

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46341; File No. SR-NASD-2002-76]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change and Amendment Nos. 1 and 2 by the National Association of Securities Dealers, Inc. Relating to Interpretive Material 4613 and Computer Generated Quoting

August 12, 2002.

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 June 13, 2002, 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 ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. On July 29, 2002, Nasdaq filed an amendment to the proposed rule change.³ On August 8, 2002, Nasdaq filed another amendment to the proposed rule change.⁴ As amended, the proposal is effective upon filing with the Commission, pursuant to section 19(b)(3)(A) of the Act,⁵ and Rule 19b-4(f)(1) thereunder.⁶ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission ("Amendment No. 1"). Amendment No. 1 clarifies that Nasdaq will summarily suspend a market maker's quoting activity if necessary to preserve capacity and to protect investors and the public interest. For example, Nasdaq will suspend a market maker's quoting activity if the performance of Nasdaq's market was in jeopardy and, after attempting to contact the market maker, the market maker failed to voluntarily suspend its computer generated quoting activity.

⁴ See letter from Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, to Lisa Jones, Attorney, Division, Commission ("Amendment No. 2"). Amendment No. 2 clarifies in the purpose section of the proposal that Nasdaq will give market makers advance notice should the standards for using computer generated quoting systems change. Amendment No. 2 also makes a technical amendment to the rule text of the proposal.

⁵ 15 U.S.C. 78s(b)(3)(A).

⁶ 17 CFR 240.19b-4(f)(1). For purposes of calculating the 60-day abrogation period, the Commission considers the period to begin as of the date Nasdaq filed Amendment No. 1, July 29, 2002.

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

Nasdaq proposes to amend NASD Interpretive Material 4613 ("IM-4613") to codify an interpretation concerning the extent to which IM-4613 applies to computer generated quoting ("CGQ") that is not designed to update a market maker's quote automatically to keep the market maker away from the inside market. Specifically, Nasdaq proposes to (1) define the term "Computer Generated Quoting," (2) clarify that CGQ is generally prohibited, and (3) provide that market makers can engage in CGQ if such activity is consistent with the intent of IM-4613. Nasdaq has also developed certain standards that a market maker must meet to engage in CGQ. According to Nasdaq, these standards are based on Nasdaq's experience with two market makers that recently began utilizing CGQ systems,⁷ and are designed to preserve the integrity of Nasdaq's systems and protect investors and the public interest. Below is the text of the proposed rule change. Proposed new language is in italics.

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IM-4613—Autoquote Policy

(a) General Prohibition—The Association has extended a policy banning the automated update of quotations by market makers in Nasdaq. Except as provided below, this policy prohibits systems known as "autoquote" systems from effecting automated quote updates or tracking of inside quotations in Nasdaq. This ban is necessary to offset the negative impact on the capacity and operation of Nasdaq of certain autoquote techniques that track changes to the inside quotation in Nasdaq and automatically react by generating another quote to keep the market maker's quote away from the best market.

(b) Exceptions to the General Prohibition—Automated updating of quotations is permitted when: (1) The update is in response to an execution in the security by that firm (such as execution of an order that partially fills a market maker's quotation size), and is in compliance with Rule 4613(b)(2); (2) it requires a physical entry (such as a manual entry to the market maker's

⁷ Nasdaq staff recently issued two letters indicating that the market makers could utilize CGQ systems that are consistent with IM-4613. See letters from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Thomas Peterffy, Chairman, Timber Hill LLC, dated November 14, 2001; and to Richard J. McDonald, Compliance Director, Susquehanna Capital Group, dated April 23, 2002.

internal system which then automatically forwards the update to Nasdaq); (3) the update is to reflect the receipt, execution, or cancellation of a customer limit order; or (4) an electronic communications network as defined in SEC Rule 11Ac1-1(a)(8) is required to maintain a two-sided quotation in Nasdaq for the purpose of meeting Nasdaq system design requirements.

(c) Computer Generated Quoting—
(1) Definition—"Computer Generated Quoting" means the practice of effecting, without a physical entry, a quote update that is not designed to keep a market maker's quote away from the Nasdaq and/or national best bid/best offer, but does not include the activity set forth in subparagraph (b) of this interpretive material.

(2) Prohibition—The prohibitions against autoquoting contained in paragraph(a) of this interpretive material, shall also apply to the practice of Computer Generated Quoting, unless the market maker meets the conditions in subparagraph (c)(3) of this interpretive material.

(3) Exception—A market maker may engage in the practice of Computer Generated Quoting if the market maker: Prior to engaging in such activity provides Nasdaq a description of its Computer Generated Quoting system; requests and obtains written interpretive relief from Nasdaq staff stating that the market maker's Computer Generated Quoting system is permissible under Interpretive Material 4613; and complies with terms that are set forth in the interpretive relief. In establishing terms of the interpretive relief, Nasdaq shall consider the applicant's impact on Nasdaq's capacity, in conjunction with the overall impact on Nasdaq's capacity of existing Computer Generated Quoting systems authorized by Nasdaq, as well as the protection of investors and the public interest. If a market maker that engages in Computer Generated Quoting fails to comply with the terms set forth in the interpretive relief, Nasdaq may summarily modify or revoke the interpretive relief and/or summarily suspend such quoting activity if necessary to preserve capacity and to protect investors and the public interest.

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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

Nasdaq believes that the underlying purpose of IM-4613 is to preserve the integrity of Nasdaq's systems by prohibiting automated quoting activity that does not contribute to the depth and liquidity of the market. However, the language of IM-4613 arguably can be read to prohibit market makers from using *any* automated means to update their quotes, with a few narrow exceptions,⁸ even if such systems would contribute to the liquidity of the market. The confusion created by this conflict caused several market makers to request interpretive advice on the applicability of IM-4613 to certain quoting activity.

Specifically, two Nasdaq market makers inquired as to whether the rule applies to situations where a market maker generates quote updates through automated means that do not track away from the inside market.⁹ These market makers engage in trading strategies where their quoted prices are based on several factors, such as the last sale, bids, offers and sizes, where available, on stocks, futures and options, and certain statistically derived relationships among these instruments. Another market maker recently requested an interpretation so that it may submit quotes automatically based on the best prices contained in an affiliated electronic communications network.¹⁰

Nasdaq believes these types of CGQ systems, if carefully monitored, can be utilized without raising the concerns that IM-4613 addresses. In the requests received to date, the market makers do not employ techniques that track changes to the inside market to keep the market maker's prevailing quote away from the inside market, and the systems are designed to result in the market maker regularly participating at or near the best bid and offer. As such, while these systems could produce quote update rates similar to those that track away from the inside market, the CGQ systems, in contrast, will contribute to the liquidity of the market.

However, Nasdaq's overall system capacity is not limitless, and Nasdaq has an overarching obligation to protect investors and the public interest. Therefore, Nasdaq cannot permit these systems to be utilized without certain controls, and has taken the position that CGQ is permitted under IM-4613 if the activity will not adversely impact the overall functioning of the Nasdaq market.¹¹ This requirement is in addition to the requirement that the system does not produce quotes to track away from the inside market, and must be designed to result in the market maker regularly participating at or near the inside market. Prior to issuing the interpretations, Nasdaq carefully analyzed its system capacity demand models, and developed quotation capacity standards that would permit market makers to utilize CGQ systems, but also maintain enough excess capacity so that Nasdaq can meet its peak demand.

These standards will be applied to all market makers utilizing CGQ systems, and Nasdaq will consider such things as quote updates per second, both at the individual security level and firm wide level, and are calibrated to ensure that Nasdaq retains excess capacity during times of peak demand.¹² Market makers also will be required to phase in their CGQ activity in consultation with Nasdaq staff, and comply with the autoquoting restrictions contained in the Nasdaq UTP Plan.¹³ In addition, market makers must be able to demonstrate compliance with these standards,¹⁴ and suspend their CGQ

activity quickly upon request from Nasdaq.

Nasdaq believes CGQ systems can enhance market quality by contributing liquidity, but it will not allow the use of CGQ systems to compromise the overall high level of performance and reliability of the Nasdaq market. Therefore, on an ongoing basis, Nasdaq will monitor closely overall quoting activity and its system capacity, and adjust the standards if necessary to ensure that Nasdaq can meet capacity demands.¹⁵ In addition, Nasdaq will monitor closely each individual market maker's quoting activity, and, if Nasdaq determines a market maker is not complying with the terms of the interpretive relief, Nasdaq may summarily modify or revoke the interpretive relief and/or summarily suspend the quoting activity of such market maker if necessary to preserve capacity and to protect investors and the public interest.¹⁶ In addition, Nasdaq may refer the matter for disciplinary action.

To summarize, the proposed rule change clarifies that IM-4613 applies to systems that, without physical entry, submit quote updates that are *not* designed to keep a market maker's quote away from the inside. Nasdaq believes that defining the term "Computer Generated Quoting" and specifically stating that such systems are prohibited accomplish this. As discussed above, the general prohibition is necessary to maintain the integrity of Nasdaq's systems, and the exception is the codification of the existing interpretation designed to permit market makers to utilize CGQ systems consistent with Nasdaq's obligations to preserve the integrity of its systems and to protect investors and the public interest.

update rates and supply such data to Nasdaq upon request.

¹⁵ Nasdaq notes that Nasdaq technology staff constantly monitors capacity levels to ensure that Nasdaq systems operate effectively. Nasdaq systems capacity is designed to meet peak usage requirements, which normally occur at the opening of the market, the closing, or at other times during the day due to scheduled events. In addition, peak usage can be caused by unexpected events, such as a merger announcement. As Nasdaq staff have gained experience with the two market makers utilizing the CGQ systems, it has modified the standards several times, and it is possible these standards would be modified again as staff gain additional experience with more market makers. In developing current and future CGQ standards, Nasdaq will look first to ensuring the overall integrity of its systems and to protect investors and the public interest. Nasdaq will notify market makers permitted to utilize CGQ systems in advance if the standards for using such systems change. See Amendment No. 2, *supra* note 4.

¹⁶ See Amendment No. 1, *supra* note 3.

¹¹ Nasdaq staff issued interpretive letters to the two market makers whose CGQ systems generate quotes based on the relationship between the price of the stock and other instruments. Nasdaq will issue a letter to another market maker, and re-issue letters to the first two market makers, contemporaneous with the filing of this proposed rule change. At such time, all three letters will contain uniform quote update limits, which are discussed later. The letters are posted on NASD Regulation's Web site at <http://www.nasdr.com>.

¹² Pursuant to the three interpretive letters issued simultaneously with the filing of this proposed rule change, Nasdaq proposes that the market makers will be subject to the following quote update limitations:

- From 9:30 a.m. to 9:35 a.m. Eastern Time and from 3:55 p.m. to 4 p.m. Eastern Time, a market maker utilizing a CGQ system shall not exceed the following parameters: 30 quotes per second in aggregate for all securities, measured over each 15 second interval; and a maximum of 3 quotes per second for each security; and
- From 9:35:01 a.m. to 3:54:59 p.m. Eastern Time, a market maker utilizing a CGQ system shall not exceed the following parameters: 50 quotes per second in aggregate for all securities, measured over each 15 second interval; and a maximum of 3 quote per second for each security.

¹³ See Nasdaq UTP Plan, Amendment 12.

¹⁴ To demonstrate compliance with the standards, a market maker's system must measure quote

⁸ The current rule contains certain exceptions, including when the update of quotes is the result of an execution, or the quote, while generated automatically, is entered manually. See NASD IM 4613(b).

⁹ See *infra* note 10.

¹⁰ *Id.*

Statutory Basis

Nasdaq believes that the proposal is consistent with section 15A(b)(6) of the Act.¹⁷ Section 15A(b)(6) requires, among other things, that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Nasdaq believes that permitting market makers to use these systems should have several benefits. Market makers will be able to utilize existing computer models, or develop new models, to automatically generate and update their quotes, which should enhance the price discovery process and allow members to increase the number of stocks in which they are registered as market makers.

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

Nasdaq has neither solicited nor received written comments on the proposed rule change.

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

The foregoing proposed rule change has become effective upon filing pursuant to section 19(b)(3)(A) of the Act¹⁸ and Rule 19b-4(f)(1)¹⁹ thereunder because the proposal is a stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule. 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.

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-2002-76 and should be submitted by September 9, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46339; File No. SR-OCC-2002-17]

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to a Change in Ancillary Service Fees

August 12, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on July 23, 2002, The Options Clearing Corporation ("OCC") 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 primarily by OCC. 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 proposed rule change amends OCC's schedule of fees to reflect the restructuring of OCC's ancillary services program.

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

In its filing with the Commission, OCC 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. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.²

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

In addition to its clearing and settlement services, OCC provides a number of ancillary services to its membership. These services range from on-line systems to report and data files. Hardware and communications lines support these ancillary service offerings. However, the current fee structure for these services and their supporting communications lines does not cover OCC's monthly expenses. Accordingly, OCC has decided to restructure its ancillary services program.

OCC is implementing a four-tiered structure with a different bundle of ancillary services being offered at each tier. The tiers, the associated ancillary services, and the proposed cost for each are set forth in Exhibit A of the proposed rule change filing (OCC's schedule of fees). OCC has also determined to revise its communication line charges. A T1 leased line provides the optimal point-to-point secure communications to OCC's systems. OCC is revising its schedule of fees to charge for T1 leased lines and to increase the current 56.0kb line speed charge. These charges also are reflected in Exhibit A. The ancillary service charges and line offerings that have been eliminated as a result of restructuring the ancillary services program are set forth in Exhibit A.

¹⁷ 15 U.S.C. 78o-3(b)(6).

¹⁸ 15 U.S.C. 78s(b)(3)(A).

¹⁹ 17 CFR 240. 19b-4(f)(1).

²⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² The Commission has modified parts of these statements.