

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 proposes to extend through September 1, 2002 its current pilot program that makes available certain Nasdaq systems and facilities until 6:30 P.M. Eastern Time. The pilot will continue to operate under the same terms and conditions as set forth in the Commission's original approval order, including mandating 90-second trade reporting until 6:30 P.M. Eastern Time.<sup>6</sup>

2. Statutory Basis

Nasdaq believes that the proposal is consistent with the provisions of Section 15A(b)(6) of the Act<sup>7</sup> in that it is 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, and processing information with respect to, and facilitating transactions in securities.

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

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

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

Written comments were neither solicited nor received.

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

Because the foregoing proposed rule change does not:

- (i) Significantly affect the protection of investors or the public interest;
- (ii) Impose any significant burden on competition; and
- (iii) Become operative for 30 days from the date on which it was filed, or such shorter time as the Commission

may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>8</sup> and Rule 19b-4(f)(6) thereunder.<sup>9</sup> At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

Nasdaq has requested that the Commission waive the 5-day pre-filing notice requirement and accelerate the operative date. The Commission finds good cause to waive the 5-day pre-filing notice requirement and the 30-day operative waiting period, because such designation is consistent with the protection of investors and the public interest. Acceleration of the operative date will allow the pilot program to continue without interruption through September 1, 2002. For these reasons, the Commission finds good cause to waive both the 5-day pre-filing notice requirement and the 30-day operative waiting period.<sup>10</sup>

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal 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 Association. All submissions should refer to file number SR-NASD-2002-29 and should be submitted by April 1, 2002.

<sup>8</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>9</sup> 17 CFR 240.19b-4(f)(6).

<sup>10</sup> For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

**Jill M. Peterson,**

*Assistant Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-45508; File No. SR-NASD-00-76]

**Self-Regulatory Organizations; Notice of Filing of Amendment Nos. 2 and 3 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Locked and Crossed Markets That Occur at or Prior to the Market Open**

March 5, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that 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" or "SEC") Amendment Nos. 2 and 3 to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The proposed rule change and Amendment No. 1 were published for comment in the **Federal Register** on February 7, 2001.<sup>3</sup> The Commission received seven comment letters regarding the proposal.<sup>4</sup> Nasdaq

<sup>11</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See Securities Exchange Act Release No. 43913 (January 31, 2001), 66 FR 9394 ("February 2001 Release").

<sup>4</sup> See letter from Mark R. Grewe, Managing Director, NDB Capital Markets, L.P., to Jonathan G. Katz, Secretary, Commission, dated February 27, 2001 ("NDB Letter"); letter from Martin Cunningham, Senior Vice President Trading, Schwab Capital Markets L.P. ("Schwab"), to Jonathan G. Katz, Secretary, Commission, dated February 28, 2001 ("Schwab Letter"); letter from Richard B. Levin, Assistant General Counsel and Regulatory Affairs Officer, Knight Securities, L.P. ("Knight"), to the Commission, dated March 1, 2001 ("Knight Letter"); letter from Kim Bang, President, Bloomberg Tradebook LLC ("Bloomberg"), to the Commission, dated March 15, 2001 ("Bloomberg Letter"); letter from Timothy G. Grazioso, Subcommittee Chairman, Trading Issues Committee, Security Traders Association ("STA"), Michael T. Bird, Chairman, Trading Issues Committee, STA, and Geoffrey W. Cloud, Counsel, Trading Issues Committee, STA, to Jonathan G. Katz, Secretary, Commission, dated March 13, 2001 ("STA Letter"); letter from Kevin J.P. O'Hara, General Counsel, Archipelago, L.L.C. ("Archipelago") to Jonathan G. Katz, Secretary, Commission, dated April 3, 2001 ("Archipelago

<sup>6</sup> See Securities Exchange Act Release No. 42003 (October 13, 1999), 64 FR 56554 (October 20, 1999) (order approving after-hours trading pilot).

<sup>7</sup> 15 U.S.C. 78o-3(b)(6).

has responded to the commenters in Amendment Nos. 2 and 3 to the proposal, which Nasdaq filed with the Commission on August 13, 2001,<sup>5</sup> and February 21, 2002, respectively.<sup>6</sup> The Commission is publishing this notice to solicit comments on Amendment Nos. 2 and 3 to the proposed rule change from interested persons.

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

In its original proposal, Nasdaq proposed to amend NASD Rule 4613(e)(1)(C), "Locked and Crossed Markets," to revise the use of Trade-or-Move Messages during locked and crossed market conditions that occur prior to the market's opening and to add provisions relating to the use of Trade-or-Move Messages prior to the market's close. In response to comment letters filed with the Commission and based upon input from a special subcommittee of Nasdaq's Quality of Markets Committee, Nasdaq proposes to amend its original proposal to: (1) Require ECNs to send Trade-or-Move Messages prior to entering locking/crossing quotes and require market makers to send Trade-or-Move Messages after entering locking/crossing quotes; (2) reduce the time to respond to a Trade-or-Move Message to 10 seconds; (3) provide a 10,000-share minimum share requirement for Trade-or-Move Messages for Nasdaq 100 and S&P 400 issues; (4) prohibit all market

participants from entering locking/crossing quotes between 9:29:30 a.m. and 9:29:59 a.m.; and (5) delete provisions imposing Trade-or-Move requirements between 3:50 p.m. and 4:00 p.m.

Proposed changes to the original proposal, as published in the February 2001 Release, appear below. Proposed additions are in *italics*; proposed deletions are in [brackets].

### **Rule 4613—Character of Quotations**

(a)–(d) No change.

(e) Locked and Crossed Markets:

(1) A market maker shall not, except under extraordinary circumstances, enter or maintain quotations in Nasdaq during normal business hours if:

(A) No change.

(B) No change.

(C) Obligations Regarding Locked/Crossed Market Conditions Prior to Market Opening [And Prior to Market Closing]—

(i) No change.

(i) Locked/Crossed Market Between 9:20 and 9:29:59 a.m.—

(a) Before an ECN [market maker] enters a quote that would lock or cross the market between 9:20 and 9:29:29 a.m. Eastern Time, the ECN [market maker] must first send through SelectNet to the market maker or ECN whose quote it would lock or cross a Trade-or-Move Message that is at or superior to the receiving market maker's or ECN's quoted price [and that is for at least 10,000 shares (if multiple market makers would be locked/crossed, each one must receive a Trade-or-Move Message and the aggregate size of all such messages must be at least 10,000 shares); provided, however, that if a market participant is representing an agency order (as defined in subparagraph (vi) of this rule), the market participant shall be required to send a Trade-or-Move Message in an amount equal to the agency order, even if that order is less than 10,000 shares. A [market maker]. An ECN that sends a Trade-or-Move Message during these periods must then wait at least [15]10 seconds before entering a quote that would lock or cross the market.

(b) *If a market maker enters a quote that would lock or cross the market between 9:20 and 9:29:29 a.m. Eastern Time, the market maker must then immediately send through SelectNet to the market maker or ECN whose quote it would lock or cross a Trade-or-Move Message that is at or superior to the receiving market maker's or ECN's quoted price.*

(c) *Market participants shall be prohibited from entering a quote that*

*would lock or cross the market between 9:29:30 and 9:29:59.*

(ii)(a) *In the case of securities included in the Nasdaq 100 Index or the S&P 400 Index, a Trade-or-Move Message must be [and that is] for at least 10,000 shares (if multiple market makers would be locked/crossed, each one must receive a Trade-or-Move Message and the aggregate size of all such messages must be at least 10,000 shares); provided, however, that if a market participant is representing an agency order (as defined in subparagraph (vi) of this rule), the market participant shall be required to send a Trade-or-Move Message(s) in an amount equal to the agency order, even if that order is less than 10,000 shares.*

(b) *In the case of all other securities, a Trade-or-Move Message must be for at least 5,000 shares (if multiple market makers would be locked/crossed, each one must receive a Trade-or-Move Message and the aggregate size of all such messages must be at least 5,000 shares); provided, however, that if a market participant is representing an agency order (as defined in subparagraph (vi) of this rule), the market participant shall be required to send a Trade-or-Move Message(s) in an amount equal to the agency order, even if that order is less than 5,000 shares.*

[Locked/Crossed Market Between 3:50 and 3:59:59 p.m.—Before a market maker enters a quote that would lock or cross the market between 3:50 and 3:59:59 p.m. Eastern Time, the market maker must first send through SelectNet to the market maker whose quote it would lock or cross, a Trade-or-Move Message that is at the receiving market maker's quoted price and that is for at least 10,000 shares (if multiple market makers would be locked/crossed, each one must receive a Trade-or-Move Message and the aggregate size of all such messages must be at least 10,000 shares); provided, however, that if a market participant is representing an agency order (as defined in subparagraph (vi) of this rule), the market participant shall be required to send a Trade-or-Move Message(s) in an amount equal to the agency order, even if that order is less than 10,000 shares. A market maker that sends a Trade-or-Move Message during this period must then wait at least 15 seconds before entering a quote that would lock or cross the market.]

(iv) A market maker that receives a Trade-or-Move Message must, within [15] 10 seconds of receiving such message, either fill the incoming Trade-or-Move Message for the full size of the message, or [, consistent with its Firm Quote obligations,] move its bid down

Letter"); and letter from William O'Brien, Senior Vice President & General Counsel, The BRUT ECN, L.L.C., ("BRUT") to the Commission, dated April 17, 2001 ("BRUT Letter").

<sup>5</sup> See letter (with attachment) from Eugene A. Lopez, Senior Vice President, Nasdaq, to Belinda Blaine, Associate Director, Division of Market Regulation ("Division"), Commission, dated August 10, 2001 ("Amendment No. 2"). In Amendment No. 2, Nasdaq responds to the commenters and proposes to revise its original proposal to: (1) Require electronic communications networks ("ECNs") to send Trade-or-Move Messages prior to entering locking/crossing quotes and require market makers to send Trade-or-Move Messages after entering locking/crossing quotes; (2) reduce the time to respond to a Trade-or-Move Message to 10 seconds; (3) provide a 10,000-share minimum share requirement for Trade-or-Move Messages for Nasdaq 100 and S&P 400 issues; (4) prohibit all market participants from entering locking/crossing quotes between 9:29:30 a.m. and 9:29:59 a.m.; and (5) delete provisions imposing Trade-or-Move requirements between 3:50 p.m. and 4 p.m.

<sup>6</sup> See letter from Jeffrey S. Davis, Nasdaq, to John Polise, Senior Special Counsel, Division, Commission, dated February 21, 2002 ("Amendment No. 3"). In Amendment No. 3, Nasdaq responds to comments from BRUT and clarifies a misstatement in Amendment No. 2. Specifically, Amendment No. 3 states that the requirement that ECNs send Trade-or-Move Messages prior to entering locking or crossing quotes applies to all orders that ECNs receive and is not limited to agency orders, as stated incorrectly in Amendment No. 2.

(offer up) by a quotation increment that restores or maintains an unlocked/uncrossed market.

(v) A market maker that sends a Trade-or-Move Message pursuant to subparagraphs (e)(1)(C)(i)[,] or (ii)[,] or (iii)] of this rule must append to the message a Nasdaq-provided symbol indicating that it is a Trade-or-Move Message.

(vi) No Change.

(2) No Change.

(3) *Except as indicated in subsection (1)(C)(ii)*, [F]or purposes of this rule, the term "market maker" shall include:

(A)–(D) No Change.

## 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

(a) Amendment No. 2.

#### Background

In its original rule proposal, Nasdaq proposed amendments to NASD Rule 4613(e)(1)(C) that would alter the obligations of market makers and ECNs during locked and crossed markets that occur prior to the market's open and also prior to the close. Specifically, Nasdaq originally proposed to: (1) Extend the application of NASD Rule 4613(e)(1)(C)(ii) regarding locked/crossed markets before the open to the period prior to the close; (2) require market makers and ECNs that send a Trade-or-Move Message to do so at least 15 seconds before entering a locking/crossing quote rather than after entering a locking/crossing quote, as the rule currently requires; (3) increase from 5,000 to 10,000 the minimum number of shares that must accompany a non-agency Trade-or-Move Message; and (4) reduce from 30 seconds to 15 seconds the amount of time within which the recipient of a Trade-or-Move Message must properly respond.

The Commission received seven comment letters regarding the original

proposal.<sup>7</sup> Nasdaq notes that the commenters, who are among the most active participants in the Nasdaq market, expressed materially different views regarding Nasdaq's proposal. In response to the comment letters, Nasdaq's Quality of Markets Committee formed a subcommittee ("Subcommittee") to address the concerns raised by the commenters. The Subcommittee was comprised of all of the commenters, as well as members representing other constituencies within the Nasdaq market making community.

At its first meeting, the Subcommittee spent two hours discussing the operation of the Trade-or-Move rule during the pre-opening period. This meeting, like the comment letters, generated significant disagreement regarding the best approach to improving the operation of the rule. Following that meeting, a straw poll of the Subcommittee on four aspects of Trade-or-Move during the pre-opening period revealed no clear majority supporting any proposal on any aspect of NASD Rule 4613(e)(1)(C).

After the first Subcommittee meeting, members of the staff of Nasdaq Transaction Services, Economic Research, Regulation and Controls, Technology Services, and the Nasdaq Office of General Counsel met several times in different groupings to develop a recommendation based upon the Subcommittee deliberations. Nasdaq staff presented its recommendations at the second Subcommittee meeting, where the Subcommittee members spent nearly two hours discussing the pre-opening period and another half-hour discussing the pre-closing period.

#### Response to Comments

Nasdaq is aware that there remain meaningful, legitimate disagreements within the market making community regarding the best solution to locked and crossed markets that occur on Nasdaq. Nasdaq's goal is to incrementally improve and simplify the operation of and compliance with the Trade-or-Move rule, rather than to pursue an impossible ideal of solving every Trade-or-Move problem experienced by every market participant. The recommendations described in greater detail below are designed to accomplish that goal, as well as to promote price discovery and the maintenance of an orderly market.

#### Pre-Opening

An orderly opening is critical to Nasdaq and to investors.<sup>8</sup> Nasdaq notes that a sizable portion of the volume in Nasdaq occurs at or around the market's opening. According to Nasdaq, many market makers guarantee their customers an execution at the opening inside bid or offer price, or in some cases the midpoint of (or other range between) the opening inside bid/inside offer. Thus, the inside market at the opening affects the price at which a sizable number of orders from individual investors in Nasdaq stocks are filled. Moreover, the prices of certain options contracts, indexes, and derivative instruments often are set based on the opening prints in Nasdaq. Accordingly, it is of utmost importance that the market open in an orderly fashion.

As discussed more fully below, Amendment No. 2 revises the proposal to eliminate the use of Trade-or-Move Messages prior to the market's close. In addition, Amendment No. 2 modifies the following aspects of the original proposal with regard to the way that Trade-or-Move operates prior to the opening: (1) The sequence of Trade-or-Move Messages; (2) the time within which to respond to a Trade-or-Move Message; (3) the number of shares accompanying a Trade-or-Move Message; and (4) the period between 9:29:30 a.m. and 9:29:59 a.m.

*Sequence of Messages:* Under current NASD Rule 4613(e)(1)(C), a market participant that enters a locking or crossing quote between 9:20 and 9:29:59 a.m. is then required to send a message with an appended Trade-or-Move designator to the party or parties it is locking/crossing. Nasdaq adopted the Trade-or-Move requirements because it believed that requiring market participants to lock/cross the market prior to sending a Trade-or-Move Message would reduce the frequency and severity of pre-opening locked and crossed markets by providing more informative quotation information and facilitating price discovery.

In its original proposal, Nasdaq proposed to revise NASD Rule 4613(e)(1)(C) to require all market participants to send Trade-or-Move Messages before rather than after entering a locking or crossing quotation during the applicable periods. Nasdaq believed that switching the sequence of messages in this way would further reduce the instances of locked and crossed markets in Nasdaq by

<sup>8</sup> See Arthur Levitt, Chairman, Commission, Remarks before the Securities Industry Association, Boca Raton, Florida (November 4, 1999).

<sup>7</sup> See note 4, *supra*.

preventing them from occurring in the first instance. Nasdaq believed that the benefits of preventing the occurrence of locked/crossed markets would outweigh the concomitant loss of price discovery provided by the entry of locking or crossing quotes.

Two commenters opposed the proposed change of sequence, claiming that the current sequence results in a one-step process that can be readily programmed into firms' automated trading systems,<sup>9</sup> while the opposite sequence would result in a two-step process that would be difficult to program. According to these commenters, the programming of automated systems improves firms' compliance with the Trade-or-Move requirements and their ability to surveil for compliance internally. These commenters also claimed that the change of sequence would result in more locked or crossed markets, not fewer, as Nasdaq believed.

Two commenters argued that reversing the sequence of messaging would unduly hinder price discovery because the recipient of a Trade-or-Move Message would not know the price to which it would be required to move its quote to maintain an unlocked/uncrossed market.<sup>10</sup> They further argued that decimalization would exacerbate this problem by permitting the recipients of Trade-or-Move Messages to move their quotes in penny increments rather than in sixteenths. Nasdaq maintains that these arguments are based upon the incorrect assumption that market participants can send Trade-or-Move Messages only to the recipient's quoted price (*i.e.*, to lock the market). In fact, a party sending a Trade-or-Move Message may send the Trade-or-Move Message at the recipient's quoted price *or at a superior price*.<sup>11</sup> In that case, the recipient would be required to trade in full or to move its quote beyond the superior price to maintain an unlocked and uncrossed market.

Two other commenters, both operators of ECNs, supported the proposed change of sequence.<sup>12</sup> One commenter argued that the current rule has a disproportionately negative effect

on ECNs because it requires them to stand willing to trade twice for every Trade-or-Move Message they send: once with the participant to which it routes the message, and again with any participant that attempts to access its quote.

Nasdaq notes that because ECNs choose not to accumulate proprietary positions, they are unwilling to accept the risk of double execution. Nasdaq states that while a neutral application of the Trade-or-Move requirements may affect market participants differently, that result stems from the ECNs' voluntary selection of a particular business model and access methodology rather than from any action of Nasdaq. Nasdaq also notes that market makers risk similar double liability from internalization and orders from non-Nasdaq means of access. Nasdaq maintains that its decision to switch the message sequence, like its decision to adopt the existing Trade-or-Move requirements, was based upon Nasdaq's assessment of the benefit of the Trade-or-Move requirements to the entire market rather than their impact on particular market participants or business models.

Nonetheless, based upon the comments received, Nasdaq has decided to amend its proposal to permit the sequence of messaging to differ by market participant business model. Amendment No. 2 will revise the proposal to require ECNs to send Trade-or-Move Messages before entering locking or crossing quotes. Market makers will enter a locking or crossing quote and then immediately send a Trade-or-Move Message.<sup>13</sup> Nasdaq believes that the proposed change has the dual benefit of permitting ECNs to participate more effectively in the pre-opening period and also permitting market makers to retain their current automated systems. It also preserves the benefits that Nasdaq sought to achieve when it first implemented the Trade-or-Move requirements, namely increased price discovery and decreased gamesmanship surrounding the occurrence and resolution of locked and crossed markets. Nasdaq believes that this approach will incrementally improve the operation of NASD Rule 4613(e)(1)(C).<sup>14</sup>

<sup>13</sup> "Immediate" issuance of a Trade-or-Move Message will be understood to mean instantaneous in the case of automated systems and not exceeding a different, specified period where manual processes are utilized.

<sup>14</sup> The STA also supported changing the sequence of messages, contending that doing so would reduce the instances of locked and crossed markets in Nasdaq. Based upon the STA's comments and upon Nasdaq's own desire to reduce the instances of

*Response Time:* Under current NASD Rule 4613(e)(1)(C), the recipient of a Trade-or-Move Message must respond properly to the message within 30 seconds. In the original proposal, Nasdaq reduced the response time to 15 seconds to reduce the duration of locked/crossed markets that occur. Nasdaq believes that markets have become materially faster and that a 30-second delay in price discovery is impractical under the current, rapid conditions. The commenters unanimously agreed that a 30-second response time is too long and that 15 seconds is more appropriate.<sup>15</sup> In fact, two commenters suggested reducing the response time to five seconds.<sup>16</sup>

Nasdaq is reluctant to reduce the response time to five seconds because that would impose a great burden on firms that lack automated systems. Nasdaq is also concerned that the operation and surveillance of a five-second rule could be compromised by potential delays in network communications between Nasdaq's systems and firms' systems.

To balance Nasdaq's desire to respond to the increased speed of markets as well as the potential burden imposed on non-automated firms, Nasdaq proposes to reduce to 10 seconds the time permitted to respond to a Trade-or-Move Message. Although this is a relatively brief period for non-automated participants, Nasdaq believes that firms that choose to participate in the pre-open must vigilantly monitor their quotes. As explained in greater detail below, the 10-second period corresponds to the minimum life of a SelectNet order, thereby allowing ECNs to avoid dual liability by canceling a Trade-or-Move Message when entering a locking or crossing quote.

*Number of Shares:* Under current NASD Rule 4613(e)(1)(C), the aggregate size of the Trade-or-Move Message must be at least 5,000 shares (*i.e.*, the market participant must send a total of 5,000 shares to all parties it is locking/crossing) in the case of a proprietary quote, or the actual size of an agency order if that is the basis for the locking/crossing quote. Under the original proposal, Nasdaq sought to raise the minimum Trade-or-Move Message share requirement to 10,000 shares or the

locked/crossed markets, Nasdaq also considered permitting each market participant to choose the sequence of messages that it preferred. After careful analysis, Nasdaq concluded that this approach would create confusion in the marketplace and hinder Nasdaq's ability to surveil for compliance with the Trade-or-Move requirements.

<sup>15</sup> See Bloomberg Letter; Archipelago Letter; Schwab Letter; and NDB Letter, *supra* note 4.

<sup>16</sup> See STA Letter and Knight Letter, *supra* note 4.

<sup>9</sup> See Schwab Letter and NDB Letter, *supra* note 4.

<sup>10</sup> See Schwab Letter and NDB Letter, *supra* note 4.

<sup>11</sup> Although Nasdaq announced this interpretation of NASD Rule 4613(e) in NASD Notice to Members 2000-29, Nasdaq notes that there appears to be some confusion concerning this point among market makers. Accordingly, Nasdaq is adding language to the current proposal to further clarify this point.

<sup>12</sup> See Archipelago Letter and Bloomberg Letter, *supra* note 4.

actual size of an agency order. Nasdaq believes that a market participant or its customer should not be able to lock or cross the market in the 10 minutes prior to the opening with a de minimus number of shares. Rather, Nasdaq believes that a market participant must be willing to risk significant capital and to trade a significant amount if it wishes to lock or cross the market during one of the most critical points in the trading day.

Several commenters supported the proposed increase and agreed with the rationale behind it.<sup>17</sup> In fact, the STA suggested that, in certain circumstances, the minimum Trade-or-Move Message share size should be 25,000 shares rather than 10,000 shares. One commenter stated that the requirement should remain at 5,000 shares due, in part, to what the commenter believes is non-compliance with the Trade-or-Move requirements by certain regional markets and NASD members.<sup>18</sup>

On the other hand, one commenter claimed that the 10,000-share requirement discriminates unfairly against ECNs and effectively prevents them from participating in the pre-opening.<sup>19</sup> The commenter suggested that Nasdaq address this issue by permitting ECNs to withhold from a Trade-or-Move Message a portion of an agency order rather than requiring the ECN to append the entire amount of the order to the Trade-or-Move Message it wishes to send. The ECN would then use the shares withheld to enter a locking or crossing quote.

Nasdaq disagrees with this argument. Contrary to the commenter's assertions, the minimum share requirement and agency exception each apply evenly to all market makers and ECNs, and also to their respective customers. The proposal simply prohibits any market participant from locking or crossing the market on a proprietary basis—regardless of the conduit through which it enters an order into the market—for less than the minimum number of shares. In fact, to do as the commenter suggests and permit ECNs to withhold a portion of their agency orders would itself create disparity between market makers and ECNs. Such an approach would be inconsistent with Nasdaq's view that, to the greatest extent possible, the lock/crossed rule should apply equally to all market participants.

Nasdaq also disagrees that the current rule operates to exclude ECNs from the pre-opening period, as evidenced by

several ECNs' current participation. Moreover, Nasdaq believes that the modifications described above will ameliorate the ECNs' concerns. Specifically, Nasdaq believes that allowing ECNs to send a Trade-or-Move Message before locking/crossing the market and reducing the response time to 10 seconds should virtually eliminate the risk to an ECN of assuming a proprietary position. For example, Nasdaq notes that an ECN could send Trade-or-Move Message for the actual size of an agency order and wait 10 seconds, the minimum life of a SelectNet order. Assuming that the ECN receives no reply, it could then cancel the SelectNet order and enter the full size of its agency order as a locking/crossing quote.

Nonetheless, in light of the comments received, Nasdaq has determined to modify the proposal as follows: proprietary orders with Trade-or-Move Messages must be accompanied by a minimum of 10,000 shares in the case of Nasdaq 100 and S&P 400 issues, and 5,000 shares for all other issues. The "agency exception" contained in current NASD Rule 4613(e)(1)(C) will continue to operate as it does today. Nasdaq believes that Nasdaq 100 and S&P 400 issues are marked by higher liquidity and faster trading and, therefore, merit a more stringent requirement to create a locked or crossed market. Nasdaq believes that this proposal proportionately increases the economic significance of entering a locking/crossing quotation for stocks that are widely followed and for which a locked/crossed market would have the greatest impact.

*Limited Prohibition On Entry Of Locking/Crossing Quotes:* Based upon the recommendation of the Subcommittee, which was comprised of the commenters and additional members of the Quality of Markets Committee, Nasdaq proposes that market participants be prohibited by rule from entering a locking or crossing quote between 9:29:30 and 9:29:59. During that period, all market participants will be permitted to send Trade-or-Move Messages for the required number of shares to parties that they would lock or cross if permitted to enter such locking/crossing quotes. Market participants that receive Trade-or-Move Messages during that time period will be obligated to respond properly by trading in full or moving their quote within the appropriate response time.

Nasdaq believes that a prohibition on the entry of locking/crossing quotes immediately prior to the market opening, in conjunction with the

continued obligation to respond properly to Trade-or-Move Messages, will facilitate the resolution of locks and crosses that exist at 9:29:30. Further, Nasdaq believes that the potential benefits to all market participants of a more orderly opening outweigh the limited loss of price discovery that will result from suppressing locking and crossing quotes during this brief but critical period.

#### *Pre-Closing*

NASD Rule 4613(e)(1)(C) does not currently apply during normal business hours. Based upon the positive effect that the Trade-or-Move requirements have had on resolving potential locked and crossed markets at and immediately before the market opening, Nasdaq originally proposed to expand the application of NASD Rule 4613(e)(1)(C) to include the 10-minute period preceding the market close (3:50 p.m. to 3:59:59 p.m.). Like the opening, the closing is a critical period characterized by volatile, rapid, and heavy trading. The closing price is a benchmark for numerous transactions and could be affected dramatically by the existence of locks and crosses.

In its original proposal, Nasdaq proposed that the Trade-or-Move Messages used prior to the close would operate in the same manner as currently proposed for Trade-or-Move Messages used prior to the opening, with one exception. Prior to the market's opening, the market participant receiving a Trade-or-Move Message has no liability under the NASD's firm quote rule (NASD Rule 4613(b)) or under the Commission's firm quote rule (Exchange Act Rule 11aAc-1). Thus, a market maker is permitted to move its quote without trading upon the receipt of what, during market hours, would be a SelectNet "liability" order. Prior to the close, however, a Trade-or-Move Message would be considered a liability order. Therefore, unlike during the earlier period, a market participant that received a Trade-or-Move Message prior to the close could move its quote or trade with just a portion of the Trade-or-Move Message only if doing so would be consistent with its firm quote obligations under the NASD and SEC rules.

The commenters argued overwhelmingly that applying the Trade-or-Move requirements before the close would be unnecessary or would cause more problems than they would solve. Several commenters argued that the implementation of Nasdaq's National Market Execution System ("SuperSOES") would obviate the need for supplemental locked and crossed

<sup>17</sup> See NDB Letter and Schwab Letter, *supra* note 4.

<sup>18</sup> See Knight Letter, *supra* note 4.

<sup>19</sup> See Bloomberg Letter, *supra* note 4.

markets restrictions or, at the very least, that Nasdaq should monitor the implementation of SuperSOES to determine whether or not this claim is accurate.<sup>20</sup> Another commenter noted that the proposal fails to account for economic inefficiencies that exist prior to the close.<sup>21</sup> No commenter expressed support for the proposal to implement Trade-or-Move requirements prior to the market close.

In light of the comments received and the implementation of SuperSOES, Nasdaq has decided to withdraw its proposal to expand the application of NASD Rule 4613(e)(1)(C) to the period prior to the closing. Nasdaq will monitor the effect of SuperSOES at the close and will, at a later date, reevaluate whether applying the Trade-or-Move requirements at the close would materially reduce the instances and duration of locked and crossed markets in Nasdaq.

(b) Amendment No. 3.

One commenter suggested that Nasdaq revise the Trade-or-Move requirements to provide that, for purposes of the Trade-or-Move rule, all ECN orders be treated as agency orders.<sup>22</sup> The commenter asserted that the change was necessary because an ECN could incur principal liability when routing a Trade-or-Move Message where the underlying subscriber order was for a size smaller than the required minimum message size. The commenter maintained that the proposal would materially increase the principal liability risk to ECNs by doubling the minimum Trade-or-Move Message size requirement from 5,000 shares to 10,000 shares.

In response, Nasdaq asserts that permitting market makers to transform their orders into agency orders by sending them to an ECN would undermine the progress that the Trade-or-Move requirements have made towards eliminating locked and crossed markets in Nasdaq.<sup>23</sup> In addition, Nasdaq maintains that the benefit to the overall market of raising the minimum Trade-or-Move Message size

requirement for certain stocks outweighs the risk the commenter perceives. Nasdaq notes that under the proposal, as amended, the 10,000-share Trade-or-Move Message requirement applies only to the most active, liquid stocks in the market, and that a smooth opening for these stocks is critical to investors.<sup>24</sup> Nasdaq also states that some ECNs have implemented systems to differentiate between agency and principal order flow from market makers.<sup>25</sup>

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) and section 11A of the Exchange Act. Section 15A(b)(6) requires that the rules of a registered national securities association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals 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; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 11A(a)(1)(C) provides that is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure: (1) Economically efficient execution of securities transactions; (2) fair competition among brokers and dealers; (3) the availability to brokers, dealers and investors of information with respect to quotations and transactions in securities; (4) the practicability of brokers executing investors orders in the best market; and (5) an opportunity for investors orders to be executed without the participation of a dealer.

Nasdaq believes that the proposed amendments to NASD Rule 4613(e) are consistent with sections 15A(b)(6) and 11A(a)(1)(C) of the Exchange Act. By attempting to resolve locks and crosses at the market opening, the proposed amendments foster cooperation and coordination with members. The proposal also ensures the fair and orderly operation of Nasdaq and the protection of investors, as its purpose is to limit the disruptions to the Nasdaq

market and the potential for harm to investors.

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

Nasdaq does not believe that the proposed rule change will 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

See response to written comments above.

## 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 Exchange 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 Amendment Nos. 2 and 3 are consistent with the Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-00-76 and should be submitted by April 1, 2002.

<sup>20</sup> See NDB Letter; Schwab Letter; Archipelago Letter, *supra* note 4.

<sup>21</sup> See Knight Letter, *supra* note 4.

<sup>22</sup> See BRUT Letter, *supra* note 4. NASD Rule 4613(e)(1)(C)(iv) states that, for purposes of that rule, an 'agency order' means an order(s) that is for the benefit of the account of a natural person executing securities transactions with or through or receiving investment banking services from a broker/dealer, or for the benefit of an 'institutional account' as defined in NASD Rule 3110. An agency order shall not include an order(s) that is for the benefit of a market maker in the security at issue, but shall include an order(s) that is for the benefit of a broker/dealer that is not a market maker in the security at issue."

<sup>23</sup> See Amendment No. 3, *supra* note 6.

<sup>24</sup> See Amendment No. 3, *supra* note 6.

<sup>25</sup> See Amendment No. 3, *supra* note 6.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>26</sup>

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 02-5816 Filed 3-8-02; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45285A; File No. SR-NASD-2001-93]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Fees Associated with the Nasdaq Application of the Primex Auction System™; Correction

March 5, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 17, 2001, the National Association of Securities Dealers, Inc., ("NASD" or "Association") through its subsidiary The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq has designated this proposal as one constituting a fee filing under section 19(b)(3)(A) of the Act, which renders the rule effective upon the Commission's receipt of this filing. Nasdaq will not assess fees pursuant to this fee schedule for approximately the first three months after the Nasdaq application of the Primex Auction System ("Primex" or "System") is operational.<sup>3</sup> Nasdaq intends to begin assessing fees pursuant to this fee schedule beginning on April 1, 2002. However, Nasdaq will issue a Head Trader Alert to notify users of the exact date it will begin assessing fees.

On December 17, 2001, Nasdaq filed Amendment No. 1 to the proposed rule change.<sup>4</sup> Amendment No. 1 corrects the

numbering of the footnotes in the narrative portion of the filing and changes the text of the fee schedule to provide that revenue sharing amounts will be paid on a monthly basis. The changes made by Amendment No. 1 were inadvertently omitted from the notice regarding filing and immediate effectiveness of the proposed rule change that the Commission published on January 24, 2002.<sup>5</sup> Accordingly, the Commission is publishing this corrected notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

Nasdaq is proposing to amend NASD Rule 7010 to establish the fee schedule for Nasdaq's application of the Primex Auction System.™ Below is the text of the proposed rule change, as amended. Proposed new language is in *italics*.

##### 7010. System Services

(a)-(q) No changes.

(r) *Nasdaq Application of the Primex Auction System™*

*The following charges shall apply to the use of the Nasdaq Application of the Primex Auction System:*

(1) *Transaction Charges:*

*Execution Services—for all participants:*

- *Order entry—No fee*
- *Auction Response—per share, per execution—\$5.00 maximum).\** *\$.01 Matching Rights—Primex Auction Market Makers (PAMMs) only:*

- *50 Percent Match—No fee*
- *Two-Cent Match (per share, per retained order—\$2.50 Maximum).\*\** *\$.0025*

*Revenue Sharing—PAMMs only*

- *Each order executed:\*\*\*—1/3 of transaction fee*

(2) *Monthly Access fees*

##### Software

- *Workstation license or unique logon—Per workstation logon*

Special Counsel, Division of Market Regulation ("Division"), Commission, dated December 17, 2001.

<sup>5</sup> See Securities Exchange Act Release No. 45285 (January 15, 2002), 67 FR 3521.

\* *This fee applies to both Indications and "real-time" Responses. When two orders match directly, a fee is charged to the party that entered the second order.*

\*\* *This fee is charged in the event a PAMM attaches its matching right to an order, and the crowd offers two cents or less price improvement to that order.*

\*\*\* *Paid to a PAMM when it enters an order that interacts with crowd interest in the system. Revenue sharing applies only to orders in those securities in which the firm is registered as a PAMM. The revenue sharing amounts will be paid on a monthly basis.*

*Stations/logons 1—10—\$200*

*Stations/logons 11—25—\$100*

*Stations/logons 26 and above—\$50*

• *Proprietary interface license Per license—*

*API specification \$500—*

*FIX (customized protocol)—\$500*

##### Network

• *Dedicated line—Per line—*

*256K primary with backup—\$1,564*

• *Installation/Uninstall—\$1,000 per*

*Nasdaq Staff site visit*

\* \* \* \* \*

#### 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

On August 17, 2001, Nasdaq filed a Form PILOT to commence operation of the Primex system.<sup>6</sup> The System is designed to replicate, in an electronic form, the competitive trading crowd that is associated with an auction market. The System is completely voluntary and available to any NASD member in good standing. Non-NASD members can access the System through an NASD member that subscribes to Primex. Members that desire access to the System must execute the necessary agreements with Nasdaq. Members granted access to the System are referred to as Participants. There are two types of Participants in Primex: (1) Crowd Participants, and (2) Primex Auction Market Makers ("PAMMs.")

By becoming a Participant, members automatically receive the right to trade as Crowd Participants. Crowd Participants can view all orders exposed in the System; interact with any order put to auction by responding to the auction using all of the System's response tools; submit orders to be

<sup>6</sup> The Form PILOT was amended on November 26, 2001. See Letter from Peter R. Geraghty, Associate General Counsel, Nasdaq, to John Polise, Senior Special Counsel, Division, Commission, dated November 26, 2001.

<sup>26</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> As described above, Nasdaq will not assess any fees pursuant to the fee schedule during the initial few months the System is operating, which also means Nasdaq will not share any transaction fees in accordance with the fee schedule during such period. However, Primex Trading N.A., L.L.C., an entity independent of Nasdaq and the licensor of the System, has indicated it will pay any revenue sharing amounts earned by participants during such period.

<sup>4</sup> See letter from Peter R. Geraghty, Associate General Counsel, Nasdaq, to John Polise, Senior