

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the ISE. All submissions should refer to File No. SR-ISE-01-09 and should be submitted by May 4, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Jonathan G. Katz,**  
Secretary.

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44158; File No. SR-NASD-01-08]

#### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to Rule 10301 of the Code of Arbitration Procedure To Prohibit Terminated, Suspended, Barred or Otherwise Defunct Firms From Enforcing Predispute Arbitration Agreements in the NASD Arbitration Forum

April 6, 2001.

#### I. Introduction

On January 25, 2001, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. ("NASD Dispute Resolution"), 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> proposed a rule change to amend Rule 10301 of the Code of Arbitration of the NASD, to prohibit a firm that has been terminated, suspended, or barred from the NASD, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the NASD arbitration forum. On February 15, 2001, NASD Dispute Resolution filed Amendment No. 1 to the proposal. On February 22, 2001, NASD Dispute Resolution filed Amendment No. 2 to the proposal.

The proposed rule change including Amendment Nos. 1 and 2, was published for comment in the **Federal Register** on March 5, 2001.<sup>3</sup> No comments were received on the proposal. This order approves the proposal.

#### II. Description of the Proposal

NASD Dispute Resolution is proposing to amend Rule 10301 of the Code of Arbitration Procedure to prohibit a member whose membership has been terminated, suspended, cancelled or revoked, or has been expelled from the NASD, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the NASD forum. The proposed rule change precludes a member whose membership has been terminated, suspended, cancelled or revoked, or has been expelled from the NASD, or that is otherwise defunct, from requiring a customer to arbitrate in the NASD forum under Rule 10301, unless the customer agrees in writing to arbitrate the claim in the NASD forum after the claim has arisen. As a corollary to this rule change, NASD Dispute Resolution stated in its Notice that it will advise customers making arbitration claims in the NASD forum against a member whose membership has been terminated, suspended, cancelled or revoked, or a member that has been expelled from the NASD, or that is otherwise defunct, of the member's status, so that the customers can decide whether to proceed in arbitration, to file their claim in court, or to take no action.

#### III. Discussions

After careful review, the Commission finds that the proposed rule changes is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national

securities association.<sup>4</sup> In particular, the Commission believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>5</sup> which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

The Commission believes that because terminated, suspended, barred or otherwise defunct firms have a significantly higher incidence of non-payment of arbitration awards than do active firms,<sup>6</sup> the proposed rule change will protect investors and the general public by giving customer greater flexibility to seek remedies against such firms. The Commission believes that because of experience with non-payment by such firm, it is inappropriate to permit terminated or suspended members to require customers who have claims against them to arbitrate such claims in the NASD forum when an arbitration award may be unenforceable against the terminated or suspended member. In such cases, the Commission believes that even if customers have signed a predispute arbitration agreement, they should be able to seek relief in court before engaging in arbitration proceedings, where they could more directly avail themselves of any judicial remedies available under state law, including those that might prevent the dissipation of assets. The Commission notes that the NASD and other self-regulatory organizations that administer arbitration programs have concluded that other categories of claims, such as class action claims, should be resolved in court rather than through arbitration.<sup>7</sup> The Commission believes that allowing customers to choose to go directly to seek relief may save them time and expense in cases against members who have been terminated or expelled and in which the dissipation of assets is a threat.

#### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>8</sup> that the

<sup>4</sup> In approving this rule proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>5</sup> 15 U.S.C. 78o(b)(6).

<sup>6</sup> See June 2000 General Account Office Report, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*.

<sup>7</sup> See e.g., NASD Rule 10301(d) and New York Stock Exchange Rule 600(f).

<sup>8</sup> 15 U.S.C. 78s(b)(2).

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

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

<sup>3</sup> Securities Exchange Act Release No. 43998 (February 23, 2001), 66 FR 13362.

<sup>7</sup> 17 CFR 200.30-3(a)(12).

proposed rule change (SR-NASD-01-08) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44165; File No. SR-NASD-2001-27]

### Self-Regulatory Organizations: Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Customer Limit Order Protection in a Decimal Trading Environment

April 6, 2001.

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 April 6, 2001, the National Association of Securities Dealers, Inc. (NASD or Association), through its subsidiary, the Nasdaq Stock Market, Inc. (Nasdaq), filed with the Securities and Exchange Commission (Commission or SEC) the proposed rule changes as described in Items I and II below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. As discussed below, the Commission is granting accelerated approval of the proposed rule change for a pilot period until July 9, 2001.

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

Nasdaq proposes to modify NASD Interpretative Material 2110-2—Trading Ahead of Customer Limit Order (Manning Interpretation or Interpretation) for securities priced in decimals. Nasdaq will implement this rule change immediately upon approval. The text of this rule change is provided below. Proposed new language is italicized and deleted language is in brackets.

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

##### (3) No Change. General Application

To continue to ensure investor protection and enhance market quality, the Association's Board of Governors is issuing an interpretation to the Rules of the Association dealing with member firms' treatment of their customer limit orders in Nasdaq securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members acting as market makers to handle their customer limit orders with all due care so that market makers do not "trade ahead" of those limit orders. Thus, members acting as market makers that handle customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without executing the limit order. Such orders shall be protected from executions at prices that are superior but not equal to that of the limit order. In the interests of investor protection, the Association is eliminating the so-called disclosure "safe harbor" previously established for members that fully disclosed to their customers the practice of trading ahead of a customer limit order by a market-making firm.

Rule 2110 of the Association's Rules states that: A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principals of trade.

Rule 2320, the Best Execution Rule, states that: In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such a market so that the resultant price to the customer is as favorable as possible to the customer under prevailing market conditions.

#### *Interpretation*

The following interpretation of Rule 2110 has been approved by the Board: A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that, until September 1, 1995, customer limit orders in excess of

1,000 shares received from another member firm shall be protected from the market maker's executions at prices that are superior but not equal to that of the limit order, and provided further, that a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than \$100,000 in value. Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, the Association wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. The Association believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders we certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer's order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm's market making capacity does not occur. For purposes of this interpretation, a member that controls or is controlled by another member shall be considered a single entity so that if a customer's limit order is accepted by one affiliate and forwarded to another affiliate for execution, the firms are considered a single entity and the market making unit may not trade ahead of that customer's limit order.

As outlined in NASD Notice to Members 97-57, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis when holding an unexecuted limit order for a Nasdaq security trading in fractions, and not be required to execute the held limit order, is as follows:

- If actual spread is greater than  $\frac{1}{16}$  of a point, a firm must price improve an incoming order by at least a  $\frac{1}{16}$ . for stocks priced under \$10, (which are quoted in  $\frac{1}{32}$  increments) the firm must price improve by at least  $\frac{1}{64}$ .
- If actual spread is the minimum quotation increment, a firm must price

<sup>9</sup> 17 CFR 200.30-3(a)(12).

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

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