

### 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 CBOE 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 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 Room. Copies of such filings will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-2001-64 and should be submitted by March 5, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

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

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45405; File No. SR-CSE-2001-04]

#### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Cincinnati Stock Exchange, Inc. Relating to the Creation of the OTC-UTP System on the Cincinnati Stock Exchange, Inc.**

February 6, 2002.

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> notice is hereby given that on October 31, 2001, the Cincinnati Stock Exchange, Inc. ("CSE" 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 Exchange. The Exchange filed an amendment to its proposal on February 5, 2002.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to amend CSE Rule 11.9, National Securities Trading System ("NSTS"), to create a parallel trading system within the Exchange for Nasdaq/National Market securities ("Nasdaq securities"). The Over-the-Counter ("OTC") Unlisted Trading Privileges ("UTP") System ("OTC-UTP System"), while operating on CSE's current hardware and communication lines, will subject CSE users to altered Exchange rules that make the CSE's price/time and agency/principal priorities voluntary for Nasdaq securities. The CSE believes that the proposed rule change will enhance the competitive position of the Exchange by promoting increased liquidity and greater opportunities for members and their customers to obtain best execution on the CSE. The text of the proposed rule change is available at the principal offices of the Exchange and at the Commission.

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

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

<sup>3</sup> See letter from Jeffrey T. Brown, Senior Vice President, Secretary and General Counsel, CSE, to Katherine England, Assistant Director, Division of Market Regulation, Commission (February 5, 2002) ("Amendment No. 1").

#### **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 Exchange 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 Exchange 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 proposes to change its rules to create the OTC-UTP System within the CSE that will provide CSE members with increased flexibility to provide best execution to their customers' orders. In order to more effectively compete for order flow in Nasdaq securities, CSE is proposing to amend its price/time and agency/principal priority rules such that CSE users ("Users")<sup>4</sup> may voluntarily and on an order-by-order basis determine to interact with other bids, offers, and orders displayed in CSE's OTC-UTP System. CSE believes that the new trading system is consistent with the federal securities laws and similar in nature to that currently employed by the Nasdaq Stock Market, Inc. ("Nasdaq") and as proposed in the Nasdaq's exchange filing.<sup>5</sup>

##### **Description**

The CSE's current trading system, NSTS, is an electronic securities communication and execution facility, that combines the display of bids, offers, and orders of Users as well as orders on the NSTS central limit order book ("CLOB") with the matching and execution of like-priced orders, bids, and offers according to programmed price/time and agency/principal priorities.<sup>6</sup> The price/time and agency/principal priority rules are set forth in CSE Rules 11.9(i), (l), (m), and (u).

Rule 11.9(i) states that NSTS shall automatically match and execute like-priced orders, bids and offers in accordance with the price/time and agency/principal priorities set forth in

<sup>4</sup> CSE Rule 11.9(a)(7) defines the term "User" as a Member of the Exchange or an Approved Dealer.

<sup>5</sup> See Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001).

<sup>6</sup> CSE Rule 11.9(a)(1).

<sup>15</sup> 17 CFR 200.30-3(a)(12).

Rules 11.9(l) and (m).<sup>7</sup> Rule 11.9(l) provides that public agency orders to buy or sell at a particular price shall, in all cases except execution of such an order pursuant to a limit order guarantee, have priority over all other bids and offers on NSTS at the same price. In addition, Rule 11.9(l) imposes price/time priority on all bids and offers, except those executed pursuant to Rule 11.9(u), such that the first in line at the best price shall be executed.<sup>8</sup>

Rule 11.9(m) requires that each Approved Dealer<sup>9</sup> or other Proprietary Member<sup>10</sup> when trading on the exchange for its own account or as agent for professional agency orders<sup>11</sup> yield priority to (1) All public agency orders in the CLOB at prices equal to, or better than, the Dealer's order, bid, or offer; and (2) all orders, bids, and offers of an Approved Dealer or other Proprietary Member for its own accounts or as agent for professional agency orders entered in NSTS (i) at an earlier time than the Dealer's order, bid, or offer, or (ii) in the case of Approved Dealers when trading for their own account against public agency orders they represent as agent pursuant to Rule 11.9(u).

Rule 11.9(u), "Preferencing Rule," permits orders to be preferenced to particular Approved Dealers and executed at the same price as current Approved Dealer bids, offers, and professional agency displayed orders without regard to the time priority of such bids, offers, and displayed orders.<sup>12</sup>

To accommodate the introduction of the OTC-UTP System, CSE is amending the above rules, where necessary, to clarify that the price/time and agency/principal priorities are voluntary with respect to trading in Nasdaq securities. For example, subparagraph (2) will be added to Rule 11.9(i) to provide that "the OTC-UTP System will match and execute like-priced orders, bids, and offers when specifically instructed by

the CSE Users. Subject to the obligations of Rule 12.10, Best Execution, Users may choose to execute like-priced orders without regard to the price/time and agency/principal priorities set forth in Rules 11.9(l) and (m)."<sup>13</sup> Similarly, Rule 11.9(l) will be amended to state that "Public Agency orders, except in Nasdaq/NM securities traded through the OTC-UTP System, \* \* \* shall have priority. \* \* \*"<sup>14</sup>

In addition, the CSE system algorithms that enforce the price/time and agency/principal priority rules will be modified to comply with the voluntary order interaction of the OTC-UTP System. However, Rule 12.6, Customer Priority, which is CSE's "Manning" rule will not be amended and will continue to be enforced as written on CSE Designated Dealers.

#### Discussion

CSE's Preferencing Rule (Rule 11.9(u)) was a step towards creating a more competitive environment for exchange-listed securities traded on a UTP basis on the CSE. By adopting a rule that permits CSE dealers to execute customer orders without regard to the time priority of other CSE dealer orders, bids, and offers, the CSE introduced elements of a dealer market, such as Nasdaq, into its exchange structure. In approving preferencing on CSE, the Commission recognized that, "the CSE combines the features of both exchange and over-the-counter markets."<sup>15</sup> Further, the Commission stated that:

[t]hus, the NSTS system provides a central location for CSE dealers to interact in a manner similar to a traditional exchange trading floor. Preferencing, however, suspends time priority between professional trading interest so that the multiple CSE dealers can execute their own customer orders without interruption by other dealers and is more akin to trading in the over-the-counter markets.<sup>16</sup>

While the Commission was cautious in supporting preferencing at its inception, CSE has proven that the quality of executions pursuant to the Preferencing Rule are equal to, and often exceed, the quality of executions on the primary markets for exchange-listed securities. As the data published pursuant to Rule 11Ac1-5 demonstrates, CSE execution quality consistently

exceeds that of the New York Stock Exchange, Inc. ("NYSE") and the American Stock Exchange LLC, the two primary listed markets. Indeed, CSE numbers are better than those of the NYSE in such categories as effective spread, execution speed, and percent of executions outside the quoted market. Clearly, eliminating time priority among CSE dealers has benefited CSE customers through better prices and faster service.

CSE now seeks to expand on these benefits by introducing the OTC-UTP System, which makes price/time and agency/principal priorities for bids, offers, and orders in Nasdaq securities voluntary among CSE market participants. The CSE believes that such an open architecture is necessary to attract liquidity from various market participants, including dealers, order-entry firms, ECNs, ATSSs, and public customers. As greater liquidity is introduced into CSE, the competitive efficiencies of this open structure will generate greater opportunities for order interaction as well as faster and cheaper executions for public customers. In summarizing the congressional intent of section 11A of the Act, the Commission stated in its Concept Release on Issues Relating to Market Fragmentation that

Investor interests are best served by a market structure that, to the greatest extent possible, maintains the benefits of both an opportunity for interaction of all buying and selling interest in individual securities and fair competition among all types of market centers seeking to provide a forum for the execution of securities transactions.<sup>17</sup>

The CSE believes that the freely competitive nature of the OTC-UTP System will attract new CSE Users and greater liquidity to the Exchange. As liquidity begets liquidity, order interaction increases and investors are better served. Once the algorithmic controls are removed and replaced by the voluntary—to the extent that volition is constrained by the duty of best execution—interaction of bids, offers, and orders, the CSE believes that its quote driven market will be on a level playing field with Nasdaq and an era of true price competition in Nasdaq securities may begin. By combining fair competition with opportunities for increased order interaction, the CSE believes it has proposed a mechanism to achieve the goals of section 11A of the Act.

As the Commission is aware, Nasdaq members trade without regard to price and time priority and intend to do so

<sup>7</sup> See CSE Rule 11.9(i).

<sup>8</sup> See CSE Rule 11.9(l).

<sup>9</sup> CSE Rule 11.9(a)(4) defines "Approved Dealer" as a Designated Dealer, a Contributing Dealer, or a specialist or market maker registered as such with another exchange or national securities association with respect to any Designated Issue.

<sup>10</sup> Article I, Section 1(k) of CSE By-Laws defines "Proprietary Member" as a person who was a "regular member" prior to the effective date of these By-Laws or a person who, pursuant to the provisions of Article II of these By-Laws, has applied for, and been admitted to, membership as a proprietary member subsequent to the effective date of these By-Laws.

<sup>11</sup> CSE Rule 11.9(a)(10) defines "professional agency order" as an order entered by a User as agent for the account of a broker-dealer, a futures commission merchant, or a member of a contract market.

<sup>12</sup> See CSE Rule 11.9(u).

<sup>13</sup> See Proposed Rule 11.9(i)(2). The CSE notes that with regard to matched like-priced orders delivered to CSE by Users, such like-priced orders are executed on CSE's OTC-UTP System at the moment in time (as captured by the User's system time stamp) that the matched like-priced orders are sent to CSE.

<sup>14</sup> See Proposed Rule 11.9(l).

<sup>15</sup> See Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322 (April 5, 1996).

<sup>16</sup> *Id.*

<sup>17</sup> See Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2001) (emphasis added).

when Nasdaq becomes an exchange. Nasdaq market makers may execute customer orders without regard to other Nasdaq bids, offers, displayed customer orders, and without being executed through a Nasdaq system. Nasdaq believes that its model promotes competition among various market participants while balancing the fundamental values necessary for the protection of investors. As stated by Nasdaq, "[i]n the real world of investor needs, price is not a simple issue. In most cases, size and immediacy are also a consideration, and the most efficient execution may not take place at the inside."<sup>18</sup>

The Commission affirmed this model in its recent approval of Nasdaq's SuperMontage system.<sup>19</sup> SuperMontage is a Nasdaq system that provides for the enhanced display of quotes and orders combined with certain execution functionalities based upon multiple priority algorithms. Nasdaq believes that SuperMontage, "advances the fairness and efficiency of the handling of individual limit orders—without inhibiting the creativity of the competitive marketplace which serves the interests of all investors."<sup>20</sup> Nasdaq preserves its creativity by making SuperMontage voluntary. Nasdaq market makers holding customer orders do not have to place them into the SuperMontage order facility and may execute such orders at any price and at any time without regard to the time and price algorithms of SuperMontage (subject, of course, to the obligations of providing best execution).

In approving SuperMontage, the Commission noted that

Today most orders in Nasdaq securities are executed directly between Nasdaq participants, not using Nasdaq systems. No price/time priority rules apply to this trading, other than a market maker's duty to protect its customer limit orders before trading as principal. While price priority is generally honored as a market principle in executing orders outside of Nasdaq's systems, time priority is not accorded to quotes in this trading. Even after SuperMontage is implemented, many orders probably will be executed outside of SuperMontage free from time priorities.<sup>21</sup>

According to the NASD, only 26 percent of share volume and 36 percent of trades in Nasdaq are executed using

SOES and SelectNet.<sup>22</sup> This leaves approximately 70 percent of Nasdaq volume to be executed outside any price and time priority rules. The Commission has stated that, "[i]t is unlikely that market makers will enter customer market orders into SuperMontage rather than simply internalizing them directly."<sup>23</sup>

The question then is whether Nasdaq's exchange status, if approved, should require Nasdaq to change its general lack of price and time priority. Nasdaq certainly believes that no change is necessary. Nasdaq's proposed exchange rules do not create any price or time priorities separate and apart from the voluntary provisions of SuperMontage. The Commission, in publishing notice of Nasdaq's application for registration as an exchange, raised certain implications related to Nasdaq's separation from the NASD and its application to be an exchange.<sup>24</sup> While this list of implications likely was not intended to be exhaustive, the Commission did not raise whether Nasdaq should be required to impose price and time priority in order to become an exchange.

The CSE, however, brought this matter before the Commission in its comment letter on Nasdaq's exchange application.<sup>25</sup> The CSE emphasized that a competitive response to Nasdaq would be necessary. In filing its exchange rules without providing for general price/time priority and mandatory centralization of order interaction, Nasdaq apparently believes that the Commission will approve Nasdaq's decentralized market model. Similarly, the CSE is proposing its OTC-UTP System because CSE believes that its proposed market structure is both consistent with the federal securities laws and promotes competition and efficient execution practices for the ultimate benefit of public investors.

#### Regulatory Oversight

The Exchange will oversee the OTC-UTP System in the same manner and using the same techniques as used for trading through NSTS. Given the significance of Rule 12.10, Best Execution, in the operation of the OTC-UTP System, however, the Exchange is designing new automated exception reports to track unusual trading activity that may indicate a failure to provide best execution. The unusual trading activity review will include, but not be

limited to, a review of trades at prices inferior to preexisting bids, offers, and orders, particularly, trades inferior to public agency orders on the CLOB. The surveillance procedures should reduce the possibility of inadvertent mishandling of orders and should detect trading abuses that may be related to a denial of best execution. In addition, these regulatory measures should induce Users to generally honor price priority across all bids, offers, and orders, on the CSE, and thereby increase the likelihood of order interaction on the CSE.

The Regulatory Staff also will include in its annual examination of members a review of order handling and execution practices in light of the daily exception reports generated by the Exchange. The Exchange believes that its proposed regulatory measures exceed those applied by NASD Regulation to trading on Nasdaq and should assure the Commission that trading activity related to the OTC-UTP System will be performed in accordance with the just and equitable principles of trade as required by the Act.

#### 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with the provisions of section 6(b) of the Act,<sup>26</sup> in general, and section 6(b)(5) of the Act,<sup>27</sup> in particular, which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, 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.

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

The Exchange does not believe that the proposed rule change will impose 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*

The Exchange has neither solicited nor received written comments on the proposed rule change.<sup>28</sup>

<sup>18</sup> See letter from Richard Ketchum, President, NASD to Jonathan G. Katz, Secretary, Commission (May 22, 2000) ("Market Fragmentation Letter").

<sup>19</sup> See Exchange Act Release No. 43514 (November 3, 2000), 65 FR 69084 (November 15, 2000) ("SuperMontage Order").

<sup>20</sup> See Market Fragmentation Letter, *supra* note 18.

<sup>21</sup> See SuperMontage Order, *supra* note 19.

<sup>22</sup> *Id.*, at Note 222.

<sup>23</sup> *Id.*, at 26.

<sup>24</sup> *Supra* note 5 at 31953.

<sup>25</sup> See letter from Jeffrey T. Brown, General Counsel, CSE, to Jonathan G. Katz, Secretary, Commission (August 28, 2001).

<sup>26</sup> 15 U.S.C. 78f(b).

<sup>27</sup> 15 U.S.C. 78f(b)(5).

<sup>28</sup> The Commission received a comment letter from the Nasdaq and a response to the letter from the CSE. Both letters are available in the Commission's Public Reference Room. See letter from Richard G. Ketchum, President, Nasdaq, to Jonathan G. Katz, Secretary, Commission (January 9, 2002) and letter from Jeffrey T. Brown, Senior Vice

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(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 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 Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CSE-2001-04 and should be submitted by March 5, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>29</sup>

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

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45406; File No. SR-CSE-2002-01]

#### **Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Cincinnati Stock Exchange, Inc. Establishing a Fee Schedule for Nasdaq National Market Securities Transactions and Establishing a Revenue Sharing Program for Trading in Nasdaq National Market Securities**

February 6, 2002.

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> notice is hereby given that on January 25, 2002, the Cincinnati Stock Exchange, Inc. ("CSE" 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 CSE.<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**

The Exchange proposes to amend the Exchange's rules to establish a fee schedule for transactions in Nasdaq National Market securities ("Nasdaq NM Securities") and to establish a revenue sharing program to reflect recent developments in competitive business strategy. The text of the proposed rule change is available at the principal offices of the CSE 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 CSE included statements concerning the purpose of, and the 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. CSE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

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

<sup>3</sup> The CSE withdrew SR-CSE-2001-05 and replaced it with SR-CSE-2002-01 by letter. See letter from Jeffrey T. Brown, Vice President Regulation and General Counsel, CSE to Katherine England, Assistant Director, Division of Market Regulation, Commission (January 25, 2002).

#### *A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

##### **1. Purpose**

The Exchange is proposing two amendments to the Exchange rules governing transaction fees and market data revenue credits in keeping with recent trends in the securities industry.

The first amendment adds subsection (2) to CSE Rule 11.10(A)(e), ("Crosses and Meets"). Proposed subsection (2) establishes a fee schedule for transactions in Nasdaq NM Securities.

The second amendment creates an incentive for CSE members to trade Nasdaq NM Securities on the Exchange and will be codified as CSE Rule 11.10(A)(l) ("Tape 'C' Transaction Credit"). The Exchange believes the credit is a logical next step in its efforts to provide competitive exchange services to CSE members trading Nasdaq NM Securities. Under the Nasdaq program,<sup>4</sup> CSE member firms will receive a 75 percent (75%) pro rata transaction credit on all Nasdaq Tape C market data revenue generated by CSE member trading of Nasdaq NM Securities.

##### **2. Statutory Basis**

The proposed rule change is consistent with section 6(b) of the Act,<sup>5</sup> generally, and section 6(b)(5) of the Act,<sup>6</sup> in particular, in that it is designed to promote just and equitable principles of trade, and 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. The proposal also is consistent with section 6(b)(4) of the Act<sup>7</sup> in that it is designed to provide for the equitable allocation of reasonable dues, fees, and other charges among Exchange members by crediting CSE members on a pro rata basis.

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

The CSE does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

<sup>4</sup> Nasdaq NM Securities will be traded on CSE pursuant to section 12(f) of the Act as well as the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation, and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("Nasdaq-UTP Plan").

<sup>5</sup> 15 U.S.C. 78f(b).

<sup>6</sup> 15 U.S.C. 78f(b)(5).

<sup>7</sup> 15 U.S.C. 78f(b)(4).

President, Secretary and General Counsel, CSE, to Jonathan G. Katz, Secretary, Commission (January 24, 2002).

<sup>29</sup> 17 CFR 200.30-3(a)(12).