

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45276; File No. SR-NASD-202-06]

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

January 14, 2002.

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 January 14, 2002, 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

This is a proposal to extend through July 15, 2002, two pilot programs contained in NASD Rule 6541, which prohibits member firms from trading ahead of customer limit orders in designated OTC Bulletin Board ("OTCBB") securities. NASD Rule 6541 was established on a pilot basis through February 8, 2002. Portions of NASD Rule 6541 were separately amended for a pilot period that originally ran for a three-month period from August 1, 2001, to November 1, 2001, and was later extended through January 14, 2002. Nasdaq is proposing no changes to the language of NASD Rule 6541.

Pursuant to Rule 19b-4(f) under the Act, Nasdaq has designated this proposal as non-controversial and has provided the Commission with the 5-day notice required by Rule 19b-4(f)(6)(iii). Nasdaq requests that the Commission waive the 30-day pre-operative requirement contained in Rule 19b-4(f)(6)(iii). If such waiver is granted by the Commission, the two pilots

programs would continue to operate without interruption, remaining in effect until July 15, 2002.

#### 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 concerning the purpose of an 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 Section, 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, extended the basis customer limit order protection principles—that presently apply to Nasdaq securities—to designated securities traded on the OTCBB.<sup>4</sup> 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 while holding customer limit orders. 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.

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 fiduciary duty not to trade for its own account at prices more favorable than the customer order.<sup>5</sup> NASD Rule 6541 expands to the trading of OTCBB the protections that NASD IM-2110-2 provides to the

trading of Nasdaq National Market and SmallCap securities.

On March 2, 2001, and April 6, 2001, the Commission approved modifications to NASD IM-2110-2.<sup>6</sup> In general, these modifications narrowed the amount of price improvement required to avoid the obligation to file a customer limit order, in recognition of the introduction of decimal pricing of Nasdaq securities. On July 26, 2001, Nasdaq filed and implemented an amendment to NASD Rule 6541(b) (SR-NASD-2001-39) that likewise narrowed the amount of required price improvement for trading of OTCBB securities.<sup>7</sup> As originally drafted, NASD Rule 6541(b) required price improvement of at least the lesser of \$0.05 or one-half of the current insider spread. Under SR-NASD-2001-39, the price improvement requirement was narrowed to \$0.01 or one-half the inside spread (whichever is less) for a market maker wishing to trade in front of a held customer limit order that is priced at or inside the current inside spread for an OTCBB security. For a customer limit order priced less than \$0.01 outside the inside spread, however, SR-NASD-2001-39 required a market seeking to trade in front of such limit order to execute its trades at a price at least equal to the inside bid (with respect to a held customer limit order to buy) or inside offer (for a held order to sell). Moreover, SR-NASD-2001-39 provided that limit order protection would not apply to a customer limit order that was priced more than \$0.01 outside the current inside spread. The amendment to NASD Rule 6541 (b) adopted by SR-NASD-2001-39 was effective for a three-month pilot period that ended on November 1, 2001.

At the expiration of that period, Nasdaq amended Rule 6541(b) to eliminate the minimum price improvement requirement for limit orders outside the inside spread.<sup>8</sup> Accordingly, any degree of price improvement would relieve a market maker from the obligation to fill a limit order that is outside of the inside spread. At the same time, Nasdaq eliminated the provision of the pilot

<sup>6</sup> See Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001) (approving SR-NASD-2001-09); Securities Exchange Act Release No. 44165 (April 6, 2001), 66 FR 19268 (April 13, 2001) (approving SR-NASD-2001-27). See also Securities Exchange Act Release No. 44529 (July 9, 2001), 66 FR 37082 (July 16, 2001) (SR-NASD-2001-43).

<sup>7</sup> See also Securities Exchange Act Release No. 44593 (July 26, 2001), 66 FR 40304 (August 2, 2001).

<sup>8</sup> See Securities Exchange Act Release No. 45011 (November 1, 2001), 66 FR 56587 (November 8, 2001) (SR-NASD-2001-78).

<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).

<sup>4</sup> See Securities Exchange Act Release No. 43944 (February 8, 2001), 66 FR 10541 (February 15, 2001) (approving SR-NASD-00-22).

<sup>5</sup> See *In re E.F. Hutton & Co.*, Securities Exchange Act Release No. 25887 (July 6, 1988 ("Manning")).

that provided no limit order protection to customer limit orders that are priced more than \$0.01 outside the current inside spread. Thus, the basic prohibition on trading ahead of a customer limit order at a price equal or superior to the limit order, without filling the limit order, applies to all limit orders in OTCBB securities covered by NASD Rule 6541. The amount of required price improvement for limit orders priced inside the current inside spread remained the lesser of \$0.01 or one-half of the current inside spread.

Nasdaq has represented that it is actively studying the impact of NASD Rule 6541 on quoting and trading of OTCBB securities. Nasdaq believes that a six-month extension of both pilots is necessary to allow Nasdaq to collect and analyze sufficient data upon which to base its analysis. Nasdaq further believes, preliminarily, that NASD Rule 6541 has had a positive effect on investors. Accordingly, it is Nasdaq's intent to implement limit order protection on a permanent basis at or before the end of this pilot extension.<sup>9</sup>

## 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) maintain the current rule language without a lapse, in keeping with the public interest and the protection of investors.

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

Nasdaq does not believe that the proposed rule change would 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 rule change pursuant to Rule 19b-4(f)(6) under the Act. Nasdaq represents that 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 for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest; therefore, it has become immediately effective pursuant to Section 19(b)(3)(A) of the Act<sup>11</sup> and Rule 19b-4(f)(6) thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change 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 requested that the Commission waive the 30-day pre-operative period required by Rule 19b-4(f)(6), which would allow the proposal to become operative immediately. The Commission finds that granting this request is consistent with the protection of investors and the public interest, as the price improvement standards under NASD Rule 6541 will remain in effect on an uninterrupted basis, thereby furthering the aim of protecting investors and the public interest.<sup>12</sup>

## 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-2002-06 and should be submitted by February 12, 2002.

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. 34-45277; File No. SR-NASD-99-04]

### Self-Regulatory Organizations; Notice of Filing of Amendment No. 1 to Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Microcap Initiative—Recommendation Rule

January 14, 2002.

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 January 11, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") Amendment No. 1 to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The proposed rule change was published for comment in the **Federal Register** on March 1, 1999.<sup>3</sup> The Commission is publishing this notice to solicit comments on Amendment No. 1 from interested persons.

### I. Self-Regulatory Organizations Statement of the Terms of Substance of the Proposed Rule Change

NASD Regulation is proposing to amend the rules of the Association to add a new rule, Rule 2315. Below is the text of the proposed new rule, as filed

<sup>9</sup> The Commission notes that permanent approval of limit order protection for OTCBB securities would require the NASD to submit a proposed rule change to this effect under Section 19(b) of the Act, 15 U.S.C. 78s(b).

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

<sup>11</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>12</sup> For the purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>13</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.

<sup>3</sup> See Securities Exchange Act Release No. 41075 (February 9, 1999), 64 FR 10037.