SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43944; File No. SR–NASD–00–22]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 by the National Association of Securities Dealers, Inc. Relating to Limit Order Protection for OTC Bulletin Board Securities

February 8, 2001.

I. Introduction

On April 19, 2000, the National Association of Securities Dealers, Inc. (''NASD''), through its 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'') [1] and Rule 19b–4 [2] thereunder, a proposed rule change that would, for a 12-month pilot period, apply limit order protection to a select subset of securities traded on the OTC Bulletin Board (''OTCBB'').[3] The proposal was published for comment in the **Federal Register** on June 16, 2000.[4] On December 7, 2000, Nasdaq filed Amendment No. 1 to the proposal.[5] On January 24, 2001, Nasdaq filed Amendment No. 2 to the proposal.[6] The Commission received twelve comments on the proposal. This notice and order approves the proposed rule change, solicits comment from interested persons on Amendment Nos. 1 and 2, and approves Amendment Nos. 1 and 2 on an accelerated basis.

II. Description of the Proposal

Nasdaq has proposed to adopt the following new rule:

6541. Limit Order Protection

(a) Members shall be prohibited from ''trading ahead'' of customer limit orders that a member accepts in securities quoted on the OTCBB. Members handling customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the customer limit order without executing the limit order. Members are under no obligation to accept limit orders from any customer.

(b) Members may not avoid such obligation specified in paragraph (a) through the provision of price improvement, unless such price improvement is for a minimum of the lesser of $.05 or one-half (1/2) of the current inside spread. For purposes of this rule, the inside spread shall be defined as the difference between the best reasonably available bid and offer in the subject security.

(c) Notwithstanding subparagraph (a) of this rule, a member may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to such orders that are:

(1) for customer accounts that meet the definition of an ''institutional account'' as that term is defined in Rule 3110(c)(4); or

(2) for 10,000 shares or more, and grater than $20,000 in value.

(d) Contemporaneous trades

A member that trades through a held limit order must execute such limit order contemporaneously, or as soon as practicable, but in no case later than five minutes after the member has traded at a price more favorable than the customer's price.

(e) Application

(1) This rule shall apply only to OTCBB securities specifically identified as such through the Nasdaq Workstation service.

(2) This rule shall apply, regardless of whether the subject security is additionally quoted in a separate quotation medium.

(3) This rule shall apply from 9:30 a.m. to 4 p.m. Eastern Time.

(*4*) *This rule shall be in effect until [12 months from date of Commission approval].*

NASD IM–2110–2 currently prohibits NASD member firms from trading ahead of customer limit orders in Nasdaq securities. The impetus for this rule (commonly known as the ''Manning Rule'') was a case brought by a customer of a member firm, William Manning, who alleged that the firm had accepted his limit order, failed to execute it, and violated its fiduciary duty to him by trading ahead of the order. In the *Manning* decision,[7] the NASD found, and the Commission affirmed, that a member firm, upon acceptance of a customer's limit order, undertakes a fiduciary duty to its customer and cannot trade for its own account at prices more favorable than the customer's order. Although at one time the NASD took the position that its members could trade ahead of customer limit orders provided they disclosed such practice to the customer,[8] NASD IM–2110–2 eliminated this disclosure ''safe-harbor'' for all securities listed on Nasdaq.

Nasdaq states that it is now appropriate to extend the principles of the Manning Rule to the OTCBB and has proposed to adopt NASD Rule 6541 that will apply limit order protection to a select subset of OTCBB securities.[9] NASD Rule 6541 will be instituted as a 12-month pilot program. While NASD members will be under no obligation to accept limit orders, those willing to do so will be prohibited from trading the securities covered by the pilot program at prices equal or superior to any customer limit orders held by the firm, regardless of whether those orders are from their own customers or from customers of firms who have routed those orders to the member for execution.[10] NASD Rule 6541 will apply even to those members who, in the past, have fully disclosed to their customers that they may trade ahead of customer limit orders.

Nasdaq intends to apply the pilot program to approximately 325 OTCBB securities.[11] Nasdaq will select securities for the pilot that will afford it

[2] 17 CFR 240.19b–4.

[3] The OTCBB is a quotation medium, owned by the NASD and operated by Nasdaq, for subscribing NASD members that permits quotations for securities that generally are not traded on a national securities exchange or quoted on Nasdaq.

[4] Securities Exchange Act Release No. 42908 (June 7, 2000), 65 FR 37808.

[5] *See* Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Nancy Sanow, Assistant Director, Division of Market Regulation, SEC (December 5, 2000). In Amendment No. 1, Nasdaq proposed additional rule text that sets forth a minimum increment by which an NASD member must trade ahead of a customer limit order to avoid violation of the proposed rule (''trading-ahead increment''). This minimum increment is the lesser of $0.05 (5 cents) per share or one-half of the current inside spread.

[6] *See* Letter from Jeffrey S. Davis, Assistant General Counsel, Nasdaq, to Nancy Sanow, Assistant Director, Division of Market Regulation, SEC (January 24, 2001). In Amendment No. 2, Nasdaq provided additional explanation of the new rule text and why the trading-ahead increment of the lesser of $0.05 per share or one-half of the current inside spread was selected.

[7] *See In re E.F. Hutton & Co.,* Exchange Act

[2] 17 CFR 240.19b–4.

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the best opportunity to test the effects of the proposed rule on a wide range of OTCBB securities. One set will include the 200 most actively traded OTCBB securities, which will be chosen on the basis of specific price and volume parameters. An additional 100 securities will be selected as a representative cross-section of all remaining OTCBB securities. The implementation of the proposed rule upon these 300 securities will be phased in over a period of several weeks, beginning with the top 200 actively traded securities, then proceeding to the 100 representative cross-section securities. According to Nasdaq, this phase-in process is intended to protect against any unanticipated or deleterious effect that might occur through an immediate application to all securities. The remaining 25 securities will be selected on a case-by-case basis after the initial phase-in period has been completed. Nasdaq anticipates that this remainder will be securities that are either highly liquid and widely held by retail investors or securities or have been delisted from Nasdaq or an exchange.

Nasdaq advises that it will monitor the operation of this rule and its effect on the OTCBB market throughout the pilot period. Prior to the end of the pilot, Nasdaq will evaluate the impact of the proposed rule and report its findings to the Commission and, thereafter, determine the appropriate course of action.

Nasdaq points out that there are significant differences between Nasdaq and the OTCBB. While both are quotation mediums, the OTCBB does not afford issuers a means to list their securities on the service and, thus, does not maintain relationships with quoted issuers or impose quantitative listing standards. In addition, OTCBB securities are quoted by market makers that enter their quotes through a closed computer network, which is accessed through the Nasdaq Workstation II. Unlike Nasdaq, the OTCBB does not have an order delivery or execution system. Therefore, although application of NASD Rule 6541 is intended to substantially mirror NASD IM–2110–2, Nasdaq has made four modifications to accommodate the differences between the Nasdaq and the OTCBB.

First, NASD Rule 6541 contains a lower threshold for order size at which the prohibition on trading ahead of customer limit orders would not apply. NASD IM–2110–2, which sets forth a general prohibition against trading ahead of customer limit orders in Nasdaq securities, permits NASD members to negotiate exceptions to the general rule with a customer when the customer submits an order for a Nasdaq security of at least 10,000 shares that has a value greater than $100,000.[12] Due to the relatively lower share prices of OTCBB securities, Nasdaq has set the corresponding thresholds at 10,000 shares and $20,000 for the securities covered by the OTCBB pilot program. Nasdaq advises that it will study these thresholds as part of its analysis of the pilot and may recommend adjustments, if necessary.

Second, the Manning Rule for Nasdaq securities and the rule to be applied to the OTCBB will differ with respect to the time interval allowed for ''contemporaneous'' executions. Under NASD IM–2110–2, an NASD member is not deemed to have traded ahead of a customer limit order in a Nasdaq security if the member provides a ''contemporaneous'' execution of that order. ''Contemporaneous'' has been interpreted for Nasdaq securities to require an execution as quickly as possible, but, absent reasonable and documented justification, within one minute.[13] Unlike Nasdaq, which has an automated order delivery and execution system, the OTCBB currently provides no means of automated communication. Market makers in OTCBB securities generally must contact each other via telephone, a time consuming process that can provide especially burdensome during periods of high trading volume. Therefore, Nasdaq has proposed that, for OTCBB securities covered by the pilot, a ''contemporaneous'' trade must be executed as quickly as possible, but in no case later than five minutes after becoming marketable.[14] Nasdaq advises that it will study this provision and may recommend modifications, as appropriate, in conjunction with the review of the pilot program.

Third, the pilot program will apply only from 9:30 a.m. to 4 p.m.,[15] although NASD IM–2110–2 applies from 9:30 a.m. until 6:30 p.m.[16] This is to accommodate the fact that, although the OTCBB service is available from 7:30 a.m. to 6:30 p.m., prices on the OTCBB are required to be firmly only during the normal market hours of 9:30 a.m. to 4 p.m.

The fourth difference between NASD Rule 6541 and NASD IM–2110–2 is discussed in the following section.

III. Amendment Nos. 1 and 2

Under NASD IM–2110–2, a member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, is deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of NASD Rule 2110. However, the NASD issued guidance stating that an NASD member would not be deemed to violate NASD member would not be deemed to violate NASD IM–2110–2 if it executed its own trade ahead of the customer limit order at a price that improved on the customer's order by at least the lesser of 1⁄16th of $1.00 per share (6.25 cents) or one-half the inside spread.[17] The fourth principal difference between NASD Rule 6541 and NASD IM–2110–2 is that, for the OTCBB pilot program, an NASD member will be permitted to trade ahead of a customer limit order if it offers price improvement of the lesser of $0.05 (5 cents) per share or one-half of the inside spread. This modification reflects the fact that OTCBB securities generally trade in decimals while Nasdaq securities trade in fractions (with the exception of certain securities trading in decimals on a pilot basis).

In Amendment No. 1, Nasdaq proposed additional rule text[18] which set forth the trading-ahead increment discussed above. In Amendment No. 2,

[12] ''The value of a limit order is calculated by multiplying the price per share specified in that order by the number of shares specified in the order. Thus, the value of a limit order does not include any markup, markdown, commission, commission equivalent, sales credit, or other internal credit.'' Securities Exchange Act Release No. 35751 (May 22, 1995), 60 FR 27997, 27998 n.17 (May 26, 1995) (order approving SR–NASD–94–62, which amended NASD IM–2110–2 to prohibit a member firm from trading ahead of limit orders of other firm's customers that have been sent to that member).

[13] *See* NASD Notice to Members 95–67 (Question and Answer No. 5) (establishing a ''general time parameter'' of one minute); NASD Notice to Members 98–78 (clarifying that, outside of normal market conditions, an NASD member would not be presumptively deemed in violation of the limit order protection rule if it failed to execute a customer limit order within the one-minute period, provided it did so ''as soon as possible under the circumstances'').

[14] NASD Rule 6541 also provides that, if market conditions or other circumstances cause the member to exceed this five-minute requirement, the member should continue to attempt to execute the order as quicly as possible while sufficiently documenting the particular conditions or circumstances causing this delay.

[15] Nasdaq has stated that the hours of application would adjust accordingly on days in which the OTCBB's market hours are shortened due to holidays or other events.

[16] *See* NASD IM–2110–2(a).

[17] *See* NASD Notice to Members 97–57 (Question and Answer No. 7). *See also* Securities Exchange Act Release No. 39049 (September 10, 1997), 62 FR 48912 (September 17, 1997) (increasing minimum trading-ahead increment in Nasdaq securities from 1⁄64th to 1⁄16th of $1.00 per share).

[18] *See* NASD Rule 6541(b).

Nasdaq indicated that this increment is based upon, and consistent with, Nasdaq's guidance on members' Manning obligations when trading Nasdaq National Market and SmallCap securities. Nasdaq also stated that there is a balance to be struck, because requiring too much price improvement could limit price competition by raising market makers' trading costs too high, while requiring too little price improvement could potentially isolate pending limit orders without meaningfully benefiting the market. Nasdaq advised that its OTC Bulletin Board Advisory Committee considered the matter and concluded that $0.05 per share is a reasonable, meaningful cost to impose for stepping ahead of a customer limit order. Nasdaq believes that, based upon this analysis and its experience in applying the Manning Rule to Nasdaq securities, the aggregate benefit to the market of narrowing the spread by a $0.05 appears to outweigh the costs to a single market participant of not receiving an execution.

In Amendment No. 2, Nasdaq also clarified the requirement that, for purposes of NASD Rule 6541(b), the inside spread will be defined as the difference between ''the best reasonably available bid and offer.'' Nasdaq states that this phrase comes from judicial precedent describing the broker-dealer's duty of best execution and cites the case of *Newton* v. *Merill, Lynch, Pierce, Fenner and Smith.*[19] Nasdaq indicates that, by importing this standard into NASD Rule 6541, it will signal to NASD members that they must use the same reasonable diligence and care to find the best prices when trading OTCBB securities that they use when trading Nasdaq National Market and SmallCap securities.

Nasdaq believes, however, that the determination of what is ''reasonably available'' is largely factual and best performed on a case-by-case basis. Nasdaq expects that broker-dealers seeking the best inter-dealer market for a customer order would, at a minimum, monitor not only the OTCBB quotations distributed as part of the Nasdaq Level 1 service, but also quotations for those same securities in the Pink Sheets or any other system of general circulation to broker-dealers that regularly disseminates quotations of identified broker-dealers.

Finally, Nasdaq states in Amendment No. 2 that, to assist members in fulfilling their obligations under NASD Rule 6541, it will issue a Notice to Members describing the new rule's operation within 30 days following Commission approval of the proposal. Nasdaq has stated that it will then wait an additional 30 days following publication of this Notice to Members before making NASD Rule 6541 operational.

IV. Summary of Comments on Original Proposal

The Commission received twelve comments on the proposal. Nine of the commenters strongly supported Nasdaq's proposal.[20] The three other commenters, while also supporting the application of Manning Rule principles to the OTCBB, expressed disappointment that the proposal did not go further by establishing limit order protection for all OTCBB securities on a permanent basis, rather than for just a selector group of OTCBB securities on a pilot basis.[21]

V. Discussion

A. Approval of Proposal

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the regulations thereunder applicable to the NASD.[22] In particular, the Commission believes that the proposal is consistent with Section 15A(b)(6) of the Act.[23] Section 15A(b)(6) requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices; to promote just and equivalent principals of trade; to remove impediments to the perfect the mechanism of a free and open market and a national market system; in general, to protect investors and the public interest.

When the Commission approved the original proposal that instituted limit order protection for Nasdaq securities, it stated:

The Commission believes that the rule change [which instituted NASD IM–2110–2] will enhance investor confidence by improving the quality of executions for customers. By giving a customer's limit order priority over the marker's proprietary trading, more trade volume will be available to be matched with the customer's order, resulting in quicker and more frequent executions for customers.

The NASD's proposal will also improve the price discovery process in NASDAQ securities. Limit order aid price discovery by adding liquidity to the market and by tightening the spread between the bid and ask price of a security. In the past, customers may have refrained from placing limit orders because of the uncertainty of the difficulty in obtaining an execution at a price between the spread. The new rule will encourage dealers to executive customer limit orders in a timely fashion so that they may resume their proprietary trading activities. The practice of delaying executions until the inside price reaches the customer's limit order also impedes price discovery by shielding those orders from the rest of the investing public. More expeditious handling of customer limit orders * * * will provide investors with a more accurate indication of the buy and sell interest at a given moment.[24]

The Commission finds that the reasons for providing limit order protection for customer limit orders in Nasdaq securities, set forth above, also apply in the context of OTCBB securities. In the Commission's view, the proposed rule change is an appropriate first step in bringing limit order protection to the OTCBB, and the pilot program will also Nasdaq the opportunity to study the application of the new rule for OTCBB securities and to consider further refinements. Moreover, the Commission finds that Nasdaq's proposal for selecting the number and types of securities to participate in the pilot program to be reasonable and consistent with the Act.

The Commission also believes that the four accommodations made from NASD IM–2110–2 to recognize the structure of the OTCBB are reasonable and consistent with the Act. In particular, the minimum size threshold that qualifies larger orders for an exception to NASD Rule 6541 and the hours of effectiveness appropriately recognize the OTCBB environment. In addition, the Commission believes that the increment by which OTCBB market makers will be required to step ahead of

[19] 153 F.3d 266, 271 (3d Cir. 1998) (duty of best execution ''requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances'').

[20] *See* E-mail from Kjrock5649@aol.com to SEC (June 22, 2000); E-mail from Al Glenn to SEC (June 22, 2000); E-mail from Dan Tramantozzi to SEC (June 22, 2000); E-mail from Mike Mimbach to SEC (June 25, 2000); E-mail from R. Richardson to SEC (June 26, 2000); Letter from William L. Morrow, Principal, SBX, Inc. to SEC (July 5, 2000); E-mail from Victor A. Marzarella to SEC (July 13, 2000); E-mail from Jonathan A. Janssen to SEC (July 13, 2000); E-mail from Kenneth Veneziano, Senior Vice President and General Counsel, GlobeNet Capital Corporation, to SEC (July 13, 2000) (''GlobeNet E-mail'').

[21] *See* E-mail from Erol Denizkurt to SEC (June 22, 2000); E-mail from Jim Mareno to SEC (June 22, 2000); E-mail from T.L. Kimber to SEC (June 26, 2000).

[22] In approving this rule, the Commission has considered its impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

[23] 15 U.S.C. 78o–3(b)(6).

[24] *See* Exchange Act Release No. 34279 (June 29, 1994), 59 FR 34883 (July 7, 1994).

customer limit orders—the lesser of $0.05 per share or one-half of the current inside spread—is appropriate for the pilot program. As the Commission has previously noted, market makers electing to trade ahead of customer limit orders must be required to do so by a sufficiently large increment, otherwise the benefits of limit orders on price competition are lost.[25] The Commission believes that the proposed increment for the pilot program satisfactorily balances the interests of providing limit order protection against the benefits of offering price improvement. However, the Commission expects that, during the pilot period, Nasdaq will study all aspects of new NASD Rule 6541. After reviewing the pilot's operation, Nasdaq will have the opportunity to propose further refinements to the rule, if necessary.

In addition, one commenter recommended that NASD Rule 6541 include a two-minute standard for contemporaneous executions, rather than five minutes proposed by Nasdaq. The Commission believes that the five-minute standard is a reasonable first step, and that Nasdaq will have the opportunity to propose any appropriate refinements to NASD Rule 6541 at the conclusion of the pilot program.

B. Pilot Program

The Commission is approving this proposal on a 12-month pilot basis ending as of February 8, 2002. As noted above, Nasdaq has stated that NASD Rule 6541 will not become operational until 30 days after issuance of a Notice to Members discussing the operation of the new rule and that the pilot securities will be subject to a phase-in period.

C. Accelerated Approval of Amendment Nos. 1 and 2

The Commission finds good cause for approving Amendment Nos. 1 and 2 to the proposal prior to the thirtieth day after the date of public of notice in the **Federal Register**, pursuant to Section 19(b)(2) of the Act.[26] The original proposal has been published in the **Federal Register**, and public comment on the proposal was favorable. The Commission believes that Amendment Nos. 1 and 2 do not materially alter the original filing, but merely clarify the obligations imposed by NASD Rule 6541 in a manner consistent with the obligations that already exist with respect to Nasdaq National Market and SmallCap securities. The Commission believes, moreover, that approving Amendment Nos. 1 and 2—which set forth and describe the trading-ahead increment—at the same time as the original proposal furthers the investor protection goals of the Act.

VI. Solicitation of Comments on Amendments Nos. 1 and 2

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 1 and 2, including whether the amendments 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 No. SR–NASD–00–22 and should be submitted by March 8, 2001.

VII. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[27] that the proposed rule change (SR–NASD–00–22) is approved on a pilot basis and that Amendment Nos. 1 and 2 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[28]

Margaret H. McFarland,

Deputy Secretary.

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[25] *See* Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406, 48420 (August 8, 2000) (proposing release for rules relating to disclosure of order execution and routing practices).

[26] 15 U.S.C. 78s(b)(2).

[27] *Id.*

[28] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43943; File No. SR–NASD–00–79]

Self-Regulatory Organizations; Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to EWN II Fees for NASD Members

February 8, 2001.

Introduction

On December 21, 2000, the National Association of Securities Dealers, Inc. (''NASD''), through its subsidiary, The Nasdaq Stock Market, Inc. (''Nasdaq''), submitted to the Securities and Exchange Commission (''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change relating to Enterprise Wide Network II (''EWN II'') Fees for NASD Members.

The proposed rule change was published for comment in the **Federal Register** on January 16, 2001.[3] No comments were received on the proposal. This order approves the proposal.

II. Description of the Proposal

In its proposed rule change, Nasdaq proposed to pass on costs associated with increased bandwidth demands of the EWN II to NASD members for the period December 1–12, 2000.[4] In the September/October 200 issue of Nasdaq's *Subscriber Bulletin*,[5] Nasdaq announced that it had increased the bandwidth of its Enterprise Wide Network II from 128 kilobits (''kb'') to 192 kb. This increased bandwidth provides Nasdaq with the ability to support increased share volume and new products and trading applications that will be introduced. A description of the history of EWN II and the recent bandwith increase may be found in SR–

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 43814 (January 8, 2001), 66 FR 3630.)

[4] Nasdaq previously filed under section 19(b)(3)(A)(ii) a proposed rule change to increase the fees beginning December 13, 2000, which was immediately effective upon filing. Securities Exchange Act Release No. 43769 (December 22, 2000) (SR–NASD–00–73), 66 FR 826 (January 4, 2001). Nasdaq also filed a parallel rule filing to effect amendments to the EWN II fee structure to apply to non-NASD members. Securities Exchange Act Release No. 43768 (December 22, 2000) (SR–NASD–00–74), 66 FR 824 (January 4, 2001).

[5] *Subscriber Bulletins* are mailed to Nasdaq Workstation II subscribers and also may be found at *www.nasdaqtrader.com/trader/news/subscriberbulletins.*