

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44257; File No. SR-NASD-2001-28]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. To Institute an Automated Order Delivery Service on the OTCBB

May 4, 2001.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4² thereunder, notice is hereby given that on April 12, 2001, 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 Nasdaq. 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

Nasdaq is proposing to implement an enhancement to the OTC Bulletin Board Service ("OTCBB"). Nasdaq proposes to create an automated order delivery service ("ODS") that will enable OTCBB users to communicate electronically with one another to negotiate and confirm the execution of orders. This communication interface would offer an alternative to telephonic communication, which would increase the speed, efficiency, and quality of execution in the OTCBB. The proposed ODS would offer much of the functionality of the SelectNet service that is used for trading of Nasdaq National Market and SmallCap securities. Nasdaq states that SelectNet has proven to be a versatile and effective trading tool in those segments of the market.

The principal purpose of this enhancement is to supplement the existing capacity of market makers to consummate transactions pursuant to applicable trading rules. The ODS would enable member firms to communicate and confirm the execution terms of individual transactions electronically, just as they do by telephone today. The ODS would impose no new trading rules or obligations, but would permit market

participants to comply more efficiently with existing rules and obligations, including best execution and firm quote obligations. Additionally, order executions negotiated through the ODS would automatically generate transaction reports for OTCBB issues and locked-in trades for clearance purposes.

The following paragraphs describe the history of the OTCBB, and also outline the major elements of the ODS enhancement.

Development and Operation of the OTCBB

The OTCBB is a regulated quotation service that displays real-time quotes, last-sale prices, and volume information in over-the-counter equity securities.³ The OTCBB began operating on a pilot basis in June 1990 as part of market structure reforms designed to improve transparency in the over-the-counter equities market. The system was designed to facilitate the widespread publication of quotation and last-sale information. Since December 1993, firms have been required to report trades in all domestic OTC equity securities through the Automated Confirmation Transaction Service ("Act") within 90 seconds of the transaction.

Today, the OTCBB provides an electronic quotation medium for subscribing members to reflect market making interest in OTCBB-eligible securities. The OTCBB currently allows market makers to use an authorized Nasdaq Workstation II ("NWII") to update quotes, query positions, register in active stocks, and add or update telephone numbers. Market makers may access the service between 7:30 a.m. and 6:30 p.m. ET and may update quotes in domestic securities, foreign securities, and ADRs any time the system is in operation.⁴

Subscribing market makers can utilize the OTCBB to enter, update, and display their proprietary quotations in individual securities on a real-time basis. Such quotation entries may consist of a priced bid and/or offer, an unpriced indication of interest (including "bid wanted" or "offer wanted" indications), or a bid/offer accompanied by a modifier to reflect unsolicited customer interest. A

³ An OTC equity security generally is any equity that is not listed or traded on Nasdaq or a national securities exchange. OTCBB securities include national, regional, and foreign equity issues, warrants, units, American Depositary Receipts ("ADRs"), and Direct Participation Programs ("DPPs").

⁴ Quotes in DPPs may be updated twice daily: once between 8:30 and 9:30 a.m. ET and again between 12:00 and 12:30 p.m. ET.

subscribing market maker can also access the proprietary quotations that other firms have entered into the OTCBB Service along with highest bid and lowest offer (*i.e.*, an inside bid-ask calculation) in any OTCBB-eligible security with at least two market makers displaying two-sided markets. All priced quotes in domestic securities, foreign securities, and ADRs are firm; all quotes in DPPs are indicative.

Additionally, all NASD Level I members with Level $\frac{2}{3}$ service may view OTCBB data without paying an additional charge beyond their NWII fees. However, only registered market makers are permitted to enter quotes and indications of interest.

Access to the ODS

Upon introduction, the ODS would be available to all NASD member firms that have authorized access to Nasdaq Level $\frac{2}{3}$ through NWII terminals or through an Applications Programming Interface, and that have appropriate clearing arrangements through a registered national clearing agency. The ODS would be accessible for negotiation and confirmation of transactions in OTCBB issues during normal business hours for the OTCBB market (from 7:30 a.m. to 6:30 p.m. ET), although quotations would be required to be firm only between 9:30 a.m. and 4 p.m. During this period, the ODS would be continuously available for use by any eligible NASD market maker or order-entry firm. Registered OTCBB market makers would be unable to inhibit the receipt of ODS messages from other eligible NASD members between 9:30 a.m. and 4 p.m. ET, and orders received within a market maker's quoted price and size would be considered liability orders. Hence, an NASD member would be assured that communication can be established with a market maker during all market conditions and that transactions can be consummated without reliance on the telephone.

Use of the ODS

The ODS would provide an alternative medium for retail firms to contact market makers and for market makers to contact one another, to negotiate trades, and to confirm executions regardless of market conditions just as they do by telephone today. The establishment of the ODS would not impose any additional obligations beyond those already applicable to the market maker and NASD member in connection with telephonic transactions, such as the firm quote and best execution obligations.

Nasdaq has established some basic operational requirements for the ODS:

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(i) An order entered through the ODS must be preferred to a market maker in the security.

(ii) Principal as well as agency orders may be entered through the ODS.

(iii) All orders entered through the ODS must be priced. Therefore, it would be impermissible to enter an order only with instructions to execute "at the market" or "on the close."

(iv) An order entered through the ODS must include the security's identifier, price and size (from 100 to 999,900 shares); be designated as buy, sell, or sell short; and have a capacity indicator. All orders must be in round lots; the system will not accept odd lots.

(v) Orders entered into the ODS would be in force for a minimum of three minutes, unless the entering firm specifies another time in force or designates as a day order. The entering firm would be permitted to attempt to cancel an order after ten seconds.

(vi) A market maker receiving an order through the ODS would have three minutes to respond with an "accept" or "reject" message. Order recipients can respond with partial acceptance, as long as the order is not designated as All-Or-None. If the receiving market maker does not act within three minutes (or other time period specified by the order entry firm), the order would be automatically timed out and a notification of that result sent to the initiating firm.

(vii) The ODS would send a "pop-up" message to a market maker's NWII terminal alerting the market maker to the presence of a liability order. The market maker would then be obligated to execute the liability order up to the size of its quoted price, unless the market maker is in the process of executing another limit order at the same price.

(viii) The ODS would prohibit orders from being entered if there is no inside market in the security (*i.e.*, there are at least two market makers with two-sided quotes).

(ix) If an incoming buy (sell) order is priced below (above) the recipient's quoted bid/offer, or for an amount exceeding the recipient's displayed size, the market maker may properly reject it. The rejecting market maker can promptly communicate a counter proposal for possible acceptance by the initiating firm. This scenario illustrates the ability of a market maker to negotiate an execution by exchanging messages via the ODS.

(x) Transmission of an "accept" message would automatically create and send a "locked-in" trade to ACT for comparison and clearing. Trades confirmed through the ODS would

automatically generate a printed confirmation of the execution to both parties.

(xi) ODS users would have access to the full functionality of ACT to enter corrective transactions, including cancel, error, break, no/was, inhibit, and kill (where appropriate under applicable trade reporting rules).

(xii) Participating market makers would have the capacity to scan transactions which they have executed through the ODS during the course of a trading day.

(xiii) The ODS would automatically reject messages involving ineligible market makers or initiating member firms.

As outlined above, the ODS would allow market participants to follow a few easy steps to enter, negotiate, and accept orders. To enter an order the market participant must choose buy, sell, or sell short; enter the share size; enter the security ID; designate a price; indicate whether price and/or size are negotiable; and specify the duration of the order, including (1) leave the order open for a minimum of three minutes, (2) make it a day order, or (3) leave it open until after-hours trading has ended. Market participants can respond to an order in several ways: accept the order, price improve it, decline it, counter the order, accept a portion of the order, or allow the order to expire or time out. When an order is countered, negotiations would begin and the parties would exchange messages until they produce a full or partial execution, they decline the transaction, or the order times out.

After an order is executed, the ODS would automatically confirm it to both parties to the transaction; send the trade report through Nasdaq for public dissemination; and compare, match, and send the locked-in trade to a clearing corporation. All Nasdaq order-entry or market maker subscribers would be eligible to participate in the ODS, provided that they have a clearing arrangement with an approved clearing agent.

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 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. 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 states that trading activity in the OTCBB grew from 41 million shares and less than 7,000 trades per day in 1995 to 323 million shares and 53,000 trades per day in 1999. In the first quarter of 2000, on average, over 1 billion shares were traded and 205,000 trades were reported each day. Nasdaq believes that there are many reasons for this increase in volume, but chief among them is the wealth of OTC information available on the Internet and the growth of online trading systems directly accessible to individual investors. The manual nature of the OTCBB, where all order delivery, communication, and negotiation between two firms regarding an OTCBB trade is done via telephone, was a drawback during these periods of explosive volume. Nasdaq believes that executions were slower and market participants had difficulty keeping abreast of telephone traffic.

Nasdaq states that the singular purpose of the ODS enhancement is to expand the communications facilities available to support the continuous, orderly operation of the OTCBB during periods of heavy trading, such as those experienced periodically during 2000. The ODS would facilitate processing of orders during fast markets, in that it would supplement the telephone capacity of market makers to interact with one another. It would, however, permit NASD members, from a functional standpoint, to continue to conduct business with one another by communicating the same basic elements of information that are needed to negotiate and confirm executions via telephone. The major difference is that electronic messages would substitute for verbal messages.

Nasdaq states that the ODS would also enable NASD members to realize certain efficiencies that are most desirable in periods of heavy trading, but unavailable respecting transactions effected via telephone. For example, consummation of a transaction through the ODS would yield a printed confirmation to both parties to the transaction and would obviate the separate entry of a trade report for an execution in an OTCBB security. Further, because orders executed through the ODS would yield locked-in trades, this feature would help reduce the volume of uncompleted trades (and

the attendant allocation of resources needed to resolve them) during periods in which overall market volume surges dramatically. Nasdaq believes that institution of the ODS would supplement both the communications and order processing capabilities of member firms.

The NASD Regulation Market Regulation Department anticipates that the ODS would enable it to surveil more effectively the OTCBB marketplace. Nasdaq is committed to maintaining a high level of regulation in the OTCBB trading environment. In fact, Nasdaq's market surveillance systems and staff would increase the capacity for real-time monitoring of trading on the OTCBB.

Nasdaq states that the OTCBB has made significant strides in making measurable market improvements in the past three years, including: (1) the implementation of the Eligibility Rule, which requires each OTCBB issuer to be fully registered with the SEC (or appropriate banking or insurance regulator) and be current in its filings;⁵ (2) the establishment of limited trading halt authority for OTCBB securities;⁶ and, (3) the upcoming launch of a Limit Order Protection pilot program, which will prohibit member firms from trading ahead of customer limit orders certain OTCBB securities.⁷ Nasdaq believes that providing automated access to the OTCBB market would further Nasdaq's efforts to make the OTCBB a more efficient and orderly marketplace for investors and market participants alike.

2. Statutory Basis

Nasdaq believes that the proposal is consistent with Sections 11A and 15A of the Act.⁸ Subsections (A) to (D) of Section 11A(a)(1)⁹ articulate the broad findings and policy goals which Congress intended to guide the operational enhancement of the nation's securities markets. In this context, Congress underscored the importance of applying new data processing and communications techniques to assure: (1) more efficient and effective market operations; (2) economically efficient execution of securities transactions; (3) broad availability of information with respect to quotations for and transactions in securities; and (4) the optimal execution of investors' orders.¹⁰ The NASD believes that the design and operation features of the ODS

enhancement comport fully with these Congressional directives.

Nasdaq believes that the proposal is also supported by subsection (b)(6) of Section 15A of the Act.¹¹ Among other things, that provision requires that the NASD's rule-making initiatives be designed: (1) to promote just and equitable principles of trade; (2) to foster cooperation and coordination with persons engaged in regulating, clearing settling, processing information with respect to, and facilitating transactions in securities; (3) to perfect the mechanism of a free and open market and a national market system; and (4) to protect investors and the public interest. As described earlier, the ODS would augment the communications and order-handling capacities of market makers in OTCBB securities. The NASD views the ODS as an essential, auxiliary communications system that would enable market makers to conduct business with one another when telephonic communications are undesirable due to unusual conditions. Providing such a back-up capability promotes continuity in market operations in order to service all classes of investors. Nasdaq believes that this result is fully consistent with the above-cited portions of Section 15A(b)(6) of the Act.¹²

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

Nasdaq states that implementation of the ODS would not involve the imposition of any competitive burden. Nasdaq believes that this conclusion is supported by several factors. First, the ODS involves an enhancement of the facilities that support market making in OTCBB securities by member firms. This type of enhancement would not alter the established terms of access respecting vendors' receipt of market information for redistribution to diverse groups of end users. Second, the ODS would not pose a competitive burden upon market makers and other eligible members. By design, the ODS would be an auxiliary medium of communication that eligible firms may employ to conduct business when telephonic communication is not desirable. Accordingly, the ODS has been structured to accommodate conveyance of the same basic elements of information which firms communicate in negotiating and executing transactions via the telephone. Third, the ODS enhancement would not impose more stringent market-making obligations on participating firms.

Rather, it would provide an alternative mechanism for market participants to conduct their routine business. Fourth, firms electing to utilize the ODS would need only to have clearing arrangements through a registered clearing agency that uses a continuous net settlement system, a requirement that exists today for trading of OTCBB securities.

Nasdaq believes, therefore, that no competitive burden would result from the Commission's approval of this filing.

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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Nasdaq consents, the Commission will:

(A) by order approve such proposed rule change; or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of 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 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-2001-28 and should be submitted by May 31, 2001.

⁵ See NASD Rules 6530 and 6540.

⁶ See NASD Rule 6545.

⁷ See NASD Rule 6541 (implementation pending).

⁸ 15 U.S.C. 78k-1 and 78o-3.

⁹ 15 U.S.C. 78k-1(a)(1)(A) to (D).

¹⁰ See 15 U.S.C. 78k-1(a)(1)(C).

¹¹ See 15 U.S.C. 78o-3(b)(6).

¹² *Id.*

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. 34-44245; File No. SR-Phlx-2001-44]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Extending the Pilot Program for Exchange Rule 98, Emergency Committee Until July 31, 2001

May 1, 2001.

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 April 12, 2001, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed a proposed rule change with the Securities and Exchange Commission ("SEC" or "Commission"). The proposed rule change is described in Items I, II, and III below, which Items have been prepared by the Exchange. The Exchange filed the proposed rule change pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposed rule change effective upon filing with the Commission. 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 the pilot program period for Rule 98, Emergency Committee until July 31, 2001. No changes to the existing rule language are being proposed.

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 Exchange 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 Exchange 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

On December 23, 1999, the Commission approved amendments to Rule 98, Emergency Committee (the "Committee"), which updated the composition of the Committee to reflect the current governance structure of the Exchange, on a 120-day pilot basis.⁵ The pilot has been extended three times, most recently to April 30, 2001.⁶ The pilot program is being extended again to July 31, 2001 as the Exchange considers other changes to the composition of the Committee.

The Exchange originally proposed to amend Rule 98, Emergency Committee, by updating the composition of the Committee to correspond with previous revisions to the Exchange's governance structure,⁷ and by deleting a provision authorizing the Committee to take action regarding CENTRAMART, an equity order reporting system which is

no longer used on the Exchange Equity Floor.

The Committee was formed in 1989⁸ prior to the aforementioned changes to the Exchange's governance structure. The original proposed rule change, approved by the Commission, deleted the word "President" from the rule, as the Exchange no longer has a "President," and included the Exchange's On-Floor Vice Chairman⁹ as a member of the Committee.

Thus, Rule 98 specifies the composition of the Emergency Committee to include the following individuals: the Chairman of the Board of Governors; the On-Floor vice Chairman of the Board of Governors; and the Chairmen of the Options Committee, the Floor Procedure Committee, and the Foreign Currency Options Committee.

The staff of the Commission has requested that the Exchange file the instant proposed rule change to extend the pilot program through July 31, 2001 so that the Committee will reflect the current governance structure of the Exchange and will be in place to take necessary and appropriate action to respond to extraordinary market conditions or other emergencies.¹⁰ The extension of the pilot program will also allow the Exchange the necessary time to propose changes to the Committee's structure to meet the Commission's concerns about whether the Committee ensures that all interests of the Exchange (e.g., On-Floor or Off-Floor) are adequately represented by the Committee.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6¹¹ of the Act in general, and with Section 6(b)(5)¹² of the Act in specific, in that it is designed to perfect the mechanisms of a free and open market and a national market system, and to protect investors and the public interest, by updating the composition of the Emergency Committee to reflect the

⁵ Securities Exchange Act Release No. 42272 (December 23, 1999), 65 FR 153 (January 3, 2000)(SR-Phlx-99-42). In the approval order, the Commission requested that the Exchange examine the operation of the Committee to ensure that the Committee is not dominated by any one Exchange interest (e.g., On-Floor or Off-Floor interests). The Commission requested that the Exchange report back to the Commission on its views as to whether the Committee structure ensures that all Exchange interests are fairly represented by the Committee.

⁶ Securities Exchange Act Release No. 42898 (June 5, 2000), 65 FR 36879 (June 12, 2000)(SR-Phlx-00-41), extending the pilot program until August 21, 2000; Securities Exchange Act Release No. 43169 (August 17, 2000), 65 FR 51888 (August 25, 2000)(SR-Phlx-00-76), extending the pilot program until November 17, 2000. On July 14, 2000, the Exchange filed a proposed rule change to effect the amendments on a permanent basis. SR-Phlx-00-63 (filed July 14, 2000). In SR-Phlx-00-63 the Exchange also enclosed the Exchange's views as to whether the Committee structure ensures that all Exchange interests are fairly represented by the Committee. Because the Exchange is considering changes to the Committee, the Commission expects SR-Phlx-00-63 to be withdrawn. In November, 2000, the pilot program was extended again until April 30, 2001. Securities Exchange Act Release No. 43614 (November 22, 2000), 65 FR 75332 (December 1, 2000).

⁷ See Securities Exchange Act Release No. 38960 (August 22, 1997), 62 FR 45904 (August 29, 1997)(SR-Phlx-97-31).

⁸ See Securities Exchange Act Release No. 26858 (May 22, 1989), 54 FR 23007 (May 30, 1989) (SR-Phlx-88-36).

⁹ See also Exchange By-Law, Article IV, Section 4-2.

¹⁰ Previously, the Exchange has described "extraordinary market or emergency conditions" as, among other things, a declaration of war, a presidential assassination, an electrical blackout, or events such as the 1987 market break or other highly volatile trading conditions that require intervention for the market's continued efficient operation. Letter dated March 15, 1989, from William W. Uchimoto, General Counsel, Exchange, to Sharon L. Itkin, Esquire, Commission, Division of Market Regulation.

¹¹ 15 U.S.C. 78f.

¹² 15 U.S.C. 78f(b)(5).

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6). The Exchange filed the pre-filing notice required by Rule 19b-4(f)(6) by filing a written description of the proposed rule change and the text of the proposed rule change on April 3, 2001.