

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45957; File No. SR-NASD-2002-23]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by National Association of Securities Dealers, Inc. Relating to Continuous Operation of the Nasdaq National Market System During Market Hours

May 17, 2002.

Pursuant to section 19(b)(1) of the Act,<sup>1</sup> notice is hereby given that on February 14, 2002, 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 ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq filed Amendment No. 1 on May 17, 2002.<sup>2</sup> 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 proposed rule change will allow the continued operation of the National Market Execution System ("NNMS" or "SuperSoes") so as to trade through the inside quotations of market participants that are inaccessible through the SuperSoes system. Below is the text of the proposed rule change. Proposed deletions are in brackets.

\* \* \* \* \*

4710. Participant Obligations in NNMS (a) through (b)(9)

[(10) In the event that there are no NNMS Market Makers at the best bid (offer) disseminated by Nasdaq, market orders to sell (buy) entered into NNMS will be held in queue until executable, or until 90 seconds has elapsed, after

which such orders will be rejected and returned to their respective order entry firms.]

\* \* \* \* \*

#### 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

In July of 2001, Nasdaq implemented SuperSoes, which provides for automatic execution against most market participant quotes in Nasdaq National Market Securities. While a great improvement over the order-delivery environment prevalent in Nasdaq before its adoption, the current operation and functionality of SuperSoes can, in a specific instance, inappropriately inhibit the smooth functioning of the Nasdaq market. This occurs when non-SuperSoes, and thus non-auto-executable, Electronic Communications Networks ("ECNs") that link to the market via Nasdaq's SelectNet order-delivery system are alone in posting the best price to buy or sell a particular security. SuperSoes will automatically execute only at the best-displayed bid or offer. If an ECN is alone in displaying either the best price to buy or sell a particular security, all SuperSoes orders entered into the system on the opposite side of the market where the ECN's best price remains alone are held by the SuperSoes system for up to 90 seconds, or until the ECN moves its quote, or until a market participant accessible via SuperSoes also moves to the inside price. During the period an ECN remains alone at the best price, the SuperSoes system, in effect, shuts down. The suspension of the SuperSoes system's operation in this circumstance prevents other market participants from automatically accessing liquidity at and near the inside and significantly degrades market quality and functionality for the overwhelming majority of Nasdaq market participants, including public investors. These negative impacts are borne out by a recent analysis by

Nasdaq's Economic Research Department of execution times in the SuperSoes system. That analysis is summarized below.

First, the analysis indicates approximately 42% of total SuperSoes orders are significantly slowed down (taking over 1/2 second to execute) because an ECN that does not accept automatic execution is alone at the inside.<sup>3</sup> In Nasdaq 100 securities, approximately 47% of SuperSoes orders are similarly delayed. The sheer length of these delays is also troublesome, with the average execution time of SuperSoes orders in Nasdaq 100 securities when an ECN is alone at the inside taking over 5 times as long (1.03 seconds) to execute, than when an auto-ex participant is at the inside and the SuperSoes system operates without restriction (0.19 seconds).

These delays are also related to just how often SuperSoes is prevented from performing at all. In Nasdaq 100 stocks, ECNs that do not take automatic execution are alone at either the bid or offer an average 70% of the time (for the median stock, 75% of the time). This means that Nasdaq's SuperSoes system is not processing normally on either the bid or offer side of market the majority of the time in one or more of Nasdaq's most active securities.

Not surprisingly, these delays also have a material impact on the execution that a party entering a SuperSoes order can expect. Nasdaq's analysis indicates that a party entering an order into SuperSoes when an ECN is alone at the inside has just a 33% chance that its order will be executed in full. When SuperSoes has an auto-ex participant at the inside, the system continues to operate, and the chance of getting an order executed in full rises dramatically to over 70%. In short, Nasdaq's analysis shows that the continuous shutting down of Nasdaq's primary execution facility has dramatic detrimental consequences for the investing public.

In response, Nasdaq has determined to modify the operation of SuperSoes as it relates to the processing of orders where an ECN is alone at the best price. In short, SuperSoes will be modified so as to not automatically shut down when an ECN is alone at the inside. Market participants will be able, consistent with ongoing best execution obligations, to continue to send market orders, or marketable limit orders, to SuperSoes

<sup>3</sup> A portion of this delay is also attributable to processing queues in the SuperSoes system itself. It is Nasdaq's view that many of these queues form as the direct result of orders not being allowed to execute automatically because SuperSoes suspends operation when an ECN that does not take automatic execution is alone at the inside.

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

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

<sup>2</sup> See Letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission (May 17, 2002).

for execution. Firms not wishing to bypass ECNs alone at the inside quote will continue to have the option to direct Nasdaq to attempt to access the ECN's quote via SelectNet if they so desire.

By enhancing SuperSoes to allow it to automatically access liquidity on an ongoing basis, Nasdaq market participants will be given the maximum amount of flexibility to protect and service their customers. In addition, the removal of the potential single point of failure represented by a single ECN quote at the inside market which is accessible only through a separate, and non-automatic, execution linkage ensures that the main trading system of the Nasdaq market continues to operate throughout the day without the potential for disruptive, intermittent suspensions that negatively impact both the price-discovery and trading process for the vast bulk of the Nasdaq market community.

Based on the above, Nasdaq believes this proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act<sup>4</sup> in that the proposal is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, 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, as amended.

#### *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 date of 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 NASD consents, 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.

### **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-2002-23 and should be submitted by June 14, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

**Jill M. Peterson,**

*Assistant Secretary.*

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## **SECURITIES AND EXCHANGE COMMISSION**

**[Release No. 34-45960; File No. SR-NASD-2002-63]**

### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Proposed Fees for the Trade Reporting and Compliance Engine (TRACE) for Corporate Bonds**

May 17, 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>

<sup>5</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.

notice is hereby given that on May 6, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The NASD submitted Amendment No. 1 to the proposed rule change on May 16, 2002.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The NASD is filing with the Commission a proposed structure for fees to be charged in connection with the NASD's creation of a corporate bond trade reporting and transaction dissemination facility. The facility is currently referred to as the Trade Reporting and Compliance Engine or "TRACE." TRACE replaces Nasdaq's Fixed Income Pricing System ("FIPS"). The proposed rule change is in addition to the NASD's Rule 6200 Series for TRACE.<sup>4</sup> The current text of NASD Rule 7010 (k) Fixed Income Pricing System (FIPS) will be deleted in its entirety and replaced by the proposed new TRACE fees. Below is the text of the proposed rule change. Proposed new language is in *italics*, proposed deletions are in [brackets].

\* \* \* \* \*

### **Rule 7010. System Services**

[(k) Fixed Income Pricing System (FIPS)]

[(1) The following charges shall apply to the operation of Full Function and Limited Function FIPS terminals. Charges for Full Function and Limited Function FIPS terminals will also

<sup>3</sup> See letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), dated May 16, 2002.

<sup>4</sup> The Commission approved the Rule 6200 Series on January 23, 2001. See SR-NASD-99-65 and Amendments No. 1 through 4 thereto, approved in Securities Exchange Act Release NO. 43873 (January 23, 2001), 66 FR 811 (January 29, 2001) ("TRACE Approval Order"). On December 21, 2001, the NASD filed SR-NASD-2001-91 to establish July 1, 2002 as the effective date of the Rule 6200 Series (see SR-NASD-2001-91). On January 3, 2002, the Commission issued a notice that the proposed rule change had become effective on filing. Securities Exchange Act Release No. 45229 (January 3, 2002), 67 FR 1255 (January 9, 2002). On April 3, 2002, the NASD filed SR-NASD-2002-46 to make certain technical amendments to the new Rule 6200 Series.

<sup>4</sup> 15 U.S.C. 78o-3(b)(6).