Act.[9] Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Reference should be made to File No. 600–23. Copies of the amended application for registration and all written comments will be available for inspection at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[10]

Margaret H. McFarland,

Deputy Secretary.

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BILLING CODE 8010–01–M

[Release No. 34–37845; File No. SR–NASD–95–54]

Self-Regulatory Organizations; Notice of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to a Modification of the Operation of the Small Order Execution System (''SOES'') During Locked and Crossed Markets

October 21, 1996.

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 November 15, 1995,[1] the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. 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 NASD proposes to modify NASD Rule 4730(b)(4)[2] to provide that during locked or crossed markets, the system will execute orders in five-second intervals against a locked or crossed market maker at the best price, regardless of whether the market maker was responsible for the locked or crossed condition. Below is the text of the rule change. Proposed new language is in italics. Deleted language is in brackets.

Marketplace Rules

* * * * *

Rule 4730 Participation Obligations in SOES

* * * * *

b. * * *

(4) At any time a locked or crossed market, as defined in Part VI, Section 2(e) of Schedule D to the NASD By-Laws, exists for an NNM security, a Market Maker with a quotation for that security in the Nasdaq System that is [causing the] locked or crossed [market] may have orders representing shares equal to the minimum exposure limit or the firm's exposure limit, whichever is greater, executed by SOES for that Market Maker's account at its quoted price if that price is the best price. Those orders will be executed irrespective of any preference indicated by the Order Entry Firm. *During locked or crossed markets, SOES will execute orders against those Market Makers that are locked or crossed in predetermined time intervals. This period of time shall initially be established as five (5) seconds, but may be modified upon necessary Commission approval and appropriate notification to SOES participants.*

* * * * *

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. The NASD 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 NASD is proposing to modify SOES to provide that during locked or crossed markets, the system will execute orders in five-second intervals against a locked or crossed market maker at the best price, regardless of whether the market maker was responsible for the locked or crossed condition. Currently, when markets are not locked or crossed, SOES provides market makers with a 15-second period of time following their receipt of a SOES execution report to update their quotation before being required to execute another order in that security through SOES. When the market for a Nasdaq National Market security is locked or crossed,[3] however, SOES is currently designed so that the market maker whose quotation is locked or crossed will have SOES orders representing shares equal to the SOES minimum exposure limit[4] or the firm's exposure limit, whichever is greater, executed by SOES against that market maker's account without any delay between SOES executions (''locked and crossed market rule'').[5] Thus, in such instances, unlike the operation of SOES during non-locked or crossed markets, the market maker's account will receive SOES executions without any delay between executions until its exposure limit is exhausted. In addition, during locked or crossed markets, SOES orders are executed against market makers whose quotations are locked or crossed irrespective of any preference indicated by the SOES order entry firm.

The locked and crossed market rule was formulated by the NASD and approved by the SEC in response to the operation of SOES during the October 1987 Market Break.[6] Specifically, the feature was added to remedy the situation where SOES would cease executing orders in locked and crossed market situations. The feature was designed to increase the accuracy of displayed quotations in NNM securities by providing an incentive for market

[9] 15 U.S.C. 78s(a)(1) (1988).

[10] 17 CFR 200.30–3(a)(16) (1996).

[1] The NASD amended the proposed rule change four times subsequent to its initial filing. Amendment No. 4, filed October 16, 1996, changed the narrative in the proposed rule change. Amendment No. 3, filed October 2, 1996, replaced Amendment No. 2, which was filed September 23, 1996. Amendment No. 2, in turn, replaced Amendment No. 1, which was filed August 5, 1996.

The proposed rule change, as originally submitted, would have provided market makers with a 15-second grace period following their receipt of a SOES execution report during locked and crossed markets in which to update their quotation in that security before being required to execute another SOES order in that security. The filing as amended would establish a 5 second grace period between SOES executions in locked and crossed markets. *See* Letter from Robert E. Aber, Vice President and General Counsel, The Nasdaq Stock Market to Katherine England, Assistant Director, Division of Market Regulation, Commission (October 2, 1996).

[2] *NASD Manual*, Marketplace Rules (CCH), Rule 4730.

[3] Quotations are ''locked'' when the bid price quoted by one market maker in a security equals the ask price quoted by another market maker in the same security. Quotations are ''crossed'' when the bid price quoted by one market maker in a security is greater than the ask price quoted by another market maker in the same security.

[4] The minimum exposure limit for SOES is currently twice the maximum SOES order size for a given security. Thus, the minimum exposure limit for a NNM security in the 1,000-share tier size is 2,000 shares.

[5] *See* Rule 4730(b)(4).

[6] *See* Securities Exchange Act Release No. 25791 (June 9, 1988), 53 FR 22594 (order approving file No. SR–NASD–88–1).

makers to reduce the frequency and duration of locked and crossed markets.

Unfortunately, in today's trading environment, the incentive created by the locked and crossed market rule to avoid locked and crossed markets has been nullified by the volume and velocity of orders received and executed during locked and crossed markets. As set forth below, the volume of orders executed through SOES during locked and crossed markets clearly illustrates that the locked and crossed market rule operates to severely penalize rather than incentivise market makers when they have caused a locked or crossed market. As a result, both the firm that caused the locked or crossed market and the firm that is locked or crossed can be exposed to high levels of risk. In sum, the rapidity with which massive amounts of SOES orders are received and executed during locked and crossed markets provides market makers no meaningful opportunity to rectify locked and crossed market situations until after they have executed significant volume through SOES.

More specifically, since the locked and crossed market rule was implemented, there have been many instances where market makers have received numerous, instantaneous SOES executions in the fleeting time period during which their quotes were locked or crossed. The rule was intended to operate as an incentive for market makers to avoid locked and crossed markets; however, that incentive has been dissimulated and the rule is now being used by active SOES order entry firms to execute significant volume through SOES against market markers that have caused locked or crossed markets, or whose quotes have been locked or crossed by another market maker, before they have had an opportunity to respond and rectify the locked or crossed market condition. In the NASD's view, the rule can only operate as a true incentive to avoid locked and crossed markets when market makers have a reasonable opportunity to react to SOES transactions executed against them during a locked or crossed market situation. Presently, by the time a market maker realizes it needs to update its quote, its exposure limit often is unknowingly exhausted.

The profound risks that market markers are exposed to because of the locked and crossed market rule are dramatically illustrated by the trading activity that occurred through SOES on Thursday morning, October 19, 1995, in Cordis Corporation (CORD). On this day, the opening in CORD was delayed until 11:15 because a hostile takeover bid was announced for shares of the company. During a span of 3 minutes and 12 seconds just after the stock opened, the market for CORD was locked or crossed on six occasions for a total of 2 minutes and 3 seconds. During this 2 minutes and 3 seconds, 176 SOES executions occurred, with 170 of these trades being for 1,000 shares and 6 for 500 shares. SOES volume in CORD during the 3 minutes and 12 seconds was 220,000 shares and SOES volume during the 2 minutes and 3 seconds that the market was locked or crossed was 173,000 shares. This trading volume, which took place in just two to three minutes, represents a substantial percentage of the average daily trading volume in CORD for the six-month period prior to October 19, 1995. Specifically, the average daily trading volume in CORD from April 18, 1995 to October 18, 1995 was 383,569 shares. Thus, in just 3 minutes and 12 seconds on October 19, 1995, SOES order entry firms executed 57.3 percent of CORD's average daily trading volume for the prior six months; and in just 2 minutes and 3 seconds SOES order entry firms executed 45.1 percent of CORD's average daily trading volume for the prior six months. Following are several illustrative examples of SOES activity during these instances.

- A total of 13 trades for 13,000 shares were executed when the market was locked for just 7 seconds. Of these 13 executions, 6 were against one firm for 6,000 shares during a 3-second period and 4 of them occurred within one second.
- A total of 21 executions for 20,500 shares occurred when the market was crossed for just 9 seconds. Of these 21 executions, 6 were against one firm, 4 were against another, and two firms each received three executions. In addition, the firm that received 6 executions received 5 of them for 4,500 shares within two seconds.
- A total of 5 executions for 4,500 shares occurred when the market was locked for just 3 seconds. Of these 5 executions, 3 occurred against the same firm within 2 seconds for 3,000 shares.

The NASD believes that this type of trading activity through SOES exposes market makers to high levels of risk that, in turn, seriously undermines the viability of the Nasdaq market and the commitment of market making capital to NNM issues. Accordingly, the NASD and Nasdaq believe it is appropriate to limit the potentially high risk exposure of market makers in locked and crossed market situations by modifying SOES to afford market makers a 5-second period to update their quotes after they have received a SOES execution report during locked and crossed market situations. The NASD believes this proposal strikes a reasonable balance between the needs to keep SOES available to small, retail investors during times of market turbulence and to provide market makers with a meaningful incentive to update their quotations so as to avoid locked and crossed markets, on the one hand, and the need to preserve the liquidity of the Nasdaq market by not exposing market makers to unwarranted risk simply because their quote was locked or crossed for a brief period of time or because they are actively adjusting their quotes to arrive at a new equilibrium price level after a trading halt has been lifted or material news has been disseminated, on the other hand. In addition, the NASD notes that its proposal is consistent with the objectives underlying the locked and crossed market rule because it still ensures that SOES will be in operation when markets are locked or crossed and it still ensures that market makers will have a meaningful incentive to unlock markets quickly because they will receives SOES executions every 5 seconds if their quotes are locked or crossed. At the same time, just as is the case when markets are not locked or crossed, market makers will be afforded a brief period of time to update their quotes without being subjected to potentially high risk exposure, thereby promoting a more orderly realignment of quotations in locked and crossed market situations. In sum, the NASD believes the detriment to the market created by the current configuration of SOES during locked and crossed markets could be minimized by adding the 5-second interval between SOES executions, without compromising the access of small investors to market maker quotes and without eliminating the incentive for market makers to not lock or cross markets.

For the above reasons, the NASD believes that the proposed rule change is consistent with Sections 15A(b)(6), 15A(b)(9), 15A(b)(11) and 15A(a)(1)(C) of the Act and Rule 11Ac1–1 thereunder. Among other things, Section 15A(b)(6) requires that the rules of a 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. Specifically, the NASD believes its proposal will promote a more orderly realignment of quotations during locked and crossed markets by affording market makers whose quotations are locked or crossed a 5-second interval to react to SOES orders that they have already automatically executed, wholly consistent with the operation of SOES during times when markets are not locked or crossed. In addition, because market makers will still be obligated to execute SOES orders during locked and crossed markets at 5-second intervals, market makers will still have an incentive to rectify locked and crossed market situations. Finally, because SOES will continue to execute trades during locked and crossed markets, small, retail investors will continue to have immediate access to the best prices available on Nasdaq during locked and crossed markets.

Section 15A(b)(9) provides that the rules of the Association may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The proposed 5-second interval after SOES executions during locked and crossed markets will apply across the board and not target any particular SOES user or participant. Accordingly, the NASD believes that its proposal is not anti-competitive, as it is uniform in application and it seeks to preserve the ability of SOES to provide fair and efficient automated executions for small investor orders, while preserving market maker participation in SOES and market liquidity.

Section 15A(b)(11) empowers the NASD to adopt rules governing the form and content of quotations relating to securities in the Nasdaq market. Such rules must be designed to produce fair and informative quotations, prevent fictitious and misleading quotations, and promote orderly procedures for collecting and distributing quotations. Because the proposed rule change will facilitate a more orderly reaction to and rectification of locked and crossed markets, the NASD believes the rule change will enhance the integrity and soundness of quotations in NNM securities.

In addition, the NASD believes that the proposed rule change is consistent with significant national market system objectives contained in Section 11A(a)(1)(C) of the Act. This provision states it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure, among other things: (i) economically efficient execution of securities transactions; (ii) fair competition among brokers and dealers; and (iii) the practicality of brokers executing investor orders in the best market. Specifically, the NASD believes the proposed 5-second interval after SOES executions during locked and crossed markets will advance each of these objectives by preserving the operational efficiencies of SOES in the processing of small investor's orders.

Finally, consistent with the SEC's finding that the 15-second interval is consistent with the SEC's Firm Quote Rule during regular market conditions, the NASD believes its proposal to extend a 5-second interval during locked and crossed markets is likewise consistent with the Firm Quote Rule. Specifically, when the SEC approved the 15-second interval with respect to regular market conditions, it stated that it was:

> Consistent with the requirements of the SEC's Firm Quote Rule which requires that brokers and dealers execute orders to buy and sell securities at their published quotes unless communicating a revised bid or offer or unless updating their quotations in response to an execution. The proposed 15-second update period in no way diminishes the requirement that market makers maintain firm quotes and be willing to execute at those quotes. The 15-second update period only will be in effect in response to an execution and only serves to provide market makers time to react to that execution and adjust their positions, if necessary. Market makers will continue to be required to execute customer orders quickly and efficiently.[7]

The NASD believes that the Commission's legal analysis and statutory finding that the 15-second interval is consistent with the Firm Quote Rule applies with equal force to the proposed rule change. Indeed, nowhere in the SEC's Firm Quote Rule does it provide that market makers are ineligible to avail themselves of the exceptions to the Rule because a market is locked or crossed. In fact, under Rule 11Ac1–1(b)(3)(C), when there is a level of trading activity or the existence of unusual market conditions such that an exchange is incapable of collecting, processing, and making available quotations in a manner which accurately reflects the current state of the market on the floor of an exchange, that exchange may relieve its market makers of their firm quote obligations.[8] Accordingly, since SOES market makers will not in any way be relieved of any of their firm quote obligations under the proposal, the NASD believes the proposed rule change is wholly consistent with the SEC's Firm Quote Rule.

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

The NASD believes that the proposed rule change will not 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 of Comments on the Proposed Rule Change Received From Members, Participants or Others

Comments were neither solicited nor received.

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 NASD 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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

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[7] *See* Securities Exchange Act Release No. 29801 (October 10, 1991), 56 FR 52098.

[8] Because only exchanges can declare fast market conditions under the Firm Quote Rule, the same market event (*i.e.*, a locked or crossed market) can presently result in dramatically different regulatory requirements for similarly situated market participants. Specifically, under SOES, exceptions from the Firm Quote Rule are eliminated when markets are locked or crossed, while exchange specialists may be entirely relieved of their firm quote obligations during locked and crossed markets.

submissions should refer to SR–NASD–94–54 and should be submitted by November 15, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[9]

Margaret M. McFarland,

Deputy Secretary.

[FR Doc. 96–27434 Filed 10–24–96; 8:45 am]

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[Release No. 34–37842; File No. SR–PSE–96–40]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Stock Exchange, Inc., Relating to Index Options on the Dow Jones & Co. Taiwan Index

October 18, 1996.

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 October 17, 1996, the Pacific Stock Exchange, Inc. (''PSE'' or ''Exchange'') 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 the self-regulatory organization. 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 PSE, pursuant to Rule 19b–4 of the Act, proposes to list for trading index options on the Dow Jones & Co. Taiwan Index (''Index'').

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 self-regulatory organization 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. The self-regulatory organization 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. The Exchange is proposing to list and trade cash-settled, European-style stock index options on the Dow Jones & Co. Taiwan Index. The Index is comprised of 113 representative stocks traded on the Taiwan Stock Exchange (''TSE'').[3] The Exchange represents that the Index is representative of the Taiwan stock market as a whole, and therefore, is deemed to be a broad-based index.

Index Design

The Index was designed by, and is maintained by, Dow Jones & Co. The 113 stocks comprising the Index were selected for their market weight, trading liquidity, and representation of the business industries reflected on the TSE. The Exchange believes that these stocks reflect the industrial composition of the broader Taiwanese equity market.

The Index is weighted by the market capitalization of the component stocks. As of August 30, 1996, the market capitalization of the Index was US$181 billion (at the exchange rate of NT $27.5 per dollar). The average market capitalization of these stocks was $1.6 billion on the same date (at the same rate of exchange). The individual market capitalization of these stocks ranged from $150 million (Hong Ho Precision Textile Co.) to $18.6 billion (Cathay Life Insurance) on the same date. The largest stock accounted for 10.26% of the Index, while the smallest accounted for .08%. The top five stocks in the Index, by weight, accounted for approximately 31% of the Index. The average daily trading volume of the component securities for the period April 1 through August 30, 1996, ranged from a low of 457,091 shares (Hsing Ta Cement Co.) to a high of 49,879,418 shares (China Steel), with an average daily trading volume for all components of the Index of approximately 7,698,763 shares.

Calculation and Maintenance of Index

The value of the Index is determined by multiplying the price of each stock by its number of shares outstanding, adding those sums, and then dividing by a divisor which gives the Index a value of 100 on its base date of December 31, 1991. The Index had a closing value of 160.33 on August 30, 1996. The Index will be maintained by Dow Jones & Co. and, in order to maintain continuity of the Index, the divisor of the Index will be adjusted to reflect certain events relating to the component stocks. These events include, but are not limited to, changes in the number of shares outstanding, spin-offs, certain rights issuances, and mergers and acquisitions.

The composition of the Index will be reviewed periodically and Dow Jones & Co. may make component changes at any time to ensure that the Index continues to represent the overall character of the Taiwanese equity market. When considering replacement stocks, Dow Jones & Co. will choose from among the most heavily capitalized and actively traded stocks on the TSE. In addition, Dow Jones & Co. will consider other factors including industry grouping, level of foreign accessibility (*i.e.*, whether foreigners may purchase the stock), name recognition, and volatility.

Index Option Trading

The Exchange proposes to base trading in options on the Index on the full value of the Index as expressed in U.S. dollars. The Exchange also may provide for the listing of long-term index option series (''LEAPS'') on the Index. The Exchange will list expiration months for Index options and Index LEAPS in accordance with PSE Rule 7.8.

The trading hours for options on the Index will be from 6:30 a.m. Pacific time to 1:15 p.m. Pacific time. Dow Jones Telerate (''Telerate'') will calculate the value of the Index every fifteen seconds throughout the trading day and disseminate the Index value through the Options Price Reporting Authority (''OPRA'').

The Exchange is proposing to establish position limits for Index options equal to 50,000 contracts on the same side of the market, with no more than 30,000 contracts in the series with the nearest expiration date. These limits are roughly equivalent, in dollar terms, to the limits applicable to options on other indices. Furthermore, the hedge exemption rule applicable to broad-based index options, Commentary .02 to PSE Rule 7.6, will apply to Index options.

The PSE also represents that it has the necessary systems capacity to support new series that would result from the introduction of the Index options.

Exercise and Settlement

The proposed options on the Index will expire on the Saturday following the third Friday of the expiration month, and trading in the expiring contract month on the PSE will normally cease on Friday at 1:15 p.m. Pacific time unless a holiday occurs.

[9] 17 CFR 200.30–3(a)(12) (1989).

[1] 15 U.S.C. § 78s(b)(1) (1988).

[2] 17 CFR 240.19b–4.

[3] A list of index components is available at the Commission and at the PSE.