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

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[9]

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)[1] and Rule 19b–4 thereunder,[2] 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 moidfy 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 ensurer 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 Nadsaq 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 form 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 won 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 1⁄16 of a point, a firm must price improve an incoming order by at least a 1⁄16. for stocks priced under $10, (which are quoted in 1⁄32 increments) the firm must price improve by at least 1⁄64.
- If actual spread is the minimum quotation increment, a firm must price

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[9] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

improve an incoming order by one-half the minimum quotation increment.

For Nasdaq securities authorized for trading in decimals pursuant to the Decimals Implementation Plan For the Equities and Options Markets, the minimum amount of price improvement necessary in order for a market maker to execute an incoming order on a proprietary basis in a security trading in decimals when holding an unexecuted limit order in that same security, and not be required to execute the held limit order, is [$0.01.] *as follows:*

(1) For customer limit orders priced at or inside the best inside market displayed in Nasdaq, the minimum amount of price improvement required is $0.01; and

(2) For customer limit orders priced outside the best inside market displayed in Nasdaq, the market maker must price improve the incoming order by executing the incoming order at a price at lease equal to the next superior minimum quotation increment in Nasdaq (currently $0.01).

The Association also wishes to emphasize that all members accepting customer limit orders owe those customers duties of ''best execution'' regardless of whether the orders are executed through the member's market making capacity or sent to another member for execution. As set out above, the Best Execution Rule requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. The Association emphasizes that order entry firms should continue to routinely monitor the handling of their customers' limit orders regarding the quality of the execution received.

(b) No Change.

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

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

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

1. Purpose

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 its held customer limit orders. Generally, if a firm 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.

On March 2, 2001, the Commission approved on a pilot basis Nasdaq's proposal to establish a uniform $0.01 price improvement standard for market makers (''MMs'') who elect to execute proprietary transactions in securities priced in decimals while holding customer limit orders on the same side of the market in those securities without triggering an obligation to ''protect'' (*i.e.,* execute, up to the amount of shares traded proprietarily by the MM) those customer orders.[3]

Recently, Nasdaq has been made aware of certain anomalies that occur under its current Manning rule when MMs elect to provide their customers the ability to enter orders into the firm's proprietary system in price increments smaller than a penny. The following example illustrates the issue:

Example 1

Market is 10.00 to 10.01
MM has accepted a customer limit order to buy 100 shares at 9.994
MM then buys 1,000 shares on a proprietary basis at 10.00.[4]

As stated above, under Nasdaq's current Manning rule, the MM must protect limit orders within $0.01 if the price at which it trades (10.00) on a proprietary basis for up to 1,000 shares (*i.e.,* the total size of the MM's proprietary trade). In this example, therefore, the MM would be obligated to execute the customer's limit order at 9.994 as well as all other customer limit orders to buy it has accepted that are priced at or between 10.00 to 9.991, up to a total of 1,000 shares.[5]

This result has raised significant negative comment from market participants who assert that if Nasdaq's Manning rule remains as currently formulated, it will force them to engage in an increasing number of unprofitable trades (*e.g.,* buy 1000 shares at 10 proprietary and be immediately obligated to sell to a total 1000 shares under Manning to a customer at 9.994). For example, a market maker may receive numerous customer limit but orders priced at just under a penny away from the inside bid and subsequently receive a market order directed to its posted best bid (or it may execute a trade at the best bid based on an understanding that it will provide its customers the best displayed price in Nasdaq), and then automatically be obligated under Manning to execute those limit orders priced outside the current inside spread, thereby consistently and unavoidably trading at a loss. In particular, market participants are concerned about electronic gaming of this pricing anomaly that could lead to significant monetary losses. For example, a single customer could electronically enter a series of limit orders into an MM's system priced outside the current market, but within one penny from the best market bid, and then subsequently enter a market sell order directed to that same MM. The resulting execution of the market order by the MM would in turn trigger a Manning obligation to that same customer's previously-entered limit orders resulting in the customer being able to automatically, and without risk, profit from the difference between the market price at which the customer sold to the MM and the price the MM is obligated to give the customer's limit orders. This concern is now at its most acute based on the upcoming full-implementation of decimal pricing for the entire Nasdaq market that will commence on Monday, April 9, 2001.

For these reasons, Nasdaq has determined to propose modifying its current Manning Interpretation. Under the proposal, Nasdaq would maintain a strict $0.01 price improvement requirement for an MM wishing to trade proprietarily in front of its held customer limit orders that are priced at

[3] Securities Exchange Act Release No. 44030 (march 2, 2001), 66 FR 14235.

[4] Nasdaq notes that the Manning pricing anomalies described in this filing are equally applicable to MM's who do not affirmatively trade in front of customer orders, but instead merely have their displayed quotes accessed by other market participants. If allowed to continue, the impact of these pricing anomalies could be exacerbated by the future expansion of automatic-execution capabilities.

[5] A firm that executes in front of customer limit orders that are owed Manning protection is obligated to only fill such limit orders for a total amount of shares equal to the number or shares traded proprietary by the firm. NASD's Notice to Members 95–43 (June 1995).

or inside the current best inside market displayed in Nasdaq. For customer limit orders priced outside the inside spread, however, Nasdaq proposes to adopt a different standard. This standard would require an MM seeking to trade in front of such limit orders, without triggering a Manning obligation, to execute its proprietary trades at a price at least equal to the next displayable minimum quotation increment in Nasdaq (currently a penny) superior to those customer limit orders.[6] The following examples illustrate how the proposed rule would operate:

Example 2

Market is 10.00 to 10.01 with MM's posted bid and offer at the inside
MM receives and accepts Customer #1's limit order to buy priced at 10.004 for 2000 shares
MM receives a market sell order directed to its posted bid of 10.00 for 1000 shares and immediately executes that order on a proprietary basis

In this example, since MM has executed within $0.01 of Customer #1's inside-the-spread buy limit order of 10.004, the MM would be obligated to protect that order and execute 1000 shares of Customer #1's order at a price of 10.004. As before, if the MM wishes to avoid a Manning obligation to Customer #1's 10.004 buy limit order, MM would have to execute its proprietary trade at a price at least $0.01 better than that limit order and execute at 10.014.

Example 3

Market is 10.00 to 10.01 with MM's posted bid and offer at the inside
MM receives and accepts Customer #2's limit order to buy priced at 9.993 for 500 shares
MM receives a market sell order directed to its posted bid of 10.00 for 700 shares and immediately executes that order on a proprietary basis

Under the proposed amendment to the Interpretation, since the MM's 700 share proprietary execution was done at a price (10.00) that is at least equal to the next superior penny minimum Nasdaq quotation increment to Customer #2's 9.993 outside-the-spread order, it would not be obligated to execute that limit order. Similarly, if the market remained at 10.00 to 10.01 and MM held a customer limit order to sell priced at 10.016, MM could trade proprietarily with an incoming buy order without triggering a Manning obligation to the 10.016 outside-the-spread limit order if the MM executes its proprietary trade at a price of at least 10.01.

Nasdaq believes that the proposed rule change draws an appropriate balance between providing effective limit order protection for customers who aggressively seek to participate in trading at the inside market while reducing the incidence of forced training losses to market makers who, in meeting their firm quote and best-execution obligations to other market participants, trade near customer limit orders which are priced outside the spread.

As they have throughout the phased-in implementation of decimal pricing in the Nasdaq market, Nasdaq and NASD Regulation will closely monitor the protection of customer limit orders during the period after the full implementation of decimal pricing and will continue to analyze and evaluate trading activity to determine if future changes to the Manning price improvement standard are warranted.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act[7] in that it is designated to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities; to perfect the mechanism of a free and open market and a national market system; and to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organizations consent, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

Nasdaq has requested accelerated approval of the proposed rule change pursuant to Section 19(b)(2) of the Act,[8] submitting that the trading anomalies described in the filing could have a significantly impact on market activity and that accelerated approval will allow NASD firms an opportunity to reprogram their systems prior to, or contemporaneously with, the full implementation of decimal pricing in the Nasdaq market scheduled for Monday, April 9, 2001.

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, N.W., Washington, D.C. 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 in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the File No. SR–NASD–2001–27 and should be submitted by May 4, 2001.

[6] 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 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* SR–NASD–01–07; Securities Exchange Act Release No. 43876 (January 23, 2001), 66 FR 8251.

[7] 15 U.S.C. 78o–3.

[8] 15 U.S.C. 78s(b)(2).

V. Commission Findings and Order Granting Partial Accelerated Approval of the Proposed Rule Change for a Pilot Period

The Commission finds that the proposed rule change is consistent with the Act and the rules and regulations promulgated thereunder.[9] Specifically, the Commission finds that approval of the proposed rule change is consistent with Section 15A(b)(6) of the Act.[10]

The Commission believes the proposed amendment to the Manning Interpretation should provide protection to customer limit orders in a subpenny trading environment by ensuring that such orders will continue to have access to market liquidity ahead of market makers in appropriate circumstances.[11] However, we believe that the amendment should be reexamined once Nasdaq decimal trading behavior can be analyzed. As a result, the Commission is approving the amendment on a pilot basis through July 9, 2001. Nasdaq must submit to the Commission trade data related to the pilot on a monthly basis in order to allow the Commission to monitor the effect of the pilot on Nasdaq trading. Such information will include reported volume of orders received and executed in subpenny increments (in terms of both trades and shares), the execution price points, and the nature of the subpenny orders received and executed (*i.e.,* agency, proprietary, professional or otherwise). Requiring this data does not alleviate the NASD of its obligations to provide any other reports required to be submitted to the Commission as part of its conversion to decimal pricing.[12] The Commission will examine the data provided pursuant to this order, and other information provided by all self-regulatory organizations as required by the Implementation Plan. As a part of that examination, the Commission intends to reconsider the amendment to the Interpretation provided in this order.

The Commission finds good cause for granting Nasdaq's request for approval of the proposed rule change on a pilot basis prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission notes that the completion of Nasdaq's decimal transition will occur on April 9, 2001, at which point market makers will be subject to accepting and executing orders in subpenny increments for all Nasdaq securities. The Commission believes that granting accelerated approval to the proposed rule change will allow Nasdaq to continue to provide protection to customer limit orders when trading in subpenny increments for all Nasdaq securities begins.

It is Therefore Ordered, pursuant to Section 19(b)(2) of the Act,[13] that the proposed rule change (File No. SR–NASD–2001–27) is approved on a pilot basis until July 9, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[14]

Margaret H. McFarland,

Deputy Secretary.

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[9] In granting accelerated approval of the proposal, the Commission has considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[10] 15 U.S.C. 78o–3(b)(6).

[11] As noted in the Interpretation, members accepting customer limit orders continue to owe those customers duties of ''best execution,'' *i.e.,* a duty to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions.

[12] 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, including an analysis of whether there should be a uniform minimum trading increment. 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.

[13] 15 U.S.C. 78s(b)(2).

[14] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–44150; File No. SR–PCX–00–36]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Exchange, Inc. Relating to Solicited Options Transactions

April 4, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 26, 2001, the Pacific Exchange, Inc. (''PCX'' or ''Exchange''), filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange.[3] The proposed rule change has been filed by the PCX as a ''non-controversial'' rule change under Rule 19b–4(f)(6)[4] under the Act. 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 PCX is proposing to add new PCX Rule 6.49 to allow members representing an options order to solicit a third party outside of the trading crowd. Below is the text of the proposed rule change. Proposed new language is in italics.

* * * * *

¶4995 Solicited Transactions

Rule 6.49

(a) A member or member organization representing an order in options (''originating order'') may solicit another member, member organization or non-member broker/dealer outside the trading crowd (''solicited party'') to participate in the transaction on a proprietary basis provided the following criteria are met.

(1) *The member or member organization, upon entering the trading crowd to execute the transaction must announce to the trading crowd the same terms and conditions of the originating order that have been disclosed to the solicited party;*

(2) *The member or member organization must bid at the price he is prepared to buy from the solicited party or offer at the price he is prepared to sell to the solicited party; and*

(3) *The member or member organization must give the trading crowd a reasonable opportunity to accept the bid or offer.*

The members of the trading crowd will have priority over the solicited party order.

(b) It will be considered conduct inconsistent with just and equitable principles of trade for any member, member organization or person associated with a member or member organization, who has knowledge of all material terms and conditions of an originating order, a solicited order, or a facilitation order, the execution of which are imminent, to enter, based on such knowledge, an order to buy or sell an option on the underlying securities of any option that is the subject of the order, or an order to buy or sell the security underlying any option that is the subject of the order, or any order to buy or sell any related instrument until either:

(1) *All the terms and conditions of the originating order and any changes in the terms or conditions of the order of which the member, member organization or person associated with the member or member*

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The PCX filed its submission of January 26, 2001, in the form of an amendment to an earlier version of the proposed rule change filed with the Commission on October 24, 2000. *See* Letter from Hassan Abedi, attorney, PCX, to Nancy J. Sanow, assistant director, Division of Market Regulation, the Commission, dated January 25, 2001. For purposes of Rule 19b4(f)(6) under the Act, the Commission deems the date of filing and effectiveness of the proposed rule change to be January 26, 2001.

[4] 17 CFR 240.19b–4(f)(6).