

submitted Amendment Nos. 1,<sup>4</sup> 2,<sup>5</sup> and 3<sup>6</sup> to the proposed rule change, respectively. The proposed rule change, as amended, was published in the **Federal Register** on October 22, 2002.<sup>7</sup> The Commission received no comments on the proposed rule change. This order approves the proposed rule change, as amended.

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>8</sup> In particular, the Commission finds that the proposal, as amended, is consistent with Section 6(b)(5) of the Act,<sup>9</sup> which requires, among other things, that the Exchange's rules be designed to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Specifically, the Commission believes requiring specialists units consisting of fewer than three members to arrange for the registration of one or more relief specialists, approved by the Exchange's Committee on Floor Members Performance, helps to ensure that there is no interruption of service when the Exchange is open for business. Similarly, the Commission believes that it is appropriate for a temporary specialist to be appointed by the Exchange in the event of an emergency or other unusual situations in which the regular or relief specialist would be unable to adequately manage the volume or business in a particular stock or stocks to ensure adequate staffing on the Exchange floor. The Commission notes that relief specialists and temporary specialists, to the extent that no regular or relief specialist is present, will be subject to the same responsibilities for the maintenance and stabilization of the market as regular registered specialists. Further, the

Commission notes that these arrangements are similar to arrangements already allowed by the New York Stock Exchange, Inc.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>10</sup> that the proposed rule change (SR-AMEX-2001-06), as amended, is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46872; File No. SR-CSE-2002-04]

### Self-Regulatory Organizations; Cincinnati Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to the Introduction of Order Delivery and Automated Response

November 21, 2002.

#### I. Introduction

On April 22, 2002, the Cincinnati Stock Exchange, Inc. ("CSE" or "Exchange") filed with the Securities and Exchange Commission ("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 related to the introduction of order delivery and automated response. The proposed rule change was published for comment in the **Federal Register** on May 10, 2002.<sup>3</sup> On September 13, 2002, the CSE filed Amendment No. 1 to the proposed rule change<sup>4</sup> and on September 17, 2002, filed Amendment No. 2 to the proposed rule change.<sup>5</sup> The

proposed rule change, as amended by Amendment Nos. 1 and 2, was republished in its entirety for comment in the **Federal Register** on October 11, 2002.<sup>6</sup> No comments were received on the proposal. This order approves the proposed rule change, as amended.

#### II. Description of the Proposal

The Exchange proposes to amend its rules to increase the flexibility of CSE execution systems to accommodate member needs. Specifically, CSE proposes to modify CSE's execution functionality within the CSE System from a process of automatically matching and executing like-priced displayed orders and quotes to an optional process of delivering orders to quoting CSE members and requiring automated responses from such members back to the CSE System. CSE is proposing this modification to facilitate a diverse membership base while promoting a fair and orderly market. CSE members that operate as electronic communications networks ("ECNs")<sup>7</sup> or alternative trading systems ("ATs")<sup>8</sup> subject to SEC Regulation ATS,<sup>8</sup> as well as members that act as Designated Dealers or specialists on CSE will have the option of selecting the type of centralized execution system that best fits their business model.

Currently, CSE's NSTS functions solely in an automatic execution mode. In an automatic execution system like NSTS, a Designated Dealer's quotation is held in NSTS, and NSTS executes any like-priced contra-side order against the dealer's quotation. NSTS then informs the Designated Dealer and the contra-side CSE member that the quotation and the order have been executed by delivering execution messages to both parties.

With the advent of ECN/ATS trading on CSE, members have expressed concern that CSE's automatic execution system exposes them to significant multiple execution liability. Given the speed with which ECN/ATSs operate, it is likely that displayed quotations will be subject to internal matches at the same time as another CSE member attempts to execute against the same displayed quotations. When faced with a similar dilemma, the Nasdaq Stock

rather than simply Nasdaq National Market Securities. In addition, Amendment No. 2 made certain non-substantive grammatical changes.

<sup>6</sup> See Securities Exchange Act Release No. 46599 (October 4, 2002), 67 FR 63484.

<sup>7</sup> ECNs are defined in SEC Rule 11Ac1-1(a)(8), 17 CFR 240.11Ac1-1(a)(8), as any electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part.

<sup>8</sup> 17 CFR 242.300-303.

<sup>4</sup> See letter from William Floyd-Jones, Jr., Assistant General Counsel, Amex, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated August 17, 2001 ("Amendment No. 1") (replacing the original filing in its entirety).

<sup>5</sup> See letter from William Floyd-Jones, Jr., Assistant General Counsel, Amex, to Nancy Sanow, Assistant Director, Division, Commission, dated September 30, 2002 ("Amendment No. 2") (replacing the original filing in its entirety).

<sup>6</sup> See letter from William Floyd-Jones, Jr., Assistant General Counsel, Amex, to Nancy Sanow, Assistant Director, Division, Commission, dated October 7, 2002 ("Amendment No. 3") (replacing the original filing in its entirety).

<sup>7</sup> See Securities Exchange Act Release No. 46655 (October 11, 2002), 67 FR 64940.

<sup>8</sup> In approving this proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>9</sup> 15 U.S.C. 78f(b)(5).

<sup>10</sup> 15 U.S.C. 78s(b)(2).

<sup>11</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. 45873 (May 3, 2002), 67 FR 31856.

<sup>4</sup> See letter from Jennifer M. Lamie, CSE, to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission (September 12, 2002). In Amendment No. 1, the CSE deleted proposed rule language in Paragraph 11.9(i)(2)(a) regarding price/time and agency/principal priorities, which was inadvertently included in the original proposal.

<sup>5</sup> See letter from Jennifer M. Lamie, CSE, to Katherine England, Assistant Director, Division, Commission (September 16, 2002). In Amendment No. 2, the CSE expanded the proposed order delivery and automated response alternative to all securities traded through the Exchange's National Securities Trading System ("NSTS" or "System"),

Market, Inc. permitted ECN/ATSS to remain on SelectNet (an order delivery system) for inbound executions against the ECN/ATSS' displayed quotations rather than requiring them to migrate to the automatic execution methodology of the Nasdaq National Market Execution System ("NNMS").<sup>9</sup> Nasdaq even amended its Intermarket Trading System ("ITS") / Computer Assisted Execution System ("CAES") (together, "ITS/CAES") definitions and functionality to permit ECN/ATSS to operate in an order delivery format when interacting with inbound commitments from ITS. Similarly, CSE now proposes to permit members to select order delivery and automated response for order interaction with displayed quotations within the CSE System or to continue interacting through CSE's automatic execution facility.

In an order delivery and automated response system, a member's quotation or displayed order will be held in the CSE System, and when a contra-side order is received in the CSE System, CSE will immediately forward the order message to the quoting member, who will be obligated by rule to respond instantaneously to the order message. Moreover, the quoting member must have a demonstrated capability to respond instantaneously to the order message. On receipt of the order message delivered by CSE, the quoting member will automatically determine whether its quote is still active. If so, the member will automatically deliver to the CSE System matched orders representing its quote and the contra-side for execution. If the member's quote is in the process of changing due to a prior internal match at the displayed price, consistent with the Firm Quote Rule,<sup>10</sup> the member will reject the inbound order and send it back to the CSE System. The CSE System will then automatically send a cancellation message to the member submitting the order. The entire duration of the order delivery and automated response process likely will be less than one second.

CSE will require that members demonstrate the capacity to accept inbound orders and to automatically respond to the CSE System before they will be permitted use of this functionality. Moreover, CSE Rule

11.9(i)(2) provides that the CSE System will offer order delivery and automated response subject to the requirement that members demonstrate the capability to respond in an automated manner.

Therefore, by rule and through demonstrated capacity verified by CSE examiners before operation, the CSE will reduce the risk of multiple execution liability, while ensuring that members comply with their obligations under the Firm Quote Rule.

### III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the provisions of section 6(b) of the Act,<sup>11</sup> in general, and section 6(b)(5) of the Act,<sup>12</sup> in particular, which requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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.

The Commission believes that the proposal furthers the purpose of this section by reducing the risk of dual liability to CSE members. By reducing the risk of dual liability, the proposal may encourage CSE members, such as ECNs, to display larger sized quotations thereby adding liquidity and transparency to the market. Moreover, the Commission approved a similar approach to reducing the risk of dual liability in the Nasdaq market and believes that CSE's proposal should similarly benefit all market participants in the Nasdaq and listed markets. The Commission believes that the proposal's requirement that CSE members demonstrate the ability to process inbound orders and respond appropriately within one second should facilitate the efficient functioning of the order delivery and automated response execution option. The Commission believes that encouraging greater participation in the national market system by market participants, including ECNs, furthers the Congressional goal of developing a comprehensive national market system.

It is important to note that, upon approval of the instant proposal, a CSE member (or other market participant routing an order to the CSE via ITS) may attempt to execute a trade at a price quoted on the CSE by an ECN. In such

a case, a CSE member (or ITS user) submitting an order to the CSE's NSTS may not receive an execution at the price originally quoted by the ECN on the CSE, because the ECN may have adjusted its quoted price while the order was in transit from the CSE to the ECN. CSE represents that this transit time is less than one second, and, for firm quote rule<sup>13</sup> compliance purposes, the Commission believes this time to be *de minimis*. Moreover, the Commission believes it is significant that this one-second transit time is generally less than the internal transmission time of order routing systems in place in other markets.

CSE has committed to examine regularly for patterns of adjustments in ECNs' quoted prices that lead to the rejection of orders. Specifically, the CSE will analyze those rejections that occur after an order arrives at the CSE and before the order arrives at the ECN. Should any such patterns be detected, CSE will scrutinize them for violations of the Firm Quote Rule and take appropriate action. The CSE has also committed to reporting the results of its examination of ECN order rejection patterns to the Commission.

### IV. Conclusion

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>14</sup> that the proposed rule change (SR-CSE-2002-04), as amended, is hereby approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46893; File No. SR-NASD-2002-167]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to NASD Rule 7010(k)—Fees for the Trade Reporting and Compliance Engine (TRACE)

November 22, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

<sup>9</sup> See Securities Exchange Act Release No. 42344 (January 14, 2000), 65 FR 3987 (January 25, 2000) in which Nasdaq designated SelectNet as the link to ECNs pursuant to the SEC's Order Handling Rules. See Securities Exchange Act Release No. 38156 (January 10, 1997), 62 FR 2415 (January 16, 1997).

<sup>10</sup> 17 CFR 240.11Ac1-1.

<sup>11</sup> 15 U.S.C. 78f(b). In approving this proposal, the Commission has considered the proposed rule change's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> SEC Rule 11Ac1-1, 17 CFR 240.11Ac1-1 ("Firm Quote Rule").

<sup>14</sup> 15 U.S.C. 78s(b)(2).

<sup>15</sup> 17 CFR 200.30-3(a)(12).