

**SECURITIES AND EXCHANGE  
COMMISSION****17 CFR Part 240**

[Release No. 34-37620; File No. S7-22-96]

RIN 3235-AH00

**Proposed Quote Rule Amendment****AGENCY:** Securities and Exchange Commission.**ACTION:** Proposed rulemaking.

**SUMMARY:** The Securities and Exchange Commission ("Commission") today is proposing an amendment to Rule 11Ac1-1 ("Quote Rule") under the Securities Exchange Act of 1934. The proposed amendment reinforces the Commission's recent initiatives to foster market liquidity, transparency and efficiency. The amendment to the Quote Rule will mandate continuous two-sided quotations from over-the-counter ("OTC") market makers and exchange specialists that account for more than 1% of the transaction volume in a security included on the Nasdaq Stock Market ("Nasdaq security").

**DATES:** Comments should be submitted on or before November 12, 1996.

**ADDRESSES:** Interested persons should submit three copies of their written data, views and opinions to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File Number S7-22-96; this file number should be included on the subject line if E-mail is used. Comment letters will be made available for public inspection at the Commission's Public Reference Room, Room 1024, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (<http://www.sec.gov>).

**FOR FURTHER INFORMATION CONTACT:** Gail A. Marshall, 202/942-7129, Attorney, Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Mailstop 5-1, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The commission is publishing for comment proposed amendment to Rule 11Ac1-1<sup>1</sup> under the Securities Exchange Act of 1934 ("Exchange Act").<sup>2</sup>

**I. Introduction and Background**

Today in a related release,<sup>3</sup> the Commission adopted the Display Rule and amendments to the Quote Rule under the exchange Act.<sup>4</sup> The new rule and amendments are designed to reduce the effects of hidden markets and enhance transparency, further permitting investors to evaluate the execution quality of their orders.<sup>5</sup> The Commission received 152 comment letters on the aforementioned proposals<sup>6</sup> and has determined to propose an additional amendment to the Quote Rule in response to an issue raised by some commenters.

Congress, in the Securities Acts Amendments of 1975 ("1975 Amendments"),<sup>7</sup> authorized the Commission to facilitate the development of a national market system ("NMS") for U.S. equity securities by improving price discovery, liquidity, and competition among OTC market makers<sup>8</sup> and exchange specialists. Moreover, the Commission is authorized, under Sections 11A(c)(1)(B) and (F) of the Exchange Act,<sup>9</sup> to assure the prompt, accurate and reliable distribution of quotation information and to assure the fairness and usefulness of the form and content of such information.

The Quote Rule requires all national securities exchanges and associations<sup>10</sup> to establish and maintain procedures for collecting from their members, bids, offers, and quotation sizes with respect

<sup>3</sup> See Securities Exchange Act Release No. 37619 (August 29, 1996) ("Adopting Release").

<sup>4</sup> The Commission proposed the new rule and the amendments to the Quote Rule for public comment in October 1995. See Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995) ("Proposing Release"). The Commission subsequently extended the comment period. See also Securities Exchange Act Release No. 36718 (January 16, 1996), 61 FR 1545 (January 22, 1996).

<sup>5</sup> See Adopting Release, *supra* note 3.

<sup>6</sup> The comment letters and a summary of comments have been placed in Public File No. S7-30-95, which is available for inspection in the Commission's Public Reference Room. Commenters included 77 individual investors, 10 industry associations, 7 self-regulatory organizations, 8 academics, 41 market participants, and the United States Department of Justice.

<sup>7</sup> Pub. L. No. 94-29, 89 Stat. 97 (1975).

<sup>8</sup> As used in this release, the term OTC market maker includes any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size. See section 240.11Ac1-1(a)(12).

<sup>9</sup> 15 U.S.C. 78k-1.

<sup>10</sup> Section 15A of the Exchange Act defines the requirements to become a national securities association registered with the Commission. The National Association of Securities Dealers ("NASD") is the only association of brokers and dealers that is registered as a national securities association. 15 U.S.C. 78o-3.

to any subject security,<sup>11</sup> and for making such bids, offers, and sizes available to quotation vendors. It also requires every exchange specialist and OTC market maker to promptly communicate to its exchange or association, pursuant to procedures established by the exchange or association, its bids, offers and quotation sizes.<sup>12</sup> In addition, the Quote Rule requires that, subject to certain exceptions, the broker or dealer responsible for communicating a quotation for a security shall be obligated to execute any order presented to it, other than an odd-lot order, by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable as its published bid or offer in any amount up to its published quotation size.<sup>13</sup>

The Commission proposes to amend the Quote Rule to require exchange specialists and OTC market makers to publish quotations for any Nasdaq security when the exchange specialist or OTC market maker is responsible for more than 1% of the aggregate trading volume for that security for the most recent calendar quarter.<sup>14</sup> Upon the effective date of the most recent amendment of the Quote Rule, the mandatory quotation requirement will apply to exchange specialists and OTC market makers that trade more than 1% of the aggregate trading volume for an exchange-listed security for the most recent calendar quarter.

**II. Discussion**

Since the Quote Rule was adopted in 1978,<sup>15</sup> transaction volume on the Nasdaq Stock Market ("Nasdaq") has grown substantially. In 1985 there were 20.7 billion shares traded on Nasdaq<sup>16</sup> compared with the more than 100

<sup>11</sup> Paragraph (a)(25) of the Quote Rule, as amended, defines "subject security" to include exchange-listed securities for which an OTC market maker or exchange specialist trades more than 1% of the aggregate trading volume, as well as any other security for which an OTC market maker or specialist has in effect an election to provide quotes.

<sup>12</sup> This is referred to as the "mandatory participation" requirement of the Quote Rule. See § 240.11Ac1-1(c)(1).

<sup>13</sup> This is referred to as the "firmness" requirement of the Quote Rule. See § 240.11Ac1-1(c)(2).

<sup>14</sup> NASD rules already require OTC market makers in Nasdaq securities, once they elect to disseminate quotations, to register and maintain continuous two-sided quotations. See NASD Rule 4613. The Commission believes the proposed amendments are consistent with the existing NASD requirements.

<sup>15</sup> See Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978).

<sup>16</sup> See *The Nasdaq Stock Market 1986 Fact Book* at 4.

<sup>1</sup> 17 CFR 240.11Ac-1.

<sup>2</sup> 15 U.S.C. 78a to 78I (1988).

billion shares traded in 1995.<sup>17</sup> Today Nasdaq is home to many companies that meet the listing requirements of the primary exchanges, whereas in 1978 securities listed on exchanges and those quoted on Nasdaq had more disparate trading characteristics and the Quote Rule reflected those disparities. The Commission questions whether disparate treatment of market makers in OTC and listed securities within the Quote Rule is still warranted in light of the considerable growth in the Nasdaq market in the last decade.

The Commission adopted today an amendment to the Quote Rule that broadens the definition of subject security to include any exchange-listed security for which an OTC market maker or exchange specialist accounts for more than 1% of the aggregate transaction volume for the most recent calendar quarter.<sup>18</sup> An effect of this amendment is to require OTC market makers and exchange specialists to provide continuous two-sided quotations for any exchange-listed security when they are responsible for more than 1% of the aggregate transaction volume in that security. Prior to this amendment, mandatory quotations were only required from OTC market makers and exchange specialists who transacted more than 1% of the volume in a Rule 19c-3 security.<sup>19</sup> The Commission adopted the amendment to the definition to improve transparency and provide investors with information about significant market participants.

Some commenters, in response to the Proposing Release, suggested the Commission further improve transparency by extending the quotation requirements of the Quote Rule to Nasdaq securities.<sup>20</sup> The Commission,

<sup>17</sup> See *The Nasdaq Stock Market 1996 Fact Book* at 35. In addition, with unlisted trading privileges extending to Nasdaq securities, pursuant to temporary Commission approval of a joint industry plan, exchange specialists may ultimately transact significant volume in these securities. See Securities Exchange Act Release No. 36985 (March 18, 1996), 61 FR 12122 (March 25, 1996).

<sup>18</sup> See § 240.11Ac1-1(a)(25).

<sup>19</sup> See § 240.19c-3. Exchange Act Rule 19c-3 prohibits the application of off-board trading restrictions to securities that: (1) Were not traded on an exchange before April 26, 1979; or (2) were traded on an exchange on April 26, 1979, but ceased to be traded on an exchange for any period of time thereafter. Accordingly, exchange-traded securities not subject to off-board trading restrictions are referred to as Rule 19-3 securities, and exchange-traded securities subject to off-board trading restrictions are referred to as non-Rule 19c-3 securities.

<sup>20</sup> See Letter from Andrew E. Feldman, Director and Associate General Counsel, Smith Barney, to Jonathan G. Katz, Secretary, SEC, dated January 29, 1996 ("Smith Barney Letter") and Letter from Joseph R. Hardiman, President, The National Association of Securities Dealers, Inc., to Jonathan

consistent with the objectives of the 1978 Amendments and the amendments adopted today, is proposing to amend the definition of "subject security" further to include any covered security<sup>21</sup> for which the volume executed during the most recent calendar quarter by an exchange specialist or an OTC market maker in the security constitutes more than 1% of the aggregate trading volume for such security.<sup>22</sup> The effect of this proposed amendment would be to require any OTC market maker or exchange specialist in a covered security responsible for more than 1% of the transaction volume in that security to disseminate continuous two-sided quotations publicly.

Presently, the Quote Rule permits, but does not require, an OTC market maker or exchange specialist trading Nasdaq securities to quote a two-sided market.<sup>23</sup> Consequently, there could be OTC market makers and exchange specialists whose trading constitutes more than a *de minimis* percentage of the volume in a particular Nasdaq security that do not provide continuous two-sided quotations. The Commission believes this potentially reduces transparency, thereby depriving the public of meaningful information about the buying and selling interest of significant market participants. The proposed amendment is intended to enhance transparency by mandating continuous two-sided quotations from OTC market makers and exchange specialists that account for more than 1% of the transaction volume for a Nasdaq security. The proposed amendment also

G. Katz, Secretary, SEC, dated January 26, 1996 ("NASD Letter").

<sup>21</sup> The term "covered security" is defined in the Quote Rule to mean any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in section 3 (a)(5)(A)(ii) of the Exchange Act (15 U.S.C. 78c(a)(5)(A)(ii)). The term "reported security" is defined in the Quote Rule to mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective reporting plan. See Paragraphs (a)(6) and (a)(20) of Rule 11Ac1-1.

<sup>22</sup> The Commission first proposed amending the Quote Rule to require OTC market makers responsible for more than 1% of the aggregate trading volume in NMS securities to disseminate continuous two-sided quotations over ten years ago. See Securities Exchange Act Release No. 17583 (February 27, 1981), 46 FR 15713 (March 9, 1981). The Commission did not adopt the proposal because, at that time, it believed that there were sufficient economic incentives to mandate meaningful quotation dissemination from OTC market makers. Moreover, the Commission believed that meaningless quotations would only burden already taxed vendor quotation systems. See Securities Exchange Act Release No. 18482 (February 11, 1982), 47 FR 7399 (February 19, 1982).

<sup>23</sup> See § 240.11Ac1-1(b)(5)(ii).

would eliminate artificial regulatory distinctions between Nasdaq securities and exchange-listed securities.

### III. Request for Comment

The Commission invites comment on the issues raised in this release, specifically, expanding the definition of subject security to include a 1% volume threshold for Nasdaq securities. The Commission requests comments on the practical implications of the amendment, including the anticipated costs and benefits associated therewith.

The Commission requests comments generally on whether, upon implementation of other initiatives adopted today, OTC markets, exchange specialists, and investors would benefit from the new proposal. The Commission also requests comment concerning whether sufficient similarities exist among trading of Nasdaq securities and exchange-listed securities to warrant extension of the 1% rule to Nasdaq securities when previously applicable only to exchange-listed securities. In addition, the Commission requests comment on whether the 1% threshold is an appropriate threshold with respect to Nasdaq securities.

The Commission also is interested in alternatives to this proposal that would better meet the aforementioned objectives.

Finally, the Commission requests comment on whether the proposed amendment, if adopted, would have an adverse effect on competition or would impose a burden on competition that is neither necessary nor appropriate in furthering the purposes of the Exchange Act. Comments on the proposal will be considered by the Commission in complying with its responsibilities under section 23(a)(2) of the Exchange Act.

### IV. Summary of the Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with 5 U.S.C. 603 regarding the proposed amendments to Rule 11Ac1-1 and Rule 11Ac1-4. The following summarizes the conclusions of the IRFA.

The IRFA uses certain definitions of "small entities" adopted by the Commission for purposes of the Regulatory Flexibility Act. In the IRFA, the Commission states that the amendment to the Quote Rule is proposed to ensure that exchange specialists and OTC market makers in covered securities adhere to the firm quote reporting obligations. The IRFA notes that the proposed Quote Rule

amendment would require OTC market makers and exchange specialists to communicate quotes if they trade more than 1% of a security included on the Nasdaq Stock Market, thus improving transparency in Nasdaq securities.

A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Gail Marshall, Division of Market Regulation, SEC, 450 Fifth Street, NW., Washington, DC 20549.

#### V. Paperwork Reduction Act

Certain provisions of Rule 11Ac1-1, as amended (the "Quote Rule"), contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) ("PRA"), and the Commission has submitted them to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 and 1320.12. The title for the collection of information is: "Rule 11Ac1-1." Providing information in response to the collections of information, as discussed below, is mandatory, and such responses are not kept confidential. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid OMB control number.

In September 1995, the Commission proposed amendments to the Quote Rule as part of its proposal to improve the handling and execution of customer orders.<sup>24</sup> The preamble of that release included a PRA section describing, in part, how the proposed amendments would affect the number of respondents and the collections of information already contained in the Quote Rule. Those proposed amendments, as modified in part in response to comments received, have been adopted and are published elsewhere in the Federal Register today.<sup>25</sup> This release provides new estimates of the overall burden in responding to collections of information under the Quote Rule as a whole, both as amended and in light of the additional amendment proposed today.<sup>26</sup>

The Quote Rule contains two related collections of information necessary to disseminate to the public market makers' published quotations to buy and sell securities. The first collection of information is found in 17 CFR 240.11Ac1-1(c). This reporting requirement obligates each "responsible

broker or dealer," as defined under the rule, to communicate to its exchange or association its best bids, best offers, and quotation sizes for any subject security, as defined under the rule. The second collection of information is found in 17 CFR 240.11Ac1-1(b). This reporting requirement obligates each exchange and association to make available to quotation vendors for dissemination to the public the best bid, best offer, and aggregate quotation size for each subject security.<sup>27</sup> Brokers, dealers, other market participants, and members of the public rely on published quotation information to determine the best price and market for execution of customer orders.

For the reporting obligation under Rule 11Ac1-1(c), the likely respondents are OTC market makers and exchange specialists. The Commission estimates that there are approximately 180 exchange specialists and 570 OTC market maker respondents to this collection of information. Each exchange specialist will respond (*i.e.*, report or update bids, offers, and quotation sizes) on average approximately 806,000 times per year (including customer limit orders reflected in the quotes), while each OTC market maker will respond on average approximately 124,000 times per year. These figures are based on a 252 trading day year. The total annual time burden for each exchange specialist is estimated to be 672 hours, while the total annual time burden for each OTC market maker is estimated to be 103 hours. These figures are based on an estimate of three seconds per response (*i.e.*, the time it takes to update a quote). The annual aggregate burden for all respondents combined is estimated to be 120,960 hours for exchange specialists, and 58,710 hours for OTC market makers.<sup>28</sup>

<sup>27</sup> A third reporting requirement under the Quote Rule, as amended at 17 CFR 240.11Ac1-1(c)(5), will give ECNs the option of reporting to an exchange or association for public dissemination, on behalf of their OTC market maker or exchange specialist customers, the best priced orders and the full size for such orders entered by market makers, to satisfy such market makers' reporting obligation under Rule 11Ac1-1(c). Because this reporting requirement is an alternative method of meeting the market makers' reporting obligation, and because it is directed to nine or fewer persons (ECNs), this collection of information is not subject to OMB review under the PRA.

<sup>28</sup> The Commission also estimates that each OTC market maker on average will display in its own quotation, or transmit to another market participant for display, approximately 42,000 limit orders per year. This translates into an additional annual time burden per OTC market maker respondent of 35 hours and an additional aggregate time burden for all OTC market maker respondents of 19,950 hours. The Commission has included these figures in its PRA burden estimate for the collection of information under the Display Rule, 17 CFR 240.11Ac1-4.

The Commission notes that the rules of the various exchanges and the NASD generally already require exchange specialists and market makers to publish quotations in those securities for which they act as market makers and publish two-sided quotations.<sup>29</sup>

The new amendment to the Quote Rule proposed by this release, specifically the change to the definition of "subject security" under paragraph (a)(25) of Rule 11Ac1-1, would require an exchange specialist or OTC market maker to fulfill the reporting obligation under paragraph (c) if such specialist's exchange or market maker accounts for more than one percent of the aggregate trading volume for any covered security during the most recent calendar quarter. This amendment of the collection of information requirement is necessary to expand the coverage of existing broker-dealer quotation requirements to include all substantial market participants in securities on the Nasdaq Stock Market and to improve the public information about the prices at which market makers are willing to buy and sell covered securities. The Commission estimates that this change will affect approximately 10 OTC market makers. These OTC market makers are included in the above estimates of the number of respondents and burden hours. The Commission also notes that most, if not all, of these respondents already are required under NASD rules to report their bids, offers, and quotation sizes for dissemination to the public.

For the reporting obligation under Rule 11Ac1-1 (b), the likely respondents are the eight stock exchanges and the NASD.<sup>30</sup> The Commission estimates that each exchange or association on average will respond (*i.e.*, disseminate and update

<sup>29</sup> In comments submitted in response to the Commission's September 1995 release proposing amendments to the Quote Rule, the NASD stated its view that the Commission's burden estimates were too low. The revised burden estimates provided above are the Commission's current burden estimates for the Quote Rule as a whole. The NASD also commented that it believes the PRA burden estimate should include the time market makers spend analyzing market trends and following quotation and last sale information. The Commission has determined not to include such activities in its estimate because market makers engage in them for reasons apart from the collection of information requirement. For example, market makers already are required to monitor the markets to ensure that they do not trade ahead of customer limit orders.

<sup>30</sup> Technically, under the PRA the Commission is not required to submit a collection of information to OMB for review unless it applies to ten or more persons. Because the collection of information under Rule 11Ac1-1(b) applies to the entire securities market industry, the Commission has determined to solicit comments on the requirement from the public and to include the collection of information in its submission to OMB.

<sup>24</sup> 60 FR at 52809.

<sup>25</sup> See *supra* note 3.

<sup>26</sup> When originally promulgated, the collections of information contained in the Quote Rule were not required to be submitted for OMB review under the version of PRA that was in effect before October 1995. See 5 CFR 1320.12(b).

bids, offers, and quotation sizes to quotation vendors) approximately 24,226,000 times per year (including customer limit orders reflected in the quotes). These figures are based on a 252 trading day year. Because the reporting and dissemination of quotation information is computerized, automatic, and continuous, and because the systems that accomplish the reporting obligation function have long been in place, the Commission believes that it is not feasible or realistic to provide a burden estimate in terms of either person hours or costs for this collection of information.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to—

(i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility;

(ii) Evaluate the accuracy of the agency's estimate of the burden of the proposed collections of information;

(iii) Enhance the quality, utility, and clarity of the information to be collected; and

(iv) Minimize the burden of collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments directly to the Commission. OMB is required to make a decision concerning the collections of

information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. Statutory Basis

The amendments to Rule 11Ac1-1 are being proposed pursuant to 15 U.S.C. 78 *et seq.*, particularly sections 11A, 6, 10(b), 11(a)(2), 11(b), 15A, 15(c) and 23(a)(1); 15 U.S.C. 78k-1, 78f, 78j(b), 78k(a)(2), 78k(b), 78o-3, 78o(c), and 78w(a)(1) (1988).

List of Subjects in 17 CFR Part 240

Brokers, Confidential business information, Reporting and recordkeeping requirements, Securities.

Texts of the Proposed Rule Amendments

For the reasons set out in the preamble, the Commission proposes to amend Part 240 of Chapter II of Title 17 of the Code of Federal Regulation as follows:

**PART 240—GENERAL RULES AND REGULATIONS, SECURITY EXCHANGE ACT OF 1934**

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Amending § 240.11Ac1-1 by revising paragraph (a)(25) to read as follows:

**§ 240.11Ac1-1 Dissemination of quotations.**

(a) *Definitions.* \* \* \*

(25) The term *subject security* shall mean:

(i) With respect to an exchange:

(A) Any covered security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system or by a national securities association; and

(B) Any other covered security for which such exchange has in effect an election, pursuant to paragraph (b)(5)(i) of this section, to collect, process, and make available to quotation vendors, bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of an association:

(A) Any other covered security for which such member acts in the capacity of an OTC market maker unless the executive volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system or by a national securities association; and

(B) Any other covered security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to paragraph (b)(5)(ii) of this section, to communicate to its association bids, offers and quotation sizes for the purpose of making such bids, offers and quotation sizes available to quotation vendors.

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By the Commission.

Dated: August 29, 1996.

Margaret H. McFarland,

*Deputy Secretary.*

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