

metropolitan area of Melbourne, with fixed assets valued at approximately N.Z. \$650.5 million; (5) Energy 21 ("Energy 21"), a gas retail company, serving eastern Melbourne, the Morningstar Peninsula and northern and western Victoria; (6) Stratus ("Stratus"), a gas distribution company, with fixed assets valued at approximately N.Z. \$650.5 million, serving the northern and southeastern suburbs of Melbourne and the Morningstar Peninsula; and (7) Gas Transmission Corporation ("GTC"), a gas transmission and supply company (Kinetick, Westar, Ikon, Multinet, Energy 21, Stratus and GTC collectively, "Australian Companies").

The bidding process for the Australian Companies will be conducted by the Victorian government in two phases, commencing in June 1998 and ending in November 1998. For purposes of the bidding process, the paired companies of Kinetick and Westar, Ikon and Multinet, and Energy 21 and Stratus, are regarded as "stapled" businesses. UtiliCorp expects to submit bids for the Australian Companies through one or more subsidiaries, which may invest as a member of a group or consortium. For Australian tax considerations, UtiliCorp explains that it may structure the proposed acquisitions as a series of asset and stock acquisitions.

UtiliCorp proposes to acquire an equity ownership interest of up to, but not more than, 50% in one or more of the three stapled businesses. With respect to GTC, UtiliCorp proposes to acquire a less than twenty percent interest. UtiliCorp plans to invest no more than \$500 million in any combination of permissible acquisitions under the bidding rules established by the Victorian government.<sup>5</sup>

Neither UtiliCorp nor any corporation owned or controlled by UtiliCorp is a holding company subject to regulation under the Act or a subsidiary company of a holding company subject to regulation under the Act. None of the Australian Companies is a public utility company operating in the United States. None of the Australian Companies presently serves, and following the proposed acquisitions by UtiliCorp none will serve, customers in the United States. None of the Companies is qualified to do business in any state of

<sup>5</sup> UtiliCorp expects to acquire the Australian Companies in the near term using bank borrowings at a subsidiary level, which may require a guarantee by UtiliCorp or from its existing earnings and/or debt facilities at the UtiliCorp level. UtiliCorp states that its obligations are subject to multiple state approvals.

the United States; each operates exclusively within Australia.

UtiliCorp requests an order under section 3(b) of the Act exempting each of the Australian Companies from all provisions of the Act. UtiliCorp states that none of the Australian Companies will derive any material part of its income, directly or indirectly, from sources within the United States. Further, none of the Australian Companies will be, or have any subsidiary company which is, a public utility company operating in the United States. UtiliCorp asserts that rule 10(a)(1) will provide an exemption for UtiliCorp and any subsidiary of UtiliCorp insofar as they are holding companies of the Australian Companies. Further, UtiliCorp asserts that rule 11(b)(1), together with rule 10(a)(1), will provide an exemption from the approval requirements of sections 9(a)(2) and 10 to which UtiliCorp would otherwise be subject.

For the Commission, by the Division of Investment Management, under delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40260; File No. 4-208]

RIN 3235-AH49

### Intermarket Trading System ("ITS") Plan; Proposed Amendments to Expand the ITS/Computer Assisted Execution System Linkage to all Listed Securities and to Eliminate the Unanimous Vote Provision

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed amendments to national market system plan.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is proposing amendments to the plan governing the operation of the Intermarket Trading System ("ITS Plan" or "Plan") that was approved pursuant to Rule 11Aa3-2 under the Securities Exchange Act of 1934, as amended ("Exchange Act" or "Act"). The proposed amendments expand the ITS/Computer Assisted Execution System ("CAES") linkage to all listed securities, including non-Rule 19c-3 securities. The amendments to the Plan also eliminate the requirement that amendments to the ITS Plan be approved by a unanimous vote of all

Participants; instead, a two-thirds supermajority of the Participants would be required for amendments.

**DATES:** Comments should be submitted by August 31, 1998.

**ADDRESSES:** All comments should be submitted in triplicate and addressed to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Mail Stop 6-9, 450 Fifth Street, NW., Washington, DC 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comments should refer to File No. 4-208; this file number should be included in the subject line if E-mail is used. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room at the same address. Electronically submitted comment letters will be posted on the Commission's web site (<http://www.sec.gov>).

**FOR FURTHER INFORMATION CONTACT:**

Katherine A. England, Assistant Director at (202) 942-0154; Elizabeth Prout Lefler, Special Counsel at (202) 942-0170; Heather A. Seidel, Attorney at (202) 942-4165; or Christine Richardson, Attorney at (202) 942-0748, Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission, Mail Stop 10-1, 450 Fifth Street, NW., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing amendments to the ITS Plan<sup>1</sup> to expand the NASD's ITS/CAES linkage to all listed securities. The Commission is also proposing amendments to the Plan to eliminate the unanimous vote requirement for amendments to the ITS Plan. The amendments, published by the Commission on its own initiative pursuant to Rule 11Aa3-2 under the Exchange Act,<sup>2</sup> are necessary to

<sup>1</sup> ITS is a communications and order-routing network linking eight national securities exchanges and the electronic over-the-counter ("OTC") market operated by the National Association of Securities Dealers, Inc. ("NASD"). ITS was designed to facilitate intermarket trading in exchange-listed equity securities based on current quotation information emanating from the linked markets. Participants to the ITS Plan are the American Stock Exchange, Inc. ("Amex"), the Boston Stock Exchange, Inc. ("BSE"), the Chicago Board Options Exchange, Inc. ("CBOE"), the Chicago Stock Exchange, Inc. ("CHX"), the Cincinnati Stock Exchange, Inc. ("CSE"), the NASD, the New York Stock Exchange, Inc. ("NYSE"), the Pacific Exchange, Inc. ("PCX"), and the Philadelphia Stock Exchange, Inc. ("Phlx").

<sup>2</sup> Rule 11Aa3-2 (17 CFR 240.11Aa3-2) establishes procedures for initiating or approving amendments to national market system plans such as the ITS Plan. Paragraph (b)(2) of Rule 11Aa3-2 states that the Commission may propose amendments to an effective national market system plan by publishing the text thereof together with a statement of purpose

encourage the statutory goals of efficient execution of securities transactions and opportunities for best execution of customer orders. They also address features of governance requirements of the ITS Plan that discourage intermarket competition. The Commission is proposing these amendments only after the ITS Participants have been unable to take action in these areas. The Commission is publishing this proposal for comment from interested persons.

## I. Background

### A. ITS/CAES Interface

Section 11A(a)(2) of the Exchange Act, adopted by the Securities Acts Amendments of 1975 ("1975 Amendments"),<sup>3</sup> directs the Commission, having due regard for the public interest, the protection of investors and the maintenance of fair and orderly markets, to use its authority under the Act to facilitate the establishment of a National Market System for securities in accordance with the Congressional findings and objectives set forth in Section 11A(a)(1) of the Act. Among those findings and objectives is the "linking of all markets for qualified securities through communication and data processing facilities."<sup>4</sup>

On January 26, 1978, the Commission issued a statement on the national market system calling for, among other things, the prompt development of comprehensive market linkage and order routing systems to permit the efficient transmission of orders among the various markets for qualified securities, whether on an exchange or over-the-counter.<sup>5</sup> In particular, the Commission stated that an intermarket order routing system was necessary to "permit orders for the purchase and sale of multiple-traded securities to be sent directly from any qualified market to another such market promptly and efficiently."<sup>6</sup> The Commission further

of the amendments. Paragraph (c)(2) requires the Commission to publish notice of any amendments initiated by the Commission and provide interested parties an opportunity to submit written comments. Further, Paragraph (c)(2) of Rule 11Aa3-2 requires that promulgation of an amendment to an effective national market system plan initiated by the Commission be by rule.

<sup>3</sup> Pub. L. 94-29 (June 4, 1975).

<sup>4</sup> Section 11A(a)(1)(D) of the Act, 15 U.S.C. 78k-1(a)(1)(D).

<sup>5</sup> Securities Exchange Act Release No. 14416 (January 26, 1978) ("1978 Statement"), at 26, 43 FR 4354, 4358. Previously, on June 23, 1977, the Commission had indicated that a national market system would include those "regulatory and technological steps [necessary] to achieve a nationwide interactive market system." See Securities Exchange Act Release No. 13662 (June 23, 1977), at 20, 42 FR 33510, 33512.

<sup>6</sup> 1978 Statement, *supra* note 5, at 4358.

stated that "[t]he need to develop and implement a new intermarket order routing system to link all qualified markets could be obviated if participation in the ITS market linkage currently under development were made available on a reasonable basis to all qualified markets and if all qualified markets joined that linkage."<sup>7</sup>

As requested by the Commission, in March 1978, various exchanges<sup>8</sup> filed jointly with the Commission a "Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage," now known as the ITS Plan.<sup>9</sup> On April 14, 1978, the Commission, noting that ITS might provide the basis for an appropriate market linkage facility in a national market system, issued a provisional order, pursuant to Section 11A(a)(3)(B) of the Act,<sup>10</sup> authorizing the filing exchanges (and any other self-regulatory organization ("SRO") which agreed to become a participant in the ITS Plan) to act jointly in planning, developing, operating and regulating the ITS in accordance with the terms of the ITS Plan for a period of 120 days.<sup>11</sup>

In 1979, during the Commission's hearings regarding proposed Rule 19c-3 under the Act,<sup>12</sup> the NASD announced plans to enhance its Nasdaq System to include, among other things, a computer assisted execution system which would enable participating firms to route their orders for listed securities through the system to obtain automatic executions against quotations of "third market makers" participating in the enhanced Nasdaq,<sup>13</sup> later known as the NASD's Computer Assisted Execution System ("CAES"). The NASD also contemplated an automated interface between the ITS and CAES ("ITS/CAES interface") to permit automated execution of

<sup>7</sup> In this connection, the Commission specifically indicated that "qualified markets" would include not only exchanges but OTC market makers as well. *Id.*

<sup>8</sup> The exchanges involved were Amex, BSE, NYSE, PCX (then called the "PSE"), and Phlx.

<sup>9</sup> The ITS Plan is contained in File No. 4-208.

<sup>10</sup> 15 U.S.C. 78k-1(a)(3)(B).

<sup>11</sup> Securities Exchange Act Release No. 14661 (April 14, 1978), 43 FR 17419. In authorizing the implementation of ITS, the Commission urged those SROs not yet ITS participants to participate in ITS. *Id.* at 7 n. 15, 43 FR 17421. On August 11, 1978, the Commission extended ITS authority for an additional period of one year. Securities Exchange Act Release No. 15058 (August 11, 1978), 43 FR 36732. In the interim the ITS Plan had been amended to include the Midwest Stock Exchange ("MSE") as a participant. The MSE is now the CHX.

<sup>12</sup> Securities Exchange Act Release No. 15769 (April 26, 1979), 44 FR 26688. Rule 19c-3 precludes exchange off-board trading restrictions from applying to most securities listed after April 26, 1979.

<sup>13</sup> The term "third market makers" refers to OTC market makers in listed securities.

commitments sent from participating exchanges and to permit market makers participating in the enhanced Nasdaq to route commitments efficiently to exchange markets for execution.<sup>14</sup>

The Commission later extended its authorization for the joint operation of the ITS<sup>15</sup> but indicated several concerns with respect to the ITS that would require the attention of the ITS participants during the extension period. In particular, the Commission indicated that, in order for ITS to serve as a means to achieve price protection on an intermarket basis, the ITS Participants should implement "a linkage between the ITS and over-the-counter market makers regulated by the NASD. \* \* \*" <sup>16</sup> The Commission further indicated its expectation that the NASD would become an ITS participant before October 1980, and stated that if the contemplated ITS/NASD interface was not implemented promptly, the Commission was prepared to review whether the temporary approval granted in the order should continue and to take appropriate steps to require the inclusion of those market centers.<sup>17</sup>

On June 11, 1980, the Commission adopted Rule 19c-3 under the Act, which eliminated off-board trading restrictions with respect to most newly-listed securities and thereby permitted member firms of the NYSE and Amex to make markets over-the-counter in what was then a small number of NYSE and Amex-listed securities.<sup>18</sup> Although the

<sup>14</sup> In its discussions with the ITS Participants, the NASD indicated that the enhanced Nasdaq would encompass trading of listed securities and that it intended to pursue an automated interface. See *In re Off-Board Trading Restrictions*, File No. 4-220, at 9-10, 23-34.

<sup>15</sup> The authorization for the joint operation was extended until January 31, 1983. See Securities Exchange Act Release No. 16214 (September 21, 1979), 44 FR 56069.

<sup>16</sup> *Id.* at 12, 44 FR 56072. The Commission also called for a linkage between the ITS and the Cincinnati Stock Exchange's ("CSE") National Securities Trading System ("NSTS").

<sup>17</sup> *Id.* at 14-15, 44 FR 56072. The Commission substantially reiterated these views in a letter to Congress shortly thereafter. See letter from Harold M. Williams, Chairman, SEC, to the Honorable Bob Eckhardt, Chairman, Subcommittee on Oversight and Investigations and the Honorable James Scheuer, Chairman, Subcommittee on Oversight and Investigations and the Subcommittee on Consumer Protection and Finance, House Committee on Interstate and Foreign Commerce, dated November 9, 1979, included in Progress Toward the Development of a National Market System, Joint Hearings before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 90th Cong., 1st Sess., Serial 96-89.

<sup>18</sup> Securities Exchange Act Release No. 16888 (June 11, 1980), 45 FR 41125 ("Rule 19c-3 Adopting Release"). The rule, as adopted, precludes exchange off-board trading restrictions from applying to securities listed after April 26, 1979 ("Rule 19c-3 securities").

Commission recognized many potential concerns regarding the rule, such as internalization,<sup>19</sup> the Commission determined that they were outweighed by the benefits of the rule, including an opportunity for competition between the OTC and exchange markets, with concomitant benefits to investors. For example, the Commission stated that the presence of additional market makers might (1) place competitive pressure on primary market specialists, thereby possibly resulting in narrower spreads in Rule 19c-3 securities; and (2) create incentives for markets to disseminate quotations of greater size and add to the depth, liquidity, and continuity of the markets for those securities.<sup>20</sup>

The Commission indicated that achieving efficient linkages between traditional exchange trading floors and over-the-counter markets was essential to obtaining maximum order interaction between the various types of markets. The Commission therefore expected the NASD and the ITS Participants to establish an automated linkage between the ITS and Nasdaq system and to provide the Commission with formal status reports on the ITS-Nasdaq linkage.<sup>21</sup>

In September 1980, several Participants submitted identical letters which indicated that they were not at that time willing to commit to the development of an automated interface.<sup>22</sup> The MSE, in a separate

<sup>19</sup>The term "internalization" refers to "the withholding of retail orders from other market centers for the purpose of executing them "in-house," as principal, without exposing those orders to buying and selling interest in those other market centers." *Id.* at 18 n.31, 45 FR 41128 n.31.

<sup>20</sup>The Commission believed that off-board trading restrictions had anti-competitive effects because they effectively confined trading in listed securities to exchange markets by precluding exchange members from trading as principal in the OTC market. Adopting Rule 19c-3 limited the expansion of the anti-competitive effects. The Commission also announced the development of a monitoring program to study the issues raised by commentators, determined to publish monitoring reports on a periodic basis and committed to a reexamination of those issues as appropriate in light of development in the markets. In connection with the adoption of Rule 19c-3, the Commission noted the importance of the NASD's completion of the Nasdaq enhancements in order to provide "a more efficient mechanism for over-the-counter market making in listed securities." *Id.* at 14-15, 45 FR 41127. See Rule 19c-3 Adopting Release, *supra* note 18, at 49-53, 45 FR 41134. The Commission notes that it is not, at this time, proposing to amend or expand Rule 19c-3.

<sup>21</sup>*Id.* at 15-16, 45 FR 41127.

<sup>22</sup>These Participants were the Amex, BSE, NYSE, Phlx and PCX. See e.g. letter from John J. Phelan, Jr., President and Chief Operating Officer, NYSE, to George A. Fitzsimmons, Secretary, SEC, dated September 16, 1980. In addition, the Amex submitted a separate letter in which it expressed its opposition to efforts to link upstairs markets to exchange markets in the context of its continuing opposition to Rule 19c-3. See letter from Robert J.

letter, raised various regulatory concerns with respect to the automated interface.<sup>23</sup> In contrast, the NASD responded by reaffirming its commitment to the automated interface<sup>24</sup> and provided the Commission and the ITS participants with a functional description of the automated interface.<sup>25</sup> On January 7, 1981, the NYSE Board of Directors approved participation in a two-step "test" linkage between ITS and the enhanced Nasdaq system.<sup>26</sup> The Commission determined that ITS, because of its ability to permit market participants to send orders from one market to another, was consistent with national market system goals and, if efficiently linked with all markets, could become a permanent feature of a national market system. Nonetheless, the Commission continued to believe that the absence of any established linkage between the exchanges and OTC market makers preserved an environment in which there were reduced opportunities to ameliorate

Birnbaum, President, Amex, to George A. Fitzsimmons, Secretary, SEC, dated September 22, 1980, contained in File No. 4-208. See also letter from Robert J. Birnbaum, President, Amex, to George A. Fitzsimmons, Secretary, SEC, dated December 12, 1980, contained in File No. 4-208.

<sup>23</sup>See letter from John G. Weithers, President, MSE, to George A. Fitzsimmons, Secretary, SEC, dated September 15, 1980 ("September MSE Letter"), contained in File No. 4-208. See also letter from John G. Weithers, President, MSE, to John J. Phelan, Jr., President, NYSE, dated July 31, 1980 ("July MSE Letter"), contained in File No. 4-208.

<sup>24</sup>See letter from Gordon S. Macklin, President, NASD, to George A. Fitzsimmons, Secretary, SEC, dated September 12, 1980 ("NASD Letter"), contained in File No. 4-208. The NASD indicated that there were no significant technical concerns in connection with building the automated interface and estimated that the automated interface could be implemented within six months of an agreement among the parties to proceed.

<sup>25</sup>See Description of NASD Market Services, Inc., Computer Assisted Execution System, contained in File No. 4-208. In its functional description, the NASD also committed to developing a capability to provide the ITS participants with the best bid and offer among all market makers participating in the enhanced Nasdaq.

<sup>26</sup>With respect to the actual operation of the automated interface, the NYSE plan contemplated an initial "pilot" phase in which trading through the automated interface would be limited to the 30 most active Rule 19c-3 securities. The other ITS participants were in general agreement with the NYSE's position with respect to the automated interface. During the pilot phase, the NYSE anticipated that the ITS participants and the Commission would evaluate trading under the Preliminary Rule and other policy concerns which may have been raised by trading Rule 19c-3 securities through the automated interface. The NYSE plan further anticipated that in the subsequent phase the automated interface would be expanded to include the trading of all Rule 19c-3 securities, but only after the completion of the pilot phase evaluation and agreement among the ITS participants and the NASD on any additional measures to address policy concerns identified by that evaluation.

market fragmentation,<sup>27</sup> to eliminate pricing inefficiencies, to obtain best execution and to promote the type of competitive market structure which a national market system was designed to achieve.<sup>28</sup>

Therefore, on April 28, 1981, the Commission issued an order<sup>29</sup> requiring the ITS Participants to implement an automated interface between CAES and ITS by March 1, 1982, limited to Rule 19c-3 securities, and to submit proposed amendments to the ITS Plan reflecting the inclusion of the NASD as an ITS Participant. On March 11, 1982 the Commission delayed the implementation date of the interface until May 1, 1982 and published its own proposed amendments to the ITS Plan.<sup>30</sup> Consequently, due to the failure of the ITS Participants to submit an amendment on May 12, 1982, the Commission adopted its own amendments to the ITS Plan.<sup>31</sup> The

<sup>27</sup>Fragmentation occurs when investor order flow is directed to several markets that are not connected. Among other things, fragmentation reduces the probability of matching customer buy and sell orders because of the smaller number of orders in each market.

<sup>28</sup>Indeed, in mandating that the Commission facilitate the establishment of a national market system, the Congress found that the linking of all markets for qualified securities through communication and data processing facilities would foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders and contribute to best execution of such orders. Section 11A (A)(1)(D) of the Act, 15 U.S.C. 78k-1(a)(1)(D).

<sup>29</sup>Securities Exchange Act Release No. 17744 (April 21, 1981), 46 FR 23856 (April 28, 1981).

<sup>30</sup>Securities Exchange Act Release No. 18536 (March 11, 1982), 47 FR 10658. The Commission deferred the implementation date in part because the Participants had failed to submit amendments to the Plan.

<sup>31</sup>A majority of the amendments were non-controversial and had been agreed upon by the parties or reflected the parties' decision to defer resolution of certain issues until after the pilot phase of the interface. The areas where the parties could not reach agreement were resolved by the Commission. See Securities Exchange Act Release No. 18713 (May 12, 1982), 47 FR 20413. The amendments included language requiring the NASD to apply trade-through safeguards to provide for a sufficient assurance of consistency with the exchanges' trade-through rules. A "trade-through" occurs when a transaction is effected at a price below the best bid, or above the best prevailing offer. The NASD submitted a proposed trade-through rule on May 4, 1982, which the Commission approved on an accelerated basis for six months. The Commission believed that the NASD rule was adequate even though it was not identical to the exchanges' trade-through rules. See Securities Exchange Act Release No. 18714 (May 6, 1982), 47 FR 20429 (May 12, 1982). The Commission had approved the exchanges' trade-through rules on April 9, 1981. See Securities Exchange Act Release No. 17704 (April 9, 1981), 46 FR 22520.

On January 27, 1983, the Commission granted permanent approval to the ITS Plan. See Securities Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983) ("Final Approval

Commission order applied to Rule 19c-3 securities initially because the Commission believed that OTC trading would be more active in these securities. The Commission fully intended the ITS/CAES linkage to subsequently expand to all listed securities.<sup>32</sup>

On November 12, 1991, the NASD submitted an application to the Commission, pursuant to Rule 11Aa3-2(e), to review the ITS Operating Committee's failure to approve two NASD recommendations that would have amended the ITS Plan to expand the ITS/CAES linkage to include non-Rule 19c-3 securities.<sup>33</sup> Since that submission, the Division of Market Regulation ("Division") issued its Market 2000 Study,<sup>34</sup> which included the Division's findings that it was necessary to expand the ITS/CAES linkage,<sup>35</sup> as well as identifying several regulatory issues that the Commission believed the NASD and Nasdaq needed to address prior to any expansion of the ITS/CAES linkage.<sup>36</sup>

Order"). On September 15, 1983 the pilot phase ended and all Rule 19c-3 securities became eligible for trading through the ITS/CAES interface. See Securities Exchange Act Release Nos. 19825 (May 31, 1983), 48 FR 25043 (June 3, 1983); and 19970 (July 20, 1983), 48 FR 33103.

<sup>32</sup> See Final Approval Order, *supra* note 31, at 4940 ("The Commission also notes that in order to achieve fully the Congressional goal that all markets for qualified securities be linked (Section 11A(a)(1)(D) of the Act), it will be necessary in the future for the ITS/CAES interface to be expanded to include all stocks traded in the third market.").

<sup>33</sup> In a July 8, 1997 letter, commenting on four issues relating to ITS that the Commission preliminarily viewed as "unreasonably impeding competition among the various markets," the NASD reaffirmed its position originally made in its 1991 application. See letter from Robert E. Aber, Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission ("NASD 1997 Letter"). However, the NASD has since withdrawn its application submitted to the Commission pursuant to Exchange Act Rule 11Aa3-2(e). See letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated July 23, 1998.

<sup>34</sup> Division Market Regulation, *Market 2000: An Examination of Current Equity Market Developments* (January 1994) ("Market 2000 Study").

<sup>35</sup> Specifically, the Market 2000 Study noted that the possibility of execution in the OTC market of a significant percentage of the total volume in multiply traded securities increased the need to enhance interaction of orders in all market centers to eliminate trade throughs and to provide market makers in those securities the ability to compete for order flow through their displayed quotations. *Id.*

<sup>36</sup> In February 1995, the NASD submitted a rule filing addressing those recommendations but subsequently withdrew that filing in light of the Commission's publication of its Order Handling Rules (Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Execution Rules" or "Order Handling Rules")), which addressed many of the topics covered by the NASD's proposed rules. The NASD has stated that it is prepared to submit remaining aspects of this 1995 filing, when appropriate, that

More recently, the Commission solicited comment on whether the ITS/CAES linkage should be expanded to cover non-Rule 19c-3 securities in the proposing release for the Order Execution Rules.<sup>37</sup> In the adopting release for those rules, the Commission deferred action on the expansion of the ITS/CAES linkage, and instead encouraged the ITS Participants to work jointly to expand the linkage.<sup>38</sup>

#### B. Unanimous Vote Requirement

A unanimous vote of all the Participants is required for any amendment to the ITS Plan. Section 4(c) of the ITS Plan states that any proposed change in, addition to, or deletion from the ITS Plan may be effected only by means of a written amendment to the Plan which is executed on behalf of each Participant. In addition, Section 3(c), regarding New Participants, states that any national securities exchange or national securities association may subscribe to the ITS Plan and become a participant by agreeing, in an amendment to the Plan adopted in accordance with its provisions, to comply and enforce compliance with the provisions of the Plan (as provided in Section 3(b)). This in effect requires a unanimous vote before a new participant can be admitted to the Plan.

## II. Discussion

In 1997, the Commission initiated a review concerning certain anti-competitive aspects of ITS. The review was prompted by the significant changes in the equity markets since the inception of ITS and the slowness or inability of ITS to accommodate these changes. The Commission believed that certain structural aspects of ITS impeded innovation and competition in the national market system. Accordingly, the Commission sent a letter to the ITS Participants on May 27, 1997 outlining four anti-competitive aspects of the ITS Plan and requesting that they develop reasonable recommendations to the Commission in the form of proposed ITS Plan amendments and proposed SRO rule

the Commission believes are necessary to achieve expansion of the ITS/CAES linkage. The NASD also states it is prepared to present any other rule changes to its Board that the Commission believes are necessary to achieve this expansion. See NASD 1997 Letter, *supra* note 33. On June 22, 1998, the NASD submitted a Petition for Rulemaking ("NASD Petition") to adopt rules necessary to remove the limitation on access to ITS with respect to non-Rule 19c-3 securities. The NASD Petition adopts by reference the substance of the NASD's 1991 appeal mentioned above.

<sup>37</sup> See Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995).

<sup>38</sup> See Order Execution Rules, *supra* note 36.

changes.<sup>39</sup> The Division followed up this letter with another letter to the Participants on September 25, 1997, in which the Division reinforced the Commission's concerns and provided specific examples of the anti-competitive nature of the unanimous vote requirement.<sup>40</sup> The responses that the Commission received in reply to both of these letters indicated that a number of the Participants will not agree to expand the ITS/CAES interface or to eliminate the unanimous vote requirement. Because of the unanimous vote requirement, these changes therefore cannot be approved by the Participants. Accordingly, the Commission is proposing rules to address the anti-competitive operation of these ITS provisions.<sup>41</sup>

<sup>39</sup> Preliminarily, the Commission found four elements of the current operation of ITS and the ITS Plan to be unreasonably impeding competition among the various markets: (1) Minimum increments for ITS commitments; (2) the lack of access to ITS for OTC market makers; (3) the unanimous vote requirement for ITS Plan amendments; and (4) the ITS Participants' special right of review for CSE proposed rule changes. See letter from Jonathan G. Katz, Secretary, Commission, to ITS Participants, dated May 27, 1997 ("May 27 Letter"). The Participants have voted to eliminate the limitation on access to increments through ITS, and the review of CSE rule changes.

<sup>40</sup> See letter from Richard R. Lindsey, Director, Market Regulation, Commission, to Allan A. Bretzer, Committee Chairman, ITS Operating Committee ("ITSOC"), dated September 25, 1997 ("September 25 Letter").

<sup>41</sup> Section 11A(a)(3)(B) of the Act authorizes the Commission, in furtherance of its statutory directive to facilitate the development of a national market system, by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under the Act in planning, developing, operating or regulating a national market system (or a subsystem thereof) or one or more facilities thereof. 15 U.S.C. 78k-1(a)(3)(B). The language of Section 11A(a)(3)(B) states explicitly that the Commission not only may approve national market system facilities in response to an application by SROs, but also may require SROs to implement such facilities on their own initiative. Moreover, the possible need for Commission regulatory compulsion in connection with the development of a national market system where necessary to supplement competitive forces was specifically recognized by the Congress in enacting the 1975 Amendments. For example, the Committee of Conference of both Houses of Congress, in discussing the implementation of a national market system stated: It is the intent of the conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed. The conferees expect, however, in those situations where competition may not be sufficient, such as the creation of a composite quotation system or a consolidated transaction reporting system, the Commission will use the power granted to it in [1975 Amendments] to act promptly and efficiently to ensure that the essential mechanisms of an integrated secondary trading system are put into place as rapidly as possible.

Committee of Conference, Report To Accompany S 249, H.R. Rep. No. 94-249, 94th Cong., 1st Sess., at 92, reprinted in [1975] U.S. Code Cong. & Ad. News 321, 323. See also Securities Exchange Act

Continued

### A. Need for Expanded ITS/CAES Interface

In its permanent approval order for ITS, the Commission stated that "in order to achieve fully the Congressional goal that all markets for qualified securities be linked (Section 11A(a)(1)(D) of the Act), it will be necessary in the future for the ITS/CAES interface to be expanded to include all stocks traded in the third market."<sup>42</sup> The Commission continues to believe that it is necessary to expand the ITS/CAES linkage to all listed securities in order to fully implement the 1975 Congressional mandate to create a national market system to link the exchanges and the OTC market. Originally, the Commission realized the need for an efficient linkage between ITS and the OTC market, especially in light of the adoption of Rule 19c-3, but limited the ITS/CAES linkage to Rule 19c-3 securities as an interim measure because it could not predict how the linkage would work in practice.<sup>43</sup> However, the Commission explicitly stated that it intended this limitation to be temporary and wanted it removed eventually through joint action by ITS Participants.

The Commission now believes that the significant changes to the third market that have occurred since 1982, when the Commission first approved the ITS/CAES linkage for Rule 19c-3 securities, support the expansion of the linkage. Any NASD member that acts in the capacity of an OTC market maker must provide continuous two-sided quotations for any exchange-listed security in which that member, during the most recent calendar quarter, comprised more than 1% of the aggregate trading volume for such security as reported in the consolidated system ("1% Rule").<sup>44</sup> The NASD now requires all third market makers registered as CQS market makers to

register and participate in ITS/CAES.<sup>45</sup> Moreover, all specialists and OTC market makers must now display the price and size of all customer limited orders that improve their quote ("Limit Order Display Rule").<sup>46</sup> Thus, the significant limitations in transparency that previously distinguished the OTC market from the exchange market have been reduced.

The increase in transparency has been accompanied by a growth in trading in the third market. In 1996, third market trading of NYSE listed stocks accounted for 8.14% of the volume and 10.74% of the trades reported to the consolidated tape. In 1981, however, 98.5% of the consolidated tape volume in exchange-listed securities occurred on exchange floors.<sup>47</sup> The growth of third market activity makes it even more important to expand the ITS/CAES linkage to all listed securities in order to ensure that customers receive the best price regardless of the market of execution. In addition, the Commission does not believe there have been any substantial adverse effects of the ITS/CAES linkage to date. There is no evidence that the linkage has led to poorer executions in Rule 19c-3 stocks versus other listed stocks. On the contrary, the linkage enables third market makers to make more competitive markets and allows orders routed to exchanges to obtain those prices. The lack of any adverse effects makes the ITS distinction between Rule 19c-3 securities and non-Rule 19c-3 securities a historical anachronism. Indeed, this distinction seems to create and inappropriate barrier to trading. The Commission preliminarily cannot identify convincing justification for maintaining an arbitrary barrier which prevents the expansion of the ITS/CAES linkage to non-Rule 19c-3 securities. Moreover, the absence of an ITS/CAES linkage, in light of growing trading in the third market and the presence at times of superior quotes in that market, raises questions about whether best execution can be obtained by default routing of customer orders to any exchange or NASD market maker,<sup>48</sup> rather than

order-by-order routing to exchange and market makers, based on the best available quotation.

Consequently, the Commission believes that expansion of the ITS/CAES linkage to all listed stocks is warranted. Such an expansion will increase a broker-dealer's ability to obtain best execution for the customer and promote competition in listed securities. It also will help ensure more equivalent access to the markets, reduce market fragmentation, and provide for additional liquidity and more efficient executions. The Commission continues to believe that it is desirable for the industry to take a lead in the development, implementation and enhancement of national market system facilities and in the formulation of solutions to national market system issues. Affected industry participants should have every reasonable opportunity to advance national market system goals without direct Commission intervention. In this instance, however, the Commission believes that change will not occur without Commission intervention.

In the Commission's view, the failure to achieve a linkage between exchange and OTC markets in all listed securities inhibits a broker's ability to ensure best execution of its customer orders.<sup>49</sup> With regard to non-Rule 19c-3 securities, orders routed to exchange floors cannot be easily redirected to the OTC market in situations where more favorable prices are offered by OTC market makers. Conversely, OTC market makers are precluded from using an efficient means of achieving rapid delivery of their orders to exchange floors when the exchange has a more favorable price.<sup>50</sup> Currently, an OTC market maker may be trading a security at a better price than an exchange specialist (or vice versa) and the exchange specialist (or OTC market maker) is not able to access

obtained from the different markets or market makers trading a security, carefully examine the extent to which directed order flow would be afforded better terms if executed in a market or with a market maker offering price improvement opportunities, and in the event that material differences exist between the price improvement opportunities offered by markets or market makers, the broker-dealer must take such differences into account. See, e.g., Order Handling Rules, *supra* note 36.

<sup>49</sup>The Commission indicated in the Rule 19c-3 Adopting Release that intermarket exposure of orders in a national market system should maximize competition between and among markets and market participants, and further the efficiency and fairness of the securities markets. See Rule 19c-3 Adopting Release, *supra* note 18, at 10, 45 FR at 41126.

<sup>50</sup>Non-exchange member OTC market makers presently are able to access exchange floors only through correspondent relationships with member firms.

Release No. 16410 (December 7, 1979), at 13-14, 44 FR 72607, 72608-09.

<sup>42</sup> See Securities Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983).

<sup>43</sup> More recently, in its Market 2000 Study, the Division stressed that "the Commission limited its mandated link (in 1981) to Rule 19c-3 securities because it concluded that the adoption of Rule 19c-3 heightened the need for an efficient linkage between the exchanges and the OTC market." See Market 2000 Study, *supra* note 34, at AII-12. Furthermore, the Commission already has encouraged the ITS Participants to solve this issue, but with no results. See Order Execution Rules, *supra*, note 36.

<sup>44</sup> The 1% Rule applied only to Rule 19c-3 securities prior to being expanded in the Order Execution Rules. See Securities Exchange Act Release No. 39367 (November 26, 1997), 62 FR 64242 (December 4, 1997) ("Autoquote Order").

<sup>45</sup> See Securities Exchange Act Release No. 34280 (June 29, 1994), 59 FR 34880 (July 7, 1994).

<sup>46</sup> See Order Execution Rules, *supra*, note 36. In addition, if a specialist or market maker enters an order into an electronic communications network ("ECN") that improves its quote, it has to either (1) reflect that limit order in its quote, or (2) use an ECN that is linked to the National Market System, displaying its specialist and market maker top of book, and that top of book quote must be accessible.

<sup>47</sup> See NYSE 1996 Fact Book at 26 and 14.

<sup>48</sup> The Commission has previously stated its belief that broker-dealers automatically routing order flow to a particular market center must regularly and rigorously examine execution quality likely to be

directly the better quote for non-Rule 19c-3 securities. Expanding the ITS/CAES linkage to non-Rule 19c-3 securities will enable the OTC market maker and the exchange specialist to directly access those superior priced quotes through ITS, rather than potentially executing an order at an inferior price.

The Commission also believes that the failure to expand the ITS/CAES linkage impedes "fair competition among brokers and dealers \* \* \* and between exchange markets and markets other than exchange markets,"<sup>51</sup> and that competitive OTC markets cannot develop fully in the absence of a linkage for all listed securities. Without an expanded ITS/CAES linkage, OTC market makers in non-Rule 19c-3 securities have little ability to interact with the vast majority of retail orders, which presently are routed to the primary exchange markets, or to attract additional order flow through their displayed quotations. The expansion of the ITS/CAES linkage should promote competition in non-Rule 19c-3 securities by encouraging market makers or specialists to improve their quotes to match or better the bid or offer in another ITS market, in order to attract order flow from those other markets. The Commission also believes the expansion should help equalize access to all the markets because OTC market makers and exchange specialists will have an ability to access directly each other's markets for non-Rule 19c-3 securities.

The expansion of the ITS/CAES linkage should also decrease market fragmentation because all exchanges and the OTC market would be linked directly through ITS for all listed securities. The failure to extend the linkage between the OTC market and exchange markets to all listed securities obviates trade-through protection for third market trades and quotes, and inhibits efforts to achieve comprehensive nation-wide price protection. Expanding the ITS/CAES linkage should make ITS a more efficient and useful linkage by expanding the applicability of the ITS trade-through rule because all market maker trades and quotes in listed securities would be subject to the rule.<sup>52</sup>

<sup>51</sup> See Section 11A(a)(1)(C)(ii) of the Act, 15 U.S.C. 78k-1(a)(1)(C)(ii).

<sup>52</sup> Currently, third market makers can trade non-Rule 19c-3 listed securities without complying with the ITS trade-through rule. The NASD, however, has indicated its willingness to amend its rules to conform with trade-through protection if the ITS/CAES link is expanded. See NASD 1997 Letter, *supra*, note 33.

Although an expansion of the ITS/CAES linkage should produce significant benefits to the national market system, the Commission and market participants have suggested in the past that certain improvements to third market trading rules and NASD procedures should be implemented before the expansion. As discussed below, the Commission believes that most of these improvements have been implemented, and that the rest could be completed during the pendency of this rulemaking.

The Division, in its Market 2000 Study, identified several areas where the NASD should amend its rules prior to an expansion of the ITS/CAES linkage. Specifically, the Division recommended that the NASD amend its rules to provide for: the display of customer limit orders that improve the existing ITS best bid or offer ("BBO"); customer limit order protection; fixed standards for queuing and executing customer orders; crossing of customers' orders, if possible, without dealer intervention; and compliance with ITS trade-through and block trade policies. The Division also stated that the NASD should develop a program specifically designed to enhance oversight examination of the third market.<sup>53</sup>

In addition, in response to a Commission letter,<sup>54</sup> the ITS Participants recently submitted their views in writing to the Division on the expansion of the ITS/CAES interface.<sup>55</sup> Eight of the nine Participants supported eliminating the ITS/CAES linkage restriction as long as certain significant changes are made to the NASD's rules prior to the expansion. Several Participants express concern about the accessibility of all third market quotes in listed securities and the application

<sup>53</sup> See Market 2000 Study, *supra*, note 34.

<sup>54</sup> See May 27 Letter, *supra*, note 39. In that letter, the Commission commented on four aspects of the ITS Plan that it believes are anti-competitive: the ITS/CAES limitation to Rule 19c-3 securities was one of those provisions.

<sup>55</sup> See letter from Thomas F. Ryan, Jr., President and Chief Operating Officer, Amex, to Jonathan B. Katz, Secretary, Commission, dated June 26, 1997 ("Amex Letter"); letter from Charles J. Henry, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated June 26, 1997; letter from Robert H. Forney, President and Chief Executive Officer, CHX, to Jonathan G. Katz, Secretary, Commission, dated November 3, 1997 ("CHX Letter"), letter from David Colker, Executive Vice President and Chief Operating Officer, CSE, to Jonathan G. Katz, Secretary, Commission, dated July 3, 1997 ("CSE Letter"); NASD 1997 letter, *supra*, note 33; letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated June 25, 1997 ("NYSE Letter"); and letter from William G. Morton, BSE, Robert H. Forney, CHX, Robert M. Greber, PCX, and Nicholas Giordano, Phlx, to Jonathan G. Katz, Secretary, Commission, dated June 23, 1997 ("Joint Letter").

of the ITS Plan, including the trade-through rule, if the linkage were expanded. One Participant believes that the NASD must implement a trade-through rule that would apply to all third market makers, even non-ITS/CAES market makers, who trade listed stocks.<sup>56</sup> Several Participants believe the NASD should require all third market makers and "unregulated exchanges" to participate in ITS,<sup>57</sup> and another believes all NASD members, both market makers and brokers, who trade listed securities should be accessible through ITS and willing to comply with the Order Handling Rules and all ITS rules, including the trade-through rules.<sup>58</sup> Another commenter suggested that all block positioners and non-market makers (that trade listed stocks) linked with the National Market System should also be required to comply with the ITS trade-through rule. The Commission is soliciting comment on whether this is necessary or appropriate, and how it could be achieved.<sup>59</sup>

The Participants also expressed concerns regarding adequate trade-reporting and surveillance of the third market. The Participants believe additional oversight of the third market and third market makers is necessary prior to any expansion of the ITS/CAES linkage. One Participant believes that the third market must implement timely and accurate trade reporting because the operation of ITS, especially the operation of the trade-through and block trade policies, depends upon timely trade reporting at the actual price of the transaction.<sup>60</sup> The Participant argues that currently, third market transactions can be reported that at a price "reasonably related to the prevailing market," taking into consideration all relevant circumstances, including the costs of executing transactions, market conditions, and the number of shares involved.<sup>61</sup> The Participants also states

<sup>56</sup> See NYSE Letter, *supra* note 55.

<sup>57</sup> See Joint Letter, *supra* note 55.

<sup>58</sup> See CSE Letter, *supra* note 55.

<sup>59</sup> See Amex Letter, *supra* note 55.

<sup>60</sup> See NYSE Letter, *supra* note 55. If the transaction is not reported accurately, there is no way of ascertaining if that transaction would have traded through a superior priced quotation in another ITS market. See *id.* The Commission notes that the ITS block trade policy requires anyone handling a block transaction to satisfy all superior ITS quotes at the block price.

<sup>61</sup> Prior to 1980, third market principal transactions were reported to the consolidated system at a "net" price which included the mark-up or mark-down charged to the customer on the transaction. In 1980 the Commission approved an NASD proposed rule change requiring third market reporting at a "gross" price, excluding the mark-up or mark-down charged a customer. The rule



that the Commission has cited its confirmation rule<sup>62</sup> as resolving the trade reporting issue, but the Participant does not think that this addresses the issue because that rule merely requires the NASD member to report the same price to the customer as they do to the tape.<sup>63</sup>

The Commission believes that most of these issues have already been addressed and that the NASD could address the others prior to the implementation of the expansion of the ITS/CAES linkage. The Commission's adoption of the Limit Order Display Rule eliminates the need for the NASD to implement a rule to require the display of customer limit orders that improve the existing ITS/BBO, as

requires that the price reported to the consolidated system shall be reasonably related to the prevailing market, taking into consideration all relevant circumstances, including, but not limited to, market conditions with respect to the security, the number of shares involved in the transaction, the published bids and offers with size at the time of execution (including the reporting firm's own quotation), accessibility to market centers publishing bids and offers with size, the cost of the execution, and the expenses involved in clearing the transaction. See Securities Exchange Act Release No. 18536 (March 11, 1982), 47 FR 10658, 10662 n.21 and NASD Rule 6420(d)(3)(A). NASD Rule 5230 states that transactions in ITS securities executed in CAES by ITS/CAES market makers or receive through the ITS system and executed by an ITS/CAES market maker are reported to the Consolidated Tape by the CAES system at the price specified in the ITS commitment or, if executed at a better price, the execution price.

<sup>62</sup> See Rule 10b-10 under the Exchange Act, 17 CFR 240.10b-10. This rule requires that when a NASD member is acting as an agent for a customer, the member must confirm to the customer the gross trade price, which is the price that was reported to the Consolidated Tape, and the commission equivalent as well as the net price to the customer. When an NASD member is acting as principal for its own account, the member must include in the confirmation the price reported to the Consolidated Tape, the net price to the customer, and the difference.

<sup>63</sup> In the original order adopting amendments to the ITS Plan in 1982, the Commission discussed the trade-reporting issue. See Final Approval Order, *supra* note 31. The ITS Participants had stated that they believed it was necessary for the NASD to agree to require market makers to report trades to the consolidated tape at the same price they confirm transactions to their customers, believing that such a requirement would impose, through customer monitoring of trade confirmations, a discipline on market makers to ensure that they reported trades as the true wholesale price. The Commission responded that it believed that concerns about accurate trade reporting could be effectively resolved through surveillance. The Commission believes that its confirmation rule amendments help enforce the trade reporting obligations by requiring disclosure of the mark-up resulting from the actual reported price. See Securities Exchange Act Release No. 18713 (May 6, 1982), 47 FR 20413, 20415 n.13 (May 12, 1982). The Commission notes that the NASD, in its petition for rulemaking to expand the ITS/CAES linkage to non-Rule 19c-3 securities, has indicated that it intends to modify its last trade reporting rules for exchange-listed securities in order to address concerns relating to the ITS/CAES linkage expansion. See NASD Petition, *supra* note 36.

recommended in the Market 2000 Study.<sup>64</sup> In addition, the Limit Order Display Rule provides enhanced opportunity for public orders to interact with other public orders without the intermediation of a specialist or market maker by requiring certain customer limit orders to be displayed in the quote.<sup>65</sup> The Commission also notes that there is an NASD rule that prohibits third market makers from trading ahead of their customer limit orders.<sup>66</sup>

In addition, the Commission believes that, for the most part, the issue of timely and accurate trade reporting has already been adequately addressed. The Commission notes that third market transactions during regular market hours must be reported to the consolidated tape within 90 seconds of execution; this is the same as the reporting of transactions on all the exchanges. Moreover, the Commission has enacted a rule requiring the third market to report transactions to the consolidated tape at the same price as they report the transactions to the customer.<sup>67</sup> Although the Commission believes that the rule relating to third market trade reporting could be clarified, they are the same for Rule 19c-3 and non-Rule 19c-3 securities, and thus provide no basis for not extending the ITS/CAES linkage to all securities. Nonetheless, the Commission believes that the NASD must continue to ensure that it is actively and adequately surveilling trade reporting in the third market.<sup>68</sup>

The Commission also believes that the NASD should provide for trade-through and block trade policy rules that will

<sup>64</sup> The Limit Order Display Rule requires all specialist and market makers to display customer limit orders that improve their quotes. See Order Execution Rules, *supra* note 36.

<sup>65</sup> *Id.*

<sup>66</sup> The Commission notes that NASD's Rule 6440(f)(1)(2), which applies to listed securities, states that no member shall buy (or sell) (or initiate the purchase or sale of) any security at or above (or below) the price at which it personally holds or has knowledge that any person associated with it holds an unexpected limited price order to buy (or sell) such security in the unit of trading for a customer.

<sup>67</sup> See *supra* notes 61-62 and accompanying text.

<sup>68</sup> In its Report Pursuant to Section 21(a) of the Securities Exchange Act of 1935 Regarding the NASD and the Nasdaq Market, the Commission noted that the NASD failed to monitor and enforce rigorously trade reporting compliance by NASD members trading exchange-listed securities in the OTC market, and that they were many transactions that constituted trade-through. See U.S. Securities and Exchange Commission, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1935 Regarding the NASD and the Nasdaq Market (August 8, 1996) ("Section 21(a) Report") at A-44. Since that time, the NASD has taken various measures designed to comply with the undertakings contained in its settlement of an enforcement proceeding with the Commission. One of the undertakings required the NASD to improve substantially the reliability of trade reporting.

apply to all third market makers who trade in listed securities, prior to an expansion of the ITS/CAES linkage. In addition, the NASD should consider developing standards for queuing and executing customer orders. The Commission invites the NASD to submit proposed rule changes to address these concerns. However, while these standards are needed to better protect OTC customers, they are not relevant to orders received via the linkage, and so are not fundamentally the concern of other markets.

Finally, the Commission also wishes to emphasize that all ITS Participants need to enforce strictly Rule 11Ac1-1 under the Exchange Act (the "Firm Quote Rule") to ensure that investors receive best execution and that the market receives reliable quotation information. The Firm Quote Rule requires that every exchange specialist or OTC market maker execute any order to buy or sell a security it receives at a price at least as favorable as its published bid or offer in any amount up to its published size, subject to two exceptions. The Commission emphasizes that the Firm Quote Rule applies to ITS commitments; where a specialist or market maker fails to honor its quote by refusing to execute an ITS commitment received at its published bid or offer, and neither of the exceptions contained in the Firm Quote Rule apply, the specialist or market maker is in violation of the Firm Quote Rule. A market maker or specialist who fails to meet his or her quote obligations is said to have "backed away."<sup>69</sup>

There are only two exceptions to the Firm Quote Rule. The first exception occurs when, prior to the receipt of the order, the market maker or specialist has communicated to its association of exchange a revised quotation size or revised bid or offer. The second exception applies when, prior to the receipt of an order, the market maker or specialist is in the process of effecting a transaction in a security when an order in the same security is presented, and immediately after the completion of such transaction, the market maker or specialist communicates to its association or exchange a revised quotation size or revised bid or offer (the "trade ahead" exception). In its Section 21(a) Report, the Commission specifically stated that the fact that SelectNet orders may have scrolled off a market maker's Nasdaq workstation terminal screen did not excuse traders from complying with the Firm Quote

<sup>69</sup> The Firm Quote Rule by its terms applies to ITS commitments.

Rule for those orders.<sup>70</sup> Similarly, the Commission stresses that a market maker or specialist cannot claim as a valid excuse for not executing an ITS commitment that he did not see the commitment before it expired ("timing out"). The Commission wishes to reiterate that order expiration is not an exception to the Firm Quote Rule.<sup>71</sup>

#### B. Unanimous Vote Requirement

The Commission preliminarily believes that the unanimous voting requirement for amendments to the ITS Plan, including the admission of new participants, is anti-competitive and impedes the ability of ITS to adapt to market changes. As the Commission stated in a May 27, 1997 letter<sup>72</sup> to the ITS Participants, the unanimous vote requirement allows any single Participant to veto changes to the Plan that could increase competition faced by that Participant, such as the entry of another market into ITS or expansion of business by a particular ITS Participant. It also allows any Participant to block modifications to ITS designed to adapt to changed circumstances. As a result, ITS has not been able to evolve significantly as the markets changed over the past two decades.

There are several recent instances that demonstrate the anti-competitive impact of the unanimous vote requirement.<sup>73</sup> The first instance involved the issue of trading derivative-type securities, such as Standard & Poor's Depository Receipts ("SPDRs"), through ITS.<sup>74</sup> Initially, there was disagreement among the Participants over amending the ITS Plan to allow eligible securities to trade in increments smaller than 1/8th of a dollar. This modification was necessary before a derivative-type product such as SPDRs, which trades in increments of 1/64th of a dollar, could begin trading over ITS. The Participants originally disagreed on whether to amend the Plan to accommodate trading in smaller increments, and what, if any, the smaller increment should be. Eventually, after much debate, the Participants agreed to amend the Plan in two stages, to first allow trading in smaller increments, and eventually in decimals. Nevertheless, due to opposition by a single Participant, resolution of this issue was delayed for

several months. As a consequence, competing markets could not trade SPDRs for an extended period of time.

Further, as noted in the May 27, 1997 letter, the Commission believes that the ITS provision which provides ITS Participants a special right of review for proposed rule changes involving the operation of the CSE's NSTS is anti-competitive because it permits other Participants to prevent the CSE from improving its market without prior notice to and comment from its market competitors. At the recent ITS meeting, a single Participant was able to block action on elimination of this provision by voting against a motion to amend the Plan. All the other Participants voted in favor of the motion.<sup>75</sup>

Another recent example of the significance of the unanimous vote requirement relates to OptiMark, a Commission-approved facility of PCX. The Commission notes that PCX and other ITS Participants have not been able yet to unanimously agree on whether the Participants need to amend the ITS Plan prior to the time OptiMark begins to operate, much less on the substance of a plan amendment, despite continuous discussion of the issue.<sup>76</sup> The OptiMark experience illustrates that a unanimous vote requirement has the potential to block changes in ITS to accommodate innovation on the part of Participants. It also suggests the obstacles that a new market could face in becoming a new Participant in ITS.

The above instances underscore the limiting effect of the unanimous vote requirement. They may represent only a small portion of potential changes to ITS hindered by the unanimous vote requirement. Most proposals may not even get proffered by ITS Participants because of the difficulty of overcoming the unanimous vote requirement. The potential veto by a single Participant can slow or prevent ideas for modifying ITS to accommodate developments in

the markets from even reaching the proposal stage, let alone being adopted.

In response to the Commission May 27, 1997 letter, several of the Participants argue that the unanimous vote requirement fosters competition and the development of the national market system because ITS, in conjunction with the Consolidated Quotation System, encourages a Participant market to compete for order flow with the knowledge that its superior-priced quotations must be honored.<sup>77</sup> These Participants further assert that "[o]ther than providing [a] limited form of access, the Plan has no other effect on market competition", and that "[t]here are no Plan provisions that allow one or more Participant markets to veto a competitive initiative of another Participant market."<sup>78</sup> However, the Commission strongly believes that ITS can affect a market's ability to compete because the unanimous vote requirement could effectively prevent a competing market implementing structural or operational changes from becoming an ITS Participant, which in turn could affect that market's ability to compete for order flow and to reach quotations in the competing ITS Participant markets.

Several of the Participants also believe that the unanimous vote requirement, "rather than being anti-competitive, \* \* \* [constitutes a] prudent safeguard[s] to ensure that all Participants are able to protect the integrity of their markets and their membership status."<sup>79</sup> In other words, a market can exercise its veto to prevent the other ITS Participants from imposing restrictive conditions through ITS rules, or from eroding its membership value by creating unlimited ITS access to its market. Although the Commission recognizes these concerns, the Commission believes that there are other means to protect a market's interests that are less restrictive and anti-competitive. Specifically, the Commission preliminarily believes that a two-thirds supermajority voting requirement, with a right to appeal to the Commission, could foster a regulatory system that will promote innovation and competition while still permitting the Participants to preserve the integrity of their markets and membership status.<sup>80</sup>

<sup>75</sup> The single Participant subsequently changed its position to support the Plan amendment.

<sup>76</sup> Two Participants, the NYSE and Amex, refused to participate in a vote in December 1997, on whether an amendment to the Plan is necessary, while the other seven Participants voted that an amendment is not needed prior to the operation of OptiMark. Nevertheless, on June 3, 1998, the PCX proposed to the ITSOC two Plan amendments to link the PCX Application of the OptiMark System to ITS. The amendments were not approved by a vote of 5-4. Although a super-majority voting provision would not have made a difference in the June 3 vote, the June 3 vote would never have been necessary had a super-majority voting provision been in place for the December vote. The Commission notes that it issued a companion release to amend the ITS Plan to link the PCX Application of the OptiMark System to ITS. See Securities Exchange Act Release No. 40204 (July 15, 1998).

<sup>77</sup> See Joint Letter, *supra* note 55.

<sup>78</sup> See *id.*

<sup>79</sup> See *id.*

<sup>80</sup> See May 27 Letter, *supra* note 39. Several commenters support, to varying degrees, this approach. See letter from Leopold Korins, Chairman and Chief Executive Officer, Phlx, to Jonathan G. Katz, Secretary, SEC, dated November 12, 1997.

<sup>70</sup> See Section 21(a) Report at note 134 and accompanying text.

<sup>71</sup> See Exchange Act Rule 11Ac1-1.

<sup>72</sup> See May 27 Letter, *supra* note 39.

<sup>73</sup> See Minutes from the ITS Users' Committee and ITSOC meetings held on September 18 and 19, 1997, respectively.

<sup>74</sup> CHX, CSE and PCX have received Commission approval to trade SPDRs and MidCap SPDRs, both Amex products.



Several of the Participants argue that the right to appeal to the Commission, in the event that a Participant objects to a certain amendment approved by a two-thirds majority, does not provide adequate protection of their interests.<sup>81</sup> The Commission believes that the appeal right to the Commission in the Plan Rule, and the review it undertakes in approving a Plan amendment, provides additional protection to all Participants, in part because such review is done in accordance with and in furtherance of the purposes of the Exchange Act.<sup>82</sup>

The Commission has recommended that the ITS Participants eliminate the unanimous vote requirement but no consensus has been reached.<sup>83</sup> Consequently, the Commission is proposing an amendment to eliminate the unanimous vote requirement contained in Section 4(c) of the ITS Plan and replace it with a supermajority/two-thirds vote requirement for Plan amendments.<sup>84</sup>

("Phlx letter") (supporting a supermajority for most issues, including Plan amendments, and a simple majority for resolution of certain ministerial issues); letter from David Colker, Executive Vice President and Chief Operating Officer, CSE, to Jonathan G. Katz, Secretary, SEC, dated January 19, 1998 ("CSE Unanimous Vote Letter") (supporting a supermajority vote for all ITS Plan amendments except admission of new participants under the existing regulatory structure, for which it supports a simple majority vote); letter from Gary K. Staggs, Vice President, Equity Floor Operations, PCX, to Jonathan G. Katz, Secretary, Commission ("PCX Letter") (supporting a majority or supermajority vote for general Plan amendments); and CHX letter, *supra* note 55 (supporting a supermajority vote requirement of two-thirds of the Participants for Plan amendments, including the admission of new Participants).

<sup>81</sup> See *id.*

<sup>82</sup> Paragraph (c)(2) of Rule 11Aa3-2 (the "Plan Rule") provides that the Commission will approve a filing only if it finds that a plan or amendment "is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system, or otherwise in furtherance of the purposes of the [Exchange] Act."

<sup>83</sup> See Phlx letter, *supra* note 80 (supporting a supermajority for most issues, including Plan amendments, and a simple majority for resolution of certain ministerial issues); CSE Unanimous Vote Letter, *supra* note 80 (supporting a supermajority vote for all ITS Plan amendments except admission of new participants under the existing regulatory structure, for which it supports a simple majority vote); PCX Letter, *supra* note 80 (supporting a majority or supermajority vote for general Plan amendments); CHX Letter, *supra* note 55 (supporting a supermajority vote requirement of two-thirds of the Participants for Plan amendments, including the admission of new participants). *But see* Joint Letter, *supra* note 55 (stating that the unanimous vote requirement in particular is appropriate because it fosters competition and the development of the National Market System).

<sup>84</sup> Those opposing the amendment would have the right to appeal to the Commission.

### III. Request for Comment

The Commission solicits comment on the substance of the proposed amendment to the ITS Plan to expand the ITS/CAES linkage as discussed above, and also requests comment on specific questions relating to this proposed expansion.

With regard to the substance of the trade-through rule the NASD must implement prior to expansion of the ITS/CAES linkage, the Commission requests comment on whether such rule should apply to all NASD members who trade listed securities, or only those market makers who trade listed securities. The Commission also requests comment on the specifics of a trade-through rule and whether a trade-through rule for the third market should be identical to the exchange trade-through rules, or whether such rule should be similar to the trade-through rule that already applies to ITS/CAES market makers,<sup>85</sup> but expanded in scope and application. Finally, the Commission requests comment on what, if any, other amendments to NASD rules are necessary prior to expanding the ITS/CAES linkage.<sup>86</sup>

The Commission notes that under current NASD rules, participation in CAES and the ITS/CAES linkage is limited to registered CQS market makers. As a result, if ITS/CAES linkage were expanded to include non-Rule 19c-3 securities, ECNs must be CQS market makers to have the ability to access the listed markets through ITS, or else exchange specialists will be unable to make full use of the ECN Alternative under the Order Handling Rules. The Commission requests comment on whether the NASD's rules need to be amended to allow ECN participation in CAES and the ITS/CAES linkage. The Commission is interested in commenters' views on what rule changes would be necessary to accommodate ECN participation in CAES and ITS/CAES linkage.

The Commission is soliciting comment on whether the unanimous vote requirement should be eliminated, and what impact such a change would have on the operation of ITS and the respective Participant markets, if any. The Commission also is soliciting comment on what alternative voting scheme should be required for Plan amendments if the unanimous vote requirement is eliminated, such as a simple majority vote or a two-thirds

vote. Should the alternative voting scheme chosen by the Commission more directly take into account the actual number of its participants? For example, should the Commission adopt a simple majority or two-thirds voting scheme if the number of participants is—as it is now—nine, but allow for automatic modification of that scheme by the Commission if the number of participants is 7, 8, 10, or 11? In addition, the Commission is soliciting comment on whether all amendments to the ITS Plan should be treated equally, or whether amendments to admit new participants (currently Section 3(c)) should be treated differently from all other ITS Plan amendments, and, if so, why the disparate treatment is necessary.

Some ITS Participants have expressed concerns that non-unanimous voting threatens their sovereignty as independent markets. At the same time, the existing ITS Plan constrains the market structure of Participants, which limits innovation, in order to prevent unbridled order routing to other markets through ITS. To address these concerns, the Commission requests comment on whether other market linkages should be developed to replace ITS. All of the Participants now operate automated order routing systems that provide access to their markets. As an alternative to ITS, these systems could be opened to other markets for use on an order-by-order basis. Alternatively, ITS Participants could provide access to other markets directly or through one of many private vendors providing order routing services. The Commission is requesting comment on two possible alternatives to the existing ITS System: (1) Eliminating ITS and requiring each national securities exchange and national securities association to provide access to other markets through one or more private vendors for the purpose of allowing access to better-priced quotations in their markets; or (2) eliminating ITS and requiring each participant national securities exchange and national securities association to provide other markets access to its order routing systems.

Finally, the Commission requests comment on whether the changes it has proposed to the ITS Plan should be supplemented, or wholly replaced, by other revisions to the ITS Plan. The current provisions can produce a restraint on competition, impediments to ITS' ability to adapt to market changes, barriers to new Participants joining the Plan, the encumbrances on innovation by the current Participants. The Commission recognizes the possibility that eliminating the

<sup>85</sup> See NASD Rule 5262.

<sup>86</sup> The Commission notes that the NASD's autoquote rule would have to be revised if the ITS/CAES linkage is expanded, as the rule is currently inconsistent with the ITS Plan.

unanimous vote requirement may not be sufficient to address the restrictive nature of the current ITS Plan, including the difficulty involved in the Plan, before change can occur to remove the provisions that control the internal operation of Participant markets. Commentators should address whether it would be productive to revise the ITS Plan to remove or modify other provisions that unnecessarily limit the internal operation of Participants, such as the descriptions of specific ITS interfaces and the requirement of two-sided quotations. Instead, the Plan could express standards or principles governing use by Participants, such as the existing prohibition contained in Plan Rule 8(a)(v),<sup>87</sup> dealing with routing a substantial portion of order flow to other markets through ITS. Regardless of whether commentators believe that the current changes proposed by the Commission provide for an adequate solution to the problems mentioned above, the Commission requests additional comment on whether further action, including, but not limited to, a revision of the entire ITS Plan by the Commission, is warranted.

#### **IV. Costs and Benefits of the Proposed Amendments and Their Effects on Competition, Efficiency and Capital Formation**

Section 23(a)(2) of the Exchange Act requires that the Commission, when promulgating rules under the Exchange Act, to consider the competitive effects of such rules and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in furthering the purpose of the Act.<sup>88</sup> The Commission preliminarily has considered the proposed amendments to the ITS Plan in light of the standards cited in Section 23(a)(2) of the Act and believes that they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. Indeed, the Commission believes that the proposed amendment to expand the ITS/CAES linkage should promote competition in non-Rule 19c-3 securities because OTC market makers will now be able to attract orders initially routed to exchange specialists, by disseminating a superior quote, in all

listed securities, not just Rule 19c-3 securities. Additionally, the expansion of the ITS/CAES linkage will allow exchange specialists to attract orders held by OTC market makers in non-Rule 19c-3 securities. The Commission also believes that eliminating the unanimous vote requirements should promote competition by restricting the ability of one or more Participants to block an ITS Plan amendment that would promote competition between the markets or within one market.

Commentators should consider the proposed amendment's effect on competition, efficiency and capital formation.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposed amendment on the economy on an annual basis. If possible, commentators should provide empirical data to support their views.

To assist the Commission in its evaluation of the costs and benefits that may result from the proposed amendments, commenters are requested to provide analysis and data relating to costs and benefits associated with the proposal herein. The Commission preliminarily believes that the amendment to the ITS Plan proposed herein to expand the ITS/CAES linkage to all listed securities will increase efficiency because investors will be able to access directly the exchange and OTC markets for all listed stocks. The Commission also notes the impact of the proposed ITS Plan amendments on the NYSE in the proposal would allow all ITS Participants to access the NYSE for non-Rule 19c-3 securities, and for the NYSE to access other Participant markets for those securities. In addition, the Commission preliminarily believes that the proposed amendments would benefit ECNs by allowing them to fully integrate into the NMS in all listed securities, which in turn would allow for more efficient use of the ECN Alternative mentioned in the Order Execution Rules. The Commission also preliminarily believes that the proposal would enhance competition between market in non-Rule 19c-3 securities and improve execution quality for non-Rule 19c-3 securities. Finally, the Commission notes that there would be implementation costs and costs of expanding the linkage to include all non-Rule 19c-3 securities.

In addition, the proposed amendment to eliminate the unanimous vote requirement for ITS Plan amendments would remove a significant barrier to imposing new and innovative modifications to ITS by preventing a

small minority of ITS Participants from thwarting innovation that could improve market efficiency. The Commission is requesting comment on the costs and benefits of the proposed amendments and any possible anti-competitive impact of the proposed amendments. Specifically, the Commission requests comments to address whether the proposed amendment would generate the anticipated benefits or impose any costs on U.S. investors or others.

Comments should be submitted by August 31, 1998.

#### **V. Initial Regulatory Flexibility Analysis**

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with Section 3 of the Regulatory Flexibility Act ("RFA").<sup>89</sup> It relates to proposed amendments to the ITS Plan to expand the linkage between ITS and the NASD/CAES to all listed securities and would eliminate the unanimous vote requirement for amendments to the ITS Plan.

##### *A. Reasons for and Objectives of the Proposal*

Although the ITS participants have addressed two of the four anti-competitive aspects of the ITS Plan identified by the Commission, they have been unable to take action regarding the expanded linkage and the unanimous vote requirement. The Commission thus is proposing to amend the ITS Plan on its own initiative.

The objective of the expanded linkage is to achieve the statutory goals of efficient execution of securities transactions and opportunities for best execution of customer orders for all listed securities. The elimination of the unanimous vote requirement is intended to improve the governance of the ITS Plan—the unanimous vote requirement in the past has been used by the ITS participants to veto changes to the ITS Plan that could increase intermarket competition.

##### *B. Legal Basis*

Section 11A(a)(3)(B) of the Exchange Act authorizes the Commission, by rule or order, to authorize or require SROs to act jointly with respect to matters as to which they share authority under the Exchange Act in planning, developing, operating or regulating a national market system (or a subsystem thereof) or one or more facilities thereof. It states explicitly that the Commission not only may approve national market system facilities in response to an application

<sup>87</sup> Section 8(a)(v) of the ITS Plan provides that ITS is not permitted to be used as an automated order delivery system whereby all or a substantial portion of orders are routinely rerouted from the market where they are received to another market for execution. This provision further requires that each Participant take reasonable efforts to probe its market to achieve a satisfactory execution there before reformatting the order as an ITS commitment to trade and rerouting it to another market.

<sup>88</sup> See 15 U.S.C. 78w(a)(2).

<sup>89</sup> 5 U.S.C. 603(a).

by SROs, but also may require SROs to implement such facilities on their own initiative. Rule 11Aa3-2,<sup>90</sup> adopted by the Commission under Section 11A, establishes procedures for proposing amendments to national market system plans such as the ITS Plan. Paragraph (b)(2) states that the Commission may propose amendments to an effective national market system plan by publishing the text of the amendment together with a statement of purpose of the amendments.

### C. Small Entities Affected by the Proposed Amendments

The proposal would directly affect the nine ITS Participants, none of which are small entities. However, specialists on the exchange floors who trade ITS securities, broker-dealers that have access to ITS through terminals located on exchange floors, and registered ITS/CAES market makers who trade in ITS securities in the third market could be indirectly affected. There would be no impact on these broker-dealers by the proposed change in the vote requirement as it relates only to the governance of the ITS Plan.

Paragraph (c)(1) of Rule 0-10<sup>91</sup> states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that: (1) Had total capital (net worth plus subordinated liabilities) of less than \$500,000 in its prior fiscal year audited financial statements or, if not required to file such statements, on the last business day of the preceding fiscal year; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization. The Commission currently does not have any data on the number of small entities that could be affected.<sup>92</sup>

To the extent, however, that a specialist or market maker does fall under the definition of "small entity," the effect is likely to be indirect and positive. Under the current system, an

OTC market maker may be trading a security at a better price than an exchange specialist (or vice versa) and the exchange specialist (or OTC market maker) is not able to access directly the better quote for non-Rule 19c-3 securities. Expanding the ITS/CAES linkage to non-Rule 19c-3 securities would enable the OTC market maker and the exchange specialist to access directly those superior priced quotes through ITS, rather than potentially executing an order at an inferior price. Finally, the expansion of the ITS/CAES linkage to non-Rule 19c-3 securities also would have an indirect, beneficial effect upon the ability of a broker with ITS access on an exchange floor to achieve best execution of customer orders.

### D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposals would not impose any new reporting, recordkeeping, or other compliance requirements.

### E. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed amendments.

### F. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant economic impact on small entities. In connection with the proposal, the Commission considered the following alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the Rule, of any part thereof, for small entities.

The Commission believes that none of the above alternatives is applicable. The ITS Participants are the only parties that are subject to the requirements of the ITS Plan. The ITS Participants are all national SROs and, as such, are not "small entities." The Commission believes that any effect that could possibly be experienced by a "small entity" would be indirect and beneficial. Therefore, having considered the foregoing alternatives in the context of the proposed amendments, the Commission does not believe they would accomplish the stated objectives of the proposal.

### G. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. The Commission requests comment as well as empirical data on the impact the proposal will have on small broker-dealers, specialists or market makers that utilize ITS. Comment is specifically requested on whether broker-dealers that access ITS meet the revised definition of "small business" and on the number of small entities that would be affected by the proposed rules. Also, the Commission is seeking comment on the perceived nature of the impact of the proposed amendments on these entities. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules themselves. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. 4-208; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (<http://www.sec.gov>).

### VI. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed amendments do not impose recordkeeping or information collection requirements, or other collections of information which require approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.*

### VII. Description of Proposed Amendments to the ITS Plan

The Commission hereby proposes to amend the ITS Plan to provide for the expansion of the ITS/CAES interface to non-Rule 19c-3 securities, as well as for the elimination of the unanimous vote requirement for amendments to the ITS Plan, pursuant to Rule 11Aa3-2(b)(2) and (c)(1) and the Commission's authority under Section 11A(a)(3)(B) of the Act.<sup>93</sup> Below is the text of the

<sup>93</sup> 5 U.S.C. 78k-1(a)(3)(B). Section 11A(a)(3)(B) authorizes the Commission, in furtherance of its statutory directive to facilitate the development of a national market system, by rule or order, to

<sup>90</sup> 17 CFR 240.11Aa3-2.

<sup>91</sup> 17 CFR 240.0-10(c)(1).

<sup>92</sup> The Commission recently adopted revised definitions of "small entity." See Definitions of "Small Business" or "Small Organization" Under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933, Exchange Act Release No. 40122 (June 24, 1998). The revision, among other things, expanded the affiliation standard applicable to broker-dealers, to exclude from the definition of a small entity many introducing broker-dealers, to exclude from the definition of a small entity many introducing broker-dealers that clear customer transactions through large firms. Currently, approximately 1,079 of all registered broker-dealers will be characterized as "small." See revised Rule 0-10(i). [The Commission estimates there are 8,300 registered brokers-dealers.]

amended ITS Plan.<sup>94</sup> Deleted text is [bracketed] and new language is italicized.

\* \* \* \* \*

Section 1. Definitions.

(1)–(16) No Change.

(17) "ITS/CAES Security (stock)" means a security (stock) (a) that is a System security[, (b) that is a 19c-3 security and (c)] and (b) as to which one or more ITS/CAES Market Makers are registered as such with the NASD for the purposes of Applications. When used with reference to a particular ITS/CAES Market Maker, "ITS/CAES security" means any such security (stock) as to which the particular ITS/CAES Market Maker is so registered.

(18)–(25) No Change.

[(26)] "(19c-3" security" means an Eligible Security that is not a "covered security" as that term is defined in SEC Rule 19c-3 as in effect on May 1, 1982.]

[(27)] (26)

[(27A)] (26A)

[(27B)] (26B)

[(27C)] (26C)

[(27D)] (26D)

[(27E)] (26E)

[(28)] (27)

[(29)] (28)

[(30)] (29)

[(31)] (30)

[(32)] (31)

[(33)] (32)

[(34)] (33)

[(34A)] (33A)

[(34B)] (33B)

[(35)] (34)

[(36)] (35)

[(37)] (36)

Section 2. No Change.

Section 3. No Change.

Section 4. Administration of ITS Plan.

(a)–(b) No Change.

(c) Amendments to the ITS Plan. Any proposed change in, addition to, or deletion from the ITS Plan may be effected only by a means of a written amendment to the ITS Plan which sets forth the change, addition or deletion, is executed on behalf of [each Participant] *two-thirds of the Participants*, and is approved by the SEC or otherwise becomes effective pursuant to section 11A of the Act and Rule 11Aa3-2.

(d)–(f) No Change.

Section 5. The System.

authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under the Act in planning, developing, operating, or regulating a national market system (or subsystem thereof) or one or more of the facilities thereof.

<sup>94</sup>The text reflects the latest unofficial compilation of the ITS Plan supplied by the ITSOC, including all previously incorporated amendments up to May 30, 1997.

(a) No Change.

(b) General Operation.

(i) No Change.

(ii) Selection of System Securities.

The System is designed to accommodate trading in any Eligible Security in the case of any ITS/CAES Market Maker, trading in one or more ITS/CAES securities in which he is registered as such with the NASD for the purposes of the Applications. The particular securities that may be traded through the System at any time ("System securities") shall be selected by the Operating Committee. The Operating Committee may add or delete System securities as it deems appropriate and may delay the commencement of trading in any Eligible Security if capacity or other operational considerations shall require such delay. [ITS/CAES securities may be traded by Exchange Participants and ITS/CAES Market Makers as provided in the ITS Plan and other System securities may be traded by Exchange Participants as provided in the ITS Plan.]

(c)–(d) No Change.

Section 6. No Change.

Section 7. No Change.

Section 8. No Change.

Section 9. No Change.

Section 10. No Change.

Section 11. No Change.

\* \* \* \* \*

The proposed amendments do not address the manner which the costs of implementing these changes would be apportioned because the Commission believes the ITS Participants should decide this issue among themselves.

Dated: July 24, 1998.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-20313 Filed 7-29-98; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40197A; File No. SR-MSRB-98-04]

### Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Granting Approval of Proposed Rule Change Relating to Rule G-32, on Disclosures in Connection With New Issues

July 23, 1998.

#### Correction

In FR Document No. 98-19445, beginning on page 39322 for Wednesday, July 22, 1998, the first full paragraph of the page is revised to read:

The amendment provides an alternate method of compliance with Rule G-32 in the case of Exempt VRDOs where the final official statement is either unavailable or incomplete. The amendment is intended to provide relief to dealers in the event they do not receive the final official statement from the issuer with enough time to deliver the document to their customers by settlement. Therefore, in those limited circumstances where dealers may in fact receive the official statement in final form in sufficient time to deliver it to customers by settlement (e.g., if an issuer approves completion of the official statement in final form prior to execution of the purchase contract), dealers would have the option of complying with the existing provision of the rule by delivering the official statement in final form to the customer by settlement.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>1</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-20366 Filed 7-29-98; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40252; File No. SR-NASD-98-46]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Technical Corrections to Delegation Plan and IM-1000-4

July 23, 1998.

On July 9, 1998, the National Association of Securities Dealers, Inc. ("NASD") through its regulatory subsidiary NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> The proposed rule change is described in Items I, II, and III below, which Items have been prepared by NASD Regulation. NASD Regulation has designated this proposal as one constituting a stated policy, practice, or interpretation with respect to the meaning of an existing rule under Section 19(b)(3)(A)(i) of the Act, which

<sup>1</sup> 17 CFR 200.30-3(a)(12).

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> 17 CFR 240.19b-4.