

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, 450 Fifth Street, NW., Washington, DC. Copies of such filing also will be available for inspection and copying at the NASD. All submissions should refer to File No. SR-NASD-98-43 and should be submitted by July 27, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁹

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40140; File No. SR-NASD-98-26]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Partial Approval to Amendment No. 4 to Proposed Rule Change by the National Association of Securities Dealers, Inc. to Institute, on a Pilot Basis, New Primary Nasdaq Market Maker Standards for Nasdaq National Market Securities

June 26, 1998.

I. Introduction

On March 19, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to: (a) implement, on a pilot basis, new Primary Nasdaq Market Maker ("PMM") standards for all Nasdaq National Market ("NNM") securities; (b) extend the NASD's Short Sale Rule pilot until November 1, 1998; and (c) extend the suspension of existing PMM standards until May 1, 1998. On March 30, 1998, the Commission issued notice of the filing

and approved, on an accelerated basis, the portions of the filing extending the NASD's Short Sale Rule pilot and the suspension of existing PMM standards.³

On April 30, 1998, Nasdaq filed Amendment No. 3 to the proposal,⁴ proposing to: (a) extend the comment period by 30 days to May 27, 1998; (b) continue to suspend the current PMM standards until July 1, 1998; (c) extend the NASD's Short Sale Rule pilot until January 4, 1999; (d) change the dates during which the PMM pilot would run to July 1, 1998, through January 4, 1999; and (e) amend subparagraph (g) of NASD Rule 4612 to change the method for determining how market makers that are not managers or co-managers in an underwriting syndicate of a secondary offering may qualify as PMMs. Also on April 30, 1998, the Commission issued notice of Amendment No. 3 and approved, on an accelerated basis, Nasdaq's request to continue to suspend the current PMM standards until July 1, 1998.⁵ The Commission also extended the comment period for the proposed rule change.

On June 24, 1998, Nasdaq filed Amendment No. 4 to the proposal,⁶ proposing to: (a) extend the comment period to July 27, 1998; (b) continue to suspend the current PMM standards until October 1, 1998; and (c) change the dates during which the PMM pilot would run to October 1, 1998, until April 1, 1999.

Background

Presently, NASD Rule 4612 provides that a member registered as a Nasdaq market maker pursuant to NASD Rule 4611 may be deemed a PMM if that member meets certain threshold standards. The implementation of the SEC Order Handling Rules⁷ and what

some perceive as a concurrent move toward a more order-driven, rather than a quote-driven, market raised questions about the continued relevance of those PMM standards. As a result, such standards were suspended beginning in early 1997.⁸ Currently, all market makers are designated as PMMs.

Since February 1997, Nasdaq has worked to develop PMM standards that are more meaningful in what may be an increasingly order-driven environment and that better identify firms engaged in responsible market making activities deserving of the benefits associated with being a PMM, such as being exempt from NASD Rule 3350, the NASD's Short Sale Rule. The NASD now proposes to extend the current suspension of the existing PMM standards and to implement new standards on a pilot basis from October 1, 1998, until April 1, 1999. The NASD intends the new standards to better evaluate whether a market maker provides meaningful liquidity to the market. To determine whether a particular market maker is such a provider of liquidity, Nasdaq will analyze that market maker's trading activity using a new test.

For the reasons discussed below, the Commission has determined to grant accelerated approval of Nasdaq's request, in Amendment No. 4, to continue to suspend the current PMM standards until October 1, 1998. Further, given the proposal's complexity and the Commission's desire to give the public sufficient time to consider the proposal, the Commission has extended the comment period to the proposed rule change, as amended, to July 27, 1998.

II. Proposed Rule Change

As discussed in detail in Securities Exchange Act Release No. 39819, Nasdaq is proposing a new set of PMM standards. In the current filing, Nasdaq would amend the timing of the proposed pilot through which the NASD, the SEC, and the public may evaluate those new standards.

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Release No. 37619A (September 6, 1996) 61 FR 48290 (September 12, 1996).

⁸ See Securities Exchange Act Release No. 38294 (February 14, 1997) 62 FR 8289 (February 24, 1997) (approving temporary suspension of PMM standards); Securities Exchange Act Release No. 39198 (October 3, 1997) 62 FR 53365 (October 14, 1997) (extending suspension through April 1, 1998); Securities Exchange Act Release No. 39819 (March 30, 1998) 63 FR 16841 (April 6, 1998) (extending suspension through May 1, 1998); Securities Exchange Act Release No. 39936 (April 30, 1998) 63 FR 25253 (May 7, 1998) (extending suspension through July 1, 1998).

⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 39819 (March 30, 1998) 63 FR 16841 (April 6, 1998).

⁴ See letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division, of Market Regulation ("Division"), SEC, dated April 29, 1998. Securities Exchange Act Release No. 39819 discussed Amendment No. 1 and Amendment No. 2 to the filing, which were filed with the Commission on March 25, and 26, 1998, respectively.

⁵ See Securities Exchange Act Release No. 39936 (April 30, 1998) 63 FR 25253 (May 7, 1998).

⁶ See letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division, SEC, dated June 24, 1998.

⁷ On August 29, 1996, the Commission promulgated a new rule, the Limit Order Display Rule (Exchange Act Rule 11Ac1-4) and adopted amendments to the Quote Rule (Exchange Act Rule 11Ac1-1), 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 Handling Rules"). See Securities Exchange Act

The proposed rule language, as amended, follows. Additions are italicized; deletions are bracketed.

Rule 4612

(a)-(g) No Change

(h) [The Board of Governors may modify the threshold standards set forth in paragraphs (a) and (b) above if it finds that maintenance of such standards would result in an adverse impact on a class of investors or on Nasdaq.] *This rule shall be in effect beginning October 1, 1998, and remain in effect until April 1, 1999.*

* * * * *

III. Discussion

After careful consideration, the Commission has concluded, for the reasons set forth below, that the extension of the current suspension of existing PMM standards until October 1, 1998, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder. Extending the suspension of the current PMM standards to accommodate implementing the new pilot is consistent with Section 15A(b)(6)⁹ of the Exchange Act. Section 15A(b)(6) of the Exchange Act requires that the NASD's rules be designed, among other things, to remove impediments to and perfect the mechanism of a free and open market and a national market system and to promote just and equitable principles of trade. The Commission believes that continued suspension of the current PMM standards will facilitate Nasdaq's efforts in implementing more meaningful PMM standards which should help to enhance market liquidity by rewarding those market makers that meet the new standards. As a result, continuing the suspension of the current PMM standards is consistent with Section 15A(b)(6) of the Exchange Act.

In finding that the suspension of the existing PMM standards is consistent with the Exchange Act, the Commission reserves judgment on the merits of the NASD's Short Sale Rule, any market maker exemptions to that rule, and the proposed new PMM standards. The Commission recognizes that the Short Sale Rule already has generated significant public comment. Such commentary, along with any further comment on the interaction of the Short Sale Rule with the proposed new PMM standards, will help guide the Commission's evaluation of the Short Sale Rule and new PMM standards. During the PMM pilot period, the Commission anticipates that the NASD

will continue to address the Commission's questions and concerns and provide the Commission staff with any relevant information about the practical effects and the operation of the revised PMM standards and possible interaction between those standards and the NASD's Short Sale Rule.

As proposed, the new PMM standards will become effective October 1, 1998, when the suspension of the existing PMM standards, under Amendment No. 4, expires. Nasdaq notes that currently all market makers registered in a security are PMMs due to the suspension of the previous PMM standards, and will continue to be so designated on the pilot's proposed start date of October 1, 1998. Under the one-month look-back provision in the PMM pilot program, Nasdaq will consider the previous calendar month and the current month to determine a market maker's continued PMM eligibility if the market maker attained PMM status in a security during the previous month, but fails to meet the applicable thresholds for the current month. To give PMMs the full benefit of the one-month look-back period and to allow market makers time to adjust their trading activity to the new standards, Nasdaq proposes to implement the new standards so that no market maker that is designated as a PMM when the pilot begins on October 1, 1998, will lose its PMM status—based on a failure to meet the new PMM standards—until December 3, 1998. Nasdaq believes, and the Commission agrees, that it is fair to give market makers this time to make necessary adjustments to their trading activity to help them maintain their PMM designation, particularly since PMM standards have been suspended for more than a year and the proposed new PMM standards are more stringent than the previous standards. The PMM pilot, pursuant to Amendment No. 4, would run until April 1, 1999.

The Commission finds good cause for approving the extension of the suspension of existing PMM standards prior to the 30th day after the date of publication of notice of the filing in the **Federal Register**. It could be disruptive to market making to reintroduce outdated PMM standards for a brief period prior to implementing a new PMM pilot. Further, the current PMM standards have been suspended until July 1, 1998, at which time the old PMM standards—which are not a meaningful measure of a market maker's liquidity-providing activity—would be used again to determine market makers' PMM status. To ensure continuity in the PMM standards and the regulation of short selling activity, to maintain orderly

markets, and to avoid confusion, it is necessary to continue the suspension of the prior PMM standards until the new standards are implemented on October 1, 1998.

IV. Solicitation of Comments

Given the proposal's complexity and the Commission's desire to give the public sufficient time to consider the proposal, the Commission hereby grants Nasdaq's request to extend the comment period for the proposed rule change, as amended, to July 27, 1998. Since making the proposal, the NASD has issued reports to all Nasdaq market makers in NNM issues to show how those market makers would have performed for April and May of 1998 had the proposed PMM standards been in place. The NASD also posted on The Nasdaq Trader Web Site¹⁰ a stock-by-stock analysis of what percentage of market makers in each stock would have been PMMs under the proposed PMM standards in April and May of 1998. The Commission expects such data will allow market participants to submit more meaningful comments.

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Exchange Act. In particular, the Commission requests that commenters provide alternative PMM standards, explaining why such alternative standards better identify and reward market participants who provide meaningful liquidity to the Nasdaq market. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., 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 such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-98-26 and should be submitted by July 27, 1998.

⁹ 15 U.S.C. 78o-3(b)(6).

¹⁰ See <http://www.nasdaqtrader.com>.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act,¹¹ that the portion of Amendment No. 4 to the proposed rule change, SR-NASD-98-26, that extends the suspension of the current PMM standards to October 1, 1998, be and hereby is approved on an accelerated basis.¹²

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40139; File No. SR-NASD-97-26]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 Relating to an Extension of the Pilot for the NASD's Rule Permitting Market Makers To Display Their Actual Quotation Size

June 26, 1998.

I. Background

On June 25, 1998, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission" or "SEC") Amendment No. 5 to 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), seeking to extend through July 31, 1998, the pilot program in which market makers may quote their actual size (*i.e.*, one normal unit of trading) in 150 Nasdaq stocks ("Actual Size Rule").

The Commission is publishing this notice to solicit comments from interested persons and is approving

Amendment No. 5 on an accelerated basis.

II. Proposed Rule Change

The NASD proposes to amend NASD Rule 4613(a)(1)(C) to extend the Actual Size Rule through July 31, 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 [June 30, 1998] *July 31, 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 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. Discussion

On August 29, 1996, the Commission promulgated a new rule, the Limit Order Display Rule³ and adopted amendments to the Quote Rule,⁴ 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 Handling Rules").⁵ To facilitate implementation of the Order Handling Rules and accommodate changes in the Nasdaq market that these rules brought about, the Commission later approved a variety of amendments to NASD Rules concerning Nasdaq's Small Order Execution System ("SOES") and the SelectNet Service ("SelectNet").⁶

³ 17 CFR 240.11Ac1-4.

⁴ 17 CFR 240.11Ac1-1.

⁵ See Exchange Act Release No. 37619A (September 6, 1997) 64 FR 48290 (September 12, 1996).

⁶ See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415 (January 16, 1997) (order partially approving SR-NASD-96-43).

In particular, the Commission temporarily approved a pilot program⁷ whereby Nasdaq market makers in the first 50 stocks subject to the Commission's Order Handling Rules were only required to display a minimum quotation size of one normal unit of trading when quoting solely for their own proprietary accounts.⁸ For non-pilot Nasdaq stocks, the minimum quotations size requirements of 1,000, 500, or 200 shares remained the same.⁹

Although the first 50 stocks were chosen to provide a broad cross section of the most liquid Nasdaq stocks, on October 29, 1997, the Commission approved an NASD proposal to amend NASD Rule 4613(a)(1)(C) to expand the pilot program to 150 Nasdaq stocks. The Commission also extended the pilot until March 28, 1998.¹⁰ The additional 100 stocks were part of an enhanced sample designed to better represent the entire Nasdaq market. The Commission approved the expansion in response to comment letters suggesting that the first 50 stocks did not sufficiently represent the Nasdaq market because all 20 of the largest Nasdaq stocks were subject to the 100 share minimum. Thus, some commenters suggested that it was difficult 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 those in the pilot.

The NASD has concluded an analysis of an expanded pilot, and on March 5, 1998, it filed with the Commission a proposed rule change to apply permanently the Actual Size Rule to all Nasdaq Stocks.¹¹ As part of that filing, the NASD published a 127-page economic study of the 150-stock pilot ("March 1998 Study").

In the March 1998 Study, the NASD concluded that:

- The Actual Size Rule did not affect the market quality—in terms of spreads, volatility, depth, or liquidity—of pilot stocks.
- The Actual Size Rule has not altered the ability of investors to access market maker capital. For pilot stocks,

⁷ *Id.*

⁸ The Actual Size Rule does not affect 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. Market makers may display a greater quotation size if they so choose or if required to do so by the Limit Order Display Rule.

⁹ See NASD Rule 4613(a)(2).

¹⁰ See Exchange Act Release No. 39285 (October 29, 1997), 62 FR 59932 (November 5, 1997).

¹¹ See Exchange Act Release No. 39760 (March 16, 1998) 63 FR 13894 (March 23, 1998) (SR-NASD-98-21).

¹¹ 15 U.S.C. 78s(b)(2).

¹² In partially approving the proposal, the Commission has considered the approved portion's impact on efficiency, competition, and capital formation. Moreover, the pilot program, if fully implemented, likely will provide the Commission with data necessary to enable it to evaluate the impact of the proposed PMM standards on the Nasdaq market and market participants. 15 U.S.C. 78c(f).

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.