

For further details with respect to this action, see the application for amendment dated July 19, 2002, which is available for public inspection at the Commission's PDR, located at One White Flint North, 11555 Rockville Pike (first floor), Rockville, Maryland. Publicly available records will be accessible from the Agencywide Documents Access and Management System's (ADAMS) Public Electronic Reading Room on the Internet at the NRC Web site, <http://www.nrc.gov/reading-rm/adams.html>. Persons who do not have access to ADAMS or who encounter problems in accessing the documents located in ADAMS, should contact the NRC PDR Reference staff by telephone at 1-800-397-4209, 301-415-4737, or by e-mail to [pdr@nrc.gov](mailto:pdr@nrc.gov).

Dated at Rockville, Maryland, this 28th day of August, 2002.

For the Nuclear Regulatory Commission.

**Victor Nerses,**

*Senior Project Manager, Section 2, Project Directorate I, Division of Licensing Project Management, Office of Nuclear Reactor Regulation.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 46428]

### Order Pursuant to Section 11A of the Securities Exchange Act of 1934 and Rule 11Aa3-2(f) Thereunder Granting a *De Minimis* Exemption for Transactions in Certain Exchange-Traded Funds From the Trade-Through Provisions of the Intermarket Trading System

August 28, 2002.

Rule 11Aa3-2(d),<sup>1</sup> adopted pursuant to Section 11A of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),<sup>2</sup> requires each self-regulatory organization ("SRO") to comply with, and enforce compliance by its members and their associated persons with, the terms of any effective national market system plan of which it is a sponsor or participant. Rule 11Aa3-2(f) authorizes the Commission to exempt, either unconditionally or on specified terms and conditions, any SRO, member thereof, or specified

security, from the requirement of this rule if the Commission determines that such exemption is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets and the removal of impediments to, and perfection of the mechanisms of, a national market system.<sup>3</sup>

The Intermarket Trading System ("ITS") is an order routing network designed to facilitate intermarket trading in exchange-listed equity securities among participating SROs based on current quotation information emanating from their markets.<sup>4</sup> The terms of the linkage are governed by the ITS Plan, a national market system plan approved by the Commission pursuant to Section 11A of the Act and Rule 11Aa3-2 thereunder.<sup>5</sup>

Under the ITS Plan, a member of a participating SRO may access the best bid or offer displayed in CQS by another Participant by sending an order (a "commitment to trade") through ITS to that Participant. Exchange members participate in ITS through facilities provided by their respective exchanges. NASD members participate in ITS through a facility of the Nasdaq Stock Market ("Nasdaq") known as the Computer Assisted Execution System ("CAES"). Market makers and electronic communications networks ("ECNs") that are members of the NASD and seek to display their quotes in exchange-listed securities through Nasdaq must register with the NASD as ITS/CAES Market Makers.<sup>6</sup>

Section 8(d)(i) of the ITS Plan provides that:

Absent reasonable justification or excuse, a member located in an Exchange Market, or an ITS/CAES

Market Maker, should not purchase any security that he is permitted to trade through the system at a price that is higher than the price at which that security, at the time of such purchase, is offered in one or more other Participant's Markets that trade the security through ITS as reflected by the offer furnished from such other Participant's Market(s) then being displayed on the trading floor of, or available in the quotation service used by, such member or available in the quotation service used by an ITS/CAES Market Maker.<sup>7</sup>

A similar provision applies with respect to the sale of any such security at a price lower than the price at which the security is bid for in one or more other Participant's markets.<sup>8</sup> If a trade-through occurs and a complaint is received through ITS from the party whose bid or offer was traded through, the party who initiated the trade-through may be required to satisfy the bid or offer traded through or take other remedial action.<sup>9</sup>

The ITS trade-through provisions were designed both to encourage market participants to display their trading interest—which contributes liquidity to the market—and to help achieve best execution for customer orders in exchange-listed securities. Like ITS itself, however, these rules were designed at a time when the order routing and execution facilities of markets were much slower, intermarket competition less keen, and the minimum quote increment for exchange-listed securities was 1/8 of a dollar (\$0.125).

With the introduction of decimal pricing and technology changes that have enabled vastly reduced execution times, the trade-through provisions of the ITS Plan have increasingly limited the ability of a Participant or ITS/CAES Market Maker to provide an automated execution when a better price is displayed by another Participant that does not offer automated execution. For example, certain electronic systems can offer internal executions in a fraction of a second, whereas ITS participants have, at a minimum, thirty seconds to respond to a commitment to trade. Thus, an ITS Participant seeking to execute a transaction at a price inferior to the price quoted by another ITS Participant must generally either (i)

<sup>3</sup> See 17 CFR 240.11Aa3-2(f).

<sup>4</sup> Quotations in exchange-listed securities are collected and disseminated by the Consolidated Quote System ("CQS"), which is governed by the CQ Plan approved by the Commission under Rule 11Aa3-2.

<sup>5</sup> See Securities Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983). The SROs participating in ITS include the American Stock Exchange LLC ("Amex"), the Boston Stock Exchange, Inc. ("BSE"), the Chicago Board Options Exchange, Inc. ("CBOE"), the Chicago Stock Exchange, Inc. ("CHX"), the Cincinnati Stock Exchange, Inc. ("CSE"), the National Association of Securities Dealers, Inc. (the "NASD"), the New York Stock Exchange, Inc. ("NYSE"), the Pacific Exchange, Inc. ("PCX"), and the Philadelphia Stock Exchange, Inc. ("Phlx") ("Participants").

<sup>6</sup> See Securities Exchange Act Release No. 42536 (March 16, 2000), 65 FR 15401 (March 22, 2000). Market makers and ECNs are required to provide their best-priced quotations and customer limit orders in certain exchange-listed and Nasdaq securities to an SRO for public display under Exchange Act Rule 11Ac1-1 (the "Quote Rule") and Regulation ATS. 17 CFR 240.11Ac1-1(c) and 242.301(b)(3).

<sup>7</sup> ITS Plan, Section 8(d)(i).

<sup>8</sup> To implement the intent of Section 8(d)(i), each Participant has adopted and obtained Commission approval of a "trade-through rule" substantially the same as the rule attached as Exhibit B to the ITS Plan. See ITS Plan, Section 8(d)(ii). See also NYSE Rule 15A; NASD Rule 5262.

<sup>9</sup> See ITS Plan, Exhibit B.

<sup>1</sup> See 17 CFR 240.11Aa3-2(d).

<sup>2</sup> Pursuant to Section 11A of the Act, the Commission may, by rule or order, "authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under [the Act] in planning, developing, operating, or regulating a national market system." See Section 11A(a)(3)(B) of the Act, 15 U.S.C. 78k-1(a)(3)(B).

attempt to access the other Participant's quote, which could delay the customer's transaction by thirty seconds or more, or (ii) become potentially liable to the other Participant for the amount by which its quote was traded through.

These provisions are particularly restrictive in the case of exchange-traded funds ("ETFs") tracking the Nasdaq-100 Index ("QQQs"), the Dow Jones Industrial Average ("DIAMONDS"), and the Standard & Poor's 500 Index ("SPDRs"). These ETFs share certain characteristics that may make immediate execution highly desirable to certain investors. In particular, because these ETFs are highly liquid securities and their value is readily derived from the values of the underlying shares, the ability to obtain an immediate execution at a displayed price may be more important than the opportunity to obtain a better price.

The Commission is granting a *de minimis* exemption from the trade-through provisions of the ITS Plan with respect to transactions in these ETFs that are effected at a price no more than three cents away from the best bid and offer quoted in CQS. A *de minimis* exemption will allow Participants and ITS/CAES Market Makers to execute transactions, through automated execution or otherwise, without attempting to access the quotes of other Participants when the expected price improvement would not be significant. The Commission believes that exempting transactions at this level from the ITS trade-through provisions will, on balance, provide investors increased liquidity and increased choice of execution venues while limiting the possibility that investors will receive significantly inferior prices. In particular, the Commission believes that the expected benefit to investors seeking an immediate execution in such ETFs, rather than a delayed execution through ITS, is not likely to exceed three cents per share.

The Commission considered other alternatives to the three-cents threshold and concluded that on balance it represents a sensible compromise between retaining the trade-through provisions in their current form (a zero-cent threshold) and permitting all trade-throughs (a large threshold). The three-cents threshold was chosen to avoid compelling broker-dealers to use ITS unless the expected price improvement is greater than the de facto cost of using ITS. The de facto cost of using ITS is largely due to the option value of the commitments that broker-dealers give to dealers in other markets when trying to obtain better execution prices. The Office of Economic Analysis estimated

the value of these options to be between one cent per share and two and one-half cents per share for the securities in question. Further, since execution of a commitment is uncertain, there is a risk that the expected price improvement will be less than the displayed quote would suggest. The staff therefore concluded that a three-cents trade-through threshold was more reasonable. Although the Commission recognizes the limitations of this analysis, it believes that the three-cents threshold represents an appropriate compromise between competing interests.

By granting the exemption on a temporary basis, moreover, the Commission will be able to gather the data necessary to study the effects of an exemption from the ITS trade-through provisions and the desirability of extending the exemption. The Commission therefore believes that it is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets and the removal of impediments to, and perfection of the mechanisms of, a national market system to grant a temporary *de minimis* exemption from the trade-through provisions of the ITS Plan with respect to transactions in these ETFs. In this connection, the Commission emphasizes that the proposed exemption does not relieve brokers and dealers of their best execution obligations under the federal securities laws and SRO rules.

Accordingly, *it is ordered*, pursuant to Section 11A of the Act and Rule 11Aa3-2(f) thereunder, that Participants of the ITS Plan and their members are hereby exempt from Section 8(d) of the ITS Plan during the period covered by this Order with respect to transactions in QQQs, DIAMONDS, and SPDRs that are executed at a price that is no more than three cents lower than the highest bid displayed in CQS and no more than three cents higher than the lowest offer displayed in CQS.

This Order shall be effective commencing on September 4, 2002 through June 4, 2003.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46422; File No. SR-NASD-2002-04]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to Rule 3010(b)(2) and IM-8310-2

August 28, 2002.

#### I. Introduction

On January 7, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> On May 31, 2002, NASD filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposal amends NASD Rule 3010(b)(2), also known as the "Taping Rule," and NASD-IM-8310-2. Notice of the proposed rule change, as amended, was published for comment in the **Federal Register** on June 18, 2002.<sup>4</sup> The Commission received three comment letters regarding the proposal.<sup>5</sup> This order approves the proposed rule change.

#### II. Description of the Proposed Rule Change

NASD Rule 3010(b)(2) requires NASD members to adopt special supervisory procedures and to tape record all of their registered representatives' telephone calls with customers (or potential customers) when they meet specified threshold levels of representatives that have worked at disciplined firms. A firm is "disciplined" within the meaning of the Rule if, in connection with securities sales practices, it has been expelled from membership or participation in a securities self-regulatory organization, or is subject to an order of the

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

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

<sup>3</sup> See letter from Grace Yeh, Assistant General Counsel, NASD Regulation, to Katherine England, Assistant Director, Division of Market Regulation, Commission, dated May 31, 2002.

<sup>4</sup> See Securities Exchange Act Release No. 46067 (June 12, 2002), 67 FR 41561.

<sup>5</sup> See letters to the Secretary, SEC, from Brad Bervert, President, Financial World Corporation, dated June 4, 2002 ("Bervert Letter"), and William Perry, President and Chief Executive Officer, Pro-Integrity Securities, Inc., dated June 27, 2002 ("Perry letter"); e-mail from James St. Claire, Chief Executive Officer, ViewTrade Securities, Inc., dated August 2, 2002 ("St. Claire e-mail").