

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47949; File No. SR-NASD-2001-75]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc., and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 To Make Permanent a Pilot Amendment to NASD Rule 4120 Relating to Nasdaq's Authority To Initiate and Continue Trading Halts

May 30, 2003.

I. Introduction

On October 18, 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 ("Commission" or "SEC"), 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 to make permanent a pilot amendment to NASD Rule 4120 relating to Nasdaq's authority to initiate and continue trading halts in circumstances where Nasdaq believes that extraordinary market activity in a security listed on Nasdaq is caused by the misuse or malfunction of an electronic quotation, communication, reporting, or execution system. On January 28, 2002, Nasdaq amended the proposal.³ The proposed rule change, as modified by Amendment No. 1, was published for notice and comment in the **Federal Register** on February 5, 2002.⁴

The Commission received one comment letter on the proposed rule change.⁵ On April 14, 2003, Nasdaq

again amended the proposed rule change.⁶ This order approves the proposed rule change as modified by Amendment No. 1, and, simultaneously, the Commission provides notice of filing of Amendment No. 2 and grants accelerated approval of Amendment No. 2.

II. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change and the comment letters, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association⁷ and, in particular, the

within the jurisdiction of other self-regulatory organizations." Amex Letter at 2. The Amex expressed no objection to Nasdaq's proposal if it is applied to situations that involve a Nasdaq system or the system of a broker-dealer or electronic communications network that is a Nasdaq member firm and over which Nasdaq has regulatory authority. *Id.* Nasdaq opposed the proposed rule change to the extent that Nasdaq wants to regulate the systems of UTP exchanges over which Nasdaq has no regulatory authority. *Id.* The Amex further stated that any authority for additional regulation of activity in Nasdaq securities having an inter-market impact should be exercised pursuant to the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis. *Id.*

The Commission notes that Instinet Corporation ("Instinet") filed a comment letter in response to SR-NASD-2001-37, the proposed rule change that established the pilot amendment to NASD Rule 4120. See July 27, 2001 letter from Jon Kroeper, First Vice President—Regulatory Policy/Strategy, Instinet, to Jonathan G. Katz, Secretary, Commission. Instinet stated that the proposed rule change (1) failed to properly define "extraordinary market activity;" (2) lacked objective standards for Nasdaq to make a determination to initiate and terminate trading halts; and (3) should be amended to allow NASD Regulation, Inc. to initiate and terminate trading halts based on extraordinary market activity instead of Nasdaq. Because Instinet's comment letter essentially addresses the same issues in the instant filing, the Commission has considered Instinet's letter in approving the instant proposed rule change.

⁶ See April 11, 2003 letter from John M. Yetter, Assistant General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, SEC, and attachments ("Amendment No. 2"). In Amendment No. 2, Nasdaq proposes changes to clarify the effect of a trading halt under the rule on exchanges trading Nasdaq securities on an unlisted trading privileges basis, as well as the NASD's Alternative Display Facility. Nasdaq filed Amendment No. 2 in response to concerns the Amex raised, and discussed the proposed rule change with members of the UTP Operating Committee on October 23, 2002. See Amendment No. 2 at 4. At that time, Nasdaq asked that members of the UTP Operating Committee inform Nasdaq of objections either to the permanent adoption of the proposed rule as amended, or to the conclusion that a trading halt initiated pursuant to the proposed rule would constitute a regulatory halt under the UTP Plan. At the time Nasdaq filed Amendment No. 2, Nasdaq had received no objections.

⁷ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

requirements of Section 15A of the Act,⁸ which requires, among other things, that a registered national securities association's rules be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and, in general, protect investors and the public interest.

The Commission believes that, in circumstances where the misuse or malfunction of electronic systems that trade Nasdaq-listed securities may impact the price and volume of transactions in such securities, Nasdaq should have the authority to halt trading in an affected security until the problem can be addressed. Such a decision to halt trading requires Nasdaq to make a determination that the action is necessary for the protection of investors and the public interest pursuant to NASD Rule 4120. Nasdaq has stated "the rule would not be invoked merely because a system malfunction rendered a particular venue for transactions in a security temporarily unavailable, nor would it be applied in other circumstances where the system problems of an individual firm or market center did not give rise to extraordinary market activity."⁹ Instead, Nasdaq states the rule is intended to address circumstances where there is "a market-wide regulatory concern that system misuse or malfunction is likely to harm investors by leading them to enter into transactions whose terms are materially influenced by the misuse or malfunction."¹⁰ Nasdaq also states that it will terminate trading halts initiated under the rule "as soon as Nasdaq can conclude that the system misuse or malfunction will no longer have a material effect on the market for the security that is the subject of the halt or that system misuse or malfunction is not the cause of an instance of extraordinary market activity."¹¹ The Commission believes that the proposed rule change is consistent with the Act, and believes that the proposed rule may assist Nasdaq in exercising its responsibility to maintain fair and orderly markets.

The Commission notes that Nasdaq, in Amendment No. 2, indicates that it believes that trading halts instituted by Nasdaq under the proposed rule would constitute "regulatory" trading halts under the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("Reporting Plan"). Under the Reporting

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See January 25, 2002 letter from Mary M. Dunbar, Vice President, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), SEC, and attachments ("Amendment No. 1"). Amendment No. 1 completely replaced and superseded the original proposal.

⁴ See Securities Exchange Act Release No. 45355 (January 29, 2002), 67 FR 5351.

⁵ See October 2, 2002 letter from Richard T. Chase, Executive Vice President, Member Firm Regulation, The American Stock Exchange LLC ("Amex"), to Jonathan G. Katz, Secretary, SEC ("Amex Letter"). In its comment letter, the Amex expressed its support of Nasdaq's efforts to protect investors and the public interest through the use of trading halts. The Amex further stated that Nasdaq should clarify that Nasdaq's "authority to determine what is and what is not extraordinary market activity is limited to transactions within its jurisdiction and does not extend to transactions

⁸ 15 U.S.C. 78o-3.

⁹ Amendment No. 2 at 2-3.

¹⁰ *Id.* at 3.

¹¹ *Id.*

Plan, regulatory trading halts instituted by Nasdaq would be honored by exchanges trading Nasdaq securities on an unlisted trading privileges basis ("UTP Exchanges") and the NASD's Alternative Display Facility ("ADF") participating in the Reporting Plan (collectively, "Plan Participants"). The Commission understands that Nasdaq and the other Plan Participants are still discussing this issue. The Commission believes that an agreement would need to be reached among the Plan Participants on this subject before trading halts instituted by Nasdaq under the proposed rule would be considered "regulatory" trading halts under the Reporting Plan. Thus, approval of the proposed rule change, as amended, does not resolve the issue of whether a trading halt instituted by Nasdaq under the proposed rule constitutes a "regulatory" trading halt under the Reporting Plan.

The Commission finds good cause for approving proposed Amendment No. 2 before the 30th day after the date of publication of notice of filing thereof in the **Federal Register**. Nasdaq filed Amendment No. 2 to further clarify the manner in which Nasdaq envisions implementing the proposed rule change. The Commission believes the substance of Amendment No. 2 does not warrant republication of the proposed rule change as amended. Therefore, the Commission finds good cause for accelerating approval of the proposed rule change, as amended by Amendment No. 2.

III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2, including whether Amendment No. 2 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 Amendment No. 2 that are filed with the Commission, and all written communications relating to Amendment No. 2 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-2001-75 and should be submitted by June 27, 2003.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act¹², that the proposed rule change (SR-NASD-2001-75), as amended by Amendment No. 1, be, and it hereby is, approved, and that Amendment No. 2 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47958; File No. SR-Phlx-2002-87]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. and Amendment No. 1 Thereto Relating to the Imposition of a 500 Contract Cap on Payment for Order Flow Fees

May 30, 2003.

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 December 26, 2002, the Philadelphia Stock Exchange, Inc. ("Phlx") filed with the Securities and Exchange Commission the proposed rule change as described in Items I, II, and III, below, which the Phlx has prepared. The Phlx submitted Amendment No. 1 to the proposed rule change on May 29, 2003. 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 Phlx proposes to amend its options payment for order flow program by imposing a 500 contract cap per individual cleared side of a transaction. Specifically, the applicable payment for order flow fee would not apply to any contracts over 500, per individual cleared side of a transaction. For example, if a transaction consists of 750 contracts by one Registered Options Trader ("ROT"), the applicable payment for order flow fee would be applied to,

and capped at, 500 contracts for that transaction. Also, if a transaction consists of 600 contracts, but is divided equally among three ROTs, the 500 contract cap would not apply to any such ROT and each ROT would be assessed the applicable payment for order flow fee on 200 contracts, as the payment for order flow fee is assessed on a per ROT, per transaction basis.³ The Phlx is proposing to implement the 500 contract cap for trades settling on or after June 2, 2003.⁴

The text of the proposed rule change is available at the Phlx and at the Commission.

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 Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it had received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Phlx 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

The Phlx recently filed a rule change with the Commission to reinstate its payment for order flow program.⁵ Under

³ Currently, specialists may request reimbursement for payment for order flow funds in connection with any transactions to which they were not a party, based on the percentage of ROT monthly volume to total specialist and ROT monthly volume. The 500 contract cap would be imposed in connection with calculating the amount of the payment for order flow fee, and not for determining the percentage of ROT monthly volume to total specialist and ROT monthly volume.

⁴ The proposed rule change specifies that the Phlx's fee schedule, entitled "Exchange's ROT Equity Option Payment for Order Flow Charges," are subject to a 500 contract cap, by individual cleared side of a transaction. The Phlx's original rule change proposal included a fee schedule that was current as of December 2002 but has been superseded by more recent schedules. The Phlx submitted Amendment No. 1 to the proposed rule change to indicate the current fee schedule and to propose that the cap be implemented for trades settling on or after June 2, 2003. See letter from Cindy Hoekstra, Counsel, Philadelphia Stock Exchange, to Patrick Joyce, Senior Counsel, Commission, dated May 29, 2003.

⁵ See Securities Exchange Act Release No. 47090 (December 23, 2002), 68 FR 141 (January 2, 2003) (SR-Phlx-2002-75). The rule change proposal, which originally included the 500-contract cap that is the subject of the current proposal, became effective immediately upon filing with the Commission in November 2002. In December 2002, the Phlx amended the filing to remove the 500-

¹² 15 U.S.C. 78s(b)(2).

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.