member issue a fairness opinion regarding the acquisition price.

B. Amendment to Rule 2720

The Commission believes that it is appropriate to amend Rule 2720 to state that in any exchange offer, merger and acquisition transaction or corporate reorganization subject to Rule 2720, the provision which requires that the price or yield of the securities be established based on the recommendation of a qualified independent underwriter shall not apply and, instead, the exchange values of the securities being offered in the transaction shall not be less than that recommended by a qualified independent underwriter. The Commission believes that the proposed new provision would clarify that the obligation of the qualified independent underwriter is to ensure that the recipient of the exchange offer, which is the party intended to be protected by the participation of a qualified independent underwriter, shall not receive fewer of the securities being issued in exchange for each security held by the recipient than is recommended by the qualified independent underwriter.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[22] that the proposed rule change (SR–NASD–97–38) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[23]

Margaret H. McFarland,

Deputy Secretary.

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[22] 15 U.S.C. 78s(b)(2).

[23] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39285; File No. SR–NASD–97–26]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approved to Amendment No. 3 Relating to an Extension and Expansion of the Pilot for the NASD's Rule Permitting Market Makers To Display Their Actual Quotation Size

October 29, 1997.

I. Background

On April 11, 1997, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act''),[1] and Rule 19b–4 thereunder,[2] to amend NASD Rule 4613(a)(1)(C) by (a) expanding from 50 to 150 the number of securities in a pilot program for which market makers may quote their actual size by reducing the minimum quotation size requirement for market makers in certain securities listed on the Nasdaq Stock Market (''Nasdaq'') to one normal unit of trading (''Actual Size Rule''), and (b) extending the pilot through December 31, 1997.[3]

On July 10, 1997, the NASD filed Amendment No. 1 to the proposed rule change proposing to extend the pilot through March 27, 1998 and expand it to 150 stocks.[4] On July 17, 1997, the NASD filed with the Commission Amendment No. 2, to correct a technical deficiency in Amendment No. 1.[5] The proposal was noticed for comment on July 24, 1996.[6]

On September 15, 1997, the NASD filed Amendment No. 3,[7] proposing to extend the pilot as previously noted and to expand the pilot by adding a different group of 100 securities to those 50 currently subject to the Actual Size Rule (''First 50'') than was proposed in Amendment Nos. 1 and 2. The NASD believes that this second group of securities will provide a better basis for comparison and economic analysis comparing the Actual Size Rule's effect on pilot and non-pilot Nasdaq securities. In addition, Nasdaq proposes to replace some of securities in the initial 50 stock pilot that are no longer listed on Nasdaq. Amendment No. 3 also proposed extending the pilot through March 27, 1998.

For the reasons discussed below, the Commission has determined to approve the proposed rule change.

II. Proposed Rule Change

The NASD proposes to amend NASD Rule 4613(a)(1)(C) to allow market makers to quote their actual size by reducing the minimum quotation size requirement for market makers in certain securities listed on Nasdaq to one normal unit of trading. As discussed below, the Actual Size Rule presently applies to a group of 50 Nasdaq securities on a pilot basis. The proposed rule change would expand the pilot group to 150 stocks and extend the pilot until March 27, 1998. The text of the proposed rule change is as follows. (Additions are italicized; deletions are bracketed.)

* * * * *

4613. Character of Quotations

(a) Two-Sided quotations

(1) No Change

(A)–(B) No Change

(C) As part of a pilot program implemented by the Nasdaq Stock Market, during the period January 20, 1997 through at least [December 31, 1997] *March 27, 1998,* a registered market maker in a security listed on the Nasdaq Stock Market that became subject to mandatory compliance with SEC Rule 11Ac1–4 on January 20, 1997 *or identified by Nasdaq as being otherwise subject to the pilot program as expanded and approved by the Commission,* must display a quotation

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] November 18, 1996, the NASD filed with the Commission a proposed rule change to implement the Actual Size Rule on a pilot basis. (SR–NASD–96–43). Among other things, the filing and subsequent amendments proposed to allow market makers to quote in minimum sizes of 100 shares for a three-month pilot Program in the 50 Nasdaq securities subject to mandatory compliance with Exchange Act Rule 11Ac1–4 (''Limit Order Display Rule'') on January 20, 1997. The remaining securities were still subject to the existing minimum quotation display requirements for proprietary quotes. The proposed rule change was intended by the NASD to facilitate the display of customer limit orders in accordance with the Limit Order Display Rule. The Commission approved the pilot through April 18, 1997. Securities Exchange Act Release 38512 (April 15, 1997) 62 FR 19373 (April 21, 1997) (SR–NASD–97–25).

On April 15, 1997, the Commission issued an order granting accelerated approval to a NASD proposed rule change that extended the pilot from April 18, 1997, to July 18, 1997. Securities Exchange Act Release 38512 (April 15, 1997) 62 FR 19373 (April 21, 1997) (SR–NASD–97–25).

On July 18, 1997, the Commission approved a rule change proposed by the NASD to extend the pilot from July 18, 1997 to December 31, 1997. Securities Exchange Act Release No. 38851 (July 18, 1997) 62 FR 39565 (July 23, 1997) (SR–NASD–97–49). The Commission did so to give it additional time to evaluate the economic studies and review the public's comments on the NASD's June 3, 1997, study. In addition, the Commission stated that it believed that extending the pilot would benefit the markets by providing more experience with the Actual Size Rule before a decision is made regarding approval.

[4] See Letter from Robert E. Aber, Vice President and General Counsel, the Nasdaq Stock Market, Inc., to Katherine England, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated July 10, 1997.

[5] See Letter from Robert E. Aber, Vice President and General Counsel, the Nasdaq Stock Market, Inc., to Katherine England, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated July 17, 1997.

[6] Securities Exchange Act Release No. 38872 (July 24, 1997) 62 FR 40879 (July 30, 1997) (SR–NASD–97–26).

[7] See Letter from Robert E. Aber, Vice President and General Counsel, the Nasdaq Stock Market, Inc., to Katherine England, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated September 15, 1997.

size for at least one normal unit of trading (or a larger multiple thereof) when it is not displaying a limit order in compliance with SEC Rule 11Ac1–4, provided, however, that a registered market maker may augment its displayed quotation size to display limit orders priced at the market maker's quotation.

* * * * *

III. Comments [8]

The Commission received over 350 comment letters.[9] A separate summary of comments has been prepared and is available in the public file. The relevant issues addressed by commenters are discussed in the appropriate sections of this order.

IV. Discussion

On August 29, 1996, the Commission promulgated a new rule, the Limit Order Display Rule [10] and adopted amendments to the Quote Rule,[11] which together are designed to enhance the quality of published quotations for securities and promote competition and pricing efficiency in U.S. securities markets (collectively, the ''Order Execution Rules'').[12] With respect to securities included on Nasdaq, the Order Execution Rules were implemented according to a phased-in implementation schedule: 50 Nasdaq securities became subject to the rules on June 20, 1997 (''first 50''), 50 more securities became subject to the rules on February 10, 1977 (''second 50''); and an additional 50 securities became subject to the rules on February 24, 1997. The remaining Nasdaq securities were phased in on October 13, 1997.[13]

The SEC's Limit Order Display Rule requires the display of customer limit orders, that: (1) Are priced better than a market maker's quote,[14] or (2) add to the size associated with a market maker's quote when the market maker is at the best price in the market.[15] By virtue of the Limit Order Display Rule, investors now have the ability to directly advertise their trading interest to the marketplace, thereby allowing them to compete with market maker quotations and affect the size of bid-ask spreads.[16] The Order Execution Rules also included amendments to the SEC's Quote Rule, the most significant of which requires a market maker to display in its quote any better priced orders that it places into an electronic communications network (''ECN'') such as SelectNet or Instinet (''ECN Rule''). Alternatively, instead of updating its quote to reflect better priced orders entered into an ECN, a market maker may comply with the display requirements of the ECN Rule through the ECN itself, provided the ECN: (1) Ensures that the best priced orders entered by market makers into the ECN are included in the public quotation; and (2) provides brokers and dealers access to orders entered by market makers into the ECN, so that brokers and dealers who do not subscribe to the ECN can trade with those orders (''ECN Display Alternative'').

In order to facilitate implementation of the SEC's Order Execution Rules and reflect the change in the Nasdaq market that was to be brought about by the implementation of these rules, the Commission approved, on January 10, 1997, a variety of amendments to NASD Rules pertaining to Nasdaq's Small Order Execution System (''SOES'') and the SelectNet Service (''SelectNet'').[17] In particular, one of the NASD Rule changes approved by the Commission provides on a temporary basis that Nasdaq market makers in the first 50 securities subject to the Commission's Limit Order Display Rule are only required to displayed a minimum quotation size of one normal unit of trading when quoting solely for their own proprietary account (*i.e.*, the Actual Size Rule).[18] They can display a greater quotation size if they so choose (or if required by the Limit Order Display Rule). For Nasdaq securities outside of the first 50, the minimum quotation size requirements of 1,000, 500, or 200 shares remained the same.[19]

The NASD submitted the proposal for the Actual Size Rule because it believed, and continues to believe, that the changes in Nasdaq brought about by the Limit Order Display Rule obviates the regulatory justification for minimum quote size requirements because investors now have the capability to display their orders on Nasdaq. The NASD originally imposed the Mandatory Quote Size Requirements to ensure an acceptable level of market liquidity and depth in an environment where Nasdaq market markers were the only market participants who could affect quotation prices. Now that the Limit Order Display Rule permits investors to enter orders as part of the quote, the NASD believes it is appropriate to treat Nasdaq market makers in a manner equivalent to exchange specialists and not subject them to minimum quote size requirements when they are not representing customer orders. In sum, with the successful implementation of the SEC's Order Execution Rules, the NASD believes that Mandatory Quote Size Requirements impose unnecessary regulatory burdens on market makers.

At the same time, the NASD does not believe that implementation of the Actual Size Rule in an environment where limit orders are displayed has or will compromise the quality of the Nasdaq market. First, the NASD believes that display of customer limit orders enhances the depth, liquidity, and stability of the market and contributes to narrower quoted spreads, thereby mitigating the effects of the loss of displayed trading interest, if any, by

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8 In order to give the public additional time to comment on the economic analysis of the pilot that the NASD filed with the Commission on June 3, 1997, the Commission extended the comment period to July 3, 1997. Securities Exchange Act Release No. 38720 (June 5, 1997) 62 FR 38156 (June 11, 1997) (SR–NASD–97–26).

9 The Commission received comment letters from numerous broker-dealer firms, some of which are market makers and others that are order entry firms. The Commission received comment letters from a large number of individuals who could be identified as SOES traders. The Commission also received comment letters from several academicians, individual investors, and professional associations.

10 17 CFR 240.11Ac1–4.

11 17 CFR 240.11Ac1–1.

12 See Securities Exchange Act Release No. 37619A (September 6, 1997) 61 FR 48290 (September 12, 1996) (''Order Execution Rules Adopting Release'').

13 See, *e.g.*, Securities Exchange Act Release No. 38490 (April 9, 1997); Securities Exchange Act Release No. 38870 (July 24, 1997).

14 For example, if a market maker's quote in stock ABCD is 10–10¼ (1000×1000) and the market maker receives a customer limit order to buy 200 shares at 10⅛, the market maker must update its quote to 10⅛–10¼ (200×1000).

15 For example, if a market maker receives a customer limit order to buy 200 shares of ABCD at 10 when its quote in ABCD is 10–10¼ (1000×1000) and the National Best Bid or Offer (''NBBO'') for ABCD is 10–10⅛, the market maker must update its quote to 10–10¼ (1200×1000).

16 There are eight exceptions to the immediate display requirement of the Limit Order Display Rule: (1) Customer limit orders executed upon receipt; (2) limit orders placed by customers who request that they not be displayed; (3) limit orders for odd-lots; (4) limit orders of block size (10,000 shares or $200,000); (5) limit orders routed to a Nasdaq or exchange system for display; (6) limit orders routed to a qualified electronic communications network for display; (7) limit orders routed to another member for display; and (8) limit orders that are all-or-none orders. See Rule 11Ac1–4(c).

17 See Actual Size Rule Approval Order.

18 Thus, the Actual Size Rule does not effect a market maker's obligation to display the full size of a customer limit order. If a market maker is required to display a customer limit order for 200 or more shares, it must display a quote size reflecting the size of the customer's order, absent an exception from the Limit Order Display Rule.

19 In particular, NASD Rule 4613(a)(2) requires each market maker in a Nasdaq issue other than those in the first 50 to enter and maintain two-sided quotations with a minimum size equal or greater than the applicable SOES tier size for the security (e.g., 1000, 500 or 200 shares for Nasdaq National Market issues and 500 or 100 shares for Nasdaq SmallCap Market issues (''Mandatory Quote Size Requirement'').

market makers. Second, it also believes that removing artificial quote size requirements may lead to narrower market spreads, thereby reducing investors' transaction costs. Third, the NASD asserts that permitting market makers to quote in size commensurate with their own freely-determined trading interest will enhance the pricing efficiency of the Nasdaq market and the independence and competitiveness of dealers quotations. Fourth, the NASD suggests that removing quotation size requirements will allowing greater quote size changes, thereby increasing the information content of market maker quotes by facilitating different quote sizes from dealers who have a substantial interest in the stock at a particular time and those who do not.

Indeed, in its order approving the Actual Size Rule on a pilot basis, the Commission noted that it ''preliminary believes that the proposal will not adversely affect market quality and liquidity'' [20] and that it ''believes there are substantial reasons * * * to expect that reducing market makers' proprietary quotation size requirements in light of the shift to a more order-driven market would be beneficial to investors.'' [21] In addition, the Commission stated that, ''based on its experience with the markets and discussions with market participants, [it] believes that decreasing the required quote size will not result in a reduction in liquidity that will hurt investors.'' [22]

Nevertheless, in light of concerns raised by commentators opposed to the Actual Size Rule regarding the potential adverse impacts of the rule on market liquidity and volatility, the Commission originally determined to approve the rule on a three-month pilot basis to afford to the Commission and the NASD an opportunity to gain practical experience with the rule and evaluate its effects. The factors identified by the Commission to be considered in this evaluation include, among others, the impact of reduced quotation sizes on liquidity, volatility and quotation spreads.[23]

As detailed below, the NASD has concluded that implementation of the SEC's Order Execution Rules has significantly improve the quality of the Nasdaq market by creating a market structure where customer limit orders provide liquidity and effectively compete with market maker quotations. In this type of environment, the NASD believes that regulatory necessity for the Mandatory Quote Size Requirements no longer exists. Nonetheless, the NASD determined to extend and broaden the pilot to gain greater experience with voluntary quotation size. The NASD is proposing the pilot be expanded to include an additional 100 securities and extended until March 27, 1998.

To evaluate that pilot, the NASD's Economic Research Department conducted an economic analysis of the pilot's operation and of the impact of the Commission's Order Handling Rules.[24] The analyses thus far indicates three general findings concerning implementation of the SEC's Order Execution Rules and the Actual Size Rule: (1) The SEC's Order Execution Rules have dramatically improved the quality of the Nasdaq market, particularly with respect to the size of spreads: (2) among those securities subject to the SEC's Order Execution Rules, there is no appreciable difference in market quality between those securities subject to the Actual Size Rule and those securities subject to Mandatory Quote Size Requirements;[25] and (3) implementation of the Actual Size Rule has not resulted in any significant diminution of the ability of investors to receive automated executions through SOES, SelectNet, or proprietary systems operated by broker-dealers. Accordingly, as is the case with 100-share minimum quotation size requirements applicable to exchange specialists in order-driven markets, the NASD believes that the Actual Size Rule has not harmed investors or the quality of the Nasdaq market.

In the June Study, the NASD found that pilot and non-pilot stocks experienced virtually the same improvements in market quality since the implementation of the Order Handling Rules. Specifically, the NASD found that investors in pilot stocks continued to have substantial and reasonable access to market maker capital through both SOES and market makers' proprietary automatic execution systems.[26]

A. Implementation of the SEC's Order Execution Rules Has Resulted in Significant Benefits to Investors and Enhanced the Quality of the Nasdaq Market

NASD Economic Research evaluated measures of market quality in four main areas: spread, volatility, quoted depth, and liquidity. The Pilot Stocks and the second tranche of 50 stocks to become subject to the Order Handling Rules both include 40 stocks selected from the first through fifth deciles of the 1,000 most active Nasdaq stocks. Therefore, those from the Pilot Stocks (''First 40'') are reasonable peers of those from the February 10 tranche (''Second 40'').[27] The NASD believes that, as shown below, the similar performance of the First 40 and Second 40 indicates that the Actual Size Rule did not impair the markets for these securities.

1. Spreads [28]

The NASD looked at mean spreads for the First and Second 40 and found that mean spreads declined by about $0.12 for both the First 40 and the Second 40, or by about 33%. For the First 40, the mean spread declined from $0.41 to $0.28, and for the Second 40 the mean spread declined from $0.36 to $0.24. The results in the NASD's study indicate an equivalent spread effect across the two groups. These results provide no statistically significant evidence of a differential change in quoted spreads between the First 40 and Second 40. Therefore, the NASD believes there is no effect on quoted spreads associated with removal of the 1,000-Share Quote Size Rule.

[20] *See* Actual Size Approval Order, 62 FR at 2425.

[21] *Id.* 62 FR at 2423.

[22] *Id.* 62 FR at 2424.

[23] *See* 62 FR 2415 at 2425.

[24] On June 3, 1997, the NASD published an economic analysis entitled ''Effects of the Removal of Minimum Sizes for Proprietary Quotes in the Nasdaq Stock Market, Inc.'' (June Study). On September 10, 1997, the NASD published a related study entitled ''Implementation of the SEC Order Handling Rules'' (September Study). Both studies are available to the public at Nasdaq's World Wide Web sit at ''http://www.nasdaq.com''.

[25] The first 50 securities includes Nasdaq's top ten issues by dollar volume plus 40 issues chosen from Nasdaq's top 500 issues: 8 ranked between 11 and 100; 8 ranked between 101 and 200; 8 ranked between 201 and 300; 8 ranked between 301 and 400; 8 ranked between 401 and 500. The second 50 securities include the ten Nasdaq stocks and ranked between 11 and 20 by dollar volume plus 40 stocks chosen from Nasdaq's top 500 stocks in the same manner explained above. The ten largest Nasdaq stocks in the first 50 have no comparable peer group among Nasdaq stocks and the next ten largest Nasdaq stocks (*i.e.,* Nasdaq stocks ranked 11–20 in size) included in the second 50 are also not comparable to the ''bottom 40'' of either the first 50 or second 50. The Nasdaq stocks ranked 1–20, therefore, have been excluded from the analysis comparing the first 50 and the second 50. Accordingly, the ''first forty'' stocks are those stocks that are the ''bottom 40'' within the first 50 stocks and the ''second forty'' stocks are those stocks that are the ''bottom 40'' within the second 50 stocks.

[26] June Study at 2.

[27] The remaining 10 stocks in the first tranche were roughly the top 10 stocks (''First 10''), and the remaining 10 from the second tranche were roughly stocks 11 through 20 (''Second 10''). Consistent with the Commission's request for a ''matched pairs analysis,'' the First 10 and Second 10 are excluded from this analysis, because these groups do not demonstrate similar trading characteristics and hence cannot be properly compared. See Actual Size Approval Order, 62 FR at 2425. Indeed, inclusion of the First 10 and Second 10 would likely produce skewed results. The market quality improvements induced by the Order Handling Rules, however, are apparent in both the First and Second 10.

[28] See also Summary of Comments, Section B.6.

2. Volatility [29]

The NASD looked at the volatility of the First and Second 40 and found that volatility slightly increased following the imposition of the Order Handling Rules for both the First 40 and the Second 40. For the First 40, average volatility rose from 1.16% to 1.25%, an increase of 7.6%. For the Second 40, volatility rose from 0.98% to 1.24%. It also found that the increase in volatility does not, however, appear to be attributable to the Order Handling Rules, because volatility also increased for other stocks in the top 500 that had not become subject to the Order Handling Rules during the sample period.

On the surface, the results indicate a general increase in volatility, in particular for the Second 40 stock group. In order to correct for stock-specific characteristics such as price, volume, and interday volatility, the NASD used a multivariate regression analysis. The multivariate regression results show that the differential increase in volatility for the Second 40 can be attributed to volume, price, and interday volatility.[30] In the presence of these factors, the differential volatility effect on the Second 40 is statistically insignificant. The NASD found that these results demonstrate that there is no statistically significant evidence of a differential change in intraday volatility between the First 40 and Second 40.

3. Quoted Depth Measures

The NASD examined the impact of the Actual Size Rule on quoted depth. First the NASD studied the percentage change in number of market makers and the percentage change in number of market makers at the market maker inside market. After performing a regression analysis, it found no statistically significant difference between the First 40 and the Second 40.[31] For both measures, the marginal impact of the removal of the 1,000-Share Quote Size Rule is negligible. The NASD also studied the distribution of the sizes of all dealer quote updates. It found that quote updates for 100 and 1,000 share stocks were similar for the First 40 and the Second 40.[32]

Based on this evidence, the NASD concluded that the changes in quoting behavior induced by the implementation of the Order Handling Rules have been qualitatively similar for both the First 40 and Second 40.

4. Liquidity [33]

The NASD looked at effective depth in order to measure liquidity. Similar to the sections on spread, volatility, and quoted depth measures above, the change in normalized effective depth [34] after implementation of the Order Handling Rules was calculated for the First 40 and Second 40. Effective depth is calculated for each Bid-Ask Midpoint (''BAM'') movement category, and mean values across all stocks and days in the sample for each category were calculated. The NASD applied multivariate regression analysis and found that there is no statistically significant association between the removal of the 1,000-Share Quote Size Rule and any change in normalized effective depth.

After accounting for changes in stock price, trading volume, and interday volatility, the NASD found no evidence of a statistically significant association between the removal of the regulatory minimum size for proprietary quotes and a change in liquidity.

B. Implementation of the Actual Size Rule Has Not Resulted in any Diminution in the Ability of Investors To Receive Automated Executions Through SOES, SelectNet, or Other Proprietary Systems Operated by Broker Dealers [35]

For some market participants, Nasdaq's SOES system is the primary means they use to obtain executions. Use of the SOES system has increased over the past few years. SOES executions accounted for 8.3% of all Nasdaq share volume in 1996, up from 5.6% in 1995 and 3.0% in 1993. Much of the SOES activity is derived from day traders. The majority of SOES orders are for 1,000 shares, the maximum tier size for stocks.

As detailed above, the SOES system was changed on January 20 to execute orders based on market maker quoted size. The NASD examined SOES activity to determine if the removal of the 1,000-Share Quote Size Rule diminished the ability of the SOES system to provide executions.

First, the NASD examined whether the incidence of ECNs alone at the inside market was different for the First 40 and Second 40 stocks. When an ECN is alone at the inside, SOES is unavailable. The NASD found that ECNs were alone at the inside market only 9.2% of the time after implementation of the Order Handling Rules for the First 40 stocks, and only 9.4% of the time for the Second 40.[36] Second, the NASD examined how often all market makers at the inside market were quoting a size of 100. The NASD found that this occurred only 1.6% of the time in the First 40 stocks and only 0.8% of the time in the Second 40.

Both measures provide evidence from which the NASD concluded that times during which SOES is unavailable are uncommon and that the degree of any degradation of the effectiveness of SOES due to the Actual Size Rule is statistically insignificant. Moreover, the NASD concluded that only certain measures of SOES performance (*e.g.*, multiple price SOES executions, average SOES trade size) have experienced any marginal change between the First 40 and the Second 40.[37] To the extent a marginal difference exists, the NASD found it to be slight and therefore concluded that the removal of the 1,000-Share Quote Size Rule has had no meaningful effect on the SOES system's ability to provide reasonable access to executions.

C. Response to Electronic Traders Association (''ETA'') Study [38]

The ETA is an association representing SOES order entry firms whose customers use SOES for day trading. The ETA conducted its own study of the Actual Size Rule. Its study found that SOES orders in pilot stocks are less likely to be executed than for non-pilot stocks; that the mean time between entry and execution of a SOES order is longer for pilot than for non-pilot stocks; and that the mean price concession is larger for pilot stocks than for non-pilot stocks.

The NASD examined the ETA study and found it seriously flawed. The NASD noted that the ETA study is based on a small sample of data from three of

[29] See also Summary of Comments, Section B.5.

[30] June Study at 31.

[31] June Study at 35 and Table B.5 of Appendix B.

[32] June Study at 34.

[33] See also Summary of Comments, Section B.4.

[34] Normalized effective depth is defined as the dollar volume required to move the BAM one percentage point, calculated for BAM moves of the following percentage movements; all movements, 0.5%, 1%, 1.5%, 2%, 2.5%, and 3%.

[35] See also Summary of Comments, Section B.9.

[36] The NASD also found that between August 11 and 29, 1997, SOES access was restricted to 100 shares only 1.2% of the time. That is, only 1.2% of the trading day was it the case that there was no market maker at the inside quoting an amount greater than 100 shares. September Study at 4.

[37] See June Study at 42–46. For example, for the First 40, average SOES trade size fell by 15.0% and by 6.0% for the Second 40. It is important to note, however, that given that the mean price of stocks in the First 40 was roughly $35, the average SOES trade size of 753 shares represents a trade of approximately $26,000. Compared to most retail activity, the average SOES trade in the First 40 continues to be quite large. Given that the average SOES trade size is still large and that SOES continues to account for a substantial proportion of Nasdaq dollar volume, it is unlikely that the decrease in average trade size of SOES executions has negatively impacted the ability of the SOES system to provide executions for retail-size orders.

[38] See also Summary of Comments, Section B. 10.

the 425 firms that enter orders through SOES; the ETA does not distinguish between SOES orders that were actively canceled by the order entry firm and those that were returned to the order entry firm; and the ETA report does not account for considerable differences in the average trading characteristics (*e.g.*, price, volume) between pilot and non-pilot stocks. The NASD found that the ETA study provides ''no basis to conclude that the Actual Size Rule has adversely affected the ability of the SOES system to provide investors with reasonable access to market maker capital.'' [39]

D. The Pilot Justifies an Expansion and Extension of the Actual Size Rule

While some market participants may maintain that the Actual Size Rule should be abandoned because it has not had a demonstrably positive market impact, the NASD believes, in light of the pilot experience and its economic research, that the Rule should be retained. The NASD believes it eliminates an unnecessary regulatory requirement and, moreover, it has not had any adverse market impacts. In particular, with respect to the first 50 securities, the NASD believes that competitive forces in the marketplace, be they the result of displaying customer limit orders, ECN quote display, or market maker competition for order flow, have driven the Nasdaq market to perform at least as well, if not better, than if the artificial 1,000 share minimum quotation size requirement was in place.[40] As a result, given the conclusion that the market performs the same with or without the Actual Size Rule, the NASD believes it is far preferable for the protection of investors and the efficiency of the capital formation process to promote a regulatory environment for Nasdaq that achieves its results through aggressive competition rather than artificial regulatory fiat. In sum, in light of the performance of the first 50 securities, the NASD believes there is no regulatory basis to justify the retention of artificial quotation size requirements for Nasdaq market makers.

The NASD is proposing to expand the pilot to 150 stocks in order to provide a better sample of stocks to use in studying the effects of the Actual Size Rule upon the Nasdaq Market. Further, to address criticism by several commentators that the group of stocks making up the pilot (both currently and as the NASD initially proposed to expand it) is not an ideal sample of Nasdaq stocks upon which to base a decision on the future of the Actual Size Rule, the NASD altered the group of 100 stocks it is proposing to add to the current pilot.

The NASD has selected stocks that are representative of the entire Nasdaq market by sampling across dollar volume categories. Within dollar volume categories, it sought variation across SOES tier sizes of 1,000 and 500 shares. The NASD then randomly chose 100 stocks.[41]

V. Conclusion

The Commission approved the Actual Size Rule on a pilot basis so that the effects of the rule could be assessed. In doing so, the Commission stated that it believed that a reduction in the quotation size requirement could reduce the risks that market makers must take, produce accurate and informative quotations, and encourage market makers to maintain competitive prices even in the changing market conditions resulting from the Order Execution Rules.

As discussed above, the NASD has produced an extensive economic analysis of the pilot, and several commentators have provided their own economic analysis as well. These economic analyses have proved useful in assessing the pilot Program's impact on the Nasdaq market. Although the economic studies arrive at conflicting results on the value of the Actual Size Rule, the Commission preliminarily believes that the data indicates that the pilot has not resulted in harm to the Nasdaq market. Indeed, as discussed above, the Actual Size Rule appears to be a reasonable means to provide market making obligations that reflect the new market dynamics produced by the Order Execution Rules. Nevertheless, as several commenters noted, the pilot Program was limited to 50 out of over 5,000 securities. Moreover, the Commission had decided that it would be appropriate to gather further data before reaching a final decision as to whether or not to extend the Actual Size Rule to the entire Nasdaq market. The Commission notes that there has been some disagreement as to how to interpret the data the NASD and others have published concerning the pilot Program. This is due in part to the limited nature of the pilot Program and the need for commenters to extrapolate data concerning these 50 securities to the entire Nasdaq market. These problems can be reduced if the pilot is expanded as proposed. An extension and expansion of the pilot will provide the Commission, the NASD, and market participants with additional data and time to study the Order Execution Rules' effects on the Nasdaq market. Based upon the expanded pilot, the Commission will be in a better position to evaluate the impact of the Actual Size Rule upon the Nasdaq market.

The NASD initially proposed to expand the pilot Program by adding the 100 securities that were next to be phased-in under the Order Execution Rules earlier this year. Although the first 50 securities were chosen to provide a broad cross section of the most liquid Nasdaq securities,[42] the NASD filed Amendment No. 3 to select an additional 110 securities [43] from an enhanced sample more representative of the entire Nasdaq market. This was done in response to a number of the comment letters which suggested that the First 50 securities were not representative of the Nasdaq Market. Specifically, it was suggested that, because all 30 of the largest Nasdaq stocks were subject to the 100 share minimum, it was impossible to gauge the Actual Size Rule's effect on large Nasdaq stocks, since there were no sufficiently large non-pilot stocks with which to compare.

These additional 100 securities were chosen from those domestic Nasdaq National Market (''NNM'') stocks with a

[39] September study at 3.

[40] Some market participants have asserted that the lack of difference in performance between the First 40 and the Second 40 is attributable to the operation of several features of SOES. Specifically, these market participants claim that the SOES Auto-Refresh Feature, which refreshes a market maker quote to the applicable SOES tier size once its quote has been completely decremented, along with the ''No Decrementation'' and ''Supplemental Size'' features of SOES, artificially increase the number of 1000-share quotes in the first 50 securities. The ''No Decrementation'' feature of SOES allows a market maker to provide that its quote shall not be decremented after the execution of SOES orders. To use this feature, a market maker's quote size must be equal to the applicable SOES tier size. The ''Supplemental Size'' feature of SOES allows a market maker to establish a ''supplemental size'' that is used to automatically replenish a market maker's quote once it has been completely decremented. When a market maker's quote is replenished from the supplemental size, it is replenished to 1000 shares. In order to use this feature, a market maker must initially enter a quote size equal to or greater than the applicable SOES tier size. The NASD notes that market maker's use of each of these system features is completely voluntary and they are available for all Nasdaq securities. Accordingly, the NASD believes it would be inaccurate to assert that these SOES features have obfuscated the impact of the Actual Size Rule. *Id.* 62 FR at 19371.

[41] Ten additional stocks were chosen to make up for delistings within the first 50 stocks in the pilot and as reserves in case other pilot stocks delist. Only domestic common stocks were chosen.

[42] Actual Size Approval Order, 62 FR 2415.

[43] As discussed above, ten additional stocks were chosen to replace those pilot stocks that have already delisted or that may delist in the future. The proposal still calls for the pilot to expand from 50 to 150 stocks.

SOES tier size of either 1,000 or 500 shares that were not included in the First 50. These stocks were ranked by average (mean) daily dollar volume over the first seven months of 1997, and then divided into deciles, each containing approximately the same number of stocks. Eleven stocks were chosen at random from each decile, for a total of 110 stocks. Ten extra stocks were chosen to make up for four stocks of the First 50 that no longer trade on Nasdaq, and as reserves should any delist in the interim. This ensures that a total of 150 stocks will be ultimately subject to the Actual Size Rule is approved. The chosen stocks will be identified in a fax or Notice to Members published after SEC approval of the proposed rule change.

The Commission believes that the proposed amendment is consistent with the Exchange Act because it will provide for a more representative group of securities under an expanded Actual Size Rule pilot. The next 100 stocks include securities with significantly different trading volumes, so the NASD will be better able to assess the impact of the Actual Size Rule on the full panoply of Nasdaq stocks. This will further the evaluation of the Actual Size Rule and will assist the SEC in its determination as to whether to expand the pilot ultimately to all Nasdaq securities or to end it. In addition, Amendment No. 3 responds to the commentators who expressed concern that an expansion of the pilot to 150 stocks would capture stocks that account for a large majority of Nasdaq trading volume and SOES activity, and thus act as a *de facto* implementation of the Actual Size Rule. Regardless of the validity of this concern, the modified additional 100 stocks no longer contain only the next 100 most active stocks.

The Commission requests that the NASD continue to evaluate the effects of the reduction in the minimum quotation size for those Nasdaq stocks included in the pilot. Specifically, the NASD should continue its analysis of. (1) The number and composition of the market makers in each of the 50 securities, and any change over time; (2) the average aggregate dealer and inside spread by stock over time; (3) the average spread for each market maker by stock; (4) the average depth by market maker (including limit orders), and any change in the depth over time; (5) the fraction of volume executed by a market maker who is at the inside quote per stock; and (6) a measure of volume required to move the price of each security one increment (to determine the overall liquidity and volatility in the market for each stock). Finally, the NASD should compare data for each decile of securities, focusing particular attention on relatively active versus inactive securities that are among the lower tier of NNM securities, by daily dollar trading volume.

VI. 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, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to Amendment No. 3 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 number SR–NASD–97–26 and should be submitted by November 26, 1997.

VII. Commission's Findings and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change

For the reasons discussed above, the Commission finds that the NASD's proposal is consistent with the Exchange Act and the rules and regulations thereunder applicable to a national securities association and has determined to approve the expansion of the pilot to 150 Nasdaq securities and to extend the pilot through March 27, 1998.[44]

The Commission also is approving Amendment No. 3 on an accelerated basis. In Amendment No. 3, the NASD has addressed criticism by several commentators who believe that the current pilot is not well designed to study effects of the Actual Size Rule. These commentators believe that the 50 stock pilot is not sufficiently representative of the entire Nasdaq Market and cannot form the basis for an adequate economic study. In particular, the commenters stated that most of the 20 largest Nasdaq stocks are subject to Actual Size Rule and that very few small stocks are subject to rule, and thus it is impossible to gauge the rule's effect on the largest and smallest stocks without similar groups of nonpilot stocks to use in comparison.

The Commission finds that the 150 stock pilot the NASD is now proposing is a reasonable sampling of the Nasdaq market, calculated to allow the NASD and others to study the effects of the Actual Size Rule. The Commission also believes that approving Amendment No. 3 to the proposed rule change will provide it with additional data for use in determining whether to expand the Actual Size Rule to cover the entire Nasdaq market or to take another course of action. The Commission finds good cause in approving the extension element of Amendment No. 3 to the proposed rule change on an accelerated basis in order to give the NASD sufficient time to collect data on the expanded pilot, analyze that data, and publish a report on its findings. By allowing the NASD to begin its analysis quickly so that it may publish its findings promptly, commentators will have more time to examine the study and the Commission will be in a better position to make a determination on the future of the Actual Size Rule in a timely manner. An additional three months is designed to provide the Commission and the public time to fully consider the results of the NASD's economic study and is merely a technical change to prevent a rushed study and comment period. The Commission therefore finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof.

Accordingly, the Commission believes that the proposed rule change (SR–NASD–97–26) is consistent with Sections 15A(b)(6) and (b)(9) of the Exchange Act[45] and

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act,[46] that the proposed rule change, SR–NASD–97–26, be and hereby is approved through March 28, 1998.

[44] The Commission also has determined to approve the replacement of those securities in the pilot that are no longer listed on Nasdaq with others from the list of securities provided by the NASD.

[45] In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. The proposed rule likely will produce more accurate and informative quotations and encourage market makers to maintain competitive prices. It will also provide the Commission with additional data, enabling it to evaluate better the impact of the Actual Size Rule on the Nasdaq market and market participants. Since the Commission believes that the data discussed above indicates that the pilot has not resulted in harm to the Nasdaq market thus far, the net effect of approving the proposed rule change will be positive. 15 U.S.C. 78c(f).

[46] 15 U.S.C. 78s(b)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[47]

Jonathan G. Katz,

Secretary.

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SOCIAL SECURITY ADMINISTRATION

Statement of Organization, Functions and Delegations of Authority

This statement amends part S of the Statement of the Organization, Functions and Delegations of Authority which covers the Social Security Administration (SSA). Chapter S7 covers the Deputy Commissioner for Human Resources. Notice is given that Chapter S7 is being amended throughout to reflect organizational and functional changes. Notice is further given to reflect that Subchapter S7C, the Office of Labor-Management Relations is being retitled as the Office of Labor-Management and Employee Relations (S7C). The changes are as follows:

Section S7.10 The Office of the Deputy Commissioner, Human Resources—(Organization)

Retitle:

E. The Office of Labor-Management Relations (S7C) to the Office of Labor-Management and Employee Relations (S7C).

Section S7.20 The Office of the Deputy Commissioner, Human Resources—(Functions):

Amend to read as follows:

A. The Deputy Commissioner, Human Resources (DCHR) (S7) is directly responsible to the Commissioner for carrying out the ODCHR mission and providing general supervision to major components of ODCHR as well as guidance, support and technical assistance to the SSA regional personnel administration operation and policy and direct service support to the Agency's executive personnel activities and other high level special categories.

C. The Immediate Office of the Deputy Commissioner, Human Resources (S7A).

Change to read as follows:

1. Provides the Deputy Commissioner and the Assistant Deputy Commissioner with staff assistance on the full range of their responsibilities.

2. Develops and implements all SSA policies and activities relating to the Agency's executive level personnel management program.

3. Recruits for and places individuals in positions in the Senior Executive Service (SES) in accordance with OPM regulations.

4. Provides staff support to the Executive Resources Board in administering a systematic program to manage SSA's executive and professional resources and ensuring the appropriate selection of candidates to participate in official executive development programs.

5. Provides staff support to the Performance Review Board in reviewing performance plans and subsequent appraisals of career and non-career executives in SES and employees in equivalent level positions.

D. The Office of Personnel (OPE) (S7B).

Delete from the fourth sentence ''executive personnel services.''

Retitle:

E. The Office of Labor-Management Relations (S7C) to the Office of Labor-Management and Employee Relations (S7C).

Retitle:

Existing Subchapter S7C, ''The Office of Labor-Management Relations'' (S7C) to ''The Office of Labor-Management and Employee Relations'' (S7C). Change all references to ''The Office of Labor-Management Relations'' to ''The Office of Labor-Management and Employee Relations'' and all references to ''OLMR'' to''OLMER''.

Section S7B.00 The Office of Personnel—(Mission)

Delete from the first sentence ''executive personnel services.''

Section S7B.20 The Office of Personnel—(Functions)

D. The Project Management Staff (S7BH).

Amend as follows:

4. Develops and implements SSA-wide program of Personnel security. Directs personnel security activities having SSA-wide significance.

5. Designs national policies for the SSA Drug-Free Workplace Program. Manages the day-to-day operations of the Agency's drug program.

6. Directs the development and operation of SSA's Workers' Compensation services program. Provides assistance to employees regarding claims for loss of wages, settlement awards, notices of injury and required medical reports.

F. The Center for Personnel Operations (S7BK).

Delete the following from Item 1, sentence 1: ''including policies and guidelines for SSA administration of the Senior Executive Service (SES).''

Change to read as follows:

2. Develops and implements SSA-wide programs of position classification and position management within SSA headquarters. Directs position classification and position management activities having SSA-wide significance.

Add a last sentence to Item 8:

Serves as the focal point for unemployment compensation activities.

Delete Items 10 through 13.

Section S7C.00 The Office of Labor-Management and Employee Relations—(Mission)

Amend to read as follows:

The Office of Labor-Management and Employee Relations (OLMER) provides overall management of an SSA-wide program of labor-management and employee relations. The mission includes the development and evaluation of the programs and the formulation of SSA-wide labor-management relations policy. The office provides services to SSA components on labor relations issues and on employee relations issues relating to disciplinary and adverse actions and employee grievances.

Section S7C.20 The Office of Labor-Management and Employee Relations—(Functions):

Amend to read as follows:

C. The Immediate Office of the Director, Office of Labor-Management and Employee Relations (S7C) provides the Director and the Human Resources Manager with staff assistance on the full range of their responsibilities. The functions of the office include the following:

1. The formulation and promulgation of Agency policy, guidance and direction for exercising management's rights and discharging the Agency's obligations under labor and employee relations law, executive orders, regulation, and negotiated agreements. The research of policy questions in these areas for management at various levels of the organization. Coordinating with the Office of the General Counsel (OGC) on matters impacting on law or requiring legal opinions.

2. The negotiation, implementation and administration of master agreements nationwide, which involves pre-negotiated activities, team preparation, advisory services and problem resolution.

3. Negotiating agreements on behalf of the Agency with unions having exclusive recognition at the level of the Agency, advising and assisting management representatives in negotiating labor-management

[47] 17 CFR 200.30–3(a)(12).