

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

DTC perceives no adverse impact on competition by reason of the proposed rule change.

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

Written comments from DTC's participants have not been solicited nor received on the proposed rule change.

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

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>6</sup> and Rule 19b-4(f)(4)<sup>7</sup> promulgated thereunder because the proposal effects a change in an existing service of DTC that (A) does not adversely affect the safeguarding of securities or funds in the custody or control of DTC or for which it is responsible and (B) does not significantly affect the respective rights or obligations of DTC or persons using the service. At any time within sixty 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 Section, 450 Fifth Street NW., Washington, DC 20549. Copies of such filing will also be available for

inspection and copying at the principal office of the DTC. All submissions should refer to the File No. SR-DTC-2002-03 and should be submitted by June 28, 2002.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-46006; File No. SR-NASD-2002-66]

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to Limit Order Protection and the Facilitation of Other Customer Orders on a Riskless Principal Basis**

May 30, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 28, 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. 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 proposes to establish a riskless principal customer facilitation exemption to NASD Interpretative Material 2110-2-Trading Ahead of Customer Limit Order ("Manning Interpretation" or "Manning"). Proposed additions are italicized.

**IM-2110-2. Trading Ahead of Customer Limit Order**

(a)-(b) No Change.

<sup>8</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.

*(c) Exemption for the Facilitation on a Riskless Principal Basis of Other Customer Orders*

*A member shall be exempt from the obligation to execute a customer limit order in a manner consistent with this interpretation if such member engages in trading activity to facilitate the execution, on a riskless principal basis, of another order from its customer (whether its own customer or the customer of another member) (the "facilitated order"), provided that all of the following requirements are satisfied:*

*(1) The handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules 4632(d)(3)(B), 4642(d)(3)(B) and 4652(d)(3)(B);*

*(2) A member that relies on this exemption to this interpretation must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee;*

*(3) A member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii) and 4652(d)(3)(B)(ii) to the Automated Confirmation Transaction Service;*

*(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exemption comply with NASD Rules 4632(d)(3)(B), 4642(d)(3)(B) and 4652(d)(3)(B). At a minimum these policies and procedures must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD Regulation to accurately and readily reconstruct, in a time-sequenced manner, all orders which a member relies in claiming this exemption.*

*Any transaction handled by a member on other than an agency basis that does not satisfy all of the above requirements remains a transaction that, where required by this interpretation, gives rise to the obligation to protect and execute customer limit order(s). This exemption applies only to the actual number of shares that are required to satisfy the facilitated order.*

<sup>6</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>7</sup> 17 CFR 240.19b-4(f)(4).

## 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 its proposal and discussed any comments it received regarding the proposal. 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

NASD's current Manning Interpretation prohibits market makers from trading at prices equal or superior to customer limit orders they hold without executing those limit orders. In addition, Nasdaq has adopted price-improvement standards that obligate market makers to execute held customer limit orders unless the market maker either buys at a price sufficiently higher than a customer's buy order, or sells at a price sufficiently lower than a customer's sell order.

Nasdaq has determined to adopt a customer facilitation exemption to Manning that would exempt from Manning single-priced riskless principal transactions done by market makers who are buying or selling securities to satisfy the order(s) of other customers. In these situations, since the true beneficiary of the market maker's activity is another customer, and not the firm's proprietary account, Manning will be interpreted to exempt such trading from being considered triggering trades obligating the market maker to protect other held customer limit orders.<sup>3</sup> Additionally, this proposed exemption addresses some of the consequences created by Manning's minimum price improvement standard in a decimal environment.

To ensure that market maker transactions that will not trigger Manning obligations are being done for the ultimate benefit of other customers, the customer facilitation exemption will be strictly construed. As such, only those market maker trades meeting all of

the following requirements would be eligible for an exemption from Manning:

(1) The handling and execution of the facilitated order must satisfy the definition of a "riskless" principal transaction, as that term is defined in NASD Rules 4632(d)(3)(B), 4642(d)(3)(B) and 4652(d)(3)(B);

(2) A member that relies on this exemption to this interpretation must give the facilitated order the same per-share price at which the member accumulated or sold shares to satisfy the facilitated order, exclusive of any markup or markdown, commission equivalent or other fee;

(3) A member must submit, contemporaneously with the execution of the facilitated order, a report as defined in NASD Rules 4632(d)(3)(B)(ii), 4642(d)(3)(B)(ii) and 4652(d)(3)(B)(ii) to the Automated Confirmation Transaction Service;

(4) Members must have written policies and procedures to assure that riskless principal transactions relied upon for this exemption comply with NASD Rules 4632(d)(3)(B), 4642(d)(3)(B) and 4652(d)(3)(B). At a minimum these policies and procedures must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to a riskless principal account within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and NASD Regulation to accurately and readily reconstruct, in a time-sequenced manner, all orders on which a member relies in claiming this exemption.

Non-agency trades not meeting all of these standards would remain subject to Manning and require, upon execution, the protection and execution of appropriate limit orders in full conformity with the Interpretation. This exemption would apply only to the actual number of shares executed by the member necessary to fill the customer order(s).

In Nasdaq's view, a transaction meeting these requirements is closely akin to an agency trade and does not materially implicate a market maker's proprietary trading. Nasdaq notes that the Commission in its recent release concerning the availability of the Section 28(e) safe harbor also highlighted the similarities in compensation transparency provided by agency and riskless principal trade reporting pursuant to NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6420(d)(3)(B), coupled with the requirements of Exchange Act Rule 10b-10.<sup>4</sup> As such, Nasdaq will not consider riskless principal trades meeting the requirements of the exemption as triggering trades for the market maker's own market-making account for purposes of Manning. This view rests primarily on the requirement that only

trades where a market maker gives the customer a trade price that reflects the market maker's actual cost in acquiring the stock be eligible for the exemption. This obligation to trade flat effectively removes concerns about a member breaching its fiduciary duty to customer limit orders that it holds that underlie the Manning protections in other trading contexts. Nasdaq believes that the above exemption draws an appropriate balance between the important customer protections afforded by Manning and the practical needs of market participants to assist other customers.

As to the Manning/price improvement issue, the Manning rule currently dictates that a market maker does not have an obligation to execute customer limit orders if it trades for its own account for at least a minimum amount more than the customer order. The amount that a market maker must better a customer's order depends on whether the customer limit order is priced at or inside the best bid and best offer, or outside of it. For limit orders that are priced at or inside the best inside market displayed in Nasdaq, a market maker must execute its trade at a price at least \$0.01 better than the customer limit order. For limit orders priced outside the best inside market displayed in Nasdaq, the market maker must trade at a price at least equal to the next rounded penny increment better than that customer limit order.<sup>5</sup> Some market participants assert that the operation of Manning's price improvement standards in a market where spreads are at a penny, forces them to accept losses if they choose to both accept sub-penny orders and facilitate the execution of other customer orders. The following example illustrates the issue:

Market is 10.01 (bid) to 10.02 (offer) with 1,000 shares on each side.

Market Maker A ("MMA") receives limit order from Customer #1 to buy 1,000 shares @ 10.0101 and, after rounding, displays it in its market maker quote @10.01.

MMA subsequently receives a market order to buy from Customer #2.

To facilitate the execution of Customer #2 market order, MMA sends a SuperSOES order to the market maker or ECN at the inside offer price of 10.02 for 1,000 shares

MMA receives an execution of its SuperSOES order, thus buying 1,000 shares at 10.02. MMA then sells to Customer 2 at 10.02, and reports the trade consistent with riskless principal trade reporting requirements.

Under the current interpretation of Manning, MMA owes Customer #1's resting 10.0101 limit order a fill since

<sup>3</sup> In this sense, the exemption is similar in purpose and effect to the treatment of agency executions in IM-2110-2. Specifically, if a broker-dealer executes a customer order on an agency basis, the firm is not required to protect (execute) other customer limit orders.

<sup>4</sup> See Securities Exchange Act Release No. 45194 (January 2, 2002), 67 FR 6 (January 2, 2002).

<sup>5</sup> See Securities Exchange Act Release No. 44164 (April 6, 2001), 66 FR 19268 (April 13, 2001).

MMA sold at 10.02 and did not meet the minimum price improvement required by the Manning rule (*i.e.*, .01 over Customer #1's order to buy at 10.0101). In effect, MMA has just bought stock at 10.02 and must sell that same amount of stock to Customer #1 at 10.0101 and thus lose .0099 cents per share on the interactions between these transactions. Under the proposed interpretation, MMA would no longer be required to fill both Customer orders since MMA acted as riskless principal for Customer #2.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act<sup>6</sup> in that it is designed to: (1) Promote just and equitable principles of trade; (2) foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities; (3) perfect the mechanism of a free and open market and a national market system; and (4) protect investors and the public interest.

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

Nasdaq does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

Written comments relating to the proposed rule change have not yet been solicited or received.

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

Within thirty-five 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 ninety 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 self-regulatory organization 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 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 Nasdaq. All submissions should refer to file number SR-NASD-2002-66 and should be submitted by June 28, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46016; File No. SR-NASD-2002-71]

### **Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change To Extend a Pilot that Permits SuperSOES To Trade Through the Quotations of UTP Exchanges That Do Not Participate in the Nasdaq National Market Execution Service**

May 31, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on May 31, 2002, the National Association of Securities Dealers, Inc. ("NASD"), acting 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 the NASD. The NASD filed the proposal pursuant to section 19(b)(3)(A)<sup>1</sup> of the Act, and Rule 19b-

4(f)(6) thereunder,<sup>2</sup> which renders the proposal effective on filing with the Commission.<sup>3</sup> 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**

There is no new language. The pilot rule language is as follows:

#### *4710. Participant Obligations in NNMS*

(a)-(e) No Change.

(f) UTP Exchanges.

(i) A UTP Exchange may voluntarily participate in the NNMS System according to the approved rules for the NNMS System if it executes a Nasdaq Workstation Subscriber Agreement, as amended, for UTP Exchanges.

(ii) If a UTP Exchange does not participate in the NNMS System, the UTP Exchange's quote will not be accessed through the NNMS, and the NNMS will not include the UTP Exchange's quotation for order processing and execution purposes.

(iii) For purposes of this rule the term "UTP Exchange" shall mean any registered national securities exchange that has unlisted trading privileges in Nasdaq-listed securities pursuant to the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination Of Quotation and Transaction Information For Exchange-Listed Nasdaq/National Market System Securities Traded On Exchanges On An Unlisted Trading Privilege Basis ("Nasdaq UTP Plan").

### **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 NASD 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.

<sup>2</sup> 17 CFR 240.19b-4(f)(6).

<sup>3</sup> Nasdaq asked the Commission to waive the 30-day operative delay. See Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

<sup>6</sup> 15 U.S.C. 78o-3.

<sup>7</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(3)(A).