

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42851; File No. SR-NASD-99-49]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to Regulation ATS

May 30, 2000.

I. Introduction

On September 21, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19(b)-4 thereunder,² a proposed rule change to amend NASD Rules 4623 and 4613(e) to incorporate the requirements of Regulation ATS into the NASD's rules.

The proposed rule change was published for comment in the **Federal Register** on March 2, 2000.³ The Commission did not receive any comments on the proposed rule change. This order approves the proposed rule change.

II. Description of Proposed Rule Change

The proposal would amend the NASD Rules to incorporate the requirements of Regulation ATS. Specifically, the proposal would amend NASD Rule 4623, which currently governs electronic communications networks ("ECNs") that display orders in Nasdaq ("ECN Rule"), and NASD Rule 4613(e), which governs locked and crossed markets ("Locked and Crossed Market Rule"). The amendments would: (1) Incorporate into the ECN Rule the new obligations that are imposed on ECNs under Regulation ATS, (2) extend the current ECN Rule so that it captures other types of alternative trading systems ("ATSs"), and (3) extend the current Locked and Crossed Market Rule to capture other types of ATSs.

ECN Rule

Regulation ATS requires ATSs (including ECNs) that account for a significant percentage of the volume in a security listed on Nasdaq to display in the public quotation stream the orders of all subscribers of the ATS, which

includes orders from institutions and broker-dealers that are not market makers.⁴ Currently, the ECN Rule only requires ECNs to display orders entered by market makers. Accordingly, the proposal would amend the ECN Rule to require ECNs to display in Nasdaq any subscriber orders required under Regulation ATS.

Regulation ATS also governs alternative trading systems that are organized other than as ECNs. Consequently, these other types of ATSs may be required to display orders in Nasdaq. The proposal would expand the current ECN Rule to encompass these other types of ATSs. These systems will have to fulfill a series of obligations identical to those imposed on ECNs that display orders in Nasdaq.

Locked and Crossed Markets

The Locked and Crossed Markets Rule, NASD Rule 4613(e), is designed to limit locked and crossed markets by imposing on market makers an obligation to take reasonable measures before locking or crossing a market. Currently included within the definition of market maker for purposes of this rule is: (1) Any NASD member that enters orders into an ECN, or (2) any NASD member that operates as an ECN (when the priced order being displayed by the ECN has been entered by an entity that is not a NASD member). Reasonable measures include attempting to execute against the contra side of the market prior to entering an order into Nasdaq's systems that would lock or cross the market in a security. The proposal would amend the Locked and Crossed Markets Rule to capture NASD members that place orders in an ATS or operate as an ATS (when the priced order being displayed by the ATS has been entered by an entity that is not a NASD member).

III. Discussion

The Commission finds that the proposed rule change is consistent with

the requirements of the Act⁵ and the rules and regulations thereunder applicable to a national securities association. In particular, the Commission finds the proposal is consistent with the requirements of Sections 11A⁶ and 15A(b)(6)⁷ of the Act. Section 11A(a)(1)(C)⁸ provides that it 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. Section 15A(b)(6)⁹ requires 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.

Recently, the Commission adopted a set of rules under the Act¹⁰ that govern alternative trading systems, including ECNs.¹¹ Regulation ATS governs alternative trading systems that choose to register as broker-dealers (ATSs). The most familiar type of ATS is an ECN; however, the definition of ATS encompasses other types of trading systems that register as broker dealers. For example, an electronic trading system that only accepts orders from institutions and non-market-maker broker-dealers would be an ATS. Such a system would not be an ECN, however, because, by definition, an ECN is a system that accepts orders from

⁴ Specifically, if during at least 4 of the preceding 6 calendar months an ATS accounts for five percent or more of the aggregate average share volume in a Nasdaq National Market ("NNM") or SmallCap security, the ATS must display the best prices of orders entered by all subscribers (e.g., market makers, nonmarket makers, and institutions). For example, if as calculated on July 1, 1999 an ATS account for 7% of the trading volume in an NNM security during January, February, April, and May 1999, the ATS would be required to reflect in Nasdaq its best priced order even if the order is from an institution or other entity that is not a Nasdaq market maker. The Nasdaq securities subject to this requirement are being phased-in according to a schedule set by the Commission. See Securities Exchange Act Release No. 41297 (April 16, 1999), 64 FR 19450 (April 21, 1999).

⁵ The Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁶ 15 U.S.C. 78k-1.

⁷ 15 U.S.C. 78o-3(b)(6).

⁸ 15 U.S.C. 78k-1(a)(1)(C).

⁹ 15 U.S.C. 78o-3(b)(6).

¹⁰ 17 CFR 242.300 *et seq.* ("Regulation ATS").

¹¹ See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 42461 (February 25, 2000), 64 FR 11359.

market makers.¹² The NASD's current rules capture only those ATSs that meet the definition of ECN. Therefore, the Commission believes that it is necessary to amend these rules to capture those ATSs that do not meet the definition of ECN.

Accordingly, the Commission finds that the proposal is consistent with sections 11A(a)(1)(C) and section 15A(b)(6)¹³ because it will permit Nasdaq to incorporate ATS orders into the Nasdaq quote montage and provide NASD members with the ability to access these orders. In addition, to limit market disruptions caused by locked or crossed markets, the proposal will require members that submit orders to ATSs and ATSs, in certain circumstances, to take reasonable measures before locking or crossing a market. Finally, the amendments will incorporate into the NASD's rules the new obligations imposed on ECNs by Regulation ATS.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change (SR-NASD-99-49) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 42858; File No. SR-NASD-99-05]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 4 and 5 to the Proposed Rule Change Relating to Margin for Exempted Borrowers, Good Faith Accounts, Joint Back Office Arrangements and Options Transactions

May 30, 2000.

On January 19, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly-owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"),

filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending the margin requirements for exempted borrowers, good faith accounts, joint back office ("JBO") arrangements, control and restricted securities, and options transactions. The NASD amended its proposal on June 1, 1999, July 7, 1999, July 15, 1999, October 7, 1999 and April 11, 2000.³ The proposed rule change and Amendment Nos. 1, 2, and 3 were published for comment in the **Federal Register** on August 11, 1999.⁴ The Commission received no comment letters on the proposal. This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comments and is simultaneously approving, on an accelerated basis, Amendment Nos. 4 and 5.

I. Description of the Proposal

NASD Regulation proposes to amend NASD rule 2520, "Margin

Requirements," to revise the margin requirements for exempted borrowers, good faith accounts, JBO arrangements, control and restricted securities, and options transactions. NASD Regulation believes that the proposal will conform NASD Rule 2520 to recent changes to NYSE Rule 431 and recently adopted changes to Regulation T.⁵ NASD Regulation is also proposing other minor changes to eliminate obsolete provisions and correct errors in the text of NASD Rule 2520.

A. Margin Requirements for Exempted Borrowers and Good Faith Accounts

Under the recent changes to Regulation T,⁶ the Federal Reserve Board has created a new category of account called the "good faith account" to replace the "non-purpose," "arbitrage," and "government securities" accounts. In the good faith account, a customer may purchase certain securities (exempted and non-equity securities, and money market and exempted securities mutual funds) on "good faith" margin (the amount of margin specified by the creditor in the exercise of sound credit judgment) or the margin specified by the regulatory authority, whichever is greater. Regulation T no longer specifies initial margin, payment and liquidation time frames for transactions in these securities in a good faith account.

NASD Regulation believes that transactions in good faith accounts raise the same safety and soundness questions as transactions in cash and margin accounts. Accordingly, the proposal amends NASD Rule 2520(c) to require all accounts, including good faith accounts, to maintain margin as required by NASD Rule 2520.⁷ Cash accounts will continue to be subject only to certain specific requirements, not to the overall requirements of the rule.

In addition, NASD Regulation states that the Federal Reserve Board established a classification of exempted borrowers which are exempt from Regulation T. An "exempted borrower," as defined in Regulation T, is a broker-dealer "a substantial portion of whose business consists of transactions with persons other than brokers or dealers."⁸ The proposal codifies this exemption

¹² SEC Rule 11Ac1-1(a)(8), 17 CFR 240.11Ac1-1(a)(8).

¹³ 15 U.S.C. 78k-1 and 78o-3(b)(6).

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated June 1, 1999 ("Amendment No. 1"); Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated July 7, 1999 ("Amendment No. 2"); Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Richard C. Strasser, Assistant Director, Division, Commission, dated July 15, 1999 ("Amendment No. 3"); Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Richard C. Strasser, Assistant Director, Division, Commission, dated October 7, 1999 ("Amendment No. 4"); and Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated April 11, 2000 ("Amendment No. 5"). Amendment No. 1 conforms several provisions of the JBO provisions of NASD Rule 2520, the NASD will interpret the terms "carrying and clearing member" and "carrying member" in the same manner as the NYSE. Amendment No. 1 also provides additional information regarding the proposed changes to the provisions of NASD Rule 2520 governing control and restricted securities. Amendment Nos. 2 and 3 make technical changes to the text of NASD Rule 2520. Amendment No. 4 states that the NASD will allow a six-month phase-in period for implementation of the proposed rule's requirements relating to JBO arrangements. Amendment No. 5 incorporates certain proposed maintenance margin requirements for non-equity securities and options-related requirements that are the subject of related rule filings by NASD Regulation and to ensure consistency with similar proposed changes to NYSE Rule 431.

⁴ See Securities Exchange Act Release No. 41704 (August 4, 1999), 64 FR 43797 (August 11, 1999).

⁵ 12 CFR 220 *et seq.* The Board of Governors of the Federal Reserve System ("Federal Reserve Board") promulgated Regulation T pursuant to Section 7(a) of the Exchange Act, which authorizes it to prescribe regulations relating to credit extensions on securities. See 15 U.S.C. 78g(a).

⁶ See Board of Governors of the Federal Reserve System Docket Nos. R-0905, R-0923, and R-0944, 63 FR 2806 (January 16, 1998).

⁷ See Amendment No. 1, *supra* note 3.

⁸ 12 CFR 220.2.