

NASD and, in particular, Sections 11A(a)(1)(C), 15A(b)(6), 15A(b)(9), and 15A(b)(11). Further, the Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the day of publication in the **Federal Register**. In addition to the reasons discussed above, the Commission believes that accelerated approval of the NASD's proposal is appropriate given the fact that the proposal is a temporary extension of the 150% Excess Spread Rule that has been in effect since January 1997. An uninterrupted application of the 150% Excess Spread Rule for a short period of time should be less disruptive to market makers while the NASD prepares its proposal regarding market maker standards.<sup>9</sup>

## V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Exchange Act, that the proposed rule change (SR-NASD-97-46) is approved through September 30, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38807; File No. SR-NASD-97-40]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Incorporated Amending the Surcharge on Members Named as Respondents in Arbitration Proceedings

July 1, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on June 13, 1997, the National Association of Securities Dealers, Incorporated ("NASD" or "Association") 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 the self-regulatory organization. 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

NASD Regulation is proposing to amend Rule 10333 of the NASD's Code of Arbitration Procedure ("Code") to increase the member surcharge on arbitration matters and to further graduate the rate of member surcharges to reflect more closely the costs associated with resolving controversies involving varying amounts in dispute.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization 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. The self-regulatory organization 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

##### Background and Introduction

In January 1996, the NASD's Arbitration Policy Task Force ("Task Force") released its report on Securities Arbitration Reform. The Task Force's report made numerous recommendations to improve the arbitration process. Some of the recommendations, such as early appointment of arbitrators and selection of arbitrators by a list selection method, involve significant changes in the way NASD Regulation's Office of Dispute Resolution ("Office") administers arbitration cases and their implementation will result in significant increases in cost. Other recommendations, including increased arbitrator compensation, also involve significant increases in cost.

Since the report was released, NASD Regulation has been engaged in a major effort to implement the numerous Task Force recommendations. In addition,

the Office has other initiatives underway to improve the arbitration process, such as improving case processing and administration by, among other things, upgrading its computerized case tracking system and hiring additional staff. Finally, the growth rate in NASD Regulation's arbitration case load over the last ten years, and the increasing length and complexity of arbitration cases, are generating additional cost pressures on the Office in its continuing efforts to meet the needs of users of the dispute resolution service.<sup>1</sup>

**Operating Costs.** The Office's arbitration service has never been self-funding. The revenues generated from filing and hearing session fees and, more recently, the member surcharge, have never covered more than approximately 70 percent of the arbitration service's operating costs. Originally a voluntary program that handled a few hundred cases each year, the arbitration service now handles more than 6,000 cases annually. Since its inception, the NASD has subsidized a large portion of the cost out of revenue obtained from members through the general assessment on member income. As the number of cases has grown and the cost and complexity of arbitration proceedings have increased, NASD Regulation has sought to increase the fees charged to the users of the service and to reduce the general assessment subsidy in order to shift the costs of the program to the service users.

Among its recent initiatives, the Office also has begun to appoint arbitrators earlier in the process, one of the Task Force's recommendations. In addition, list selection of arbitrators will be implemented in 1998 (subject to SEC approval), and updating the Office's arbitration case tracking system is in progress. The costs of these initiatives and others are increasing operating expenses significantly. For example, in 1996, the costs of the dispute resolution program exceeded revenue by \$11.3 million. The revenue shortfall is expected to reach \$20.0 million in 1997, a 77 percent increase. After incorporating planned increases in arbitrator compensation, the revenue shortfall is projected to be \$25.0 million in 1998, a 121 percent increase over 1996.<sup>2</sup>

<sup>1</sup> The number of cases filed with NASD Regulation's Office of Dispute Resolution in the first three months of 1997 is up 15 percent over the same period in 1996. The number of cases filed has risen from 2,886 in 1987 to an estimated 6,356 for 1997 based on the number filed in the first three months, a 120 percent increase.

<sup>2</sup> See Exhibit 2 to the rule filing.

<sup>9</sup> The Commission notes that a failure to extend the 150% Excess Spread Rule would result in no excess spread standard for Nasdaq market makers. Without deciding that the 150% Excess Spread Rule is preferable to no excess spread standard, the Commission concludes that it is not unreasonable to continue the pilot uninterrupted for a short period to allow the Commission to reach a conclusion on this matter.

<sup>10</sup> 17 CFR 200.30-3(a)(12).

### Development of Proposed Fee Increases

As a result of the continuing growth of the program and the operating losses, NASD Regulation determined that changes to the funding mechanisms were necessary. In order to ensure that the changes were appropriate to the goals of the program and fair to its users, NASD Regulation established guidelines for fee increases and analyzed the program to identify the cost of each service.<sup>3</sup> In addition, to support a shift in the source of member financial support from general assessment revenue to user fees, NASD Regulation identified the member users of the program.

*Guidelines for Proposed Fee Increases.* In developing the proposed rule change, NASD Regulation identified several important principles to guide its decisions on the appropriate fees for the arbitration service it provides:

- The current ratio of public investor fees to member fees should remain the same. Currently public investors pay approximately 26 percent of the arbitration service fees and members pay 74 percent.
  - The fees should not create a financial barrier to prevent a public investor from seeking arbitration. The maximum fee charged to public investors should not exceed the direct costs of providing the service.
  - The cost for a public investor to file a case in arbitration (the filing fee plus hearing session deposit fee) should not exceed the cost to the member named in the arbitration (the member surcharge).
- The revenue contribution plan should, to the extent possible, impose costs on member firms and associated persons who use the program.
- Any fee increases should be allocated to reducing the revenue shortfall for the arbitration service alone. Additional fee increases to cover revenue shortfalls for other dispute

resolution programs and indirect operating costs may be developed in the future.

*Member-Users of Dispute Resolution Services.* In addition, 1996 case volume was analyzed to obtain a profile of the users of arbitration services and to project the impact of future fee changes upon member firms. This analysis revealed that only 753 firms (14 percent) out of approximately 5,500 NASD member firms used arbitration services. Of these 753 firms, 88 firms (12 percent) accounted for over 50 percent of the case volume. Each of these 88 firms reported revenues in excess of \$100 million on their FOCUS filings. In contrast, firms that reported revenues of less than \$500,000 accounted for only 9 percent of NASD member firms and represented less than 3 percent of the total projected case load. Thus, a small number of large firms are involved in more than 50 percent of all arbitration cases. NASD Regulation considers these firms to be the primary and most frequent member users of the service and, therefore, believes it is appropriate for any fee changes to shift member costs from general revenues to these member users. The proposed rule changes, including the changes to the member surcharge proposed in another rule filing, accomplish this goal.

### General Description of Proposed Fee Increases

In view of the foregoing, and in conjunction with proposed increases in filing fees and hearing session deposits as set forth in a separate rule filing,<sup>4</sup> NASD Regulation is proposing to amend the surcharge assessed on members who are named as respondents in arbitration proceedings<sup>5</sup> to fund implementation of the Task Force's recommendations and other initiatives to improve the arbitration services administered by the Office. The changes, taken together, will maintain the current ratio of funding of the arbitration services between customers and members while limiting the increases in filing fees and hearing deposits for customers. This will continue to encourage the use of the arbitration service while limiting the cost to the users of the program to an amount less than the direct costs of providing the service.

<sup>4</sup> The NASD also submitted a proposed rule change to amend Rules 10205 and 10332, fees and hearing session deposits for disputes between public investors and members and between members or associated persons and other members or associated persons.

<sup>5</sup> The member surcharge is also imposed on members where an associated person of the member is named; however, there is only one surcharge imposed on each member in each case.

NASD Regulation estimates that the combination of increases in member fees will generate \$8.4 million in additional revenues (71 percent of total additional revenues to be generated by all fee changes proposed in this and other filings). Overall, NASD Regulation expects that all of the proposed fee changes on both members and public investors will generate approximately \$12 million in additional revenue. Even with this additional revenue, the Office will continue to incur operating losses of more than \$13 million.<sup>6</sup>

### Proposed Increases in Member Surcharge

NASD is proposing to amend the surcharge schedule to add brackets<sup>7</sup> and substantially increase the surcharge for the upper brackets. Under the current rule there are five brackets with surcharges from \$100 to \$500. Under the proposed new schedule there will be 12 brackets with surcharges starting at \$150 for cases of \$2,500 or less, up to \$3,600 for cases exceeding \$10,000,000. The addition of the new brackets and the graduation of the surcharge from the smallest case to the largest will cause the members' share of the costs of the arbitration service to be assessed upon the members who actually use the process in proportion to their financial involvement and exposure in the process.

The proposed rule change also replaces "Arbitration Department" with "Director of Arbitration" in Rule 10333(a) of the Code. In addition, the proposed rule change adds section (c) to Rule 10333 of the Code to state that if the dispute, claim, or controversy does not involve, disclose, or specify a money claim, the surcharge shall be \$1,200 or such greater or lesser amount as the Director of Arbitration or the panel of arbitrators may require, but cannot exceed the maximum amount in the schedule.

NASD Regulation intends to make the proposed rule change effective on July 1, 1997.

### 2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(5) of the Act<sup>8</sup> in that the proposed rule change provides for the equitable allocation of reasonable charges among members using the Association's arbitration facility because it further

<sup>6</sup> See Exhibit 3 to the rule filing.

<sup>7</sup> Fees are based on the amount in dispute; a range of amounts in dispute (e.g., \$50,000.01 to \$100,000) to which a particular fee applies is referred to as a bracket.

<sup>8</sup> 15 U.S.C. 78o-3.

<sup>3</sup> The NASD Regulation Board of Directors formed a Subcommittee on Arbitration Fees to examine the current revenue, cost and fee structure and recommend changes. The Subcommittee was composed of three public members (James E. Burton, CalPERS; Bonnie Guiton Hill, Times-Mirror Corp.; and William S. Lapp, Esq., Lapp, Laurie, Libra, Abramson & Thomson, board member of the Public Investors Arbitration Bar Association and member of NASD Regulation's National Arbitration and Mediation Committee (NAMC) and three securities industry members (Raymond E. Wooldridge, Southwest Securities Group, Inc., NAMC member and Chairman of NAMC's Finance Subcommittee, and former member of NASD Regulation's Board of Directors; Philip S. Cottone, Rutherford, Brown & Catherwood, Inc., Chairman of NAMC and former member of NASD Regulation's Board of Directors; and O. Ray Vass, Merrill, Lynch, Pierce, Fenner & Smith, Inc., member of NASD Regulation's Membership Committee).

graduates the fee schedules and requires member firm users to absorb a reasonable share of the costs of operating the arbitration service.

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

The NASD does not believe the proposed rule change will impose any burden on competition.

*C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

No written comments were solicited or received with respect to the proposed rule change.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

The proposed rule change has become effective upon filing pursuant to Section 19(b)(3)(A) of the Act and subparagraph (e) of Rule 19b-4 thereunder, in that the proposal constitutes a change to a fee which the NASD imposes on its members. At any time within 60 days of the filing of such 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.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 at 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-97-40 and should be submitted by July 30, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-38806; File No. SR-PCX-97-19]

**Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Granting Accelerated Approval to Proposed Rule Change Relating to Its Specialist Evaluation Program**

July 1, 1997.

**I. Introduction**

On May 29, 1997, the Pacific Exchange, Inc. ("PCX" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "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 to extend its specialist evaluation pilot program for an additional six months, until January 1, 1998, and make certain amendments to the pilot.

The proposed rule change was published for comment in Securities Exchange Act Release No. 38712 (June 3, 1997), 62 FR 31857 (June 11, 1997). No comments were received on the proposal. This order approves the proposed rule change on an accelerated basis.

**II. Description**

On October 1, 1996, the Commission approved a nine-month pilot program for the evaluation of PCX equity specialists.<sup>3</sup> The exchange is now

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

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

<sup>3</sup> Prior to the adoption of the pilot program, PCX Rule 5.37(a) provided that the Exchange's Equity Allocation Committee ("EAC") evaluate all registered specialists on a quarterly basis and that each specialist receive an overall evaluation rating based on three criteria of specialist performance: (1) Specialist Evaluation Questionnaire Survey ("Questionnaire") (45% of overall score); (2) SCOREX Limit Order Acceptance Performance (10%); and (3) National Market System Quote Performance (45%). See PSE Rule 5.37 (July 1995).

The pilot program modifies Rule 5.37(a) by adding three new criteria of performance and eliminating one performance criterion. The new criteria are: (1) Executions (50%) (itself consisting of four criteria: (a) Turnaround Time (15%); (b) Holding Orders Without Action (15%); (c) Trading Between the Quote (10%); and (d) Executions in Size Greater Than BBO (10%)); (2) Book Display Time (15%); and (3) Post-1 p.m. Parameters (10%). The pilot eliminates the SCOREX Limit Order

proposing to extend the pilot program for an additional six month period, until January 1, 1998. The Exchange represented that the reason for the extension is to allow it more time to evaluate the impact of the SEC's new order handling rules on the performance criteria.<sup>4</sup> During the extension of the pilot, the Exchange has represented that it will determine an appropriate overall passing score and individual passing scores for each criterion used in the pilot program.

In addition, the Exchange proposes to implement for use in the evaluation program, beginning with the third quarter review period of 1997 (*i.e.*, the quarter beginning July 1, 1997), certain programming changes requested by the Commission in its October 1, 1996 order approving the pilot program. Specifically, the Commission requested that the Exchange reprogram its systems so that the following criteria are calculated using the NBBO instead of the primary market quote: Trading Between the Quote, Book Display Time, and Quote Performance (Equal or Better Quote Performance and Better Quote Performance). The description of these performance criteria will be modified as follows:

*Trading Between the Quote*<sup>5</sup>

"Trading Between the Quote" currently measures the number of market and marketable limit orders that are executed between the best primary market bid and offer. For this criterion to count toward the overall evaluation score, ten orders or more must have been executed during the quarter in which the specialist is being evaluated. If less than ten orders are executed, this criterion will not be counted and the rest of the evaluation criteria will be given more weight.

When a market or marketable limit order is executed, the execution price is compared to the primary market bid and

Acceptance Performance criterion. Further, the pilot adds more questions to the Questionnaire, and reduces its weight from 45% to 15% of the overall score. Finally, the National Market System Quote Performance criterion (renamed Quote Performance under the pilot) has been amended to include within it a submeasure for bettering the quote (each of the two submeasures is accorded a weight of 5% of the overall score). For a more detailed description of the performance criteria utilized in the PCX's pilot program, see Securities Exchange Act Release No. 37770 (October 1, 1996), 61 FR 52820 (October 8, 1996) (File No. SR-PSE-96-28). See also generally PCX Rule 5.37 (description of the standards and procedures applicable to the EAC's evaluation of specialists).

<sup>4</sup> See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

<sup>5</sup> "Trading Between the Quote" is one of the four criteria which together constitute the "Executions" criterion. See *supra* note 3.