

participants. The Commission finds that the proposed rule change requiring dual transaction reporting will contribute to the reliability of transaction information and thereby enhance price transparency in and regulatory surveillance of the corporate bond market, which are the twin goals of the TRACE Rules. In addition, the Commission notes that several comments on previously proposed Rule 6231 indicated that dual trade reporting would require fewer programming changes.⁹

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposal to amend NASD Rule 6230(b) is consistent with the requirements of the Act and the rules and regulations thereunder.

It is Therefore Ordered, pursuant to section 19(b)(2) of the Act, that the proposed rule change (SR-NASD-01-04) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44030; File No. SR-NASD-01-09]

Self-Regulatory Organizations; Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding Trading Ahead of Customer Limit Orders and Short Sales on a Pilot Basis and Transaction Reporting Pursuant to Decimal Pricing in the Nasdaq Market

March 2, 2001.

I. Introduction

On January 25, 2001, the National Association of Securities Dealers, Inc. (NASD or Association), through its

⁹ See Letters from Noland Cheng, Chairman, Fixed Income Transparency Subcommittee of the Securities Industry Association's Operations Committee (December 20, 2000) and Messrs. William H. James, III, 1999 Chairman, Vincent Murray, 2000 Chairman, and Thomas Thees, 2001 Chairman, Corporate Bond Division, The Bond Market Association (December 20, 2000). These comments noted that previously Rule 6231, contained in the original TRACE Rules in SR-NASD-99-65, would have required member firms to engage in additional software development efforts and would have required member firms to duplicate the existing clearance data transmission and retention process by re-sending this data to the NASD after having sent it to the clearing entities.

¹⁰ 17 CFR 200.30-3(a)(12).

subsidiary, the Nasdaq Stock Market, Inc. (Nasdaq), filed with the Securities and Exchange Commission (Commission or SEC), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (Act)¹ and Rule 19b-4 thereunder,² a proposed rule change that would modify several NASD rules to support the implementation of decimal pricing in the Nasdaq market. Notice of the proposed rule change appeared in the **Federal Register** on February 2, 2001.³ The Commission received no comments on the proposed rule change. This order approves the proposed rule changes regarding trading ahead of customer limit orders and short sales on a pilot basis ending on Friday, March 1, 2002, and grants approval for the proposed rule change concerning transaction reporting pursuant to decimal pricing in the Nasdaq Market.

II. Description of the Proposal

In preparation for decimal pricing, the NASD proposes to amend certain of its rules that contain references to fractions through the addition of language and decimal-based values so as to govern trading activity in securities when they transition from fractional to decimal pricing.⁴ After Nasdaq's full implementation of decimal pricing, Nasdaq will automatically remove, where appropriate, any remaining references to fractions in NASD rules.⁵ Specifically, Nasdaq is proposing to amend the following: IM-2110-2 (Trading Ahead of Customer Limit Order); IM-3350 (Short Sale Rule); and NASD Rule 4632 (Transaction Reporting). A summary of the proposed changes is provided below.

IM-2110-2. Trading Ahead of Customer Limit Order

Nasdaq is amending NASD IM-2110-2 and the related interpretation of IM-2110-2 (Manning Interpretation or Interpretation)⁶ to add language that the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 43893 (January 26, 2001), 66 FR 8823.

⁴ Nasdaq will implement these rule changes starting on March 12, 2001, for each security converted to decimal pricing. Securities not trading in decimal increments will continue to be governed by the current versions of these proposed rules.

⁵ Many NASD Rules and interpretations do not contain, and are not enforced based on, any particular value, fractional or otherwise. Nothing in Nasdaq's move to decimal pricing should be construed as relieving NASD members from their ongoing obligation to comply with all current NASD Rules.

⁶ See Securities Exchange Act Release No. 39049 (September 10, 1997), 62 FR 48912 (order approving Interpretation). The Interpretation was announced to the NASD membership in NASD's Notice to Members 97-57 (September 1997) (NTM 97-57).

minimum amount of price improvement that an NASD member holding an unexecuted customer limit order in a decimal-priced Nasdaq National Market (NNM) or SmallCap security must provide when executing an incoming order in that same security to avoid a violation of the Interpretation is \$0.01. The Interpretation is also being amended to incorporate the price improvement standard for NMS and SmallCap securities trading in fractions currently contained in NASD's NTM 97-57.

According to Nasdaq, the Manning Interpretation is designed to ensure that customer limit orders are executed in a fair manner and at similar prices at which a firm has indicated it is willing to trade for its own account. To provide customers with the greatest opportunity to have their orders executed, NASD's Manning Interpretation requires NASD member firms to provide a minimum level of price improvement to incoming orders in NMS and SmallCap securities if the firm chooses to trade as principal with those incoming orders at prices superior to customer limit orders they currently hold. If a firm fails to provide the minimum level of price improvement to the incoming order, the firm must execute the customer limit orders it holds. Generally, if a firm trades for its own account and fails to provide the requisite amount of price improvement and also fails to execute its held customer limit orders, it is in violation of the Manning Interpretation. Currently, the minimum price improvements necessary to avoid a Manning violation, as outlined in NTM 97-57, are:

- If actual spread is equal to or greater than $\frac{1}{16}$ th of a point: Firm must price improve incoming order by at least a $\frac{1}{16}$ th.
- If actual spread is the minimum quotation increment: Firm must price improve incoming order by one-half the minimum quotation increment.⁷

In a decimal environment, Nasdaq is proposing the following Manning Interpretation price improvement standards for NNM and SmallCap securities:

- A firm must always price improve an incoming order by at least \$0.01.⁸

⁷ For stocks priced under \$10 (which are quoted in $\frac{1}{32}$ nd increments) the firm must price improve by at least $\frac{1}{64}$ th. Nasdaq notes that, for securities quoted in decimals, under the proposal there would no longer be any differentiation in the amount of price improvement required based on the price of a particular security.

⁸ Pursuant to the terms of the Decimals Implementation Plan (Implementation Plan) submitted to the Commission on July 24, 2000, the minimum quotation increment for Nasdaq

Nasdaq chose to propose the \$0.01 price improvement standard for securities quoting in decimals, taking the position that the current $\frac{1}{16}$ th price improvement values contained in NTM 97-57 discussing the Interpretation generally approximate the existing minimum quotation increment for most Nasdaq securities.⁹ One exception to this approach is price improvement when the spread equals the minimum quotation increment. Recognizing that retaining the Interpretation's current "one-half the spread" price improvement alternative standard when the spread equals the minimum quote increment would result in a firm being able to price ahead of a customer order for one-half a penny (\$0.005), Nasdaq proposes to strengthen that standard by requiring at least a penny price improvement before executing ahead of a held customer limit order. Nasdaq believes that, given the size of the new decimal quotation increment, uniform price improvement of a penny, particularly for stocks that are already trading with a penny spread, is an appropriate price improvement standard for the initiation of decimal pricing.

As contemplated in the Implementation Plan, Nasdaq and NASD Regulation will monitor the protection of customer limit orders during the implementation of decimal pricing in the Nasdaq market, and will analyze and evaluate trading activity to determine if future changes to the price improvement standard are warranted.

IM-3350. Short Sale Rule

Nasdaq proposes to amend IM-3350 to add language indicating that when the current best bid in a decimalized NNM security is lower than the preceding best bid in that security, a "legal" short sale must be executed at a price at least \$0.01 above the current best bid.

NASD's Short Sale Rule requires that no member execute a short sale in an NNM security for a customer or

proprietary account at or below the current best bid (unless operating pursuant to an exemption to the rule) when the current best bid is below the preceding best bid in the security. Under the current rule, a valid short sale in an NNM security must be executed at the following specified amounts above the current bid in a bid context:

- Spread $\frac{1}{16}$ th or greater: Legal Short Sale must be executed at least $\frac{1}{16}$ th above current best (inside) bid.
- Spread less than $\frac{1}{16}$ th: Legal Short Sale must be executed at price equal or greater than current best (inside) offer.

In a decimal environment, Nasdaq proposes the following standard for "legal" short sales:

- A valid short sale on a down bid would have to be executed at least \$0.01 above the current best (inside) bid.

Nasdaq believes that the current $\frac{1}{16}$ th increment contained in the short sale rule generally approximates the current minimum $\frac{1}{16}$ th quotation increment for most Nasdaq securities. Nasdaq believes that short sale regulation should reflect the minimum quotation increment once trading commences in a decimals environment, *i.e.*, where there is a down bid in a security a legal short sale must be executed at a price at least \$0.01 above the current best bid.

As contemplated in the Implementation Plan, Nasdaq and NASD Regulation will monitor the operation of the short sale rule in Nasdaq's decimal environment, and will analyze and evaluate trading activity to determine if the short sale price improvement standard adopted here adequately advances the market quality goals of the rule.

Rule 4632 Transaction Reporting

Nasdaq proposes to amend Rule 4632 to provide alternative reporting examples for securities trading in decimals.¹⁰

III. Discussion

The Commission has reviewed carefully the proposed rule change, and finds that it is consistent with the Act and the rules and regulations promulgated thereunder.¹¹ Specifically, the Commission finds that approval of the proposed rule change is consistent with section 15A(b)(6) of the Act.¹²

The Commission finds that the proposed amendment to the Interpretation to IM-2110-2 is consistent with section 15A(b)(6) of the

Act,¹³ in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The proposal is intended to ensure that customer limit orders are executed fairly, and to require firms to provide price improvement of at least \$0.01 before trading ahead of customer limit orders that they hold.

Regarding Nasdaq's proposed amendment to IM-3350, the Commission finds that the proposal is consistent with section 15A(b)(6) of the Act,¹⁴ in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Nasdaq is setting the \$0.01 increment standard for legal short sales in securities quoting in decimals to mirror current operation of this rule for most Nasdaq securities quoting in fractions.

The Commission believes the proposed amendments to the Manning Interpretation and IM-3350 are a reasonable approach during the initial stages of the Nasdaq conversion to decimal pricing. However, we believe that the amendments should be reexamined once Nasdaq decimal trading behavior can be analyzed. As a result, the Commission is approving the amendment on a one-year pilot program basis. The primary purpose of pilot program is to allow Nasdaq, participants, and the Commission to examine the operation of the Interpretation and the Short Sale Rule. Ninety days prior to the end of the pilot period, Nasdaq must submit to the Commission a study analyzing the operation of these rules as amended.¹⁵ The study must include, but is not limited to, an analysis of whether the rules are effective in achieving their

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Requiring this study does not alleviate NASD of its obligations to provide any other reports required to be submitted to the Commission as a part of its conversion to decimal pricing. Specifically, NASD has agreed, pursuant to the Implementation Plan, to perform a detailed statistical analysis of quoting and trading activity that will be used to form the basis for a study or studies on systems capacity, liquidity, and trading behavior. This report is required to be delivered to the Commission no later than 60 days after the full implementation of decimals. Securities Exchange Act Release No. 42914 (June 8, 2000), 65 FR 38010.

securities (both National market and SmallCap) at the outset of decimal pricing is \$0.01. As such, Nasdaq will only display priced quotations to two places beyond the decimal point (to the penny). Quotations submitted to Nasdaq that do not meet this standard will be rejected by Nasdaq systems. See Securities Exchange Act Release No. 43876 (January 23, 2001), 66 FR 8251.

⁹ Originally, Nasdaq's Manning Interpretation required that member firms price improve an incoming order by the then minimum trade reporting increment of $\frac{1}{64}$ th. See NASD's Notice To Members 95-43 (June 1995). In response to changing market conditions, including a move to a $\frac{1}{16}$ th minimum quotation increment, Nasdaq adopted the current $\frac{1}{16}$ th price improvement standard. See NTM 97-57. See also Securities Exchange Act Release No. 39049 (September 10, 1997), 62 FR 48912.

¹⁰ *Supra* note 3.

¹¹ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78o-3(b)(6).

investor protection and market quality goals with a \$0.01 minimum increment.¹⁶ The Commission finds that the proposed amendments are appropriate during the pilot period.¹⁷

With regard to the amendments to NASD Rule 4632, the Commission finds that providing alternative reporting examples for securities quoting in decimals is consistent with the Act in general, and in particular with section 15A(b)(6).¹⁸ By providing examples of trade reporting for securities quoting in decimals, Nasdaq clarifies how trade reporting will operate in a decimals environment, which should help to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of notice of the filing in the **Federal Register**. Notice of the proposal indicated that the Commission would consider granting accelerated approval of the proposed rule change after a 15-day comment period.¹⁹ The Commission received no comments on the proposal. Given the absence of comments, and Nasdaq's resolve to begin decimal pricing in certain Nasdaq securities on March 12, 2001, the Commission finds good cause to approve the proposal on an accelerated basis to ensure that the amendments are approved in advance of March 12, 2001.

IV. Conclusion

For the above reasons, the Commission finds that the proposed rule change is consistent with the provisions of the Act, in general, and with section 15A(b)(6),²⁰ in particular.

¹⁶ We note that concerns have been raised recently about the effect of a penny increment on trading behavior. See Norris, Big Board Will Study Effects of Decimal Trading, The New York Times, Feb. 17, 2001, at C1. We also note that the NASD has previously expressed concerns that transactions based on very small price changes could undermine the operation of the Short Sale Rule in a fractional pricing context. See Securities Exchange Act Release No. 31003 (August 6, 1992), 57 FR 36421, 36426 (Amended Notice Proposing NASD Short Sale Rule). The Commission will separately study the effect of decimal pricing on the operation of self-regulatory organization and Commission rules containing provisions that are designed to give public orders precedence over member orders, e.g., Exchange Act Rule 11a1-1(T). In addition, we will study the effect of decimal pricing on the operation of short sale rules.

¹⁷ Approving the amendment on a one-year pilot basis does not prevent Nasdaq from proposing a rule change regarding the Interpretation and the Short Sale Rule before the end of the one-year pilot should Nasdaq believe it is appropriate.

¹⁸ *Id.*

¹⁹ *Supra* note 3.

²⁰ 15 U.S.C. 78o-3(b)(6).

It is therefore ordered, pursuant to section 19(b)(2) of the Act,²¹ that the proposed rule change (SR-NASD-01-09), be and hereby is approved on a pilot basis for the proposed rule changes to IM-2110-2 and the related Interpretation to IM-2110-2, and IM-3350 on a pilot basis ending on Friday, March 1, 2002;

It is further ordered, pursuant to section 19(b)(b) of the Act,²² that the proposed rule change (SR-NASD-01-09), be and hereby is approved as to the amendment to NASD Rule 4632.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²³

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44032; File No. SR-NSCC-00-09]

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Proposed Rule Change Relating to Certain Securities Undergoing Reorganization

March 3, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on July 12, 2000, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by NSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The proposed rule change would permit NSCC to process otherwise ineligible securities in the continuous net settlement ("CNS"), balance order or other related system.

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

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NSCC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.²

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

NSCC's rules permit NSCC to continue to process certain securities undergoing reorganization or issuing dividends and specify how NSCC shall handle those issues. However, not all types of reorganizations or dividends fit the procedures specifically set forth in the rules. Ordinarily, this would require that the affected security be exited from the applicable system. Exiting the affected security from the applicable system poses a burden on the financial investment community when the issue is widely traded.

The purpose of the proposed rule filing is to permit NSCC the flexibility to process in the CNS, balance order, or other related system, on an exception basis, securities that would not otherwise have been eligible for processing to the extent NSCC has the capability to do so. The proposed rule change would provide that in such circumstance, NSCC would issue a notice to its members setting forth how NSCC would process the security. The proposed rule change further would provide that the procedures set forth in the notice would have the same effect as if they were set forth in NSCC's rules.

NSCC believes that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder. In particular, NSCC believes that the proposed rule change is consistent with section 17A(b)(3)(F) of the Act³ which requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.

²¹ 15 U.S.C. 78s(b)(2).

²² *Id.*

²³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² The Commission has modified parts of these statements.

³ 15 U.S.C. 78q-1(b)(3)(F).