

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44593; File No. SR-NASD-2001-39]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Manning Pilot on the OTC Bulletin Board

July 26, 2001.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder, notice is hereby given that on June 7, 2001, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), 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 Nasdaq. Nasdaq has designated the proposed rule change as constituting a "non-controversial" rule change under Paragraph (f)(6) of Rule 19b-4 under the Act,<sup>3</sup> which renders the proposal effective upon receipt of this filing by the Commission. 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

Nasdaq is herewith filing a proposal to amend NASD Rule 6541 which, for a pilot period ending February 8, 2002, prohibits member firms from trading ahead of customer limit orders in designated OTC Bulletin Board ("OTCBB") securities. Specifically, Nasdaq proposes to amend Subsection (b) of NASD Rule 6541 for a three-month pilot period to reduce the minimum price improvement increment establishment therein from five cents to one cent, as explained in more detail below. Nasdaq believes that this change is non-controversial and, therefore, will implement the change immediately upon filing, pursuant to Rule 19b-4(f)(6) under the Act. The three-month pilot change to NASD Rule 6541(b) will operate from August 1, 2001, to November 1, 2001.

The text of this rule change is provided below. Proposed new language

is in italics; proposed deletions are in brackets.

\* \* \* \* \*

#### 6541. Limit Order Protection

(a) Members shall be prohibited from "trading ahead" of customer limit orders that a member accepts in securities quoted on the OTCBB. Members handling 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 customer limit order without executing the limit order. Members are under no obligation to accept limit orders from any customer.

(b) Members may not avoid such obligation specified in paragraph (a) through the provision of price improvement, unless: [such price improvement is for a minimum of the lesser of \$.05 or one-half (1/2) of the current inside spread.]:

*(1) for customer limit orders priced at or inside the current inside spread, the price improvement is for a minimum of the lesser of \$.01 or one-half (1/2) of the current inside spread; or*

*(2) for customer limit orders priced outside the current inside spread by \$.01 or less, the market maker executes the incoming order at or better than the inside bid (for held buy orders) or offer (for held sell orders).*

*(3) for customer limit orders priced more than \$.01 outside the current inside spread, no obligation is imposed under subsection (a) above.* For purposes of this rule, the inside spread shall be defined as the difference between the best reasonably available bid and offer in the subject security.

(c)-(e) 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 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. 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

On February 8, 2001, the Commission approved new NASD Rule 6541 which,

on a pilot basis, applies the basic customer limit order protection principles that presently apply to Nasdaq securities to certain designated securities that are traded on the OTCBB. NASD Rule 6541(a), in general, prohibits member firms that accept customer limit orders in these securities from trading "ahead" of their customers for their own account at prices equal or superior to the limit orders, without executing them at the limit price. NASD Rule 6541(b) requires member firms to provide a minimum level of price improvement to incoming orders in OTCBB securities if the firm chooses to trade as principal with those incoming orders at prices superior to customer limit orders they currently hold. Specifically, NASD Rule 6541(b) states that members may not avoid their obligations under the Rule "through the provision of price improvement, unless such price improvement is for a minimum of the lesser of \$0.05 or one-half (1/2) of the current inside spread." 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 rule.

On March 2, 2001, the Commission approved on a pilot basis a Nasdaq proposal that established a different price improvement increment for the trading of Nasdaq issues than that established in NASD Rule 6541 with respect to the OTCBB.<sup>4</sup> Nasdaq's proposal established a uniform \$0.01 price improvement standard for Nasdaq market makers who elect to execute proprietary transactions in decimalized securities 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 market maker) those customer orders. After that approval, Nasdaq became aware of certain anomalies that occur under its then-existing Manning rule when market makers elect to provide their customers the ability to enter orders into the firms' proprietary system in price increments smaller than a penny. Accordingly, on April 6, 2001, the Commission approved, on an expedited basis, modifications to NASD IM-2110-2.<sup>5</sup>

<sup>4</sup> See Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001).

<sup>5</sup> See Securities Exchange Act Release No. 44165 (April 6, 2001), 66 FR 19268 (April 13, 2001) (approving proposal to establish new trading-ahead

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

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

<sup>3</sup> 17 CFR 240.19b-4(f)(6).

As noted in the original filing to extend trading-ahead prohibitions to OTCBB securities on a pilot basis, the limit order protection embodied in NASD Rule 6541 is an investor protection tool based on NASD IM-2110-2 (commonly known as the "Manning Rule"). In *Manning*, the NASD found and the Commission affirmed that a member firm that accepts a customer limit order has a fiduciary duty not to trade for its own account at prices more favorable than the customer order.<sup>6</sup> NASD Rule 6541 expands, to securities traded on the OTCBB, the protections that NASD IM-2110-2 currently provides only to securities traded on the Nasdaq National Market and SmallCap Market. In fact, when Nasdaq proposed to the Commission that the price improvement increment be set at five cents, it indicated that "this increment is based upon, and consistent with, Nasdaq's guidance on Members' Manning obligations when trading Nasdaq National Market and SmallCap securities."<sup>7</sup>

Nasdaq believes that the cost for stepping ahead of a customer's limit order should not be higher in the OTCBB, where stock prices are significantly lower, than in Nasdaq. Accordingly, Nasdaq is amending NASD Rule 6541(b) to resemble the relevant language of NASD IM-2110-2, including the amendments approved by the Commission on April 6, 2001. Nasdaq will implement this rule change for three months from the date that NASD Rule 6541 takes effect. Nasdaq has stated that it will give effect to NASD Rule 6541 30 days following the publication of a Notice to Members that explains the operation of NASD Rule 6541, including the operation of the price improvement increment.

Under the proposal, Nasdaq would implement on the OTCBB a price improvement requirement of \$0.01 or one-half the inside spread (whichever is less) for a market maker wishing to trade on a proprietary basis in front of a held customer limit order that is priced at or inside the current inside spread for an OTCBB security. For customer limit orders priced outside the inside spread, however, Nasdaq proposes to adopt a different standard. This standard would require a market maker seeking to trade

in front of such a limit order, without triggering a Manning obligation, to execute its trade at a price at least equal to the inside bid (with respect to held customer limit orders to buy) or inside offer (for held orders to sell<sup>8</sup>). Market makers will be required to protect only customer limit orders that fall within \$0.01 outside the current inside spread.

The following examples illustrate how the proposed rule would operate:

#### Example #1

*Market is 5.00 to 5.01 with MMA's posted bid and offer at the inside*

*MM receives and accepts Customer #1's limit order to buy priced at 5.004 for 2000 shares*

*MM receives a market sell order directed to its posted bid of 5.00 for 1000 shares and immediately executes that order on a proprietary basis*

Here, since MMA has executed within \$0.01 of Customer #1's inside-the-spread buy limit order of 5.004, MMA would be obligated to protect that order and execute 1000 shares of Customer #1's order at a price of 5.004. If MMA wished to avoid a Manning obligation with respect to Customer #1's 5.004 buy limit order, MMA would have to execute its proprietary trade at a price at least \$0.005 better than that limit order and execute at 5.009.

#### Example #2

*Market is 10.00 to 10.01 with MMA'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 Manning changes proposed here, since the market maker's 700 share proprietary order was executed at a price (10.00) that is at least equal to the inside bid, it would not be obligated to execute that limit order. Similarly, if the market remained at 10.00 to 10.01 and MMA held a customer limit order to sell priced at 10.016, MMA could trade proprietarily with an incoming buy order without triggering a Manning obligation with respect to the 10.016 outside-the-spread limit order if the market maker executes its proprietary trade at a price of at least 10.01.<sup>9</sup>

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 trading losses to market makers who, in meeting their firm quote and best-execution obligations to other market participants, trade near customer limit orders priced outside the spread.

Nasdaq has stated that both Nasdaq and NASD Regulation will closely monitor the protection of customer limit orders and analyze and evaluate trading activity to determine if future changes to the NASD Rule 6541 price improvement standard are warranted. One goal of this pilot program is to bring NASD Rule 6541 into closer conformity with NASD IM-2110-2, and to permit Nasdaq to analyze the extent to which the two rules should differ.

#### 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act<sup>10</sup> in that it is designed to: (1) Promote just and equitable principles of trade; (2) foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities; (3) perfect the mechanism of a free and open market and a national market system; and (4) 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

The proposed rule change has been filed by Nasdaq as a "non-controversial"

Nasdaq. Telephone conversation between Jeffrey Davis, Assistant General Counsel, Nasdaq, and Michael Gaw, Special Counsel, Division of Market Regulation, Commission, on July 24, 2001.

<sup>10</sup> 15 U.S.C. 78o-3(b)(6).

increment on Nasdaq, on a pilot basis, until July 9, 2001); see also Securities Exchange Act Release No. 44529 (July 9, 2001), 66 FR 37082 (July 16, 2001) (extending pilot program until November 5, 2001.)

<sup>6</sup> See In re E.F. Hutton & Co., Securities Exchange Act Release No. 25887 (July 6, 1988) ("Manning")

<sup>7</sup> See Letter from Jeffrey S. Davis, Assistant General Counsel, Nasdaq, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated January 24, 2001 (Amendment No. 2 to SR-NASD-00-22).

<sup>8</sup> In the filing submitted by the NASD, this phrase originally appeared as "\* \* \* or inside offer (for held orders to buy)" but has been corrected in the manner that appears above. Telephone Conservation between Jeffrey S. Davis, Assistant General Counsel, Nasdaq, and Michael Gaw, Special Counsel, Division of Market Regulation, Commission, on July 16, 2001.

<sup>9</sup> A third example that was provided in the draft notice has not been published at the request of

rule change pursuant to Rule 19b-4(f)(6) under the Act.<sup>11</sup> Nasdaq has stated that, because the foregoing proposed rule change: (1) Does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative until more than 30 days from the date on which it was filed, and Nasdaq provided the Commission with written notice of its intent to file the proposed rule change at least five days prior to the filing date, the proposed rule change has become immediately effective. In addition, the establishment of this pilot program will permit Nasdaq to monitor the operation of NASD Rule 6541 on the OTCBB, and to analyze the extent to which NASD Rule 6541 and NASD IM-2110-2 should differ.

At any time within 60 days of this filing, the Commission may summarily abrogate this proposal if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

Nasdaq has stated that it would implement the new trading-ahead provisions of NASD Rule 6541(b) for a three-month period from the date that NASD Rule 6541 takes effect. Nasdaq also has stated that it would give effect to NASD Rule 6541 30 days following publication of a Notice to Members that will explain the operation of NASD Rule 6541, including the operation of the new price improvement provisions. This Notice to Members was published in July 2001 and indicates that NASD Rule 6541 will become effective on August 1, 2001, and that the price improvement provisions of NASD Rule 6541(b) will be effective until November 1, 2001.<sup>12</sup> The overall pilot program for Manning protection of selected OTCBB securities will be effective until February 8, 2002.

#### 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 in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2001-39 and should be submitted by August 23, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44596; File No. SR-NYSE-00-61]

#### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the New York Stock Exchange, Inc., Amending the Interpretation of NYSE Rule 412, "Customer Account Transfer Contracts"

July 26, 2001.

On December 22, 2000, the New York Stock Exchange, Inc., ("NYSE") filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") and on February 12, 2001, amended the proposed rule change.<sup>1</sup> Notice of the proposal was published in the **Federal Register** on May 22, 2001.<sup>2</sup> Four comment letters were received.<sup>3</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

#### I. Description

NYSE Rule 412, "Customer Account Transfer Contracts," prescribes

procedures for member organizations transferring customer accounts and requires the use of the Automated Customer Account Transfer Service ("ACATS") that is administered by the National Securities Clearing Corporation ("NSCC"). Since ACATS's inception in 1985, several enhancements to the system and to NYSE Rule 412 have allowed for faster and more efficient transfers of customer accounts. Recent ACATS modifications facilitate the transfer of accounts containing third party and/or proprietary products.

In the current ACATS environment, a carrying firm must deliver third party mutual funds without knowing whether the receiving firm has the capability to accept, service, and support such funds. If the receiving firm cannot support a particular fund, the delivery will be made to the receiving firms and then reversed back to the carrying firm. This results in substantial processing time by both firms and an overall delay in completing the transfer.<sup>4</sup>

The proposed amendments to paragraphs (b)(1)/01, /04, and /06 of the Interpretation of NYSE Rule 412, in conjunction with the corresponding recent modifications to the ACATS system, require the receiving firms to review an asset validation report provided by the carrying firms and designate those third party products (i.e., mutual funds/money market funds) it is unable to support. Regarding the third party products it is unable to support, the receiving firm will have to provide the customer with a list of the specific assets and will have to request in writing further instructions from the customer with respect to the disposition of those third party products prior to or at the time it makes such a designation. The customer would, at minimum, have to be provided with the following options: (1) Liquidation; (2) retention by the carrying organization; (3) physical delivery in the customer's name to the customer; or (4) transfer to the third party that is the original source of the product. The transfer of the other assets in the account will be undertaken simultaneously with the receiving firm's designation of nontransferable assets.

The amendments also include a notification enhancement that will expedite the disposition of nontransferable proprietary products of

<sup>13</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> Securities Exchange Act Release No. 44302 (May 14, 2001), 66 FR 28210.

<sup>3</sup> Letters to Jonathan G. Katz, Secretary, Commission from Richard Bommer, President, Customer Account Transfer Division, Securities Industry Association (June 6, 2001); Brian Warshaw, Director, Merrill Lynch, Pierce, Fenner & Smith (June 8, 2001); Pattie Schuchman, Associate Vice President, A.G. Edwards & Sons, Inc. (June 11, 2001); and Frederic M. Krieger, Senior Vice President, Charles Schwab & Co., Inc. (June 15, 2001).

<sup>4</sup> NYSE-member organizations approximate that 50% of their ACATS "fails-to-deliver" that are ultimately reversed are caused by the attempted transfer of mutual funds that the receiving firm is unable to support. The ACATS-generated fails result in considerable expense to carrying firms because they are required to credit the receiving firm funds equivalent to the value of the assets they are unable to deliver.

<sup>11</sup> 17 CFR 240.19b-4(f)(6)

<sup>12</sup> See NASD Notice to Members 01-46.