

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44194; File No. SR-NYSE-97-18]

### Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change Relating to Specialists' Entry of Bids and Offers in Electronic Communications Networks and Other Market Centers

April 18, 2001.

#### I. Introduction

On June 2, 1997, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), 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> a proposed rule change to prohibit a specialist from entering bids and offers in electronic communications networks ("ECNs") or other market centers at prices superior to the specialist's quote on the Exchange. On November 19, 1997, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On February 10, 1999, the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>4</sup>

The proposed rule change, including Amendment Nos. 1 and 2, were published for comment in the **Federal Register** on May 20, 1999.<sup>5</sup> The Commission received three comment letters on the proposal. This order approves the proposed rule change as amended.

#### II. Description of the Proposal

The proposal would amend NYSE Rule 104.10 to explain that a specialist<sup>6</sup> has a duty to quote his or her best bid and offer on the Exchange. Under the proposed rule, a specialist's bid or offer for a specialty stock on the Exchange could not be inferior to his or her bid or offer in an ECN or another market

center.<sup>7</sup> Thus, if a specialist placed a bid or offer in an ECN or on another market center at a price superior to the then disseminated best bid or offer on Exchange, the specialist would be required to communicate<sup>8</sup> such price to the Exchange.

In addition, the proposed rule change would prohibit a specialist from entering a bid or offer for a specialty stock in an ECN or on another market center at a price variation in which the specialist would not be permitted to quote or trade under Exchange rules. The Exchange believes that if the specialist placed a superior priced bid or offer in an ECN<sup>9</sup> or other market center at a variation that could not be quoted or traded on the Exchange, the specialist would be unable to satisfy his or her specialist obligations, *i.e.*, the specialist could not trade at his or her best bid or offer with contra-side marketable orders received on the Exchange. Also, if the specialist placed in an ECN or other market center an inferior bid or offer at a variation not accepted by the Exchange and the order was subsequently executed on the ECN or other market center, the specialist could not satisfy any superior-priced orders on his or her book at the price of his or her trade off the Exchange, consistent with his or her responsibilities as agent.

#### III. Summary of Comments

The Commission received comment letters from American Century Investment Management ("ACIM") and Archipelago, LLC, opposing the proposed rule change.<sup>10</sup> The Exchange responded to these letters but did not amend the proposed rule change.<sup>11</sup>

In its letter, ACIM suggested that the proposal was an attempt by the NYSE to control the trading of its own member firms to protect the NYSE's monopoly of

listed equity trading in the U.S. ACIM urged the Commission to reject the proposal because it limits the competitiveness of the U.S. equity markets, raises the costs for investors, and conflicts with the Order Handling Rules ("OHR")<sup>12</sup> by limiting the choices of specialists in the display and routing of orders. ACIM also questioned how the proposal would be implemented after decimalization, asking: (1) Will the specialist be forced to follow the increment selected by the NYSE, and (2) what happens to orders routed to the NYSE that do not meet the increment guidelines of the NYSE? In addition, ACIM argued that when a specialist faces the possibility of double liability because the specialist has used an ECN to post an order, the NYSE should not be able to mandate procedures for the specialist's behavior; the specialist should be able to make his own investment decisions.

Archipelago also challenged the proposal as anti-competitive. Specifically, Archipelago charged that the proposal violates the 1975 Amendments to the Act<sup>13</sup> and Rule 19c-1<sup>14</sup> because it undermines the concept of the National Market System ("NMS") by severely limiting the ability of specialists to use ECNs in an agency capacity, which in turn prevent specialists from meeting their best execution obligations to customers.<sup>15</sup> In addition, the proposal deprives investors of pricing efficiency and flexibility; specifically the ability to enter competitively priced limit orders in sub- $\$1/16$  increments. Archipelago further commented that the proposal, by limiting the ability of specialists to use ECNs competitively, is an attempt to circumvent the OHR, which require full integration of ECNs into the marketplace. Lastly, Archipelago stated that the NYSE has not provided any meaningful analysis concerning the competitive effects of the proposal as required by Rule 19b-4,<sup>16</sup> offering only perfunctory boilerplate.

In response, the Exchange argued that Archipelago and a ACIM's letters mischaracterized the NYSE's proposal and raised broad policy questions regarding the future evolution of the NMS that are not relevant to the

<sup>7</sup> "Another market center" means a registered national securities exchange or registered national securities association.

<sup>8</sup> The Exchange views "communicate" in this context to require the specialist to make the price, whether the bid or the offer, available for execution on the Exchange. The specialist would then be liable for executions at this price on both the Exchange and on the ECN or other market center.

<sup>9</sup> The proposed rule applies only to specialists when they add liquidity to an ECN or another market center (*i.e.*, enter a new bid or offer) and not when they remove liquidity (*i.e.*, hit a pre-existing bid or offer) or enter "fill-or-kill" orders.

<sup>10</sup> See letter from Mike Cormack, Manager, Equity Trading, ACIM, to Jonathan G. Katz, Secretary, SEC, dated July 28, 1999. The Commission received two substantially similar comment letters from Archipelago. See letters from Gerald D. Putnam, CEO, Archipelago, to Jonathan G. Katz, Secretary, SEC, dated July 20 and July 21, 1999.

<sup>11</sup> See Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, dated September 23, 1999.

<sup>12</sup> Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

<sup>13</sup> 15 U.S.C. 78k-1.

<sup>14</sup> Rule 19c-1 precludes exchanges from prohibiting exchange members from routing customer orders to off-exchange trading venues. 17 CFR 240.19c-1.

<sup>15</sup> Archipelago also noted that off-exchange restrictions on proprietary specialist trading are inconsistent with the NMS as well.

<sup>16</sup> 17 CFR 240.19b-4.

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

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

<sup>3</sup> In Amendment No. 1, NYSE modified references the Exchange had made to the Commission's Quote Rule.

<sup>4</sup> In Amendment No. 2, NYSE removed all references to the Commission's Quote Rule. NYSE also eliminated its proposed exemption for bids or offers relating to program trading orders entered into an ECN or other market centers by an upstairs trading operation conducted by a specialist member organization.

<sup>5</sup> Securities Exchange Act Release No. 41397 (May 13, 1999), 64 FR 27610.

<sup>6</sup> The Exchange defines "specialist" as an individual specialist on the floor.

proposed rule change. Specifically, the NYSE responded that the proposal does not undermine the NMS or Rule 19c-1 because the proposal does not impose any restrictions on the routing of customer orders. The proposal only sets standards for a specialist's market maker bid or offer on the exchange. The NYSE also stated that the proposal is consistent with the OHR because it does not impose any restrictions on a specialist's responsibility to display customer orders.

Further, the NYSE wrote that the proposal does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act with respect to the routing of customer limit orders to ECNs or other market centers. The NYSE opined that the restriction on specialists is appropriate because it is designed to ensure that specialists' dealer capital is committed to meeting their affirmative obligation to maintain fair and orderly markets in the primary market in which they are registered as dealers. Finally, the NYSE argued that each market center would determine its own decimal trading variation. If these variations are the same, then the restriction against bidding or offering at a variation not permitted on the Exchange will not apply. In any event, the NYSE suggested that contra side order flow would seek to trade at whatever variation it chooses.

#### IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of section 6(b)(5) and 6(b)(8).<sup>17</sup> Section 6(b)(5) requires that the rules of an exchange be designated to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>18</sup> Section 6(b)(8) requires that the rules of an exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Further, the Commission finds that the proposal is consistent with section 11(b) of the Act<sup>19</sup> and Rule 11b-1 thereunder,<sup>20</sup> which allow exchanges to promulgate rules relating to specialists to ensure orderly markets.

Specialists play a crucial role in providing stability, liquidity, and continuity to the trading of securities on the Exchange. In return for the privilege of serving as the only specialist in stocks traded on the NYSE, which as the primary market for listed stocks continues to receive a significant percentage of the order flow, the NYSE improves conditions designed to improve the quality of its market. Among the obligations imposed upon specialists by the Exchange, and by the Act and rules thereunder, is the maintenance of an orderly market in designated securities.<sup>21</sup> To ensure that specialists fulfill these obligations, it is important that the Exchange have the ability to implement rules and develop measures to guide and improve specialists' performance. The Commission believes that the proposal is consistent with the Exchange's objective to promote the maintenance of orderly markets because it enhances the Exchange's ability to encourage improved specialist performance and market quality by clarifying specialists' duty at the NYSE—to quote his or her best bid and offer on the Exchange.

The Commission carefully considered the concerns expressed by Archipelago and AICM in their letters opposing the proposal. Although the proposed rule change places restrictions on specialists, the Commission finds that the restrictions are reasonable. First, NYSE's proposal only applies to the bids and offers of individual specialists on the floor of the Exchange. The Commission notes that the NYSE has amended the proposal so that it no longer applies to affiliates of individual specialists. Therefore, the proposal is limited to the firms that benefit from the privilege of acting as specialists on the NYSE. Second, the proposal is not inconsistent with Rule 19c-1 because it does not impose restrictions on the routing of customer orders. Third, it is not inconsistent with the OHR because it does not impose restrictions on a specialist's responsibility to display customer orders. Specialists will continue to have an obligation under the OHR to display a customer limit order that betters their quote.<sup>22</sup> Fourth, exchanges have historically maintained a minimum increment for quoting and trading listed securities on the exchange in order to ensure fair and orderly trading, including capacity limitations

of exchange computer systems.<sup>23</sup> Fifth, as discussed above, exchanges need to have the ability to set standards for specialists' performance. This proposal with allow specialists to meet their obligations by ensuring that if a specialist places a superior priced bid or offer on an ECN or other market center, the specialist can trade at his or her best bid or offer with contra-side marketable orders received on the Exchange.

For these reasons, the Commission finds that the proposal is consistent with the Act, including sections 6(b)(5), 6(b)(8) and 11(b), in that it does not impose any burden on competition that is not necessary or appropriate in furtherance of the Act.

#### V. Conclusion

*It is Therefore Ordered*, pursuant to section 19(b)(2) of the Act,<sup>24</sup> that the proposed rule change (SR-NYSE-97-18), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>25</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 01-10232 Filed 4-24-01; 8:45 am]

BILLING CODE 8010-01-M

---

### OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE

[Docket No. 301-121]

#### Notice of Change in Location of Public Hearing: Intellectual Property Laws and Practices of the Government of Ukraine

**AGENCY:** Office of the United States Trade Representative.

**ACTION:** Notice.

**SUMMARY:** The location of the public hearing scheduled for April 27, 2001 in the Section 302 investigation of the intellectual property laws and practices of the Government of Ukraine has been changed to the Office of the United States Trade Representative, 1724 F Street, NW., Rooms 1 and 2, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Sybia Harrison, Staff Assistant to the Section 301 Committee, (202) 395-3419; or William Busis, Associate General Counsel, (202) 395-3150.

**SUPPLEMENTARY INFORMATION:** In a notice published on April 6, 2001 (66 FR

<sup>17</sup> 15 U.S.C. 78f(b)(5) and 78f(b)(8).

<sup>18</sup> In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>19</sup> 15 U.S.C. 78k(b).

<sup>20</sup> 17 CFR 240.11b-1.

<sup>21</sup> See, e.g., 17 CFR 240.11b-1; NYSE Rule 104.

<sup>22</sup> See *supra* note 11 at 48316; see also NYSE Rule 79A.

<sup>23</sup> Currently, the exchanges have adopted a minimum price variation of a penny. See Securities Exchange Act Release No. 42914 (June 8, 2000).

<sup>24</sup> 15 U.S.C. 78s(b)(2).

<sup>25</sup> 17 CFR 200.30-3(a)(12).