least \$200,000.

(3) The term *covered security* shall mean any "reported security" and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in 15 U.S.C. 78c(a)(51)(A)(ii); *Provided, however,* that with respect to over-the-counter securities, the term covered security shall include only the 250 over-the-counter securities with the highest average daily trading volume over the previous quarter.

(4) The term *customer market order* shall mean an order to buy or sell a covered security at the best available price that is not for the account of either a broker or a dealer; *Provided, however,* that the term customer market order shall include an order transmitted by a broker or dealer on behalf of a customer.

(5) The term *exchange-traded security* shall have the meaning provided in § 240.11Ac1-1.

(6) The term *minimum variation* shall mean the minimum increment by which a covered security may be quoted on the primary market for the security.

(7) The term *national best bid* shall mean, with respect to a "covered security," the highest bid published for that security in the United States equity markets.

(8) The term *national best offer* shall mean, with respect to a "covered security," the lowest offer published for that security in the United States equity markets.

(9) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(10) The term *price improvement* shall mean the execution of an order at a price that is better than the existing national best bid or offer.

(11) The term *reported security* shall have the meaning provided in § 240.11Aa3-1.

(12) The term *stop* shall mean to guarantee the execution or partial execution of an order at a specified price.

(13) The term *stop price* shall mean the specified price at which an order is stopped.

(b) *Execution duty.* Each specialist or OTC market maker that accepts a customer market order in a covered security shall provide that order an opportunity to receive price improvement when the difference between the national best bid and offer for the security is greater than the minimum variation by which the security may be quoted on the principal market for such security.

(c) *Compliance with the duty.* Each specialist or OTC market maker shall be deemed to have provided an opportunity for price improvement pursuant to paragraph (b) of this section, if the specialist or OTC market maker follows the procedures set forth in paragraph (d) of this section.

(d) *Order exposure procedures.* (1) To provide an opportunity for price improvement pursuant to this

paragraph, when the spread between the national best bid and offer is greater than the minimum variation, an exchange specialist or OTC market maker shall, before executing a customer market order in a covered security:

(i) Stop the customer order at the national best bid (for a sell order) or offer (for a buy order) for the lesser of:

(A) The full size of the order; or

(B) The size associated with the national best bid (for a sell order) or offer (for a buy order); and

(ii) Publish and maintain for at least 30 seconds an offer (for a sell order) or a bid (for a buy order) on behalf of the customer, for the full number of shares of the order, at a price that is one minimum variation higher (for a sell order) or lower (for a buy order) than the stop price.

(2) If, during the time a specialist or OTC market maker is exposing a customer market order pursuant to paragraph (d)(1)(ii) of this section, the specialist or OTC market maker receives a subsequent customer market order on the same side of the market as the exposed order, such specialist or OTC market maker may execute immediately the exposed order at the stop price and shall stop and expose the subsequent customer market order pursuant to paragraph (d)(1) of this section.

(3) When a specialist or OTC market maker is exposing a customer market order pursuant to paragraph (d)(1)(ii) of this section, such specialist or OTC market maker may execute immediately such order at the stop price if, after exposure has commenced:

(i) Another specialist or OTC market maker executes a transaction at a price equal or inferior to the stop price; or

(ii) Another specialist or OTC market maker changes its bid or offer to a price equal or inferior to the stop price.

(4) The size associated with any bid or offer required to be maintained on behalf of a customer pursuant to paragraph (d)(1)(ii) of this section may be reduced to the extent of any partial execution during the exposure period.

(5) The requirements of paragraph (d) of this section shall not apply to:

(i) Any order for a covered security with a spread between the national best bid and offer of greater than four times the minimum variation;

(ii) Any order of block size;

(iii) Transactions for odd-lot orders;

(iv) Customer market orders in covered securities received within five minutes of the opening or closing of the trading day for the primary market in which the security trades; or

(v) Customer orders effected in conjunction with a block size trade

effected outside the national best bid or offer.

(e) *Exceptions.* The requirements of paragraphs (b) and (d) of this section shall not apply to:

(1) Any transaction for an exchange-traded covered security effected on an exchange during any period when such exchange is relieved of its obligation to collect, process and make available to quotation vendors bids and offers pursuant to paragraph (b)(3)(i) of § 240.11Ac1-1;

(2) Any transaction for an exchange-traded covered security effected otherwise than on the floor of an exchange during any period when the

principal exchange market for the security is relieved of its obligation to collect, process and make available to quotation vendors bids and offers in such security pursuant to paragraph (b)(3)(i) of § 240.11Ac1-1;

(3) Any transaction for a non-exchange-traded covered security effected during any period when an association determines, pursuant to rules and regulations approved by the Commission pursuant to Section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that the level of trading activities or the existence of unusual market conditions is such that the association is incapable

of collecting, processing, and making available to quotation vendors the data normally reported with respect to the security; or

(4) A customer market order that is delivered immediately upon receipt to another specialist or OTC market maker that complies with the requirements of this section with respect to that order.

Dated: September 29, 1995.

By the Commission.

**Jonathan G. Katz,**

*Secretary.*

[FR Doc. 95-24911 Filed 10-6-95; 8:45 am]

**BILLING CODE 8010-01-P**