

arguments concerning the foregoing, including whether Amendment No. 1 is consistent with Act. 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 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 the filing will also be available for inspection and copying at the Board's principal offices. All submissions should refer to File No. SR-MSRB-97-15, Amendment No. 1 and should be submitted by October 20, 1998.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40455; File No. SR-NASD-98-01]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc., and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4, Relating to the NASD's Rules Regarding Electronic Communications Networks, Locked and Crossed Markets, and a Member's Obligation to Provide Nasdaq with Certain Information

September 22, 1998.

#### I. Introduction

On January 27, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with 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> a proposed rule change to

amend the NASD's rules on locked and crossed markets and to propose a new rule to require NASD members to provide Nasdaq staff with certain information upon request. Nasdaq filed Amendment No. 1 to the proposal on June 8, 1998,<sup>2</sup> Amendment No. 2 on June 30, 1998,<sup>3</sup> and Amendment No. 3 on July 16, 1998.<sup>4</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on July 24, 1998.<sup>5</sup> The Commission received three comment letters on the proposal. On August 26, 1998, in response to issues raised by commenters, Nasdaq filed Amendment No. 4 to the proposal.<sup>6</sup> The Commission is publishing this notice and order to solicit comments on Amendment No. 4 and to approve the proposed rule change, as amended.

#### II. Background

SEC Rule 11Ac1-1(c)(5) ("ECN Rule"),<sup>7</sup> requires a Nasdaq market maker to reflect in its public quotes any superior prices for orders that the market maker privately places within an electronic communications network ("ECN"). A market maker will be deemed to have complied with the ECN Rule if the ECN in which the market maker has placed a superior priced order displays the best ECN prices in Nasdaq's quote montage and provides broker-dealers that do not subscribe to the ECN's service access, through Nasdaq, to those publicly displayed prices. To accommodate this "ECN Display Alternative," Nasdaq allowed ECNs to display their best prices from market makers and other ECN subscribers in the Nasdaq quote. It created a link to its SelectNet service to permit Nasdaq members to access those prices by sending orders to ECNs through SelectNet.

<sup>2</sup> See letter from Robert E. Aber, Senior Vice President and General Counsel, The Nasdaq Stock Market, Inc. to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), SEC, dated June 5, 1998.

<sup>3</sup> See letter from Robert E. Aber, Senior Vice President and General Counsel, The Nasdaq Stock Market, Inc. to Katherine A. England, Assistant Director, Division, SEC, dated June 29, 1998.

<sup>4</sup> See letter from Robert E. Aber, Senior Vice President and General Counsel, The Nasdaq Stock Market, Inc. to Richard Strasser, Assistant Director, Division, SEC, dated July 15, 1998.

<sup>5</sup> See Securities Exchange Act Release No. 40227 (July 17, 1998), 63 FR 39919 (July 24, 1998).

<sup>6</sup> See Letter from Robert E. Aber, Senior Vice President and General Counsel, The Nasdaq Stock Market, Inc. to Richard Strasser, Assistant Director, Division, SEC, dated August 25, 1998. Amendment No. 4 clarifies that ECNs are not required to register manually in each security with Nasdaq Market Operations.

<sup>7</sup> The ECN Rule is embodied in SEC Rule 11Ac1-1. 17 CFR 240.11Ac1-1.

Based on its experience with the ECN Rule and operation of the SelectNet linkage, Nasdaq determined that it was necessary to revise certain NASD rules. For instance, certain ECN procedures regarding reserved quotation size appear to cause an increased incidence of locked and crossed markets, particularly at the market opening. Moreover, Nasdaq did not have an adequate mechanism in place to obtain important regulatory information from NASD members on a timely basis. Nasdaq, therefore, proposed to amend NASD Rules 4613(e) and 4623, as well as adopt new NASD Rule 4625, to address these issues.

#### III. Description

Nasdaq proposes to amend NASD Rule 4613(e) to clarify that if, at or after 9:25:00 a.m. Eastern Time, a market maker or ECN enters a quotation that would lock or cross the market at the opening,<sup>8</sup> that market maker or ECN must act (such as by sending a SelectNet order to take out the quotation that will be crossed or locked, or canceling its own quotation) to avoid locking or crossing the market at the opening, but in no case later than 30 seconds thereafter (*i.e.*, 9:30:30 a.m.). The 9:25 a.m. benchmark will permit market makers and ECNs to determine which party entered a market-locking/crossing quotation, and thus which party is obligated to unlock or uncross the market at the opening. The 9:30:30 provision establishes a deadline by when the market participant must resolve the locked or crossed market.

Nasdaq is also proposing to amend NASD Rule 4623 regarding ECNs. Under proposed NASD Rule 4623(c), if an ECN displays in Nasdaq an order having a reserved size and a market participant attempts to access that order by sending an order that is larger than the displayed size, the ECN would be required to execute the Nasdaq-delivered order: (1) Up to the size of the Nasdaq-delivered order, if the ECN order (including the reserved size and displayed portion) is the same size as or larger than the Nasdaq-delivered order; or (2) up to the size of the ECN order (including the reserved size and displayed portion), if the Nasdaq-delivered order is the same size as or larger than the ECN order (including the reserved size and displayed portion).<sup>9</sup>

<sup>8</sup> A locked market occurs when the quoted bid price is the same as the quoted ask price. A crossed market occurs when the quoted bid price is greater than the quoted ask price.

<sup>9</sup> Nasdaq also proposed to amend NASD Rule 4623(b)(4) to specify an ECN's obligation to register with Nasdaq Market Operations. As discussed

<sup>9</sup> 17 CFR 200.30-3(a)(12).

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

Nasdaq is also proposing to adopt new NASD Rule 4625, which will authorize Nasdaq staff to request information in specific circumstances and will obligate members to comply with such requests. Specifically, under proposed new NASD Rule 4625, Nasdaq staff (*i.e.*, Nasdaq MarketWatch or Market Operations staff) would be permitted to request from a member information directly related to an SEC or NASD rule that the Nasdaq department is responsible for administering, or other duties or responsibilities imposed on the Nasdaq department by the Plan of Allocation and Delegation of Function or otherwise delegated by the Association to the Nasdaq department. Failure to comply with a request for information under the proposed new rule in a timely, truthful and complete manner could be deemed to be conduct inconsistent with just and equitable principles of trade.

#### IV. Summary of Comments

The Commission received three comment letters on the proposal. Two letters were from entities that operate ECNs, Bloomberg, L.P. (which owns Bloomberg Tradebook LLC) and Instinet Corporation, and one letter was from Morgan Stanley & Co. Inc., a large broker-dealer and Nasdaq market maker.<sup>10</sup>

##### *ECN Registration*

Two commenters opposed Nasdaq's proposed amendment to NASD Rule 4623(b)(4), discussing ECNs' obligation to register with Nasdaq Market Operations.<sup>11</sup> The commenters interpreted the proposed amendment as requiring ECNs to register with Nasdaq Market Operations for each security as an ECN prior to entering prices and sizes in the SelectNet linkage on that security.<sup>12</sup>

##### *Preventing Locked and Crossed Markets*

All commenters supported the proposed amendment to NASD Rule 4613(e) to reduce the instances of locked and crossed markets at the opening. Additionally, one commenter believed the proposal to require ECNs to execute against reserve size will reduce

the number of market maker and ECN quotations that lock or cross the market throughout the day and bring greater stability to the Nasdaq market.<sup>13</sup> Two commenters were concerned, however, with the proposed requirement in NASD Rule 4623(c) that ECNs provide non-subscribers access to the reserve size to reduce intraday locking and crossing.<sup>14</sup> One commenter was concerned that providing unlimited access to reserve size to broker-dealers that do not subscribe to the ECN's service creates a credit risk for the ECN.<sup>15</sup> This commenter, therefore, suggested that non-subscriber access be limited to 10,000 shares to better balance the advantages of access with any counterparty risk an ECN might assume.<sup>16</sup> In the alternative, this commenter suggested that the credit risk could be lessened by requiring the National Securities Clearing Corporation ("NSCC") to take responsibility for a trade from the moment NSCC receives the executed trade. One commenter opposed this provision of the proposal because it was concerned that requiring ECNs to execute against reserve size creates a disparate standard for ECNs vis-a-vis dealers that are given large orders to "work."<sup>17</sup>

##### *Obligation to Provide Information to Nasdaq Staff*

The two commenters that addressed the NASD's proposed new Rule 4625, which would require NASD members to provide Nasdaq staff with regulatory information, generally supported the proposal.<sup>18</sup> One commenter noted, however, that the proposal, by requiring ECNs and market makers to divulge sensitive client information to Nasdaq, could alter the working relationship among ECNs, market makers, and Nasdaq's MarketWatch.<sup>19</sup> Another commenter, while supporting the proposed new rule, cautioned staff against setting unrealistic deadlines for receiving the requested information.<sup>20</sup> This commenter proposed that Nasdaq apply a "good faith" test to any disciplinary action brought against an

NASD member for not producing the requested information in a timely manner.

#### V. Discussion

The Commission finds that the proposed rule change is consistent with the Act and the rules and regulations applicable to the NASD. In particular, the proposal is consistent with sections 15A(b)(6), 15A(b)(11), and 11A(a)(1)(C) of the Act.

Section 15A(b)(6) requires, among other things, that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.<sup>21</sup>

Section 15A(b)(11) requires that the NASD as a national securities association have rules that govern the form and content of quotations relating to securities in the Nasdaq market.<sup>22</sup> Such rules must be designed to produce fair and informative quotations, prevent fictitious or misleading quotations, and promote orderly procedures for collecting, distributing, and publishing quotations. Sections 11A(a)(1)(C) provides that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure, among other things, the economically efficient execution of securities transactions and the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities, and to assure fair competition among brokers and dealers.<sup>23</sup>

Specifically, both the requirement to avoid locking and crossing the market at the opening and to permit market participants to execute against reserve size are consistent with sections 15A(b)(6), 15A(b)(11), and 11A(a)(1)(C). The Commission believes that these proposals will reduce the frequency of locked and crossed markets, which should provide more informative quotation information and contribute to the maintenance of a fair and orderly market. These improvements should benefit the markets and investors.

below, this provision was further amended in Amendment No. 4.

<sup>10</sup> See Letters to Jonathan G. Katz, Secretary, SEC, from Kevin M. Foley, Bloomberg L.P., dated August 14, 1998 ("Bloomberg Letter"); from Douglas Atkin, Chief Executive Officer, Instinet Corporation, dated August 17, 1998 ("Instinet Letter"); and from Jill W. Ostergaard, Counsel, Morgan Stanley & Co. Inc., dated August 19, 1998 ("Morgan Stanley Letter").

<sup>11</sup> See Bloomberg and Instinet Letters.

<sup>12</sup> As discussed below, Nasdaq filed Amendment No. 4 with the Commission to clarify that ECNs need not register separately for each security.

<sup>13</sup> See Morgan Stanley Letter.

<sup>14</sup> See Bloomberg and Instinet Letters.

<sup>15</sup> See Bloomberg Letter.

<sup>16</sup> *Id.*

<sup>17</sup> See Instinet Letter. *But see* Morgan Stanley Letter, which noted that the proposal does not go far enough in leveling the playing field between ECNs and market makers. This commenter noted that to provide unfettered competition among all market participants, market makers should be allowed to charge fees to market participants that access their quotations as ECNs are currently permitted to do.

<sup>18</sup> See Bloomberg and Morgan Stanley Letters.

<sup>19</sup> See Bloomberg Letter.

<sup>20</sup> See Morgan Stanley Letter.

<sup>21</sup> 15 U.S.C. 78o-3(b)(6).

<sup>22</sup> 15 U.S.C. 78o-3(b)(11).

<sup>23</sup> 15 U.S.C. 78k-1(a)(1)(C).

The Commission believes, as do two commenters, that continued locking and crossing of the market can negatively impact market quality.<sup>24</sup> As the Commission has previously stated, market makers and ECNs are required to use reasonable means to avoid locking and crossing the market.<sup>25</sup> Consequently, Nasdaq market makers and ECNs must use "reasonable means" to take out the quote that their quote, if immediately posted, would lock or cross. NASD has interpreted "reasonable means" to include referencing a SelectNet order to the firms at the bid or offer.<sup>26</sup> Experience has shown, however, that ECNs increasingly are remaining at the inside quote after executing an incoming order at the displayed size even when the incoming order exceeds the displayed ECN order size. As a result, the incidence of locked and crossed markets has increased.

The Commission believes that the proposal to require ECN orders having reserve size to interact with incoming orders from SelectNet will help reduce the frequency of locked and crossed markets on Nasdaq and, as a result, improve market quality. Moreover, the Commission believes that requiring an ECN to accept a SelectNet order for larger than the ECN's displayed size balances the interest to reduce the frequency of locked and crossed markets with market participants' desire to display only portion of a large order.

One commenter expressed concern that the proposal increases an ECN's counterparty risk by allowing non-participant broker-dealers (with whom the ECN has no contractual relationship) to access the ECN's reserve size.<sup>27</sup> The Commission notes, however, that the risk is no greater than that involved in any other broker-to-broker transaction. Moreover, the SEC's broker-dealer capital requirements as well as NSCC's novation of executed trades should greatly reduce the risk of non-performance that ECNs may face. Moreover, since the SEC implemented its Order Handling Rules, non-subscriber broker-dealer non-performance resulting from permitting

non-subscriber access in those instances.

The Commission believes that the proposed provision applying the restrictions against locking or crossing the market at the opening should help to clarify NASD members' responsibilities, including setting a deadline for required action. As a result, the proposed provision should promote a more orderly opening in Nasdaq securities.

The Commission believes that the proposal to adopt NASD Rule 4625, regarding a member's obligation to supply Nasdaq MarketWatch and Market Operations staff with certain information upon request, is consistent with the NASD's regulatory responsibilities under section 15A of the Act. The Commission believes that to properly fulfill its obligation to administer NASD and SEC rules, as well as other applicable requirements, Nasdaq staff must be able to obtain information regarding matters such as locked and crossed markets, trade reports, trading activity, and erroneous transactions on a timely basis from market participants.

In response to two commenters who were concerned with the proposal requiring ECNs to register independently for each security, Nasdaq filed Amendment No. 4 to the proposal.<sup>28</sup> This amendment clarifies that ECNs are required to register with Nasdaq Market Operations prior to being included in Nasdaq as an ECN but are not required to register manually in each security. According to the NASD, in practice, once an ECN registers with Nasdaq Market Operations, Nasdaq systems allow the ECN to enter quotations in all Nasdaq securities. The Commission believes that this amendment addresses the commenters' concerns that the rule change, as originally proposed, would unnecessarily burden ECNs by requiring them to register on a per-security basis.

The Commission believes that Amendment No. 4 should be approved on an accelerated basis because it does not impose any requirements in

addition to those originally proposed and published for comment. In fact, Amendment No. 4 revised the NASD's proposal so that the ECN registration requirement is consistent with the current practice that once an ECN registers with Nasdaq Market Operations Nasdaq systems allow the ECN to enter quotations in all Nasdaq securities.

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to the NASD,<sup>29</sup> and, in particular, with sections 15A(b)(6), 15A(b)(11), and 11A(a)(1)(C) of the Act. In addition, the Commission finds good cause for approving Amendment No. 4 to the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**.

## VI. Conclusion

*It is therefore ordered*, pursuant to section 19(b)(2),<sup>30</sup> that the proposed rule change (SR-NASD-98-01) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>31</sup>

**Jonathan G. Katz,**  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40454; File No. SR-NASD-98-25]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Fees for Nasdaq Market Distributors or Vendors

September 22, 1998.

## I. Introduction

On May 14, 1998,<sup>1</sup> the Nasdaq Stock Market, Inc. ("Nasdaq") filed with the

<sup>29</sup> In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>30</sup> 15 U.S.C. 78s(b)(2).

<sup>31</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> The NASD initially submitted this proposal on March 16, 1998. However, a substantive amendment was requested to clarify the applicability of the proposed fee. The NASD filed Amendment No. 1 on April 28, 1998. See letter from Thomas P. Moran, Senior Attorney, Office of General Counsel, The Nasdaq Stock Market, Inc., to Mignon McLemore, Esq., Division of Market Regulation, SEC, dated April 28, 1998 ("Amendment No. 1"). On May 14, 1998, the Board

<sup>24</sup> See Instinet and Morgan Stanley Letters.

<sup>25</sup> See Letter to Joseph R. Hardiman, President, NASD, from Richard R. Lindsey, Director, Division, SEC, dated November 22, 1996 (noting that, in the OTC market, a Nasdaq market maker holding a limit order that is marketable against another market maker's or ECN's quote may send a SelectNet message to the market maker or ECN displaying the existing quote. However, after using reasonable efforts to execute against the existing quote, the market maker should display the limit order even if it locks the market).

<sup>26</sup> See NASD Notice to Members 97-49.

<sup>27</sup> See Bloomberg Letter.

<sup>28</sup> In Amendment No. 4, Nasdaq is withdrawing the previously proposed amendment to NASD Rule 4623(b)(4) and is proposing to replace it with the following (new language is italicized; deletions are bracketed):

(4) agree to provide for Nasdaq's dissemination in the quotation data made available to quotation vendors the prices and sizes of Nasdaq market maker orders (and other entities, if the (electronic communications network) ECN so chooses) at the highest buy price and the lowest sell price for each Nasdaq security entered in and widely disseminated by the (electronic communications network) ECN, and prior to entering such prices and sizes, register with Nasdaq Market Operations as an ECN.