

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39120; File No. SR-NSAD-97-70]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to an Extension of the Effectiveness of the NASD's Excess Spread Rule Until October 13, 1997

September 23, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on September 15, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which items have been prepared by The Nasdaq Stock Market, Inc. ("Nasdaq"). The Commission is publishing this notice to solicit comments from interested persons and to grant accelerated approval of the proposed rule change.

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

The NASD proposes to amend NASD Rule 4613(d) to extend the effectiveness of its current excess spread rule through October 13, 1997. The excess spread rule is applicable to Nasdaq National Market ("NNM") securities and provides that a registered market maker in a security listed on Nasdaq shall be precluded from being a registered market maker in that issue for twenty (20) business days if its average spread in the security over the course of any full calendar month exceeds 150 percent of the average of all dealer spreads in such issue for the month. The text of the proposed rule change is as follows. Additions are italicized and deletions bracketed.

NSAD Rule 4613

(d) Reasonably Competitive Quotations.

A registered market maker in a Nasdaq National Market security will be withdrawn as a registered market maker and precluded from re-registering as a market maker in such issue for 20 business days if its average spread in the security over the course of any full calendar month exceeds 150 percent of the average of all dealer spreads in such issue for the month. This subparagraph

shall not apply to market makers in Nasdaq SmallCap securities.

(1) If a registered market maker has not satisfied the average spread requirement set forth in this subparagraph (d) for a particular Nasdaq National Market security, its registration in such issue shall be withdrawn commencing on the next business day following the business day on which the market maker was sent notice of its failure to comply with the requirement. A market maker may request reconsideration of the withdrawal notification. Requests for reconsideration will be reviewed by the Market Operations Review Committee, whose decisions are final and binding on the members. A request for reconsideration shall not operate as a stay of the withdrawal or toll the twenty business day period noted in subparagraph (d) above.

(2) Grounds for requests for reconsideration shall be limited to claims that Nasdaq's calculation of the market maker's average spread for the month was in error.

(3) This subparagraph (d) shall be in effect until *October 13, 1997* (September 30, 1997).

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

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

Prior to January 20, 1997, the NASD's excess spread rule (the "Rule" or the "Excess Spread Rule") provided that registered market makers in Nasdaq securities could not enter quotations that exceeded 125 percent of the average of the three narrowest market maker spreads in that issue, provided, however, that the maximum allowable spread could never be less than 1/4 of a point ("125% Rule"). The Rule was originally designed to bring a measure of quality to the Nasdaq market by preventing firms from holding themselves out as market makers without having a meaningful quote in the system. Despite the regulatory

objectives underlying the rule, however, many market participants believed the rule produced a variety of unintended consequences that undermined the integrity of Nasdaq. Most notably, the SEC found in its 21(a) Report on the NASD and Nasdaq that "the interdependence of quotes mandated by the rule may deter market makers from narrowing their dealer spreads, because, once the spread is tightened, the rule in some instances precludes a market maker from widening the spread to earlier levels."¹ As a result, the SEC found that the Excess Spread Rule created an economic incentive for market makers to discourage one another from narrowing their quotes, thereby interfering with the "free flow of prices in the market and imped[ing] attempts by the market to reach the optimal competitive spread."² Accordingly, the SEC requested that the NASD "modify the rule to eliminate its undesirable effects, or to repeal it."³

In response to the SEC's 21(a) Report, the NASD submitted a proposal, which was approved by the SEC and which amended the Excess Spread Rule on a pilot basis through July 1, 1997.⁴ Under the revised Excess Spread Rule, a registered market maker in a Nasdaq security is precluded from being a registered market maker in that issue for twenty business days if its average spread in the security over the course of any full calendar month exceeded 150 percent of the average of all dealer spreads in such issue for the month ("150% Rule").⁵

In formulating the 150% Rule, Nasdaq Committees and Nasdaq staff felt that it was important to strike a reasonable balance between the need to eliminate any constraints that the Excess Spread

¹ See "Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market," at p. 98 ("21(a) Report") (S.E.C., Aug. 8, 1996).

² *Id.* at p. 99.

³ *Id.*

⁴ See Securities Exchange Act Rel. No. 38180 (January 16, 1997), 62 FR 3725 ("Pilot Program Approval Order"). The pilot originally was set to expire on July 1, 1997, but was extended through September 30, 1997. See Securities Exchange Act Rel. No. 38804 (July 1, 1997), 62 FR 36588.

⁵ On February 28, 1997, the SEC approved the NASD's proposal to exclude Nasdaq Small-Cap Securities from the Excess Spread Rule. This rule change was necessary because, unlike the manner in which Nasdaq National Market securities are handled for purposes of the rule, Nasdaq does not presently calculate and display through the Nasdaq system the average spread of all market makers in a particular SmallCap issue or a comparison of the size of an individual market maker's quoted spread relative to the average spread of all market makers. Thus, Nasdaq does not presently afford market makers in SmallCap securities with any indication as to whether they are satisfying the requirements of the 150% Rule.

Rule places on firms to adjust their quotations and the need to avoid fostering a market environment where registered market makers can maintain inordinately wide spreads and still receive the benefits of being a market maker (e.g., affirmative determination exemption and preferential margin treatment). Nasdaq also believed it was critical to transform the Excess Spread Rule into a performance standard used to determine market maker eligibility, instead of a strict regulatory requirement applicable to every quote update in a Nasdaq security, violations of which were punishable by disciplinary action. Based on its experience with the Rule, the Nasdaq Board of Directors in June 1997 approved a resolution to seek permanent approval of the 150% Rule "as is," without modifications. In addition, the NASD ratified the Nasdaq Board resolution in July of 1997 and Nasdaq planned to seek permanent approval shortly thereafter.

However, the Commission has expressed, and continues to express, serious concerns about the effects of the Rule on market maker activity. More specifically, in its approval order of the 150% Rule, the SEC stated that "[a]lthough the amended excess spread rule may reduce some of the anticompetitive concerns outlined in the 21(a) Report, the Commission believes that the amendment * * * may not completely satisfy the NASD's obligations under the Commission's Order with regard to the excess spread rule. Specifically, it may not remove completely the anticompetitive incentives for market makers to refrain from narrowing quotes because the market makers' quotation obligation continues to be dependent to some extent upon quotations of other market makers in the stock."⁶

Additionally, in recent discussions, SEC staff has indicated that it believes that the 150% Rule may not have completely eliminated the concerns outlined in the 21(a) Report and may not completely satisfy the NASD's obligations under the Commission's Order. SEC staff further has stated that it believes that the Rule should be completely eliminated, or at the very least, be eliminated for stocks with a small number of market makers.

In light of the foregoing, the NASD is proposing to extend the Excess Spread Rule only until October 13, 1997. Additionally, Nasdaq staff will ask the Nasdaq Board of Directors ("Board") at its September 23, 1997 board meeting to reconsider its previous decision to seek

permanent approval of the Rule, in light of the Commission's concerns that the Rule does not remove completely incentives for market makers to refrain from narrowing quotes. Nasdaq will inform the Commission by letter of the final disposition of the Board's reconsideration of this matter as soon as possible.

The NASD and Nasdaq believe that the proposed rule change is consistent with Sections 15A(b)(6), 15A(b)(9), 15A(b)(11) and 11A(a)(1)(C) of the Exchange Act. Among other things, Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles 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. Section 15A(b)(9) provides that the rules of the Association may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Section 15A(b)(11) empowers the NASD to adopt rules governing the form and content of quotations relating to securities in the Nasdaq market. Such rules must be designed to produce fair and informative quotations, prevent fictitious and misleading quotations, and promote orderly procedures for collecting and distributing quotations. Section 11A(a)(1)(C) provides that it is in the public interest to, among other things, assure 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.

Specifically, the NASD and Nasdaq believe that the 150% Rule has promoted the integrity of quotations on the Nasdaq market and has enhanced competition among market makers, thereby contributing to greater market liquidity, improved price discovery, and the best execution of customer orders. The Rule has helped to ensure that all registered market makers are providing some threshold level of market making support in their issues, and has helped to avoid a market environment where registered market makers can maintain inordinately wide spreads and still receive the benefits of being a market maker. Thus, a continuation of the Rule until October 13, 1997, will address the

Commission's aforementioned concerns while preserving the Rule's benefits (such as ensuring meaningful market maker quotes) until the Nasdaq Board reconsiders its previous position on the Rule. Additionally, the proposed to extend the pilot program for a limited period is consistent with the Exchange Act and will ensure continuity of regulation until the Nasdaq Board reconsiders its previous position on the Rule.

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

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

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

Comments were neither solicited nor received.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of 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-97-70 and should be submitted by October 21, 1997.

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission has determined to approve the extension of the 150% Rule pilot until October 13, 1997. As noted previously, the Commission has identified anticompetitive concerns associated with the 125% Rule in place prior to January 20, 1997. Further, in the Pilot Program Approval Order, the Commission recognized that while the

⁶ Pilot Program Approval Order, *supra* note 4.

150% Rule could reduce, to some degree, the Commission's concerns regarding the 125% Rule, the Commission was not convinced that permanent approval of the 150% rule would sufficiently address those concerns. The Commission believes that the pilot should continue to operate on a temporary basis through October 13, 1997, while the Nasdaq Board reconsiders its position on permanent approval. Consequently an extension will ensure that the Rule remains in effect on an uninterrupted basis until the Nasdaq Board has had an opportunity to fully evaluate the most appropriate permanent solution regarding the excess spread rule.

In addition, the Commission believes that the temporary rule can remain limited to National Market securities. Due to Nasdaq's current systems limitations, market makers in Nasdaq SmallCap securities are unable to monitor compliance with the Rule. However, the NASD has stated that it anticipates that market makers in Nasdaq SmallCap securities will be subject to the same excess spread requirements, if any, as market makers in Nasdaq National Market securities when a permanent resolution is reached.

Accordingly, the Commission finds that the NASD's proposal is consistent with Sections 11A and 15A of the Exchange Act and the rules and regulations thereunder applicable to the NASD and, in particular, Sections 11A(a)(1)(C), 15A(b)(6), 15A(b)(9), and 15A(b)(11). Further, the Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication in the **Federal Register**. In addition to the reasons discussed above, the Commission believes that accelerated approval of the NASD's proposal is appropriate given the fact that the proposal is a temporary extension of the 150% Rule that has been in effect since January 1997. An uninterrupted application of the 150% Rule for a short period of time should be less disruptive to market makers while the Nasdaq Board reconsiders its permanent approach to the concerns raised by the Commission regarding the excess spread rule.⁷

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act, that the proposed rule change (SR-

NASD-97-70) is approved through October 13, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39106; File No. SR-PCX-97-32]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Pacific Exchange, Inc. Relating to an Extension of its LMM Book Pilot Program for One Year

September 22, 1997.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 5, 1997, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange is proposing to extend its LMM Book Pilot Program for one year. The text of the proposed rule change is available at the Office of the Secretary, PCX and at the Commission.

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

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in sections A, B and C below, of the most significant aspects of such statements.

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

On October 11, 1996, the Commission approved an Exchange proposal to establish its LMM Book Pilot Program, under which a limited number of Lead Market Makers ("LMMs") are able to assume operational responsibility for the options limit order book ("Book") in certain options issues.³ Subsequently, on October 28, 1996, the Commission approved an Exchange proposal to adopt a new change applicable to LMMs who participate in the program.⁴ In addition on April 1, 1997, the Commission approved an Exchange proposal to expand the scope of the pilot program to allow up to nine LMMs to participate and up to 150 symbols to be used.⁵ The Exchange is now proposing to extend the pilot program for one year, to October 12, 1998.

Under the pilot program, the approved LMMs manage the Book function, take responsibility for trading disputes and errors, set rates for Book execution, and pay the Exchange a fee for systems and services. The program allows LMMs to have greater control over their operations on the Exchange floor by allowing them, among other things, to set their own rates for execution services provided to customers. The LMMs who participate during the pilot program are selected by the Options Floor Trading Committee based on certain designated factors. Approved LMMs must maintain "minimum net capital," as provided in SEC Rule 15c-1,⁶ and must also maintain a cash or liquid asset position of at least \$500,000, plus \$25,000 for each issue over 5 issues for which they perform the function of an Order Book Official. Only multiply-traded option issues are eligible during the pilot phase.

The Exchange is requesting a one-year extension to the pilot program so that it

³ See Exchange Act Release No. 37810 (October 10, 1997), 61 FR 54481 (October 18, 1996) ("Pilot Program Approval Order").

⁴ See Exchange Act Release No. 37874 (October 28, 1996), 61 FR 213 (November 1, 1996).

⁵ See Exchange Act Release No. 38462 (April 1, 1997), 62 FR 16886 (April 8, 1997). Each option issue typically has only one symbol associated with it, unless LEAPs are traded on that issue, in which case there would usually be two additional symbols related to the issue, or unless a contract adjustment is necessary due, for example, to a merger or stock split, in which case one additional symbol would usually be added. Previously, the pilot program was limited to allow up to 3 LMMs to participate and up to 40 option symbols to be used.

⁶ 17 CFR 240.15c-1.

⁷ The Commission notes that a failure to extend the 150% Rule past the October 13, 1997 date would result in no excess spread standard for Nasdaq market makers.

⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.