

Section 6(b)(5)<sup>9</sup> requirements that the rules of an exchange be designed to remove impediments to and perfect the mechanism of a free and open market, to facilitate transactions in securities and, in general, to protect investors and the public interest.<sup>10</sup>

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. The Commission notes that the instant proposed rule change, as amended, is substantively similar to NYSE Rule 124, which has been reviewed and approved by the Commission.<sup>11</sup> Thus, this proposal does not raise any new regulatory issues or concerns. For instance, like NYSE Rule 124, the proposed rule change would amend Article XXXI, Rule 9 to base odd-lots prices on the adjusted ITS BBO if: (1) The security is included in ITS in the relevant market center, (2) the size of the quotation is greater than 100 shares, (3) the bid or offer is no more than \$0.25 away from the bid or offer disseminated by the primary market, (4) the quotation conforms to Exchange requirements regarding minimum trading variations, and (5) the quotation does not result in a locked market. Article XXXI, Rule 9 is also similar to NYSE Rule 124 in that when the adjusted ITS BBO is unavailable due to unusual market conditions the odd-lot market for an ITS security would be determined by the next round-lot sale on the Exchange.

The Commission believes that generally pricing odd-lots for listed securities based on the ITS BBO should improve the execution quality for odd-lot orders. Further, the Commission believes that the proposal should help to ensure that odd-lot executions are based on market activity that is relevant and reliable. The Commission believes that the proposed rule change, as amended, should provide small investors, who may find it difficult to trade orders in round-lot increments, with better executions and should enhance the integrity of the market.

## V. Conclusion

For the foregoing reasons, the Commission finds that the proposal, as amended, is consistent with the requirements of the Act and rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (SR-CHX-2002-18), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 02-26690 Filed 10-18-02; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46652; File No. SR-NASD-2002-133]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change and Amendment Nos. 1 and 2 by the National Association of Securities Dealers, Inc. To Establish an Execution Price Governor in SuperMontage

October 11, 2002.

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> notice is hereby given that on September 30, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") a proposed rule change, as described in Items I and II below, which Items have been prepared by the NASD. The NASD amended its proposal on October 9, 2002<sup>3</sup> and October 10, 2002.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change and Amendment Nos. 1 and 2 from interested persons and to approve the proposal, as amended, on an accelerated basis.

<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated September 27, 2002 ("Amendment No. 1"). In Amendment No. 1, the NASD submitted the proposal on a pilot basis under Section 19(b)(2) of the Act, requested accelerated approval, and replaced in its entirety the original rule filing submitted to the Commission dated on September 27, 2002.

<sup>4</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 10, 2002 ("Amendment No. 2"). In Amendment No. 2, the NASD made minor technical corrections to the rule text.

### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq is proposing to establish, for a 60-day pilot period, a SuperMontage execution price governor to prevent inadvertent executions significantly away from the inside market. The text of the proposed rule change is below. Proposed new language is *italicized*.

\* \* \* \* \*

#### 4710. Participant Obligations in NNMS

(a) No Change.

(b) Non-Directed Orders

(1) General Provisions—A Quoting Market Participant in an NNMS Security shall be subject to the following requirements for Non-Directed Orders:

(A) No Change.

(i) No Change.

(ii) No Change.

(iii) No Change.

(B) Processing of Non-Directed Orders—No Change.

(i) through (iii) No Change.

(iv) Exceptions—The following exceptions shall apply to the above execution parameters:

(a) If a Nasdaq Quoting Market Participant enters a Non-Directed Order into the system, before sending such Non-Directed Order to the next Quoting Market Participants in queue, the NNMS will first attempt to match off the order against the Nasdaq Quoting Market Participant's own Quote/Order if the participant is at the best bid/best offer in Nasdaq.

(b) If an NNMS Market Participant enters a Preferred Order, the order shall be executed against (or delivered in an amount equal to) both the Displayed Quote/Order and Reserve Size of the Quoting Market Participant to which the order is being directed, if that Quoting Market Participant is at the best bid/best offer when the Preferred Order is next in line to be delivered (or executed). Any unexecuted portion of a Preferred Order shall be returned to the entering NNMS Market Participant. If the Quoting Market Participant is not at the best bid/best offer when the Preferred Order is next in line to be delivered (or executed), the Preferred Order shall be returned to the entering NNMS Market Participant.

(c) *If an NNMS Market Participant enters a Quote or Non-Directed Order that would result in NNMS either: 1) delivering an execution to a Quoting Market Participant(s) that participates in the automatic-execution functionality of the system at a price substantially away from the current inside bid/offer in that security; or 2) delivering a Liability*

<sup>9</sup> 15 U.S.C. 78f(b)(5).

<sup>10</sup> In approving this rule, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with section 3 of the Act. 15 U.S.C. 78c(f).

<sup>11</sup> See *supra* note 5.

Order to a Quoting Market Participant(s) that participates in the order-delivery functionality of the system at a price substantially away from the current inside bid/offer in that security, the system shall instead process only those portions of the order that will not result in either an execution or delivery at a price substantially away from the current inside best bid/offer in the security and return the remainder to the entering party. For purposes of this subsection only, an execution or delivery based on a sell order shall be deemed to be substantially away from the current inside bid if it is to be done at a price lower than a break-price established by taking the inside bid, reducing it by 10% of the bid's value, and then subtracting \$0.01. For example, in a stock with a current inside bid of \$10.00, the maximum price at which a single sell order could be executed would be \$8.99 calculated as follows:  $(\$10.00 - (\$10.00 \times .10 \text{ e.g. } \$1) - \$0.01 = \$8.99)$ . For offers, an execution or delivery based on a buy order shall be deemed to be substantially away from the current inside offer if it is done at a price higher than a break-price established by taking the inside offer, adding 10% of the offer's value to it, and then adding \$0.01. For example, in a stock with a current inside offer of \$10.00, the highest price at which a single sell order could be executed would be \$11.01 calculated as follows:  $(\$10.00 + (\$10.00 \times .10 \text{ e.g. } \$1) + \$0.01 = \$11.01)$ .

(C) Decrementation Procedures—No Change.

(i) through (iv) No Change.

(D) through (E) No Change.

(2) Refresh Functionality

(A) Reserve Size Refresh—No Change.

(B) Auto Quote Refresh ("AQR")—No change.

(i) through (iv) No Change.

(3) through (8) No Change.

(c) through (f) No Change.

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

In its filing with the Commission, Nasdaq included statements concerning the purpose of, and basis for, the proposed rule change, as amended, and discussed any comments it received on the proposed rule change, as amended. The text of these statements may be examined at the places specified in Item III below. Nasdaq 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

Nasdaq's SuperMontage system allows the entry of individual orders of up to 999,999 shares in size and quotes of 99,900 shares. Once entered, SuperMontage immediately processes those quotes/orders against the quotes and orders of other market participants then residing in the system. If warranted by the price of the quote/order, and the trading interest on the other side of the market, the system automatically and continuously moves to inferior price levels until the entered quote/order is executed in full or until there is no longer any quotes or orders that would satisfy the terms of the quote/order.

While this processing dramatically increases the speed and efficiency of the Nasdaq market, in certain limited circumstances it may also have a material negative impact on market quality. This could occur when a very large market quote/order, or a marketable limit order priced significantly away from the inside, is entered into the system and quickly executes through numerous price levels and establishes a new inside wholly unrelated to previous trading activity in the security.<sup>5</sup> In turn, the resulting abnormal execution prices and quotes can create new historic high and/or low prices for the particular security at issue, as well as potentially trigger the automatic execution of other customer orders in electronic systems that monitor the last sale and inside prices disseminated by Nasdaq.

In response, Nasdaq has determined to incorporate into SuperMontage, for a 60-day pilot period commencing on October 14, 2002, an execution price governor to reduce the impact of grossly mis-priced or mis-sized quotes/orders.<sup>6</sup> In short, SuperMontage will, using the formula outlined below, establish a maximum execution or break-point price a little over 10% away from a security's current inside price (for both the bid and offer side) and will execute a single quote/order only up to that price level, and reject the remaining unexecuted portion of the quote/order (if any) back to entering party for re-

<sup>5</sup> Nasdaq's experience with similar orders in the SuperSoes environment indicates that the overwhelming majority of such quote/orders are not entered intentionally, but are generally simple mistakes in price or size terms made by entering party.

<sup>6</sup> Nasdaq has separately filed with the Commission a proposal, pursuant to Section 19(b)(2) of the Act, to make the execution price governor permanent. See SR-NASD-2002-142.

submission if desired. The following specific threshold formula is proposed:

- For incoming sell quotes/orders, the break price will be the current Inside Bid less 10% less \$0.01.<sup>7</sup>

- For incoming buy quotes/orders, the break price will be the current Inside Offer plus 10% plus \$0.01.<sup>8</sup>

For example, in a stock with a current Inside Bid of \$10.00, the maximum or break price at which a single sell order could be executed would be \$8.99 calculated as follows:  $(\$10.00 - (\$10.00 \times .10 \text{ e.g. } \$1) - \$0.01 = \$8.99)$ . In turn, this price determines how many shares of a particular quote/order can be executed based on the trading interest on the other side of the market residing in SuperMontage. For example, if the sell order discussed here was for 10,000 shares and there was only a total of 6,000 shares available between the current inside bid price of \$10.00 and the threshold price of \$8.99, SuperMontage would execute a total of 6,000 shares and reject the remaining 4,000 back to the entering party. Market participants receiving such a reject would be able to re-enter the rejected portion of their original order, if desired, with a new maximum break-point for that quote/order being calculated using the current inside price at the time of re-entry.

Nasdaq believes that the above approach best balances the goals of rapid execution and price discovery while protecting market participants, and the public investors they represent, from excessive volatility and market confusion that can result from the entry and execution of a grossly mis-priced or mis-sized quotes/orders in an automated and linked trading environment.

#### 2. Statutory Basis

Nasdaq believes that the proposed rule change, as amended, is consistent with Section 15A of the Act<sup>9</sup> in general, and furthers the objectives of Section

<sup>7</sup> Values resulting from the application of the formula will not be taken into consideration beyond two decimal places. Telephone conversation between Thomas P. Moran, Associate General Counsel, Nasdaq, and Terri Evans, Assistant Director, Division, Commission, October 10, 2002.

<sup>8</sup> When approving this formula, the Nasdaq Board of Directors also authorized the Chief Executive Officer of Nasdaq and/or the President of Nasdaq to alter the base percentages used in the threshold formula by 10% in either direction for a particular security or securities if its trading activity or share price warrants it. If Nasdaq Senior Management determines to alter this standard, Nasdaq will submit a proposed rule change to the Commission and alert market participants by posting the new percentages on NasdaqTrader.com. Telephone conversation between Thomas P. Moran, Associate General Counsel, Nasdaq, and Terri Evans, Assistant Director, Division, Commission, October 10, 2002.

<sup>9</sup> 15 U.S.C. 78o-3.

15A(b)(6)<sup>10</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, to protect investors and the public interest.

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

Nasdaq does not believe that the proposed rule change, as amended, will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Written comments were neither solicited nor received.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change and Amendment Nos. 1 and 2 are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. 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 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-2002-133 and should be submitted by November 12, 2002.

### IV. Commission Findings and Order Granting Accelerated Approval of the Proposed Rule Change

Nasdaq has asked the Commission to approve the proposal and Amendment Nos. 1 and 2 on an accelerated basis for a 60-day pilot period to reduce the impact of grossly mis-priced or mis-sized quotes/orders.

The Commission finds that the proposed rule change, as amended, is

consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association and, in particular, with the requirements of section 15A(b)(6) of the Act,<sup>11</sup> in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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>12</sup> The Commission believes that the establishment of a SuperMontage execution price governor pilot may prevent inadvertent executions significantly away from the inside market. The Commission also agrees with Nasdaq that this approach may act to balance the goals of rapid execution and price discovery while protecting market participants and the public investors they represent from excessive volatility and market confusion that can result from grossly mispriced/sized quotes/orders in an automated and linked trading environment.

The Commission finds good cause for approving the proposed rule change, as amended, prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that accelerated approval of the pilot will enable the Commission and Nasdaq to gain experience with the execution price governor before the Commission considers permanent approval of the pilot.<sup>13</sup> Furthermore, the Commission believes that granting accelerated approval to the proposed rule change and Amendment Nos. 1 and 2 would ensure that the execution price governor is in place for the start of the SuperMontage system roll-out scheduled for October 14, 2002.

Accordingly, the Commission believes that there is good cause, consistent with sections 15A(b)(6) and 19(b)(2) of the Act<sup>14</sup> to approve the proposal and Amendment Nos. 1 and 2 on an accelerated basis.

### V. Conclusion

*It is Therefore Ordered*, pursuant to section 19(b)(2) of the Act<sup>15</sup>, that the proposed rule change, as amended, (File

No. SR-NASD-2002-133) be, and it hereby is, approved until December 13, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

[FR Doc. 02-26685 Filed 10-18-02; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46650; File No. SR-NASD-2002-142]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by National Association of Securities Dealers, Inc. To Establish an Execution Price Governor in SuperMontage

October 11, 2002.

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> notice is hereby given that on October 9, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), 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 NASD. The NASD amended its proposal on October 10, 2002.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq is filing a proposed rule change, as amended, to establish in SuperMontage a permanent execution price governor to prevent inadvertent executions significantly away from the inside market.

The text of the proposed rule change is below. Proposed new language is *italicized*.

\* \* \* \* \*

<sup>11</sup> 15 U.S.C. 78o-3(b)(6).

<sup>12</sup> In approving the proposed rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> Approval of the 60-day pilot should not be interpreted as suggesting that the Commission is predisposed to approving the proposal on a permanent basis.

<sup>14</sup> 15 U.S.C. 78o-3(b)(6) and 78s(b)(2).

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

<sup>16</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated October 10, 2002 ("Amendment No. 1"). In Amendment No. 1, the NASD made minor technical corrections to the rule text.

<sup>10</sup> 15 U.S.C. 78o-3(b)(6).