The Commission also agrees with the ISE that public customer bids (offers) on the Exchange at the time a facilitation order is executed that are priced higher (lower) than the facilitation price should be executed at the facilitation price. The Commission believes that this proposal will both protect public customer limit orders on the ISE's book and provide public customers with the benefit of price improvement through the facilitation mechanism. The Commission also believes that allowing the execution of higher bids and lower offers from non-customer orders and quotes by executing them at their stated price is reasonable. Accordingly, the Commission finds that the proposed amendment to ISE Rule 716(d)(4)(i) is consistent with Section 6(b)(5) of the Act [25] in that it promotes just and equitable principles of trade and facilitates transactions in securities by allowing the partial execution of a facilitation order at an improved price for the number of non-customer contracts available, while protecting public customer orders on the book by giving them the benefit of a better execution price.

The Commission also finds that the proposed amendments to ISE Rule 716(d)(4)(ii) are consistent with Section 6(b)(5) of the Act.[26] Under current ISE rules, a PMM is guaranteed certain participation rights in a facilitation order after public customer orders are executed and the facilitating EAM receives an allocation of 40 percent of the order. Amendment No. 1 eliminates the PMM's participation guarantee. Thus, any indication or quote by a PMM will be treated the same as other Crowd Participants' interest. The Commission believes that this proposed amendment is consistent with the public interest, and that it promotes just and equitable principles of trade by ensuring that market makers will be able to compete in a fair and equitable manner, based on the competitiveness of their quotes, for that portion of an order remaining after public customer interest and the EAM's facilitation guarantee.

The Commission finds good cause for approving this proposed amendment prior to the thirtieth day after date of publication of the notice of filing in the **Federal Register**. The proposed change to paragraph (d)(4)(ii) of ISE Rule 716 makes available to Crowd Participants a greater percentage of facilitation orders. [27] Specifically, this change ensures that, if a PMM is among the Crowd Participants with interest at the facilitation price, the PMM will be treated equally with all other Crowd Participants, rather than being ''guaranteed'' special participation rights. Because this amendment reduces the guarantees to PMMs, the Commission believes it will increase the opportunity for other participants in ISE to complete for order flow and finds that granting accelerated approval to the proposed amendments to ISE Rule 716(d)(4)(ii) in Amendment No. 1 consistent with Section 18(b)(2) Act. [28]

Finally, the Commission believes that ISE's proposed amendment to ISE Rules 716(d)(2) and (3) to clarity that members may enter indications into the facilitation mechanism at prices that improve the facilitation price, if such improved price is inferior to the ISE best bid or offer, is consistent with the Act. ISE's rules currently state that indications from Crowd Participants must be priced *at* the price of the order to be facilitated and must not exceed the size of the order to be facilitated. To facilitate the order at a price superior to the facilitation price, ISE's current rules require Crowd Participants to enter orders change their quotes, as applicable. The proposed amendment allows a Crowd Participant to enter an indication to facilitate an order at a price better than the facilitation price, but inferior to the ISE best bid or offer. Without this change, it would have been possible for a Crowd Participant to improve the facilitation price, but not be at the ISE best bid or offer. In this situation, only the PMM [29] would know about the improved price, creating the potential for PMM to benefit at the expense of the customer order being facilitated. For these reasons, the Commission finds that ISE's proposed amendment is consistent with Section 6(b)(5) of the Act [30]

The Commission also finds good cause for approving the proposed amendments of ISE Rules 716(d)(2) and (3) prior to the thirtieth day after the date of publication of notice of filing in the **Federal Register**. These proposed changes eliminate a potential avenue for abuse and ensure that a public customer order would receive the benefit of any price offered that is better than the facilitation price. Accordingly, the Commission believes that these proposed amendments do not significantly alter the original proposal, which was subject to a full notice and comment period and addresses the issued raised by commenters. Therefore, the Commission finds that granting accelerated approval to the proposed changes to ISE Rules 716(d)(2) and (3) in Amendment No. 1 is consistent with Section 19(a)(2) of Act. [31]

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, [32] that the proposed rule change (SR–ISE–00–03), including Amendment No. 1, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[33]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 00–13413 Filed 5–26–00; 8:45 am]

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[25] *Id.*

[26] *Id.*

[27] *See* Amendment No. 1, *supra* note 5.

[28] 15 U.S.C. 78f(b)(2).

[29] Under ISE's rules, only the PMM has access to all orders on the ISE book; not just the top of the book.

[30] 15 U.S.C. 78f(b)(5).

[31] 15 U.S.C. 78f(b)(2).

[32] *Id.*

[33] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42808; File No. SR–ISE–00–01]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 by the International Securities Exchange LLC Relating to Market Maker Allocations

May 22, 2000.

I. Introduction

On February 25, 2000, the International Securities Exchange LLC (''ISE'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change relating to its proposed market maker allocation algorithm.

The proposed rule change was published for comment in the **Federal Register** on March 6, 2000.[3] The Commission received three comment letters regarding the proposal.[4] On May 19, 2000, the ISE filed Amendment No.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 42473 (February 29, 2000), 65 FR 11818.

[4] *See* letters to Jonathan G. Katz, Secretary, SEC, from Holly H. Smith, Sutherland, Asbill & Brennan LLP, dated March 24, 2000 (''SA&B Letter''); Peter J. Chepucavage, Fulbright & Jaworski L.L.P., dated March 28, 2000 (''Phlx Letter''); and Charles J. Henry, President and Chief Operating Officer, Chicago Board Options Exchange, dated March 31, 2000 (''CBOE Letter'').

1 to proposed rule change.[5] This order approves the proposed rule change. In addition, the Commission is publishing this notice to solicit comments on Amendment No. 1 and is simultaneously approving Amendment No. 1 on an accelerated basis.

II. Description of the Proposal

ISE Rule 713(d) provides that public customer orders at a given price have priority. ISE Rule 713(e) provides that, if there are two or more non-customer orders or market maker quotations at the Exchange's inside market, after filling all customer orders at that price, executions will be allocated between the non-customer orders and market maker quotations ''pursuant to an allocation procedure to be determined by the Exchange from time to time. * * *'' ISE Rule 713(e) also states that if the PMM is quoting at the Exchange's inside market, it will have precedence over non-customer orders and CMM quotes for execution of orders that are up to a specified number of contracts. The ISE is proposing to establish its allocation procedure for non-customer orders and market maker quotations, and to define the size of orders for which the PMM has priority.

According to the ISE, the allocation procedure is a trading algorithm programmed in the ISE's electronic auction market system (''System'') that determines how to split the execution of incoming orders among professional trading interests at the same price. All public customer orders at a given price are executed fully before the trading algorithm is applied. Moreover, because the algorithm is applied automatically by the System upon the receipt of an executable order, only those non-customer orders and market maker quotes that are in the System participate in the algorithm. The ISE represents that, subject to the PMM's participation rights discussed below, the allocation of executions to non-customer orders and market maker quotes is based on the size associated with the order or quote relative to the total size available at the execution price.

The ISE is also proposing certain participation rights for PMMs. If the PMM is one of the participants with a quote at the best price, it has participation rights equal to the greater of (1) the proportion of the total size at the best price represented by the size of its quote, or (2) 60 percent of the contracts to be allocated if there is only one other non-customer order or market maker quotation at the best price, 40 percent if there are two other non-customer orders and/or market maker quotes at the best price, and 30 percent if there are more than two other non-customer orders and/or market maker quotes at the best price. In addition, the PMM has precedence to execute orders of five contracts of fewer if it is quoting at the best price. The proposal provides that the PMM cannot receive any portion of an allocation unless it is quoting at the best price at the time the System receives the executable order. Moreover, the size associated with the PMM's quote must be sufficient to fill the portion of the order that would be allocated to it according to the participation rights.

The Exchange proposes to implement the PMM five contract preference as a one-year pilot program.[6] During that time, ISE proposes to evaluate what percentage of the volume executed on the Exchange, excluding volume resulting from the execution of orders in the facilitation mechanism, is comprised of orders for five contracts or fewer executed by PMMs, and will reduce the size of the orders included in this provision if such percentage is over 40 percent.[7] In addition, during this pilot period, ISE proposes to provide certain data to the Commission on a quarterly basis, with respect to OCC cleared transaction: (1) The percentage of volume executed on the Exchange (excluding facilitation orders) that results from the execution of orders of five contracts or fewer (''Five Contract Volume''); (2) the percentage of Five Contract Volume executed by PMMs; (3) the ratio of PMM and CMM trades; and (4) the ratio of the PMM contract volume divided by the total of PMM and CMM contract volume.[8]

III. Summary of Comments

The Commission received three comment letters on the proposal.[9] These commenters opposed ISE's proposed rule change, as originally proposed. The commenters argued that the ISE's proposed allocation algorithm would discourage competition among market participants by requiring that other market makers and non-customers be quoting at the best bid or offer on ISE to participate in the execution of an incoming order. Thus, ISE Rule 713 would allow a PMM to trade with 100 percent of an incoming order when it was along at the ISE's best bid or offer.[10] In addition, commenters asserted that the algorithm would permit a PMM to internalize order flow by giving PMMs at the best bid or offer an absolute right to trade against all orders of five contracts or fewer.[11] Commenters characterize this proposed guarantee as essentially a small order referencing rule giving PMMs a distinct economic advantage over all other non-customer trading interest entered into the ISE. In connection with the proposed allocation procedure, the commenters argued that these rules build an infrastructure for percentage and crossing, and guarantee that the orders routed to ISE will not be exposed to the level of price competition necessary to protect the public interest.[12]

Commenters also disagreed with ISE's characterization of five contracts as an ''odd lot,'' noting that five contracts represent 500 shares of underlying stock and that orders of five contracts or fewer constitute a significant portion of all portion of all options order flow.[13] According to commenters, the proposed five contract precedence for PMMs will result in referencing arrangements, internalization, and payment for order flow to attract these low-risk orders, and is anticompetitive because it reduces incentives for other market makers to quote aggressively due to their inability to attract these smaller orders.[14]

In response to commenters' objections, the ISE notes that the percentage of an order that a PMM executes is uncertain from the outset, and far from a ''guarantee.'' [15] Instead, the allocation is dependent on the number of public customer orders, the price and size of the PMM's quote, and

[5] *See* letter from Katherine Simmons, Vice President and Associate General Counsel, ISE, to Deborah Flynn, Senior Special Counsel, Division of Market Regulation, SEC, dated May 19, 2000 (''Amendment No. 1''). In Amendment No. 1, the ISE requests that the Commission approve its proposal with respect to its proposed five contract preference as a one-year pilot program. Consistent with this request, the ISE proposes to revise paragraph .01(c) of Supplementary Material to ISE Rule 713 to require that the ISE provide the following information to the Commission on a quarterly basis, with respect to OCC cleared transactions: (1) The percentage of volume executed on the Exchange (excluding facilitation orders) that results from the execution of orders of five contracts or fewer (''Five Contract Volume''); (2) the percentage of Five Contract Volume executed by Primary Market Makers (''PMMs''); (3) the ratio of PMM trades to the total of PMM and Competitive Market Maker (''CMM'') trades; and (4) the ratio of PMM contract volume to the total of PMM and CMM contract volume.

[6] *See* Amendment No. 1, *supra* note 5.

[7] *Id.*

[8] *Id.*

[9] *See* note 4, *supra.*

[10] *See* CBOE Letter.

[11] *See* SA&B Letter, Phlx Letter; CBOE Letter.

[12] *Id.*

[13] *See* CBOE Letter.

[14] *Id.*

[15] *See* letter to Jonathan G. Katz, Secretary, SEC, from Katherine Simmons, Vice President and Associate General Counsel, ISE, dated May 19, 2000 (''ISE Response Letter'').

the number of non-customers competing with the PMM at the same price. The ISE argues that, contrary to the commenters' characterization of an absolute ''guarantee,'' the algorithm provides only that if an order is not completely executed after public customer orders are executed, the PMM has preference as to the balance, but only if quoting at the best price and only if it has displayed sufficient size. Thus, according to the ISE, a PMM must be competitive on price in order to receive any allocation, and must be competitive on size—otherwise its allocation is limited by the size associated with its quote.[16]

Similarly, the ISE argues that the commenters' assertions that the PMM preference as to orders of five contracts or fewer will lead to decreased competition for small orders, preferencing, internalization, and payment for order flow is erroneous because it is based on the flawed premise that this preference is an ''exclusive right'' and absolute ''guarantee.'' [17] The ISE further claims that preferencing and payment for order flow arrangements are unlikely because orders for five contracts or fewer are expected to constitute only a small percentage of order flow.[18] Moreover, the ISE maintains that because its market is based on intramarket price and size competition and incoming orders are executed automatically, market participants, including the PMM, would not have the opportunity to know the size of an incoming order, nor would market participants know whether the PMM would be quoting at the best with sufficient size.[19]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether the proposed amendment 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the ISE. All submissions should refer to File No. SR–ISE–00–01 and should be submitted by June 20, 2000.

V. Discussion

After careful review, the Commission 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 exchange.[20] In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act.[21]

Under Section 6(b)(5) of the Act, a registered national securities exchange must have rules that are 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 is 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.

The Commission finds that ISE's proposed amendments to Supplementary Material .01 to ISE Rule 713 are consistent with Sections 6(b)(5) of the Act.[22] The Commission believes that ISE's proposed amendment to the commentary to ISE Rule 713 establishing its algorithm governing the allocation of orders to market participants, including PMMs, is reasonable. Moreover, because PMMs, like specialists on floor-based options exchanges, perform important functions and undertake responsibilities greater than those of other market makers, the Commission believes it is reasonable for the ISE to choose to offer its PMMs an elevated level of participation rights like other options exchanges currently provide to their specialists.

Although the Commission recognizes that intramarket competition, as well as protection of public customers, could be compromised if such a participation right constituted an absolute guarantee or if it consumed too great a percentage of order flow, the Commission believes that the ISE's proposal sets forth reasonable safeguards against such potential harms. The ISE's proposal prioritizes public customer limit orders on the book. Indeed, if sufficient existing customer interest exists, a PMM might not receive *any* allocation of a given incoming order. Moreover, a PMM's participation is directly dependent on the competitiveness of the PMM's quote as well as the number of non-customers who have entered competitive quotes at the same price at the time an order is received by the market. In addition, the size of a PMM's quote is important, because a PMM's execution is limited by the size of its quote, regardless of any participation right that ISE's allocation algorithm would otherwise prescribe. The Commission believes that these limits on a PMM's participation right should assure reasonable protection for public customers and prevent impediments to a free and open market that might otherwise result from an absolute specialist guarantee.

The Commission further finds that the ISE's proposal to provide on a one-year pilot basis PMMs with a preference for orders of five contracts or fewer is consistent with Section 6(b)(5) of the Act.[23] The Commission acknowledges the potential competitive issues noted by commenters, and intends to use the one-year pilot period to monitor the rule's impact on competition. To assist the Commission in evaluating the pilot program, the ISE will provide four types of specific data to the Commission, on a quarterly basis and should allow the ISE to achieve its stated goal of limiting execution for five contracts or fewer by PMMs to 40 percent or less of total exchange volume (excluding facilitation orders).[24]

The Commission finds good cause for approving proposed Amendment No. 1 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission notes that Amendment No. 1 clarifies the proposed rule change and is responsive to the issues raised by commenters. By approving this proposal as a one-year pilot program and requesting certain statistics from the ISE on a quarterly basis regarding the volume of orders for five contracts or fewer executed by PMMs, the Commission should be able to adequately assess the operation of this proposal and determine whether the competitive issues raised by commenters pose a concern. Because Amendment No. 1 does not significantly

[16] *See* ISE Response Letter.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] In approving this rule, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[21] 15 U.S.C. 78f(b)(5).

[22] *Id.*

[23] *Id.*

[24] *See* Amendment No. 1, *supra* note 5.

alter the original proposal, which was subject to a full notice and comment period, and addresses the issues raised by commenters, the Commission finds that granting accelerated approval to Amendment No. 1 is consistent with Section 19(b)(2) of the Act.[25]

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[26] that the proposed rule change (SR–ISE–00–01), including Amendment No. 1, is approved, and that PMM five contract preference proposal contained in Amendment No. 1 is approved as a one-year pilot to expire on May 22, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[27]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 00–13414 Filed 5–26–00; 8:45 am]

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[25] 15 U.S.C. 78f(b)(2).

[26] *Id.*

[27] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–42806; File No. SR–NASD–99–33]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2 Relating to the Establishment of Trade and Quote Halt Authority for the National Association of Securities Dealers, Inc.'s Over-the-Counter Bulletin Board Service

May 22, 2000.

I. Introduction

On July 14, 1999, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), through its wholly-owned subsidiary, the Nasdaq Stock Market, Inc. (''Nasdaq'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission'') pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to establish trade and quote halt authority for the NASD's over-the-counter Bulletin Board Service (''OTCBB'').

The proposed rule change, including Amendment Nos. 1 and 2, was published for comment in the **Federal Register** on January 25, 2000.[3] No comments were received on the proposal. This order approves the proposal.

II. Description of the Proposal

The OTCBB is an NASD system which, pursuant to delegated authority, Nasdaq is responsible for operating. In the proposed rule change, the NASD and Nasdaq propose to expand Nasdaq's authority so that Nasdaq may impose quotation and trading halts in OTCBB securities when: (1) The OTCBB security or the securities underlying the OTCBB American Depository Receipt (''ADR'') is dually listed or registered and a foreign regulatory authority or market halts trading in the security; (2) the OTCBB security is a derivative or component of a security listed on Nasdaq, a domestic exchange, or foreign exchange/market (*e.g.,* a convertible security or warrant) and Nasdaq, the exchange, or foreign exchange/market halts trading in the underlying security; or (3) the OTCBB issues does not timely provide the NASD with information required by Rule 10b–17 under the Act.[4]

Currently, NASD Rule 4120 authorizes Nasdaq to impose trading halts in Nasdaq-listed securities and securities listed on a national securities exchange and traded in the third market. There are, however, no rules that grant Nasdaq authority to impose trading or quotation halts in OTCBB securities, Additionally, unlike the Nasdaq market, there is no listing agreement between Nasdaq and OTCBB issuers, and thus Nasdaq does not have the ability to compel such issuers to disclose information to Nasdaq. Accordingly, it is difficult for Nasdaq to unilaterally impose trade and quote halts in an OTCBB security because, in most cases, information from the issuer is necessary before the NASD can assess the situation and determine if a halt and/or resumption of trading is appropriate.[5] In light of the foregoing, the NASD and Nasdaq are proposing to vest Nasdaq with trade and quote halt authority as described below.

Foreign Regulatory Authority Halts. First, the NASD and Nasdaq are proposing to impose trading and quotation halts in OTCBB eligible securities [6] when a foreign market or regulatory authority has imposed a trade halt in the security in its open market for regulatory reasons. This authority would permit Nasdaq to impose a trade and quotation halt on an OTCBB security or OTCBB ADRs when a foreign market on which the OTCBB security is also traded, or a regulatory authority that has oversight authority for the OTCBB security, halts trading in the security or the security underlying the ADR for ''regulatory'' reasons. (Nasdaq currently has similar trading-halt authority for Nasdaq-listed securities.) [7] Under the proposal, upon receipt of information from a foreign securities market on which the OTCBB security or the security underlying the OTCBB ADR is listed or registered or from a regulatory authority overseeing such issuer, exchange, or market, Nasdaq's Stockwatch section will evaluate the information (generally, a trade-halt order issued by the foreign market or regulatory authority) and determine whether a trade and quotation halt in the OTCBB security is appropriate. Nasdaq will impose such a halt only when the foreign market or regulatory authority has imposed its halt because of potential fraudulent conduct or other public interest concerns. Nasdaq will not impose a halt if the foreign entity's halt is based on the dissemination of material news, an issuer's failure to meet regulatory filing requirements imposed by a foreign market or regulatory authority, or for operational reasons (*e.g.,* order imbalance in the foreign market). [8]

For this and the proposed halts described below, an OTCBB halt would be lifted if Nasdaq determines that the basis of the halt no longer exists or upon the passage of five trading days, which ever occurs first. [9] If quoting and trading

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 42345 (January 18, 2000), 65 FR 4002.

[4] 17 CFR 240.10b–17. For a description of the rule, *see* text accompanying notes 12 and 13 *infra.*

[5] Under Section 12(k) of the Act, the Commission may impose trading suspensions in the U.S. securities markets. *See* 15 U.S.C. 78*1*(k). Additionally, NASD Rule 3340 prohibits members from trading any security as to which a trading suspension is in effect. When the Commission suspends trading in an OTCBB security, Nasdaq announces the trading ban via the NEWS frame on the Nasdaq Workstation II and prohibits trading and quotations on the OTCBB.

[6] NASD Rules 6530 and 6540 impose certain regulatory filing requirements for securities to be included in the OTCBB.

[7] *See* NASD Rule 4120(a)(4).

[8] The NASD and Nasdaq do not proposed to halt for material news because Nasdaq does not have a formal listing agreement with OTCBB issuers, and thus cannot compel the full disclosure and dissemination of material news. The NASD and Nasdaq do not propose to halt trading if an issuer fails to meet filing or disclosure requirements imposed by a foreign regulatory authority or market, because Nasdaq would, in essence, be importing filing obligations of a foreign regulatory authority on OTCBB issuers when such requirements may not currently exist in the United States for such issuers. Lastly, the NASD and Nasdaq are not proposing to halt trading based on a foreign exchange's operational halt, such as an order imbalance, because Nasdaq generally does not halt for operational reasons.

[9] Of course, if an issuer failed to meet the eligibility requirements contained in NASD Rules