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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42212; File No. 4-208]

RIN 3235-AH49

### Adoption of Amendments to the Intermarket Trading System Plan To Expand the ITS/Computer Assisted Execution System Linkage to All Listed Securities

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Adoption of amendments to national market system plan.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is adopting amendments to the plan governing the operation of the Intermarket Trading System ("ITS Plan" or "Plan"). The amendments expand the ITS/Computer Assisted Execution System ("CAES") linkage to all listed securities, including non-Rule 19c-3 securities.

**EFFECTIVE DATE:** February 14, 2000.

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#### SUPPLEMENTARY INFORMATION:

#### I. Background and Description

The Commission is adopting amendments to the ITS Plan to expand the National Association of Securities Dealers, Inc.'s ("NASD") ITS/CAES linkage to all listed securities. The Commission believes that these amendments, adopted by the Commission on its own initiative pursuant to Rule 11Aa3-2 under the Securities Exchange Act of 1934 ("Exchange Act" or "Act"),<sup>1</sup> are

<sup>1</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 of the amendments. Paragraph (c)(1) requires the Commission to publish notice of any amendments initiated by the Commission and provide interested parties an opportunity to submit written comments.

necessary to encourage the statutory goals of efficient execution of securities transactions and opportunities for best execution of customer orders. The Commission is adopting these amendments only after the ITS Participants<sup>2</sup> have been unable to reach agreement.

#### A. History of ITS

Section 11A(a)(2) of the Exchange Act<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 ("NMS") 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 multiply-traded securities to be sent directly from any qualified market to another such market promptly and efficiently."<sup>6</sup> The Commission further stated that "[t]he need to develop and implement a new intermarket order routing system to link all qualified markets could be obviated if

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>2</sup> Current signatories to the ITS Plan include American Stock Exchange LLC ("Amex"), Boston Stock Exchange, Inc. ("BSE"), Chicago Board Options Exchange, Inc. ("CBOE"), Chicago Stock Exchange ("CHX"), Cincinnati Stock Exchange ("CSE"), NASD, New York Stock Exchange, Inc. ("NYSE"), Pacific Exchange, Inc. ("PCX"), and Philadelphia Stock Exchange, Inc. ("Phlx"), collectively, the "Participants."

<sup>3</sup> Section 11A(a)(2) was adopted by the Securities Acts Amendments of 1975 ("1975 Amendments"). Pub. L. No. 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> 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 Exchange Act Release No. 13662 (June 23, 1977), at 20, 42 FR 33510, 33512.

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

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. On April 14, 1978, the Commission, noting that ITS might provide the basis for an appropriate market linkage facility, issued a provisional order, pursuant to Section 11A(a)(3)(B) of the Act,<sup>9</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>10</sup>

Subsequently, during the Commission's hearings regarding proposed Rule 19c-3 under the Act,<sup>11</sup> the NASD announced plans to enhance its Nasdaq System to include, among other things, a computer assisted execution system that would enable participating firms to route their orders for listed securities through the system to obtain automatic executions against quotations of third market makers.<sup>12</sup> This system later came to be known as CAES. The NASD also contemplated an automated interface between the ITS and CAES ("ITS/CAES") to permit automated execution of 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>13</sup>

<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 the Amex, BSE, NYSE, PCX (then called the "PSE"), and Phlx.

<sup>9</sup> 15 U.S.C. 78k-1(a)(3)(B).

<sup>10</sup> See 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. See 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>11</sup> Exchange Act Release No. 15769 (April 26, 1979), 44 FR 26688. Rule 19c-3 precludes exchange off-board trading restrictions from applying to securities listed after April 26, 1979.

<sup>12</sup> The term third market makers refers to OTC market makers in listed securities.

<sup>13</sup> In its discussions with the ITS Participants, the NASD indicated that the enhanced Nasdaq would

Continued

The Commission later extended its authorization for the joint operation of ITS<sup>14</sup> but indicated several concerns with respect to 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>15</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/CAES interface was not implemented promptly, the Commission was prepared to take appropriate steps to require the inclusion of third market makers in ITS.<sup>16</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, thereby permitting 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>17</sup> The

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>14</sup> The authorization for the joint operation was extended until January 31, 1983. See Exchange Act Release No. 16214 (September 21, 1979), 44 FR 56069.

<sup>15</sup> *Id.* at 12, 44 FR 56072. The Commission also called for a linkage between the ITS and the CSE's National Securities Trading System ("NSTS").

<sup>16</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>17</sup> See Exchange Act Release No. 16888 (June 11, 1980), 45 FR 41125 ("Rule 19c-3 Adopting Release"). The rule, as adopted, essentially precludes exchange off-board trading restrictions from applying to securities listed after April 26, 1979 ("Rule 19c-3 securities"). Although the Commission recognized many potential concerns regarding the rule, such as internalization, 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. 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.

Commission stated that the presence of additional market makers might: (1) Place competitive pressure on primary market specialists, potentially narrowing spreads in Rule 19c-3 securities; and (2) create incentives for markets to disseminate quotations of greater size, adding to the depth, liquidity, and continuity of the markets for those securities.<sup>18</sup>

The Commission also 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 stated that it expected the NASD and the ITS Participants to establish an automated linkage between ITS and the Nasdaq system and to provide the Commission with formal status reports on the ITS-Nasdaq linkage.<sup>19</sup>

<sup>18</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 and determined to publish monitoring reports on a periodic basis. 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 17, at 49-53, 45 FR 41134.

<sup>19</sup> *Id.* at 15-16, 45 FR 41127. In September 1980, several Participants (the Amex, BSE, NYSE, Phlx, and PCX) submitted identical letters that indicated that they were not at that time willing to commit to the development of an automated interface. The NASD responded by reaffirming its commitment to the automated interface and providing the Commission and the ITS Participants with a functional description of the automated interface. See Description of NASD Market Services, Inc., Computer Assisted Execution System, contained in File 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. On January 7, 1981, the NYSE Board of Directors approved participation in a two-step "test" linkage between ITS and the enhanced Nasdaq system.

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 failed to come to an agreement, the Commission published a release proposing to issue an order requiring an automated interface between ITS and the enhanced Nasdaq system.<sup>20</sup> In proposing the order, 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.<sup>21</sup> The Commission reiterated its belief 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 market fragmentation,<sup>22</sup> to eliminate pricing inefficiencies, to obtain best execution, and to promote the type of competitive market structure that a national market system was designed to achieve.<sup>23</sup>

Finally, on April 28, 1981, the Commission issued an order<sup>24</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.<sup>25</sup> When the ITS Participants failed to submit an amendment, the Commission adopted its own amendments to the ITS Plan on May 12, 1982.<sup>26</sup> The Commission's

Participants and the NASD on any additional measures to address policy concerns identified by that evaluation.

<sup>20</sup> See Exchange Act Release No. 17516 (February 5, 1981), 46 FR 12379 (February 13, 1981).

<sup>21</sup> Indeed, in mandating that the Commission facilitate the establishment of a national market system, 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>22</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>23</sup> See Exchange Act Release No. 17516 (February 5, 1981), 46 FR 12379 (February 13, 1981).

<sup>24</sup> See Exchange Act Release No. 17744 (April 21, 1981), 46 FR 23856 (April 28, 1981).

<sup>25</sup> 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. See Exchange Act Release No. 18536 (March 11, 1982), 47 FR 10658.

<sup>26</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 a pilot phase

amendments applied to Rule 19c-3 securities initially because the Commission believed that the adoption of Rule 19c-3 would likely result in an increase in volume for these securities, thereby heightening the need for an efficient linkage between the exchanges and the OTC market.<sup>27</sup> The Commission fully intended the ITS/CAES linkage eventually to be expanded to all listed securities.<sup>28</sup> As the Commission stated, "in order to achieve fully the Congressional goal that all markets for qualified securities be linked \* \* \* 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>29</sup>

The Commission permanently approved the ITS Plan on January 27, 1983.<sup>30</sup> The Plan contains a number of market integrity provisions to provide for continuity of transaction prices among the various market centers, including a trade through rule.<sup>31</sup> It also contains a block trade policy that provides special rights to any market displaying the best national bid or offer when block-size transactions are occurring in another market.<sup>32</sup>

### B. Recent Developments

On November 12, 1991, the NASD submitted an application to the Commission, pursuant to Rule 11Aa3-

of the interface. The areas where the parties could not reach agreement were resolved by the Commission. See 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 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 Exchange Act Release No. 17704 (April 9, 1981), 46 FR 22520.

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

<sup>27</sup> See Division of Market Regulation, *Market 2000: An Examination of Current Equity Market Developments* (January 1994) ("Market 2000 Study"), at A.II.12.

<sup>28</sup> See Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983) ("Final Approval Order").

<sup>29</sup> *Id.*

<sup>30</sup> See *id.*

<sup>31</sup> The ITS Plan promotes price continuity among the various markets by ensuring that all markets have the opportunity to interact with the best national bids and offers.

<sup>32</sup> See ITS Plan, Section 8(d)(iii).

2(e), to review the ITS Operating Committee's ("ITSOC") 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> Following 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> and identified several regulatory issues that the Commission believed the NASD needed to address prior to any expansion.<sup>36</sup>

In addition, in 1995, in the proposing release for the Order Handling Rules, the Commission solicited comment on whether the ITS/CAES linkage should be expanded to cover non-Rule 19c-3 securities.<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>

Subsequently, on May 27, 1997, the Commission sent a letter to the ITS Participants outlining four aspects of the ITS Plan that it considered anti-

<sup>33</sup> The NASD has since withdrawn its application. 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> See Market 2000 Study, *supra* note 27.

<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 multiple 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. Market 2000 Study, *supra* note 27.

<sup>36</sup> 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. *Id.*

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 (Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996)), which addressed many of the topics covered by the NASD's proposed rules. 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.

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

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

competitive and requesting that they develop reasonable recommendations to the Commission in the form of proposed ITS Plan amendments and proposed SRO rule changes.<sup>39</sup> The responses that the Commission received indicated that not all the Participants would agree to expand the ITS/CAES linkage.<sup>40</sup> Because the ITS Plan currently requires a unanimous vote on proposed amendments, these changes could not be approved by the Participants. Accordingly, in July, 1998, the Commission proposed, on its own initiative, to expand the ITS/CAES linkage.<sup>41</sup> The Commission received numerous comment letters in response to its proposal. After careful review of those comments, the Commission is now amending the ITS Plan to expand the ITS/CAES linkage to all listed securities.

<sup>39</sup> Preliminarily, the Commission found four elements of the current operation of ITS and the ITS Plan to be an unreasonable impediment to 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 of 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. The Commission recently approved amendments to the ITS Plan to eliminate the special right of review of CSE rule changes. See Exchange Act Release No. 40553 (October 14, 1998), 63 FR 56278 (October 21, 1998).

<sup>40</sup> Eight of the nine Participants supported eliminating the ITS/CAES linkage restrictions as long as certain significant changes are made to the NASD's rules prior to the expansion. See letter from Thomas F. Ryan, Jr., President and Chief Operating Officer, Amex, to Jonathan G. 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 ("CBOE Letter"); 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"); letter from Robert E. Aber, Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission ("NASD 1997 Letter"); 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").

<sup>41</sup> See Exchange Act Release No. 40260 (July 21, 1998), 63 FR 40748 (July 30, 1998) ("Proposing Release"). In the Proposing Release, the Commission also proposed to eliminate the requirement that amendments to the ITS Plan be approved unanimously. The Commission is deferring consideration of that proposal at this time. The Commission plans to deal with several larger issues relating to market structure in an upcoming concept release.

## II. Summary of Comments

The Commission received 15 comment letters relating to the expansion of the ITS/CAES linkage to all listed securities.<sup>42</sup> All 15 commenters generally support the expansion, both with and without certain conditions. In general, most of the commenters state that expanding the linkage will greatly benefit the market place and public investors.<sup>43</sup> Specifically, the commenters believe that expanding the linkage will: increase market efficiency and transparency, reduce trade throughs, and level the playing field between third market firms and exchanges;<sup>44</sup> decrease market fragmentation and produce long-term benefits to the NMS;<sup>45</sup> increase the

liquidity and competitiveness of the securities markets;<sup>46</sup> and increase the opportunity for investors to obtain the best price available in all markets for orders in exchange-listed securities.<sup>47</sup> One commenter states that there is no longer any good economic reason to trade Rule 19c-3 securities differently from non-Rule 19c-3 securities,<sup>48</sup> while another states that from a marketplace and economic standpoint the distinction is meaningless.<sup>49</sup> The NYSE, on the other hand, believes that it is more appropriate for the ITS Participants themselves to draft the necessary Plan amendments, rather than for the Commission to adopt the amendments.<sup>50</sup>

### A. Conditional Expansion

The Commission specifically requested comment on what, if any, regulatory steps needed to be taken prior to expansion of the ITS/CAES linkage. Some commenters support the expansion outright,<sup>51</sup> while several commenters support the linkage if the Commission removes certain regulatory disparities between the third market and the exchange community.<sup>52</sup> For example, the NASD states that the expansion of the linkage is fully warranted at this time given that there have been significant changes to the third market since the link was originally established in 1982.<sup>53</sup> On the other hand, the NYSE believes that three issues need to be resolved prior to any expansion of the linkage: (1) Enhanced NASD oversight of the third market; (2) the adoption of fixed standards for queuing and executing customer orders; and (3) the application of the ITS trade through rule and block policy to cover NASD members that are not registered

with the NASD as "ITS/CAES Market Makers" in a security.<sup>54</sup>

### 1. Trade Through Rule

The Commission specifically requested comment on which, if any, third market participants should be subject to a trade through rule, and what the substance of that rule should be. In response, the NYSE stated that the trade through rule should apply to all "third market making," as opposed to "third market makers." The NYSE notes that the current NASD trade through rule already applies to all third market makers in ITS/CAES eligible securities, and would continue to do so even if the linkage were expanded. The NYSE believes that the trade through rule should apply not only to trades reported by ITS/CAES market makers, but also to all trades reported by NASD members that trade exchange-listed securities.<sup>55</sup> Similarly, the Specialist Association, CSE, Amex, and CHX believe that a trade through rule should apply to all member firms that effect trades in ITS/CAES eligible securities, even those that are not registered as ITS/CAES market makers in those securities, and including block positioning firms and order entry firms.<sup>56</sup>

CHX states that third market makers that fall under the 1%<sup>57</sup> threshold

<sup>42</sup> See letters from James Angel, Associate Professor of Finance, Georgetown University School of Business, to Jonathan G. Katz, Secretary, Commission, dated August 3, 1998 ("Angel ITS/CAES Letter"); Adam W. Gurwitz, CSE, to Jonathan G. Katz, Secretary, Commission, dated August 27, 1998 ("CSE ITS/CAES Letter"); James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated August 31, 1998 ("NYSE ITS/CAES Letter"); Robert H. Forney, President and Chief Executive Officer, CHX, to Jonathan G. Katz, Secretary, Commission, dated August 28, 1998 ("CHX ITS/CAES Letter"); Robert Lazarowitz, Chief Operating Officer, Trimark Securities, to Jonathan G. Katz, dated August 28, 1998 ("Trimark Letter"); Joanne Moffic-Silver, General Counsel and Corporate Secretary, CBOE, to Jonathan G. Katz, Secretary, Commission, dated September 1, 1998 ("CBOE ITS/CAES Letter"); Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, dated September 2, 1998 ("ICI Letter"); Kevin M. Foley, Bloomberg, to Jonathan G. Katz, Secretary, Commission, dated September 4, 1998 ("Bloomberg Letter"); Richard Ketchum, President and Chief Operating Officer, NASD, to Jonathan G. Katz, Secretary, Commission, dated September 8, 1998 ("NASD ITS/CAES Letter I"); Robert W. Seijas, Co-President, The Specialist Association, to Jonathan G. Katz, Secretary, Commission, dated September 1, 1998 ("SA Letter"); Lon Gorman, President, Schwab Capital Markets and Trading Group, Charles Schwab & Co., to Jonathan G. Katz, Secretary, Commission, dated September 14, 1998 ("Schwab Letter"); John C. Katovich, Senior Vice President and General Counsel, OptiMark Technologies, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 22, 1998 ("OptiMark ITS/CAES Letter"); Andrew M. Brooks, Vice President and Head of Equity Trading, T. Rowe Price Associates, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 29, 1998 ("T. Rowe Letter"); James F. Duffy, Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, Commission, dated October 17, 1998 ("Amex ITS/CAES Letter"); Richard Ketchum, President and Chief Operating Officer, NASD, to Jonathan G. Katz, Secretary, Commission, dated December 17, 1998 ("NASD ITS/CAES Letter II"); and Richard Ketchum, President and Chief Operating Officer, NASD, to Jonathan G. Katz, Secretary, Commission, dated June 3, 1999 ("NASD ITS/CAES Letter III").

<sup>43</sup> See CSE ITS/CAES Letter; Trimark Letter; CBOE ITS/CAES Letter; Bloomberg Letter; NASD ITS/CAES Letter I; and OptiMark ITS/CAES Letter.

<sup>44</sup> See Trimark Letter.

<sup>45</sup> See CBOE ITS/CAES Letter; T. Rowe Letter (reduce market fragmentation).

<sup>46</sup> See Bloomberg Letter; OptiMark ITS/CAES Letter.

<sup>47</sup> See NASD ITS/CAES Letter I; Schwab Letter.

<sup>48</sup> See Angel ITS/CAES Letter.

<sup>49</sup> See Trimark Letter. OptiMark states that there is no fundamental regulatory or functional basis for discriminating between Rule 19c-3 securities and non-Rule 19c-3 securities. See OptiMark ITS/CAES Letter.

<sup>50</sup> See NYSE ITS/CAES Letter.

<sup>51</sup> See Angel Letter; Trimark Letter; Bloomberg Letter; NASD ITS/CAES Letter I.

<sup>52</sup> See CSE ITS/CAES Letter; CHX ITS/CAES Letter; CBOE ITS/CAES Letter; Schwab Letter; SA Letter; NYSE ITS/CAES Letter; Amex ITS/CAES Letter.

<sup>53</sup> These include the requirement that: OTC market makers provide continuous two-sided quotations for any listed security in which the firm is responsible for more than 1% of the consolidated trading volume; all third market makers register as CQS market makers and participate in ITS/CAES, thereby subjecting them to the obligations and protections afforded Participants in the ITS Plan; the price and size of customer limit orders that improve the public quote be displayed; members be prohibited from "trading ahead" of customer orders. See NASD ITS/CAES Letter I.

<sup>54</sup> See NYSE ITS/CAES Letter. Similarly, the Specialist Association ("SA") believes that certain changes to the third market must be implemented and proven, not just adopted, before expansion of the linkage (such as rules establishing fixed standards for queuing and executing customer orders, and assuring that customers' orders will be crossed, if possible, without dealer intervention). The SA realizes that the Commission's Order Handling Rules, which require all specialists and market makers to display, directly or through ECNs, customer limit orders that improve such specialists' or market makers' quotations, mean that those orders are available to be crossed with customer market orders on the other side of the market. The SA also notes that NASD Rule 6440(f) precludes NASD members from effecting a transaction for their own account ahead of customers' market and limit orders. The SA, however, argues that the NASD still lacks a rule requiring NASD members to cross customer market orders against each other, rather than executing them as principal for the member's own account, whenever it is possible to do so. The SA also states that the NASD must expand the application of its trade through and block trade policy rules to cover all third market trading in ITS securities. See SA Letter.

<sup>55</sup> See NYSE ITS/CAES Letter. The NYSE also believes that the approach taken by the NASD in a previous filing (SR-NASD-95-09), which was withdrawn, is an appropriate and acceptable means of addressing this issue. *Id.* See also NASD ITS/CAES Letter I.

<sup>56</sup> See SA Letter; Amex ITS/CAES Letter; CSE ITS/CAES Letter; CHX ITS/CAES Letter. Amex notes that this is what the NASD originally proposed in SR-NASD-95-09, which was later withdrawn.

<sup>57</sup> Under Exchange Act Rule 11Aac1-1, third market makers who account for less than 1% of trading volume in a security, block positioners who do not hold themselves out as being willing to buy

should be bound by the trade through rules, as should block positioners and automated trading systems ("ATs").<sup>58</sup> Specifically, CHX believes that block positioners that are not quoting two-sided continuous markets should have limited ITS/CAES access for the purpose of sending commitments when they would otherwise trade through a market, while third market makers who do hold themselves out as willing to buy and sell on a continuous basis should have complete ITS access. CHX also believes that ATs that have elected to be subject to the display alternative should have a passive form of access to ITS (and should be subject to the trade through rule) but that non-display alternative ATs should not have any access to ITS (but should still be subject to the trade through rule).<sup>59</sup>

Finally, the ICI supports the adoption of a trade through rule for third market makers, but believes that the scope of the protection should be limited to displayed orders and not "reserved" or other "hidden" orders.<sup>60</sup> Schwab suggests that the NASD affix a trade report modifier identifying prints by NASD members that are not ITS/CAES market makers.<sup>61</sup>

The NASD notes that all voluntary CQS market makers<sup>62</sup> and any other OTC market maker accounting for more than 1% of the consolidated volume in a security are already subject to the NASD's trade through rule, Rule 5262, and that expanding the universe of ITS/CAES eligible securities will automatically extend the existing trade through rule to these participants with respect to the new securities. In response to many of the concerns discussed above, the NASD initially stated that it was willing to consider a trade through rule applicable to all members who would not otherwise be subject to the rule (either because they account for less than 1% of the volume

and choose not to become CQS market makers or because they fit into the block positioner exception to the Commission's 1% Rule).<sup>63</sup> More recently, however, the NASD stated that it does not believe that the application of a trade through rule to non-market makers would be fair because non-market makers do not have access to ITS.<sup>64</sup> The NASD further believes that it can alleviate concerns about the trade through issue by surveilling ITS/CAES market makers for compliance with ITS/CAES rules, including the trade through rule. The NASD also notes that Nasdaq, through its ITS Desk in its Market Operations Department, is able to determine on a real time basis the identity of each NASD member that reports a trade, and if another market center inquires regarding a perceived trade through of its market by an NASD member, the ITS Desk is able to immediately inform the inquiring market center whether the print was reported by a market maker subject to the rule or an NASD member not subject to the rule.<sup>65</sup> Finally, the NASD has indicated its commitment to, at some point after Year 2000, develop a special trade report modifier that the NASD or non-CAES market maker member reporting a trade could append to each trade report to distinguish such trade report from those of CAES market makers.<sup>66</sup>

## 2. Trade Reporting Rule

Two commenters believe that, prior to expanding the linkage, the NASD must amend its trade reporting rules for listed securities to align them with exchange reporting rules.<sup>67</sup> In response, the NASD proposed to amend its trade reporting rule for listed securities.<sup>68</sup> Specifically, the NASD proposed to eliminate a provision of its rules applicable to the reporting of transactions in exchange-listed securities, which requires

members to report transactions in a manner "reasonably related to the prevailing market taking into consideration all relevant circumstances." For years, the ITS Participants have asserted that this language provides inappropriate flexibility in the manner in which NASD members may report third market transactions. The NYSE states that the NASD's proposal addresses its concerns with the trade reporting issue.<sup>69</sup> CHX, however, does not believe that the NASD's proposal solves the perceived problem with the NASD's trade reporting rule because it would not eliminate the discretion that the trade reporting rule gives to third market makers to determine the price at which to report a trade. CHX asserts that the proposal would merely eliminate the standard articulating how to calculate the markup or markdown on the sale.<sup>70</sup> CHX further argues that the rule change increases the likelihood that a third market maker will be able to avoid a violation of the trade through rule.<sup>71</sup> The NASD responds to this criticism by noting that concerns over the trade reporting rule will be effectively addressed through surveillance and enforcement of best execution obligations and confirmation disclosure requirements.<sup>72</sup>

## 3. Surveillance of Third Market

With regard to surveillance concerns, CHX believes that the NASD must implement a more thorough program for surveillance of the third market so that the NASD can ensure that the third market trading firms that provide automated routing and execution services are operating within their stated execution parameters.<sup>73</sup> The NYSE states that it assumes that the Commission would not propose to expand the linkage unless it was satisfied that the NASD had installed an adequate oversight examination program for the third market.<sup>74</sup>

## 4. Other Conditions

In the CSE's view, ITS should only be opened to all listed securities at the same time that the securities of large, well-capitalized companies that trade in the OTC market are included in ITS.<sup>75</sup> CSE also believes that the Commission

and sell securities on a continuous basis, and ATs that do not elect the display alternative do not have to display quotations ("1% Rule").

<sup>58</sup> See CHX ITS/CAES Letter.

<sup>59</sup> See CHX ITS/CAES Letter.

<sup>60</sup> See ICI Letter.

<sup>61</sup> Schwab states that currently the NASD's trade through and block trade rules apply only to ITS/CAES market makers, which can put specialists in the position of having to provide price protection against prints from NASD members that are not registered CAES market makers, such as block positioners who do not post quotes and are inaccessible through ITS/CAES. Schwab believes this situation could be remedied if the NASD were to affix a trade report modifier identifying prints by NASD members that are not ITS/CAES market makers (and therefore not subject to the trade through rule). See Schwab Letter.

<sup>62</sup> All third market makers registered as CQS market makers in securities eligible for inclusion in the ITS/CAES linkage are required to register as ITS/CAES market makers. See NASD rule 5210(e).

<sup>63</sup> See NASD ITS/CAES Letter I. The NASD initially stated it would consider a trade through rule like the one it filed with the Commission in 1995, consideration of which was deferred pending the Order Handling Rules. See NASD-95-09.

<sup>64</sup> See NASD ITS/CAES Letter III.

<sup>65</sup> See NASD ITS/CAES Letter III. The NASD further notes that today, if another market center sees a print from the OTC market in a rule 19c-3 security, the same procedure described above is conducted.

<sup>66</sup> The NASD does not believe that a system change is possible at this time given the resources being expended on Y2K preparation by the NASD, SIAC and the other exchanges.

<sup>67</sup> See CHX ITS/CAES Letter; NYSE ITS/CAES Letter.

<sup>68</sup> See Exchange Act Release No. 40360 (August 25, 1998), 63 FR 46267 (August 31, 1998) (SR-NASD-98-61). The Commission notes that this proposal was approved in July 1999. See Exchange Act Release No. 41647 (July 23, 1999), 64 FR 41478 (July 30, 1999).

<sup>69</sup> See NYSE ITS/CAES Letter.

<sup>70</sup> See CHX ITS/CAES Letter.

<sup>71</sup> See CHX ITS/CAES Letter.

<sup>72</sup> See NASD ITS/CAES Letter II.

<sup>73</sup> See CHX ITS/CAES Letter.

<sup>74</sup> See NYSE ITS/CAES Letter. See also Amex ITS/CAES Letter.

<sup>75</sup> See CSE ITS/CAES Letter. CHX also believes that Nasdaq stocks should be eligible for ITS. See CHX ITS/CAES Letter.

should address the prohibition on regional markets from trading initial public offering securities during the first day of trading because the third market is not subject to such a restriction.<sup>76</sup> CHX asserts that ATS-type regulations should be applied to third market makers that provide automated routing and execution facilities to other broker-dealers in a fashion directly in competition with exchanges. CBOE argues that Nasdaq market makers should be required to reflect limit orders from options market makers or other broker-dealers in their displayed quotes and provide price protection to such limit orders.<sup>77</sup>

### B. ECN Participation

The Commission also requested comment on whether electronic communications networks ("ECNs," also known as ATSS)<sup>78</sup> should be allowed to participate in ITS.<sup>79</sup> Most commenters who discuss the issue support ECN participation in some form. The ICI believes that a truly national market requires a linkage between exchanges, market makers and

<sup>76</sup> See also CHX ITS/CAES Letter.

<sup>77</sup> See CBOE ITS/CAES Letter. CBOE sees this as injurious to the options market and investors in that market and believes it prevents investors in Nasdaq stocks from achieving best execution because they cannot see or trade with a significant source of orders in those stocks.

<sup>78</sup> The term ECN is defined, with certain exceptions, as any electronic system that widely disseminates to third parties orders entered into the ECN by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part. See Exchange Act Rule 11Ac1-1(a)(8). The term ATS is defined more broadly as any organization, association, person, group of persons, or system: (1) That constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Exchange Act Rule 3b-16; and (2) that does not: (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading. See Regulation ATS, Sec. 242.300(a). Essentially, an ECN is a type of ATS.

<sup>79</sup> Under the ECN Display Alternative, an order entered by a market maker into an ECN that widely disseminates the order is deemed to be a bid or offer to be communicated to the market maker's association for at least the minimum quotation size required by the Association's rules if the priced order is for the account of the market maker, or the actual size of the order up to the minimum quotation size required if the priced order is for the account of a customer. The ECN Display Alternative deems the market maker to be in compliance with this requirement if the ECN displays the market maker's order in Nasdaq. If the only option is for ECNs to link to the NMS through the NASD, specialists and market makers would only have the ECN alternative for trading rule 19c-3 securities through ITS. Specialists or market makers, therefore, could not use ECNs for non-rule 19c-3 securities because their quotes would not be accessible to the other ITS Participants.

ECNs, and therefore supports the inclusion of ECNs in ITS.<sup>80</sup> Bloomberg agrees that ECNs should be allowed to participate in the ITS/CAES linkage. The NASD believes that the Commission should allow bilateral access between ECNs and ITS Participants, without restriction as to any spread parameter for a two-sided quote by the ECNs. The NASD also believes it would be appropriate to implement a formula to guard against the linkage being used as an order routing facility to gain access to ITS Participants.<sup>81</sup> Schwab encourages the Commission to work with the NASD and the other ITS Participants to eliminate regulatory and structural impediments to ECN participation in ITS and the ITS/CAES linkage.<sup>82</sup>

The NYSE states that it remains flexible in considering Plan amendments to accommodate ECNs, and points out that the NASD has raised for consideration a number of potential ways in which ECNs could access ITS through the linkage.<sup>83</sup> CHX believes that ATSS that have elected to be subject to the display alternative should have a passive form of access to ITS but that non-display alternative ATSS should not have any access to ITS.<sup>84</sup>

### C. Miscellaneous

Several commenters raise additional issues regarding the expansion of the linkage. In the Proposing Release, the Commission noted that the NASD's autoquote policy would conflict with the ITS Plan, which limits computer-generated quotations to 100 shares, if the ITS/CAES linkage were expanded. The Commission requested comment on the autoquote issue. The NASD responds that it intends to discuss the issue with the ITSOC, with a view toward implementing a computer-generated quotation policy that could apply to all ITS/CAES eligible securities.

The Commission also requested the NASD to consider developing standards for queuing and executing customer orders. The NASD does not believe there are any significant problems in this area. It states that it believes that any potential problems might manifest themselves as a failure to promptly display customer orders at the opening

<sup>80</sup> See ICI Letter.

<sup>81</sup> See NASD ITS/CAES Letter I. The NASD is also willing to proceed with a proposal to have ECN quotes be subject to trade through protection by exchange markets and accessible through the ITS/CAES linkage if the Commission is unwilling to support a formula.

<sup>82</sup> See Schwab Letter.

<sup>83</sup> See NYSE ITS/CAES Letter.

<sup>84</sup> See CHX ITS/CAES Letter.

or as a failure to provide best execution while holding multiple orders, for which enhanced regulatory standards have been implemented. The NASD notes that it is unaware of any problems or customer complaints in either context. It also notes that NASD market makers generally guarantee customer orders the opening price of the primary market, thereby eliminating the potential for queuing at the open.<sup>85</sup>

OptiMark believes that Participants should be required to substantially improve the system performance and capacity of ITS, noting that the technology in use is an inefficient combination of manual and automated sub-systems within ITS. OptiMark is concerned that this creates capacity limitations that lead to poor or untimely executions of ITS commitments and delays in obtaining access to ITS.<sup>86</sup> CSE urges the Commission to fix inefficiencies that exist within ITS and other national market systems, including CTA and CQS, to enable faster trade reporting and quote updating.<sup>87</sup>

CHX believes problems exist relating to the expiration of ITS commitments that are not executed by the receiving market. Generally, CHX regards the expiration of ITS commitments as a violation of the firm quote rule and believes that ITS Participants should have liability under the ITS Plan when a market fails to act on an ITS commitment before it expires.<sup>88</sup>

### D. Replacing or Rewriting the ITS Plan

The Commission specifically requested comment on whether the ITS facility itself should be replaced or the ITS Plan rewritten. CHX sees no reason to take such measures at this time, believing that ITS, although twenty years old, has served the industry well and has evolved over time to meet changing market conditions. CBOE also states that the Plan has served the NMS well in the last two decades, and believes that with increased automation and other improvements, it will continue to serve the industry into the next century.

In contrast, the NYSE and Amex both assert that they are receptive to discussing alternatives to ITS.<sup>89</sup> ICI believes that further enhancements may be necessary to realize the goals of a true NMS where a customer order entered anywhere can interact with the best

<sup>85</sup> See NASD ITS/CAES Letter I. The NASD does not believe that the issue of queuing is directly relevant to the ITS/CAES expansion.

<sup>86</sup> See OptiMark ITS/CAES Letter.

<sup>87</sup> See CSE ITS/CAES Letter.

<sup>88</sup> See CHX ITS/CAES Letter.

<sup>89</sup> See NYSE ITS/CAES Letter; Amex ITS/CAES Letter.

price available.<sup>90</sup> Schwab believes that the Commission should “scrap” ITS, and that access to prices in other markets could be achieved more efficiently and competitively by requiring each SRO to grant access to its automated order routing system—either through private vendors or through sponsored access by members of that SRO.<sup>91</sup>

The NYSE is open to discussing the possible replacement of the current ITS computer system with either existing order routing systems or a third-party system, but suggests that the Commission consider whether any linkage is necessary at all.<sup>92</sup> The NYSE also has concerns about the legal structure that would govern any new system. Moreover, the NYSE believes that any new linkage should provide non-members with access only to superior-priced quotations.<sup>93</sup> Finally, the NYSE believes that if the Commission did amend the Plan, it would need to retain the descriptions of the ITS interfaces contained in the current Plan, and adopt language clarifying that these descriptions are the only means by which the Participants can access ITS.

### III. Discussion and Basis for Adoption

#### A. Expansion of Linkage Generally

As it originally stated in its permanent approval order for ITS, 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 linking the

exchanges and the OTC market.<sup>94</sup> When the Commission approved the limited linkage for Rule 19c-3 securities in May 1982,<sup>95</sup> it intended it to be the first step toward a more expansive linkage.<sup>96</sup> The Commission’s amendments applied to Rule 19c-3 securities initially because the Commission believed that the adoption of Rule 19c-3 would likely result in an increase in volume for these securities, thereby heightening the need for an efficient linkage between the exchanges and the OTC market.<sup>97</sup> Since that time, there has been a marked increase in the level of trading in the third market. In 1987, third market trading of NYSE listed stocks accounted for 1.9% of the volume and 2.05% of the trades reported to the consolidated tape. By 1997, third market trading of NYSE listed stocks accounted for 7.7% of the volume and 10.49% of the trades reported to the consolidated tape.<sup>98</sup>

There have been other significant improvements in the third market. Specifically, 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 the security as reported in the consolidated system (“1% Rule”).<sup>99</sup> The NASD also now requires all third market makers registered as CQS market makers in ITS-eligible securities to register and participate in ITS/CAES.<sup>100</sup> In addition, the NASD prohibits third market makers from trading ahead of their own customer limit orders.<sup>101</sup> Finally, the Limit Order Display Rule requires third

market makers to display customer limit orders in their quote if those orders improve the quote.<sup>102</sup> 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 recommended in the Market 2000 Study.<sup>103</sup> The Limit Order Display Rule also provides an 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.

In light of these changes, as discussed below, the Commission believes that there is no longer any need for the historical distinction between Rule 19c-3 and non-Rule 19c-3 securities in the ITS/CAES linkage. The Commission believes that expansion will increase a broker-dealer’s ability to obtain the best price available for the customer, promote competition in listed securities, help ensure more equivalent access to the markets, and provide for additional liquidity and more efficient executions.

Failure to achieve a linkage between exchange and OTC markets in all listed securities inhibits a broker’s ability to ensure best execution of customer orders because orders in non-Rule 19c-3 securities routed to exchange floors cannot be easily redirected to the OTC market when more favorable prices are offered by OTC market makers. Conversely, OTC market makers are precluded from using an efficient means to deliver their orders to exchange floors when the exchange has a more favorable price in non-Rule 19c-3 securities.<sup>104</sup> The Commission believes that expanding the ITS/CAES linkage to non-Rule 19c-3 securities will enable the OTC market maker and the exchange specialist to access more directly 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 would impede competition among brokers and dealers and between exchange markets and other markets, and that competitive OTC markets cannot develop fully in the absence of

<sup>90</sup> ICI suggests allowing any vendor to establish an intermarket linkage system, or that all ITS Participants should be required to be open to such linkages, including linkages that provide for the automated routing of orders. See ICI Letter.

<sup>91</sup> Schwab believes that ITS is an archaic system and that any number of private communications systems are faster, cheaper, more reliable, and more efficient. See Schwab Letter.

<sup>92</sup> With respect to the operation of the current ITS, the NYSE does not believe that any amendments are necessary to the ITS Plan. See NYSE ITS/CAES Letter. Amex also believes that the existing order routing and execution systems of the exchanges and the NASD could be used in place of ITS, and would support any Commission action to assess whether ITS could be readily replaced by other available access mechanisms. Amex, however, does not believe amendments to the current ITS Plan are necessary or appropriate at this time.

<sup>93</sup> The NYSE believes it would still be necessary to adopt special rules governing pre-opening procedures, trade throughs, block trades, and locked and crossed markets. In addition, the NYSE believes it would be necessary to specify that non-member trading interest are not “orders” that have the same standing in an exchange Participant’s market as member orders. See NYSE ITS/CAES Letter.

<sup>94</sup> See Final Approval Order, *supra* note 28. Specifically, the Commission noted 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.” *Id.* at 4940.

<sup>95</sup> See Exchange Act Release No. 18713 (May 12, 1982), 47 FR 20413.

<sup>96</sup> See also Market 2000 Study, *supra* note 27, at AII-12; and Order Handling Rules, *supra* note 36.

<sup>97</sup> See Market 2000 Study, *supra* note 27, at A.II.12.

<sup>98</sup> See NYSE 1997 Fact Book at 26-27.

<sup>99</sup> The 1% Rule applied only to Rule 19c-3 securities prior to being expanded in the Order Execution Rules. See Exchange Act Release No. 39367 (November 26, 1997), 62 FR 64242 (December 4, 1997) (“Autoquote Order”).

<sup>100</sup> See Exchange Act Release No. 34280 (June 29, 1994), 59 FR 34880 (July 7, 1994).

<sup>101</sup> NASD 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 unexecuted limited price order to buy (or sell) such security in the unit of trading for a customer.

<sup>102</sup> See Order Handling Rules, *supra* note 36.

<sup>103</sup> The Limit Order Display Rule requires all specialists and market makers to display customer limit orders that improve their quotes. See Order Handling Rules, *supra* note 36.

<sup>104</sup> Non-exchange member OTC market makers presently are able to access exchange floors only through correspondent relationships with member firms.

a linkage for all listed securities.<sup>105</sup> 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 increased competition in non-Rule 19c-3 securities. The Commission also believes the expansion should help equalize access to all the markets because OTC market makers and exchange specialists will have more direct access to each other's markets for non-Rule 19c-3 securities. Finally, the Commission believes that expanding the ITS/CAES linkage will reduce the occurrence of trade throughs because the NASD's trade through rule will apply to all listed securities traded in the third market, not just Rule 19c-3 securities.<sup>106</sup>

#### B. Conditional Expansion

As mentioned above, several of the commenters asserted their belief that certain regulatory steps were necessary prior to expanding the ITS/CAES linkage. Many commenters argued that the NASD should expand its trade through rule to apply to all NASD members. The Commission believes that the NASD should continue to consider modifying its existing trade through rule, but that it is not an essential precondition to approval of an expanded linkage. Currently, all third market makers registered as CQS market makers who trade ITS/CAES eligible securities must register as ITS/CAES market makers, which subjects them to the trade through rule. If the linkage is expanded, non-Rule 19c-3 securities will become ITS/CAES eligible securities. Therefore, any CQS market makers in those securities will be required to register as ITS/CAES market makers and will become subject to the NASD's trade through rule.

Several commenters argued that the NASD's trade through rule should apply not only to ITS/CAES market makers, but to all third market participants. The Commission, however, recognizes the NASD's concern that it is not fair to apply the trade through rule to other

third market participants that trade in listed securities, such as block positioners that fit within the block positioner exception to the Commission's 1% Rule, and market makers that account for less than one percent of trading volume in a security and choose not to register as CQS market makers because they do not have access to ITS/CAES. The Commission notes that the NASD has indicated its commitment to modifying the trade reporting process so that exchange Participants can distinguish a trade originating from an ITS/CAES market maker from one originating from another third market participant.<sup>107</sup> This result should permit exchange participants to recognize when an NASD member subject to the trade through rule has executed a trade through. Until such time as the NASD makes the requisite systems changes to attach trade modifiers to trade reports, the Commission believes that the NASD can adequately surveil for compliance with the trade through rule.

Commenters also expressed concerns regarding the NASD's trade reporting rule. The Commission believes that the issue of timely and accurate trade reporting of listed securities by the third market has already been adequately addressed. In July 1999, the Commission approved an NASD proposed rule change to amend NASD Rule 6420(d)(3)(A), the trade reporting rule for principal transactions in listed securities.<sup>108</sup> Prior to the rule change, the NASD's rule required members to report transactions in a manner "reasonably related to the prevailing market taking into consideration all relevant circumstances." Commenters asserted that that this language provided too much flexibility in the manner in which NASD members may report third market transactions. The NASD rule change eliminated the "reasonably related to the prevailing market" language. The Commission recognizes that there are differences in the trade reporting rules of the third market and the exchange markets, but believes that the rule change adequately addresses some of the ambiguity in the rule for the purpose of expanding the ITS/CAES linkage.<sup>109</sup> The Commission also 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's confirmation rule requires participants in the third market to report transactions to the consolidated tape at the same price as they report the transactions to the customer.<sup>110</sup> The Commission notes that the NASD must continue to ensure that it is actively and adequately surveilling trade reporting in the third market.<sup>111</sup>

#### C. ECN/ATS Participation

In the proposing release, the Commission requested comment on whether ECNs (or ATSS) should be required or allowed to participate in ITS, and if so, what form that participation should take. Most of the commenters who discuss the issue supported ECN and ATS access to ITS in some form. For example, CHX believes that ECNs that have elected to be subject to the display alternative should have a passive form of access to ITS but that non-display alternative ATSS should not have any access to ITS.<sup>112</sup> The Commission believes that, in order to further the goals of the national market system, ECNs trading in listed securities should be linked to ITS. ITS should not prevent efficient electronic routing between markets. The

including those that already are ITS/CAES eligible securities.

<sup>110</sup> See Exchange Act Rule 10b-10, 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, 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, if any.

<sup>111</sup> In its Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 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 there were many transactions that constituted trade throughs. See U.S. Securities and Exchange Commission, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 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, one of which required the NASD to improve substantially the reliability of trade reporting through enhancement of surveillance, examination, and enforcement. See In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37538 (August 8, 1996); Administrative Proceeding File No. 3-9056 ("SEC Order"), at 8 (Undertaking No. 9).

<sup>112</sup> See CHX ITS/CAES Letter.

<sup>105</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 17, at 10, 45 FR at 41126.

<sup>106</sup> Currently, third market makers may trade non-Rule 19c-3 listed securities without complying with the ITS trade through rule.

<sup>107</sup> See NASD ITS/CAES Letter III. The NASD has stated that it will develop a special trade report modifier that an NASD or non-CAES market maker member reporting a trade may append to each trade report to distinguish such trade report from those of CAES market makers. The NASD, however, does not expect to accomplish this goal in the near future because of resources aimed at Y2K issues.

<sup>108</sup> See Exchange Act Release No. 41647 (July 23, 1999), 64 FR 41478 (July 30, 1999).

<sup>109</sup> The Commission notes that NASD Rule 6420(d)(3)(A) applies to all listed securities,

Commission notes that the Participants have begun a dialogue about the parameters of ECN access to ITS. The Commission strongly urges the Participants to continue to discuss the issue and reach a resolution.

#### D. NASD Autoquote Policy

The Commission recognizes that the NASD's current autoquote policy may conflict with the ITS Plan if the linkage is expanded to cover all listed securities.<sup>113</sup> However, the Commission notes that the Participants have been discussing this issue, and expects the Participants to continue to discuss how to amend the Plan to permit computer-generated quotations.<sup>114</sup>

#### IV. Costs and Benefits of the Proposed Amendment

To assist the Commission in its evaluation of the costs and benefits that may result from the ITS amendments, commenters were requested to provide analysis and data, if possible, relating to costs and benefits associated with the proposal. No comments were received regarding this request.

The Commission believes that any possible increase in costs to market participants are justified by the overall benefits of the proposed amendment. The proposed amendments will further the goals of a national market system under Section 11A by increasing a broker-dealer's ability to achieve best execution of customer orders, promoting

competition in listed securities, equalizing access to markets, and providing for additional liquidity and more efficient executions. Specifically, the Commission believes that expanding the ITS/CAES linkage to non-Rule 19c-3 securities will enable an OTC market maker and an exchange specialist to directly access superior priced quotes in each other's markets through ITS, rather than potentially executing an order at an inferior price. In addition, 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. Finally, the Commission believes that the proposed amendment should provide additional liquidity to the market in non-Rule 19c-3 securities because direct access (*i.e.*, the increased ability to access a better price in a security) and increased competition should enable investors to execute transactions more efficiently.

Any monetary costs to the Participants, including implementation costs and costs of expanding the linkage to include all non-Rule 19c-3 securities, would most likely be minimal, if they exist at all, compared to the overall costs of ITS. The Commission consulted with the Securities Industry Automation Corporation ("SIAC") as to any possible costs of implementing the expanded linkage.<sup>115</sup> SIAC informed the Commission that there would not be any systems costs from expanding the linkage, although there may be internal administrative costs for the NASD.<sup>116</sup> The Commission notes that the NASD fully supports the adoption of the Commission's amendment to expand the ITS/CAES linkage. The Commission also notes that most commenters supported the expanded linkage. The Commission further notes that the proposal may affect ITS order flow between the Participants, by increasing it for some Participants, decreasing it for others, or increasing it for all Participants. The Commission believes that any costs to Participants in the form of possible reduced order flow or decreased tape fees (from decreased executions) are justified by the benefits of the proposal, including increased liquidity, increased competition, and a

better chance for best execution of customer orders.

#### V. Effects on Competition, Efficiency and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether such action will promote efficiency, competition, and capital formation.<sup>117</sup> In the Proposing Release, the Commission solicited comment on the effect on competition, efficiency, and capital formation. Many commenters believe that the expanded linkage will ultimately increase market efficiency, competition and transparency.<sup>118</sup>

In the Commission's view, the amendment to the ITS Plan is not likely to impose any significant burden on competition, efficiency or capital formation not necessary or appropriate in furtherance of the Act. Indeed, the Commission believes that expansion of the ITS/CAES linkage to all listed securities should promote competition among market centers and improve efficiency in the execution of customer orders.

Section 23(a)(2) of the Exchange Act requires 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 furtherance of the Act.<sup>119</sup> The Commission has considered the proposed amendment to the ITS Plan to expand the ITS/CAES linkage in light of the standards cited in Section 23(a)(2) of the Act and believes that it 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 should now be able to attract orders typically routed to exchange specialists by disseminating a superior quote in all listed securities, not just Rule 19c-3 securities. In addition, the expansion of the ITS/CAES linkage should allow exchange specialists to attract orders held by OTC market makers in non-Rule 19c-3 securities. The Commission believes that the proposed amendment

<sup>113</sup> See Autoquote Order, *supra* note 97. Currently, NASD Rule 6330 permits computer-generated quotations in exchange-listed securities that generate proprietary quotes for 100 shares or more if such quote systems equal or improve either or both sides of the NBBO, add size to the NBBO, or are used to expose a customer's market or marketable limit order for price improvement opportunities. This rule applies only to non-Rule 19c-3 securities, because of the concern that it conflicts with the ITS Plan provision that currently restricts automated quotation tracking systems to 100 shares or less. See Section 8(d)(ii) of the Plan.

<sup>114</sup> The Commission notes that on December 3, 1999, the NASD filed a petition for rulemaking to address this issue. The Commission is currently considering that petition. On a miscellaneous issue, one commenter argued that the unlisted trading privilege rule for IPOs (Rule 12f-2(a) under the Exchange Act), which restricts regional exchanges from trading securities subject to an IPO for the first day, should be amended prior to expanding the ITS/CAES linkage. The Commission notes that it received a study on this issue and is publishing a proposing release addressing this issue. Although two commenters argue that Nasdaq stocks should trade over ITS, the Commission believes that this issue is separate from, and not relevant to, whether or not to expand the ITS/CAES linkage to all listed securities. The Commission notes that it recently approved the expansion of Nasdaq UTP-eligible securities from 500 to 1,000 securities. See Exchange Act Release No. 41392 (May 12, 1999), 64 FR 27839 (May 21, 1999). Finally, the Commission believes that the additional issues raised by the commenters are not directly relevant to the expansion of the ITS/CAES linkage.

<sup>115</sup> SIAC serves as the facilities manager for ITS and is responsible for the operation and maintenance of ITS.

<sup>116</sup> Phone conversation between Tom Demchak, SIAC, Katherine A. England, Assistant Director, Market Regulation, Commission, and Christine Richardson, Attorney, Commission, on November 23, 1998.

<sup>117</sup> See 15 U.S.C. 78c(f).

<sup>118</sup> See, e.g., NASD ITS/CAES Letter I; Trimark Letter; Bloomberg Letter; Schwab Letter; and ICI Letter.

<sup>119</sup> See 15 U.S.C. 78w(a)(2).

should help to increase efficiency and improve execution quality because investors will be able to access directly the exchange and OTC markets for all listed stocks.

## VI. Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the provisions of the Regulatory Flexibility Act ("Reg. Flex. Act"), to provide a description and estimate of the number of small entities that would be affected by the ITS Plan amendment to expand the ITS/CAES linkage to all listed securities.<sup>120</sup>

Paragraph (c)(1) of Rule 0-10<sup>121</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's 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. None of the exchanges are included within the definition of "small entity." The Commission estimates that there are 8,300 registered broker-dealers, including approximately 5,000 "small entities." The Commission requested comment on the number of small entities that could be affected by the proposed amendment, but did not receive any comment on the subject.

As discussed more fully in the FRFA, the proposal would directly affect the nine ITS Participants, none of which is a small entity as defined by paragraph (c)(1) of Exchange Act Rule 0-10.<sup>122</sup> However, specialists on the exchange floors who trade ITS-eligible securities, broker-dealers that have access to ITS through terminals located on exchange floors, and registered ITS/CAES market

makers who trade in ITS-eligible securities in the third market could be indirectly affected.

To the extent that a specialist or market maker does fall under the definition of "small entity," the Commission believes that 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 should 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. Furthermore, 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. Finally, the ITS Plan amendment does not establish any new reporting, recordkeeping or compliance requirements for small entities.

The Commission received no comments on the Initial Regulatory Flexibility Analysis prepared in connection with the Proposing Release. A copy of the FRFA may be obtained by contacting Christine Richardson, Attorney, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1001.

## VII. Commission Authority

The Commission is adopting changes to the ITS Plan as set forth below under Section 11A(a)(3)(B) of the Exchange Act, which authorizes the Commission 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.<sup>123</sup>

<sup>123</sup> 15 U.S.C. 78k-1(a)(3)(B). This is in addition to the authority granted to the Commission under Section 11(A)(b)(3) to approve national market system facilities in response to an application by SROs. 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,

## VIII. Conclusion

The Commission continues to believe that it is desirable for the industry to take the 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. Therefore, the Commission has determined to adopt final amendments to the ITS Plan to provide for the expansion of the ITS/CAES linkage to all listed securities. The Commission finds that the final amendments are consistent with the Act, particularly Section 11A of the Act.

## IX. Text of Amendments to the ITS Plan

The Commission hereby adopts amendments to the ITS Plan to provide for the expansion of the ITS/CAES interface to non-Rule 19c-3 securities, pursuant to Rule 11Aa3-2(b)(2) and (c)(1) and the Commission's authority under Sections 2, 3, 6, 11, 11A(a)(3)(B), 15A, 17 and 23<sup>124</sup> of the Act. Below is the text of the amended ITS Plan.<sup>125</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

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 [the 1975 Amendments] to act promptly and efficiently to ensure that the essential mechanisms of an integrated secondary training 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 Exchange Act Release No. 16410 (December 7, 1979), at 13-14, 44 FR 72607, 72608-09.

<sup>124</sup> 15 U.S.C. 78b, 78c, 78f, 78k, 78k-1(a)(3)(B), 78o-1, 78q, and 78w(a).

<sup>125</sup> The text reflects the latest unofficial completion of the ITS Plan supplied by the ITSOC, including all previously incorporated amendments up to May 30, 1997.

<sup>120</sup> 5 U.S.C. 603(a).

<sup>121</sup> This amendment was proposed under an older, more expansive definition of "small entity" and as such is being adopted under the older definition. The Commission however, recently adopted a revised definition 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 Exchange Act, and the Securities Act of 1933, Exchange Act Release No. 40122 (June 24, 1998), 63 FR 35508 (June 30, 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 that clear customer transactions through large firms. See revised Rule 0-10(i). The Commission notes that, under the revised definition of "small entity," approximately 1,100 of all registered broker-dealers are characterized as "small."

<sup>122</sup> 17 CFR 240.0-10(c)(1).

(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. No Change.

Section 5. The System.

(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.

\* \* \* \* \*

Dated: December 9, 1999.

By the Commission.

**Jonathan G. Katz,**

*Secretary.*

[FR Doc. 99–32555 Filed 12–15–99; 8:45 am]

**BILLING CODE 8010–01–P**

## SECURITIES AND EXCHANGE COMMISSION

### Sunshine Act Meeting

Notice is hereby given, pursuant to the provisions of the Government in the Sunshine Act, Pub. L. 94–409, that the Securities and Exchange Commission will hold the following meeting during the week of December 20, 1999.

A closed meeting will be held on Tuesday, December 21, 1999, at 11:00 a.m.

Commissioners, Counsel to the Commissioners, the Secretary to the Commission, and recording secretaries will attend the closed meeting. Certain staff members who have an interest in the matters may also be present.

The General Counsel of the Commission, or his designee, has certified that, in his opinion, one or more of the exemptions set forth in 5 U.S.C. 552(c) (4), (8), (9)(A) and (10) and 17 CFR 200.402(a) (4), (8), (9)(A) and (10), permit consideration for the scheduled matters at the closed meeting.

Commissioner Johnson, as duty officer, voted to consider the items listed for the closed meeting in a closed session.

The subject matters of the closed meeting scheduled for Tuesday, December 21, 1999, will be: Institution and settlement of injunctive actions; and Institution and settlement of administrative proceedings of an enforcement nature.

At times, changes in the Commission priorities require alterations in the scheduling of meeting items. For further information and to ascertain what, if any, matters have been added, deleted or postponed, please contact: The Office of the Secretary at (202) 942–7070.

Dated: December 13, 1999.

**Jonathan G. Katz,**

*Secretary.*

[FR Doc. 99–32684 Filed 12–13–99; 4:34 pm]

**BILLING CODE 5010–01–M**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42213; File No. SR–NASD–99–71]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. To Delay Date of Commencement for Providing Nasdaq-Generated Best Bid/Offer Inside Quotation From 4:00 p.m. to 6:30 p.m. Eastern Time

December 9, 1999.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and rule 19b–4 thereunder,<sup>2</sup> notice is hereby given that on December 3, 1999, the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. On December 6, 1999, Nasdaq filed an amendment to the proposed rule change.<sup>3</sup> Nasdaq has designated this proposal as one which does not significantly affect the protection of investors or the public interest, and does not impose any significant burden on competition under section 19(b)(3)(A) of the Act<sup>4</sup> and rule 19b–4(f)(6) thereunder,<sup>5</sup> which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

#### I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq proposes to defer, until February 7, 2000, the date by which Nasdaq will commence providing an Inside Quote. Nasdaq had originally proposed, and received Commission approval, to provide an Inside Quote commencing on December 6, 1999.

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

<sup>2</sup> 17 CFR 240.19b–4.

<sup>3</sup> See December 6, 1999 letter from Thomas Moran, Esquire, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (“Amendment No. 1”). In Amendment No. 1, Nasdaq states that it received a letter from the Investment Company Institute (“ICI”) in which the ICI indicated its support of a delay in the implementation of a Nasdaq-generated best bid/offer inside quotation (“Inside Quote”) until February 7, 2000.

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>5</sup> 17 CFR 240.19b–4(f)(6).