

Market, with the exception of listed convertible debt. Therefore, the types of Nasdaq securities subject to the fees include: common, preferred, ADRs, foreign, Canadian foreign, warrants, rights, and units.

Because NASD rules also require such prompt last sale reporting for transactions involving all domestic, Canadian, and ADRs that are non-Nasdaq OTC Equity Securities,<sup>5</sup> the transaction fee applies to these securities as well. This includes many securities quoted in the OTC Bulletin Board or in the National Quotation Bureau's "Pink Sheets." Conversely, foreign securities (other than Canadian securities and ADRs) that are non-Nasdaq OTC Equity Securities are not subject to the SEC fee, because NASD rules currently permit members to report transactions in these securities on the day after trade date (T+1).<sup>6</sup>

The fee also applies to transactions in covered securities executed outside normal hours. These transactions are reported into ACT pursuant to NASD Rules 4632(a)(4), 4642(a)(4), 6420(a), and 6620(a)(3).<sup>7</sup>

The NASD also will be collecting the SEC fee for odd-lot transactions and transactions effected pursuant to the exercise of an option on a covered security. The NASD notes that although these types of transactions generally are not reported into ACT, they are nonetheless subject to the SEC fee.<sup>8</sup> With respect to transactions that result from the exercise of a listed option cleared through Options Clearing Corp ("OCC") where the underlying security is subject to the fee (e.g., because it is a Nasdaq security or is otherwise subject to prompt last sale reporting), the fee will be collected by OCC on behalf of the NASD. With respect to odd-lot transactions and transactions pursuant to the exercise of a conventional or "OTC" option where the underlying security is subject to the fee, there currently is no automated means to calculate and assess the fee. Therefore, for these types of transactions only, the NASD will require NASD clearing firms to account and submit payment for such activity by them and their respective correspondents on a monthly basis. Self-clearing firms also will be required to

account and submit payment for such activity on a monthly basis.<sup>9</sup>

Each NASD member firm will be responsible for determining whether the securities they trade are subject to prompt last sale reporting requirements, and thus subject to the transaction fee. Nonetheless, the NASD recognizes that member firms may experience difficulty in modifying their systems by January 1, 1997 to distinguish between Canadian and other foreign non-Nasdaq OTC equity securities. To assist members in determining which foreign non-Nasdaq OTC Equity Securities are subject to the transaction fee, the NASD will initially make available a list of non-Nasdaq Canadian securities on which it intends to assess the transaction fee.

The transaction fee applies to all transactions in covered securities by or through any member otherwise than on a national securities exchange, regardless of the capacity in which the member is trading. For transactions between two NASD members, the NASD generally will assess the fee on the member on the sell side. For transactions between an NASD member and a customer, the NASD will assess the fee on the NASD member.

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(5) of the Act,<sup>10</sup> which requires, *inter alia*, that the NASD's rules provide for the equitable allocation of reasonable fees among members. The proposed fees are consistent with the appropriations Act and the Improvement Act, and are similar to the transaction fees that have applied to exchange transactions for many years.

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

The NASD 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 Other*

No written comments were solicited or received with respect to the proposed rule change.

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

Because the foregoing rule change establishes or changes a due, fee, or other charge imposed by the Exchange, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule

19b-4 thereunder. 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. 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 Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR-NASD-96-57 and should be submitted by January 27, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

[FR Doc. 97-861 Filed 1-13-97; 8:45 am]

BILLING CODE 8010-01-M

## **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-38149; File No. SR-NASD-97-01]

### **Self-Regulatory Organizations; Notice of Proposed Rule Changes by the National Association of Securities Dealers, Inc. Relating to SelectNet Orders**

January 10, 1997.

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 January 8, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary,

<sup>5</sup> NASD Rule 6610.

<sup>6</sup> NASD Rule 6620(a).

<sup>7</sup> See letter from Anne H. Wright, Associate General Counsel, NASD, to James T. McHale, Esq., Office of Market Supervision, Division of Market Regulation, Commission, dated January 6, 1997 ("Clarification Letter").

<sup>8</sup> See Securities Exchange Act Release No. 38073 (December 23, 1996), 61 FR 68590 (December 30, 1996), at footnote 27.

<sup>9</sup> See Clarification Letter, *supra* note 7.

<sup>10</sup> 15 U.S.C. 78o-3.

<sup>11</sup> 17 CFR 200.30-3(a)(12).

The Nasdaq Stock Market, Inc., 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.

Nasdaq requests the Commission to find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Order Execution Rules become effective January 20, 1997. The rule change proposed in this filing is essential to ensure the successful implementation and operation of Nasdaq's system designed to facilitate the ECN Display Alternative envisioned by the Order Execution Rules. Accordingly, Nasdaq requests the Commission to accelerate the effectiveness of the proposed rule change prior to the 30th day after its publication in the Federal Register.

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

Pursuant to Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act") and Rule 19b-4 thereunder, the NASD is submitting this rule filing to adopt certain rules regarding The Nasdaq Stock Market's ("Nasdaq") SelectNet Service to clarify members' obligations regarding the use of the service as it will operate under the Commission's new limit order display rule, Rule 11Ac1-4 ("Display Rule") and amendments to Rule 11Ac1-1(c)(5) ("ECN Amendment").<sup>1</sup> (New Text is italicized.)

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#### Conduct Rules

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#### 3300. TRADING

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#### 3380. SELECTNET SERVICE

##### (a) Cancellation of a SelectNet Order

*No member shall cancel or attempt to cancel an order, whether preferred to a specific market maker or electronic communications network, or broadcast to all available members, until a minimum time period of ten seconds has expired after the order to be canceled was entered. Such ten second time period shall be measured by the Nasdaq processing system processing the SelectNet order.*

<sup>1</sup> See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Execution Rules Adopting Release") adopting Rule 11Ac1-4 and amendments to Rule 11Ac1-1 ("Quote Rule") (collectively "Order Execution Rules").

#### (b) Prohibition Regarding The Entry of Conditional Orders

*No member shall enter an order into SelectNet that is preferred to an electronic communications network covered by Rule 4623 that has any conditions regarding responses to the order, e.g., preferred SelectNet orders sent to electronic communications networks shall not be all or none, or subject to minimum execution size above a normal unit of trading, or deemed non-negotiable.*

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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, 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

On November 18, 1996, the NASD and Nasdaq proposed several changes to their rules and systems to address changes to the Nasdaq Stock Market stemming from the Commission's adoption of the Order Execution Rules.<sup>2</sup> The Display Rule requires the display in a market maker's quote of certain customer limit orders and the ECN Amendment requires a market maker to display in its quote any better priced order the market maker places into an electronic communication network ("ECN"). Alternatively, the ECN Amendment provides an exception to the market maker's display obligation that depends upon the ECN itself displaying its best-priced orders in Nasdaq and allowing brokers and dealers to access such orders ("ECN Display Alternative").

Among the changes to Nasdaq's rules and systems to accommodate trading in the new environment the Order Execution Rules create, Nasdaq has proposed a mechanism to allow ECNs to take advantage of the ECN Display Alternative by providing a linkage to Nasdaq. A critical portion of Nasdaq's

<sup>2</sup> See Securities Exchange Act Release No. 38008 (December 2, 1996), 61 FR 64550 (December 5, 1996) notice of NASD filing of proposed rule change, file number 96-43.

mechanism involves an existing Nasdaq system, SelectNet, which will be the means by which NASD members that are not subscribers to a particular ECN may access the ECN's orders that are being displayed in Nasdaq's quote montage pursuant to the ECN Display Alternative. To access those orders, NASD members will be permitted to enter SelectNet preferred orders, *i.e.*, orders that are directed to a particular ECN at its displayed price. Under the terms of agreements Nasdaq will enter into with each ECN choosing to utilize this SelectNet linkage ("ECN agreements"), the ECN will be required to respond as soon as possible within seconds to the preferred order.

In the course of working with ECNs on this access linkage via SelectNet, Nasdaq and the ECNs have discovered that problems occur when members entering orders into SelectNet, whether preferred orders or broadcast, immediately cancel such orders. In addition, there are problems when members impose conditions, restrictions or limitations on the orders entered. For example, an ECN operating an automated response system develops response difficulties when it receives an all or none preferred order. Nasdaq proposes, through this proposed rule change, to prohibit members from entering conditional orders into SelectNet when they are preferred to an ECN. Nasdaq plans to develop system changes that will prevent the entry of such conditional orders as soon as possible.

Additionally, the immediate cancellation of an order entered in SelectNet causes significant problems for the ECN that had received such order and was attempting to accept that order. All ECNs will be required, pursuant to performance standards that will be in the ECN agreements, to operate an automated system for accepting orders via SelectNet. The ECN automated system must be able to accept the SelectNet preferred order and send a message to Nasdaq and to the ECN's own customer indicating that an execution has occurred. However, because an execution does not occur until the Nasdaq system processor receives the ECN acknowledgement that it has in fact accepted the order, a member's cancellation message may arrive at the Nasdaq processor first. Consequently, by the time the acceptance message arrives at Nasdaq's processor for its acknowledgement, the Nasdaq processor may have already accepted the cancellation. This will result in Nasdaq rejecting the execution acknowledgement from the ECN and hence harm the customer of the ECN

who believed an execution had occurred. Nasdaq believes it is appropriate, therefore, to require a member that has entered any order into SelectNet, a preferenced order or broadcast, to wait at least ten seconds before cancelling that same order. In this manner, the ECN or market maker operating a rapidly responding system will not be adversely disadvantaged.

Nasdaq notes that the establishment of a minimum life of an order at ten seconds is its initial response to a significant concern that it has had with the use of SelectNet and the rapid cancellation of orders. The entry of large numbers of preferenced and broadcast orders into SelectNet that are cancelled within a very short time span creates serious market quality concerns. Two particular problems occur: (1) the rapid entry and almost immediate cancellation of SelectNet orders causes a misleading appearance of activity that is virtually impossible to access (i.e. "flickering" orders); and (2) because of the system design of SelectNet, the large number of order sent to the SelectNet window on Nasdaq Workstation II ("NWII") rapidly scroll off the screen before a market maker can see the order and react to it (the "scroll-off" problem).

Two issues arise because of the many SelectNet orders that are cancelled almost as soon as they have been entered. First, the market may be misled by an appearance of significant activity in a particular issue, when, in fact, very few orders actually are accessible or carry any real price discovery information. The appearance of massive numbers of buy or sell orders first showing up on the screen could cause market makers and other members to believe that significant news on an issue is causing the order flow, leading market makers to adjust their quotations and order entry firms to incorrectly make order entry decisions based on their observation of the heavy influx of orders. The entry of these particular SelectNet orders is essentially a distracting and potentially harmful "noise" that disrupts the efficient price discovery process. Indeed, because these orders are so rapidly cancelled, it appears that many of these orders were not entered with the intention of being executed.

Additionally, assuming that each order is entered with the intention that it is to be executed, the almost immediate cancellation often prevents other market participants from reacting effectively to the display of customer order interest. Nasdaq believes that the flurry of SelectNet orders being entered with almost immediate cancellations is

the functional equivalent of the "flickering quote" problem.<sup>3</sup>

Nasdaq believes that the immediate cancellation of orders entered into SelectNet poses problems similar to those caused by flickering quotations. Essentially, if orders entered through SelectNet are immediately cancelled they are thus virtually inaccessible and therefore misleading. If orders entered into SelectNet are to have any meaning, particularly when they are broadcast to the entire market, it seems that such orders should have a reasonable minimum period of life that permits other market participants to access them.

In addition to the problems caused by the basic inaccessibility of such orders, the unique design by which SelectNet orders are displayed is adversely effected by the heavy influx of such orders and subsequent cancellations. The NWII displays SelectNet orders on a four-line window at the bottom. Each SelectNet order occupies one line of the four-line window. Thus, when more than four orders are sent to a market maker through SelectNet, the oldest order scrolls off the display to be replaced by the newest order. When many SelectNet orders are sent through the system it causes the SelectNet window to scroll orders up and off the four-line window. Consequently, it is virtually impossible for the market maker to effectively interact with the orders. Even if a market maker were to

<sup>3</sup>The NASD believes that the Commission has expressed concern over the value of 'ephemeral' quotes, noting that while certain non-specialists in the trading crowd may make bids or offers that temporarily change the market's quote for "an instant in time," they do not really become part of the market quote because they are withdrawn immediately if not accepted. Such price information, if broadcast to the world via a consolidated quotation system, is essentially inaccessible, confusing to the market, and ultimately, potentially misleading. See Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342, 4345 (February 1, 1978) release adopting the Quote Rule. See also Securities Exchange Act Release No. 15771 (April 26, 1979), 44 FR 26067 (May 4, 1979) and Securities Exchange Act Release No. 18482 (February 11, 1982), 47 FR 7399 (February 19, 1982) adopting amendments to the Quote Rule.

The NASD also maintains that, in determining not to adopt its price improvement rule, proposed Rule 11Ac1-5, the Commission stated that the inaccessibility of quotes created pursuant to this proposal weighed against its adoption at this time. See Order Execution Rules Adopting Release. Lastly, the NASD notes that in recent news report that SEC Commissioner Wallman had concerns with flickering quotes and caused the Commission to rethink its proposed Rule 11Ac1-5 regarding price improvement and a proposed safe harbor mechanism that would have required members to change their quotes for 30 seconds in an effort to obtain price improvement for market orders when spreads are wider than a minimum increment. See Bloomberg, "SEC Commissioner Voices Concern About Nasdaq Access Rule Plan," August 14, 1996.

observe an order that it wanted to interact with, it is likely that, due to the high rate of SelectNet cancellations, the order may be cancelled before the market maker is able to act on it. The scrolling, coupled with the almost immediate cancellation of orders, leads some market participants to regard SelectNet as a less viable trading mechanism.

The large influx of orders and cancellations exacts a heavy toll on the capacity of Nasdaq's host processors and the Enterprise-Wide Network II ("EWN"). All of the components have had to be upgraded significantly in the last year, an upgrade driven in significant part by the amount of traffic caused by the SelectNet Broadcast feature and the requirement to process the messages generated in entry and cancellation of SelectNet orders.

Nasdaq believes that the immediate cancellation of SelectNet orders causes a myriad of problems, any of which warrants the imposition of a minimum period for the life of a priced order entered into SelectNet. At this juncture, to prevent harmful market quality effects, Nasdaq believes that orders entered into SelectNet should be accessible for at least a 10 second minimum period of time before such order should be permitted to be cancelled.

Nasdaq has reviewed other possible time periods for examples of minimum time periods that permit reasonable access. One such example is drawn from the Commission's proposed price improvement rule which included a proposed safe harbor.<sup>4</sup> The proposed safe harbor provided that to obtain price improvement for a customer's market order when the spread in the best bid and offer was greater than the smallest quote increment (e.g., larger than 1/8th), the market maker should change its quote for 30 seconds to a price better than the current bid or offer to see if it could obtain a more favorable execution. Another example of a minimum time period is in the Intermarket Trading System ("ITS") Plan where the exchanges and the NASD have agreed to minimum time periods for orders sent from one market center to another via ITS. ITS rules specifically provide that orders sent by a specialist or market maker in one market center to a specialist or market maker in another market are "irrevocable" for either one or two

<sup>4</sup> See Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995) release proposing Order Execution Rules which included a proposed price improvement rule.

minutes, depending on the time period that the sending market establishes.

Nasdaq notes that once the Order Execution Rules become effective, experience may determine that the ten second time period is too brief to effectively address the market quality concerns that present problems to market makers and investors alike that are seeking to trade at published prices that are withdrawn before they can be accessed. Nasdaq will continue to review SelectNet cancellation patterns to determine whether a longer minimum period is necessary. If it determines that market quality is being harmed by cancellations that indicate such orders are ephemeral, not executable or perhaps fictitious or manipulative Nasdaq will propose additional means to eliminate the harm. Accordingly, Nasdaq may revisit its initial determination to establish 10 seconds as the minimum life of a SelectNet order.

The NASD believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act and Rule 11Ac-1. 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, by imposing limits on SelectNet orders as proposed herein, Nasdaq believes the proposal will promote fair and orderly markets and the protection of investors.

#### *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 on 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 publication of this notice in the Federal Register or within such other 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 doing so or (ii) to which the self-regulatory organization consents, the Commission will:

(A) by order approve the 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 submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of this publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

Margaret H. McFarland,

*Deputy Secretary.*

[FR Doc. 97-986 Filed 1-10-97; 12:29 pm]

BILLING CODE 8010-01-M

## **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-38127; File No. SR-PSE-96-48]

### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Stock Exchange Incorporated Relating to A.M.-Settlement**

January 6, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup>

<sup>5</sup> 17 CFR 200.30-3(a)(12) (1989).

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1982).

<sup>2</sup> 17 CFR 240.19b-4 (1991).

notice is hereby given that on December 18, 1996, the Pacific Stock Exchange Incorporated ("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 is proposing to amend its rules to codify certain existing procedures relating to a.m.-settled index options. The text of the proposed rule change is available at the Office of the Secretary, PSE 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 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 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 adopt new Rule 7.8(e), entitled "A.M.-Settled Index Options." This rule provides that the last day of trading for A.M.-settled index option shall be the business day preceding that last day of trading in the underlying securities prior to expiration. It states that the current index value at the expiration of an A.M.-settled option shall be determined on the last day of trading in the underlying securities prior to expiration. It states that the current index value at the expiration of an A.M.-settled option shall be determined on the last day of trading in the underlying securities prior to expiration. It further provides that the current index value shall be determined by reference to the reported level of such index as derived from first reported sale (opening) prices of the underlying securities on such day. In addition, in any case where the security