IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submission should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington DC 20549. Copies of the submissions, 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 5th Street, NW., Washington, DC 20549. Copies of such filings will also be available for inspection and copying at the principal office of PSE. All submissions should refer to file number SR–PSE–95–14 and should be submitted by June 15, 1995.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[7]

Jonathan G. Katz,

Secretary.

[FR Doc. 95–12925 Filed 5–25–95; 8:45 am]

BILLING CODE 8010–01–M

[7] 17 CFR 200.30–3(a)(12) (1994).

[Release No. 34–35751; File No. SR–NASD–94–62]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Limit Order Protection and Nasdaq

May 22, 1995.

On November 22, 1994, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed a proposed rule change with the Securities and Exchange Commission (''SEC'' or ''Commission'')[1] pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[2] and Rule 19b–4 thereunder.[3] The proposed rule change amends the NASD's Interpretation to Article III, Section 1 of the NASD Rules of Fair Practice (''Interpretation'')[4] to prohibit a member firm that accepts and holds an unexecuted limit order from its own customer or from a customer of another member in a Nasdaq security from trading ahead of the customer's limit order—that is to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order—unless it also executes that limit order.

Notice of the proposed rule change, together with the substance of the proposal as initially filed, was provided by issuance of a Commission release (Securities Exchange Act Release No. 35122, Dec. 20, 1994) and by publication in the **Federal Register** (59 FR 66389, Dec. 23, 1994, ''Release 34–35122''). Two comment letters were received.[5]

On February 15, 1995, the NASD filed Amendment No. 1 with the Commission. Amendment No. 1 clarified that the ''terms and conditions'' exception to the Interpretation applies only to limit orders from institutional accounts, as defined in Article III, Section 21(c)(4) of the NASD Rules of Fair Practice,[6] whether such limit orders originate with a firm's own customers or are sent to it for execution by another member firm.

Notice of the proposed rule change, as amended, together with the substance of the proposal, was provided by issuance of a Commission release (Securities Exchange Act Release No. 35391, Feb. 16, 1995) and by publication in the **Federal Register** (60 FR 9878, Feb. 22, 1995, ''Release 34–35391''). No comment letters were received in response to Amendment No. 1.

On March 7, 1995, the NASD filed Amendment No. 2 with the Commission. Amendment No. 2 amended the proposed rule change to extend the ''terms and conditions'' exception to the Interpretation to limit orders for 10,000 shares or more, unless such orders are less than $100,000 in value, as well as to limit orders from institutional accounts.

Notice of the proposed rule change, as amended, together with the substance of the proposal, was provided by issuance of a Commission release (Securities Exchange Act Release No. 35454, Mar. 8, 1995) and by publication in the **Federal Register** (60 FR 13199, Mar. 10, 1995, ''Release 34–35454''). One comment letter was received in response to Amendment No. 2.[7] This order approves the proposed rule change.

I. Introduction and Background

Last year, the NASD submitted to the Commission a proposed Interpretation to its Rules of Fair Practice to prohibit member firms from trading ahead of their customers' limit orders in their market making capacity.[8] The Commission approved the NASD Interpretation on June 29, 1994, but expressed concern that the prohibition did not extent to trading ahead of limit orders of other firm's customers that have been sent to the market maker for execution.[9] In fact, the Commission's Division of Market Regulation, in its Market 2000 Study, previously had examined this practice and recommended that a ban apply to trading of all customer limit orders, not just those of a firm's own customer.[10] The Study noted that the adverse effects of trading ahead exist whether the customer's order is handled by the customer's firm or by another market maker.[11]

Upon Commission approval the NASD Interpretation, the NASD convened a special task force (''Task Force'') to study the potential effect of expanded limit order protection on market liquidity and market maker capital commitment and to report to the NASD Board of Directors in September 1994. At the time, the Commission

[1] On February 15, 1995, the NASD filed Amendment No. 1 with the Commission on March 7, 1995 the NASD filed Amendment No. 2 with the Commission. *See infra* notes 6–7 and accompanying text.

[2] 15 U.S.C. 78s(b)(1).

[3] 17 CFR 240.19b–4.

[4] *NASD Manual,* Rules of Fair Practice, Art. III, Sec. 1 (CCH) ¶ 2151.07.

[5] *See* Letter from James T. Halverson, Esq., Shearman & Sterling, on behalf of Herzog, Heine, Geduld, Inc. (''Herzog'') to Jonathan G. Katz, Secretary, SEC, dated January 12, 1995 (''January Herzog Letter''); and Letter from James F. Duffy, Executive Vice President and General Counsel, Legal & Regulatory Policy, American Stock Exchange (''Amex'') to Jonathan G. Klatz, Secretary SEC, dated January 18, 1995 (''Amex Letter'').

[6] *NASD Manual,* Rules of Fair Practice, Art. III, Sec. 21 (CCH) ¶ 2171.

[7] *See* Letter from James T. Halverson, Esq., Shearman & Sterling, on behalf of Herzog, to Jonathan G. Katz, Secretary, SEC, dated March 27, 1995 (''March Herzog Letter'') (the January Herzog Letter and the March Herzog Letter are referred to collectively as ''Herzog Letters'').

[8] Securities Exchange Act Release No. 33697 (March 1, 1994), 59 FR 10842 (March 8, 1994).

The Commission first addressed the issue of customer limit order protection in the Nasdaq market in the co-called *Manning* decision in 1988. In that decision, the Commission affirmed, based on principles of agency law, an NASD determination that it is inconsistent with just and equitable principles of trade for a market maker to trade ahead of a customer limit order unless the customers is first informed of the firm's limit order policy. *See In re E.F. Hutton & Co.* (the so-called ''*Manning* decision''), Securities Exchange Act Release No. 25887 (July 6, 1988), 41 SEC Doc. 473, appeal filed *sub nom Hutton & Co. Inc.* v. *SEC,* Dec. No. 88–1649 (D.C. Cir. Sept. 2, 1988), (Stipulation of Dismissal Filed, Jan. 11, 1989).

[9] Securities Exchange Act Release No. 34279 (June 29, 1994), 59 FR 34883 (July 7, 1994) (''Release 34–34279'').

[10] Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (''Market 2000 Study''), V–8 (1994).

[11] *Id.*

stated that while such a study could be helpful to future consideration of this issue, the Commission believed that member-to-member trades raise significant concerns that should be addressed and, if necessary, the Commission would consider instituting its own rulemaking proceeding for that purpose.[12]

The Task Force's report (''Task Force proposal'') recommended that market makers be prohibited from trading ahead to customer limit orders only when such trades occurred at prices superior to the limit order price. The NASD Board of Directors reviewed the Task Force Proposal and proposed for member comment on amended proposal that would have restricted a market maker from trading ahead of a customer limit order at a price equal to or better than the price of the customer limit order if the size of that order was 1,000 shares or less, and from trading to prices better than a customer's limit order if the size of that order was greater than 1,000 shares (''Board Proposal'').[13]

The Commission then published for comment its own proposed rule to prohibit any market maker in Nasdaq National Market securities from trading ahead of the orders of other firms' customers sent to it for execution without regard to the size of the order (''Commission Proposal'').[14] The Commission wished to solicit public comment on alternatives that would provide more extensive limit order protection for public customers than those alternatives that the NASD had then proposed. The Commission also was motivated in part by a desire to solicit comment from public investors and non-NASD members.

II. Description and Scope of the Proposed Rule Change

The rule change we are considering today provides that a member firm cannot accept a customer[15] limit order in a Nasdaq security and continue to trade that security for its own account at prices that would satisfy the customer limit order without filing that order at the limit order price or a price more favorable to the customer. The Interpretation no longer distinguishes between customer limit orders accepted from a member's own customer and customer limit orders sent to it for execution from another member (so-called ''member-to-member'' limit orders). In either situation, such ''trading ahead'' activity would constitute a violation of just and equitable principles of trade.

The NASD requested that the Commission allow the rule change to be implemented on a phased-in-basis. During the time period between the rule's adoption and September 1, 1995, member-to-member limit orders that are greater than 1,000 shares would be protected when the member firm accepting the order trades for its own account at prices that are superior to the limit order price, but not at prices equal to the limit order price. The NASD requested the phase-in-period to provide NASD member firms an opportunity to adjust their order handling procedures for orders over 1,000 shares to the requirements of the Interpretation and to reassess their existing revenue structure.

The rule change also amends the Interpretation by limiting the ''terms and conditions'' exception of the Interpretation to: (a) limit orders from ''institutional accounts'' as that term is defined in Article III, Section 21(c)(4) of the Rules of Fair Practice (''institutional orders''),[16] regardless of whether such institutional orders come from a firm's own customers or are member-to-member limit orders; and (b) limit orders from accounts other than institutional accounts (''retail orders'') if the order is for: (i) 10,000 shares or more; and (ii) has a value of $100,000 or greater (''institution-sized retail orders.'').[17] The rule change does not permit a market maker to accept and hold other retail orders subject to terms and conditions, but does permit a market maker to accept and hold an institutional order subject to terms and conditions even if that order is for less than 10,000 shares or is less than $100,000 in value.

The NASD's rule would continue to permit a market maker to charge its customers or an order entry firm commissions or commission equivalents for handling a limit order, provided those charges previously are disclosed in a clear fashion to the customer, and provided those charges otherwise comply with applicable law.[18] Furthermore, an individual Nasdaq market maker is not obligated to accept any limit orders and is not required to accept limit orders from any particular customer.[19]

III. Summary of Comments

As noted above, the Commission received three comment letters (one commenter two letters) concerning the rule change. These comment letters raised the same types of arguments that were raised in comment letters received on the Commission Proposal.

A. Amex Letter

The Amex Letter addressed three aspects of the rule proposal. First, Amex stated that broker-dealers should be included within the universe of customers entitled to the benefits of limit order protection in the Nasdaq market.[20] Amex reasoned that options market makers, for example, would not be able to hedge their positions in listed options on Nasdaq stocks efficiently if broker-dealers are not protected by the Interpretation.

Second, the Amex Letter requested that the NASD elaborate on the terms and conditions that a market maker is permitted to impose, with a view to guarding against discrimination among customers. As noted above, the rule change was amended after the Commission received the Amex Letter to permit a market maker to negotiate limit order terms and conditions only with respect to institutional orders and institution-sized retail orders, and the rule change specifies that any terms and conditions under which institutional

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[12] Release 34–34279, *supra* n. 9.

[13] *See* Special NASD Notice to Members 94–79 (September 23, 1994).

[14] Securities Exchange Act Release No. 34753 (Sept. 29, 1994), 59 FR 50867 (Oct. 6, 1994) (''Release 34–34753'') (proposing 17 CFR 240.15c5–1).

[15] Article II, Section 1(f) of the NASD Rules of Fair Practice defines ''customer'' to exclude a broker or dealer. *See NASD Manual,* Rules of Fair Practice, Art. II, Sec. I (CCH) ¶2101.

[16] An ''institutional account'' is defined as an account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment company; (2) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b–3; or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million. *NASD Manual*, Rules of Fair Practice, Art. III, Sec. 21 (CCH § 2171.

[17] The value of a limit order is calculated by multiplying the price per share specified in that order by the number of shares specified in the order. Thus, the value of a limit order does not include any markup, markdown, commission, commission equivalent, sales credit or other internal credit.

[18] *See* Release 34–35391. Article III, Section 4 of the NASD Rules of Fair Practice states in part that, if a member acts as agent for a customer in any transaction, the customer shall not be charged more than a fair commission or service charge, taking into consideration all relevant circumstances. *See also* NASD Regulatory & Compliance Alert, Vol. 7, no. 4 (December 1993) at 1.

[19] *See* Release 34–34279, *supra* n. 9; Market 2000 Study, *supra* n. 10, at V–8–9.

The Commission notes that Sections 15A(b)(6) and 19(b)(2) of the Act, 15 U.S.C. §§ 78o–3(b)(6), 78s(b)(2), together require, among other things, that a rule change approved by the Commission not be designed to permit unfair discrimination between customers. The Commission expects that the NASD will exercise its oversight authority to ensure that market makers do not refuse to accept certain limit orders in a manner that unfairly discriminates among customers.

[20] Broker-dealers are not deemed to be customers for purposes of the NASD Rules of Fair Practice. *See supra* n. 15.

orders or institution-sized retail orders are accepted must be made clear to customers at the time an order is accepted.

Third, Amex expressed a concern regarding the scope of the limit order protection proposed, stating that the protection afforded by the Interpretation was not an extensive as that provided by exchange markets. Amex recommended that the Interpretation be extended to trigger limit order protection whenever a Nasdaq market making firm executed a trade in any firm account or for any person associated with the firm, rather than limiting the Interpretation to trades executed in a market making account. The Amex Letter also noted that the rule change would entitle a customer only to an execution at the limit price, and not to a better price that a market maker might have obtained by trading ahead. Amex recommended amending the rule change to require market makers to execute a limit order at a price better than the limit price if obtainable, in accordance with principles of agency law.

B. Herzog Letters

Herzog opposed the rule change, asserting that it is wholly unsuited to the nature of the Nasdaq market. Herzog stated that much market making activity on Nasdaq is carried out by wholesale firms, who do not conduct a retail business. The sole source of revenue for these firms is the ''spread'' between their bid and their ask. Herzog noted that wholesale firms must provide the capital to maintain inventories in each stock in which they make markets.

Herzog asserted that if the rule change is approved, market makers would be required to fill limit orders to sell (or buy) stocks at the same price at which they buy (or sell) for their own account. Sophisticated traders would use limit orders to buy and sell stocks at the same price as market makers, without incurring the obligations of market makers. Herzog asserted that market makers would be able to recover their costs only if they widened spreads or increased fees for traders who do not enter limit orders. The impact of the increased fees and widened spreads would fall disproportionately on less sophisticated investors who continue to use market orders and who would continue to pay the spread.

Although Herzog stated that the rule would cause spreads to widen, it also asserted that the rule change would artificially restrict dealers from recovering a competitive ''spread'' in relatively illiquid stock, causing reduced liquidity for those stocks. This, in turn, would disproportionately harm small issuers. Herzog also predicted reduced liquidity for more liquid stocks, because dealers would be less willing to commit capital when institutions wish to move blocks of stock that the market cannot accommodate. Herzog asserted that by imposing limit order obligations on market makers, the rule change would restrict market makers' ability to dispose of the stock acquired in such transactions. The January Herzog Letter also claimed that the rule change would reduce liquidity by reducing a market maker's ability to charge different prices for different transactions—market makers would be less willing to trade in between the spread for certain customers because the transactions would impose costly limit order obligations upon those market makers.

Herzog also forecasted that the rule change would lead to increased concentration of market makers, because vertically integrated firms, unlike wholesale firms, possess the greatest ability to directly charge customers higher commissions, markups or other fees to compensate for the loss of spread income. It stated that less sophisticated customers would be adversely affected by these changes. Herzog predicted that those market makers who cease making markets would continue to trade for their own account without incurring the obligations that a market maker must undertake.

Herzog also asserted that the rule change violated the statutory criteria imposed under the Act.[21] It asserted that the rule change would undermine competition and harm customers because it would reduce competition among different types of markets to obtain listings from companies and among market makers to fill orders, and would reduce the ability of small issuers of stock to raise capital by having their less liquid shares trade at competitive prices on Nasdaq. As an alternative, Herzog recommended that the NASD permit market makers to establish a minimum spread and fully disclose to customers a suitable net price at which they would execute limit orders.[22]

Herzog stated that the terms and conditions exceptions were unduly limited.[23] It stated that many professional investment funds do not qualify as institutional accounts as defined in Article III, Section 21(c)(4). Herzog stated that these funds are no less sophisticated or in need of protection than are accounts that meet the terms of the definition. Herzog also believes that the exception for institution-sized retail orders will protect parties beyond the small retail investors that the NASD wishes to protect. Herzog stated that the NASD will need to monitor carefully to ensure that a single large order is not broken up into multiple orders that qualify for limit order protection.

IV. Discussion

The Commission believes that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the NASD and, in particular, Sections 15A(b)(6), 15A(b)(9) and 11A(a)(1)(C) of the Act. 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 and 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. Section 15A(b)(9) requires that the rules of the association not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Section 11A(a)(1)(C) (i) and (iv) sets forth the objectives of assuring economically efficient execution of securities transactions and the practicability of brokers executing investors' orders in the best market.[24]

[21] Herzog claims that the rule change would violate, *inter alia,* Section 6(b)(5) of the Act, 15 U.S.C. § 78f(b)(5) (requiring that the rules of national securities exchanges not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers); and Section 15A(b)(9) of the Act, 15 U.S.C. § 78o–3(b)(9) (requiring that the rules of registered securities associations not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act).

The Commission notes that Section 6(b) of the Act is inapplicable to the rules of the NASD, which is not a national securities exchange. However, Section 15A(b)(6) of the Act, 15 U.S.C. § 78o–3(b)(6), imposes requirements upon NASD rules that are virtually identical to those imposed upon the rules of national securities exchanges by Section 6(b)(5).

[22] Herzog did not address whether a rule establishing a minimum spread would violate Section 15A(b)(6) of the Act, which requires, *inter alia,* that NASD rules not be designed to fix minimum profits or to impose any schedule or fix rates of commission, allowances, discounts or other fees to be charged by NASD members.

[23] *See* March Herzog Letter.

[24] Although the Commission is required to evaluate the proposed rule change for consistency with Section 15A of the Act, the Commission believes the goals of Section 11A are equally served by this proposed rule change.

A. Enhanced Limit Order Protection

The Commission recognizes that prior to adoption of the Interpretation in June 1994, the practice of Nasdaq market makers trading ahead of their customers' limit orders was widespread and longstanding. These practices generally are not in the interests of customers. The Interpretation is approved in June 1994 recognized the need to enhance customer limit order protection on Nasdaq. The current proposed rule change fosters fair and open markets and investor protection by extending limit order protection for investors to member-to-member trades.

Market makers argue that extending customer limit order priority to member-to-member orders would deny market makers their customary compensation for being at risk. It is not clear, however that the risk associated with market making in Nasdaq securities requires compensation derived from trading ahead of the customer. Market makers will continue to be able to derive trading profits in executing orders, including limit orders, and are entitled to receive compensation for handling limit orders, provided that the method of compensation chosen is clearly disclosed to the customer, such as by charging a commission for handling the limit order. Accordingly, the Commission believes that extending the prohibition against the practice of trading ahead of customer limit orders to member-to-member trades will not result in a ''mass exodus'' of market makers from Nasdaq. Indeed, experience with customer limit order priority since last June suggests that such concerns are overstated. Firms that refuse to accept limit orders because they may not trade ahead of such orders may find their customers gravitating toward other firms that are willing to provide limit order protection.

The Commission also believes that disclosure is not an adequate remedy for the practice of trading ahead of customer limit orders. In a typical agency relationship, disclosure often is relied upon as an adequate means of resolving a conflict of interest between an agent and its principal.[25] Investors enjoy greater protection under the federal securities laws, however, than that afforded by common law; a general common law remedy of disclosure does not always suffice.[26] A stricter duty may be imposed where, as here, the principals are investors and the agents control access to the trading market. The NASD already has recognized this obligation in the context of customer limit order priority for a member's own customers. The NASD also has a similar prohibition that applies to its members trading in the third market.[27]

Disclosure does not protect the interests of many customers affected by trading ahead. The cost of the customer each time a market maker fails to execute a customer's limit order it is holding is not removed by disclosure. A customer cannot receive the most timely execution or best price if the dealer handling the customer's order trades at superior prices without executing the limit order. The broker trading ahead of a public limit order is competing with public customers for an execution. To derive any benefit from disclosure, a customer must find a broker that will route orders to market makers that do not trade ahead of customer limit orders. Because the practice of market makers trading ahead of customer limit orders sent to them form other market makers is widespread in the over-the-counter market, the choices of market makers are limited.[28]

In extending customer limit order priority to member-to-member trades, the Commission does not intend to suggest that trading of Nasdaq securities must conform to all auction market principles.[29] Nevertheless, just as the Commission believes that the dealers in exchange-listed securities must adhere to certain minimum standards with respect to order handling procedures, it also believes that market makers in Nasdaq securities should adhere to certain minimum standards of fair treatment of customers.

The Commission believes that certain current Nasdaq limit order practices have created confusion in the minds of investors and are inconsistent with the growth and maturity of the Nasdaq market. The Commission believes that a customer's limit order should be protected from trading ahead regardless of whether that order is entered in an auction or dealer market, and regardless of whether the order accepted and handled by the firm is that of the firm's own customer or is a member-to-member limit order.

The Commission recently stated that it is reasonable for customers to expect that the quality of the execution received will not vary from trade to trade.[30] NASD rules currently allow the quality of the execution of a customer limit order to vary depending on whether the customer's firm or an affiliate makes a market in a security or whether that firm sends the order to another market maker for execution. The rule change approved today will assure that the quality of execution of customer limit orders will not depend upon whether the agency chosen by a customer to handle its limit order also makes a market in a security in which that customer is interested.

The Commission believes that the rule change will improve significantly the timeliness of customer executions. By providing a customer's limit order priority over the market maker's propriety trading, more trade volume will be available to be matched with the customer's order, resulting in quicker and more frequent executions for customers. More expeditious handling of customer limit orders will, in turn, provide all investors with a more accurate indication of the buy and sell interest at a given moment. The rule change also will encourage dealers to execute customer limit orders promptly so that they may continue their proprietary trading activities.

The rule change also will improve the price discovery process in Nasdaq securities. Limit orders contribute to price discovery by disclosing preferred customer trading prices and by tightening the spread between the bid and ask price of a security. In the past, customers may have refrained from placing limit orders because of the uncertainty of and difficulty in obtaining an execution for such orders until the inside price reached the limit order price. The practice of delaying executions until the inside price reaches the customer's limit order price also impedes price discovery by artificially delaying or preventing execution and reporting of customer limit orders.

Customers also incur costs in terms of inferior or missed executions for limit orders when a market maker delays execution of customer limit orders until the inside price reaches the customer's limit order price. The rule change approved today enhances the ability of customers to monitor the cost of a

[25] Market 2000 Study, *supra* n. 10, at V–8.

[26] *See, e.g., Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 389 (1983) (''An important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protection by establishing higher standards of conduct in the securities industry.'').

[27] Third market dealers operate similarly to Nasdaq market makers. The NASD's rules already prohibit trading ahead of customer limit orders in the third market. *NASD Manual,* Schedules to the By-Laws, Schedule G, Section 4(f) (CCH) ¶ 1921. Despite this prohibition, statistics compiled by the Consolidated Tape Association indicate that third market dealers currently account for better than 10% of listed stock orders as a percentage of share volume.

[28] Unlike institutional customers, most retail customers do not submit orders of a character which enables them to negotiate effectively execution parameters.

[29] Market 2000 Study, *supra* n. 10, at V–9.

[30] Release 34–34753, *supra* n. 14.

transaction and choose a broker-dealer on that basis.[31] This imposes a competitive discipline on market makers to achieve the best possible execution for customers or risk losing business. Unlike institutional clients who are in a better position to negotiate their own protection with market makers, public customers have less viable alternatives in determining where their orders are ultimately sent for execution. The rule change provides market makers with a necessary incentive to provide superior executions to public customers.

B. Scope of the Rule Change

The NASD has determined to extend limit order protection to Nasdaq SmallCap securities. The Commission Proposal also requested comment on including within the rule Nasdaq SmallCap securities and over-the counter Bulletin Board-eligible securities. Lehman recommended that the Commission Proposal be limited to Nasdaq National Market securities, because the markets for non-National Market securities are less developed.[32] Lehman stated that the adverse liquidity consequences of extending limit order protection to non-National Market securities is more severe. Nonetheless, there has not been any evidence offered to the Commission of adverse liquidity consequences caused by the limit order protection currently extended to Nasdaq SmallCap securities. Indeed, the Commission believes that the positive effects of increased trading volume from customer limit orders on liquidity will surpass the negative effect, if any, from lost market maker profits. Furthermore, the NASD has stated that it will evaluate carefully any impact the new Interpretation may have on market maker participation or market quality during the rule's phase-in period. Therefore, the Commission believes that the benefits of uniform treatment of customer limit orders for Nasdaq SmallCap securities outweigh speculative concerns about adverse liquidity consequences.

The Commission also does not believe it is necessary to amend the Interpretation to expressly trigger limit order protection whenever a Nasdaq market making firm executes a trade in any firm account or for any person associated with the firm. Although the Interpretation by its terms applies only to trades executed in a market making account, the Commission notes that the NASD interprets a member's best execution obligation to prohibit a market maker from knowingly trading ahead of a customer's limit order when it is not acting as a market maker in the security.[33]

The Commission is not persuaded that the rule is deficient because, as suggested by Amex, it does not guarantee a customer limit order a superior priced execution in the circumstance where a market maker trades for its own account at a price better than the customer's limit price.[34] The Interpretation will benefit the customer by requiring execution of the limit order if the market maker trades for its own account even if the limit price is inside the Nasdaq best bid and offer.[35]

The Commission also believes that it is appropriate to provide a ''terms and conditions'' exception for certain types of orders. As noted above, the rule change permits a market maker to accept and hold a customer limit order subject to terms and conditions only if it is an institutional order or an institution-sized retail order.

The rule distinguishes between retail orders and institutional orders because firms and institutions typically have developed business practices pursuant to which they negotiate the conditions under which their limit orders are to be handled. In approving the NASD's rule to prohibit member firms from trading ahead of their own customers, the Commission noted its agreement with an analysis provided in the Market 2000 Study that:

> Because most market makers cannot typically fill institution-size orders out of inventory, institutions generally only hold market makers to a ''best efforts'' standard in return for the willingness of the market maker to put up substantial capital to provide liquidity for large orders. In order to permit a member firm to employ the necessary trading strategy without being subjected to the requirements of the proposed ban, the Interpretation allows the parties to set the specific ''terms and conditions'' for acceptance of institutional orders.[36]

Given that most market makers cannot typically fill institution-sized retail orders out of inventory, the rule permits market makers to negotiate with retail customers the terms and conditions under which an institution-sized retail limit order is to be handled. This provision will permit customers to negotiate separate execution parameters with market makers on a trade-by-trade basis.

The terms and conditions exception is tailored to apply to limit orders which require market makers to employ special strategies to execute and to limit orders from customers who have the ability to monitor the market for the security and to negotiate alternative execution procedures with another market maker. The Commission believes that the 10,000 share/$100,000 threshold for institution-sized retail orders appropriately distinguishes between: (1) Those orders that do not require market makers to exhaust their inventory or commit large amounts of capital and those orders that do; and (2) customers who have the ability to negotiate effectively the execution parameters of their trades and those who do not.

Market makers must protect an institutional order unless they have negotiated specific terms and conditions regarding the order. As a general matter, all limit order should be entitled to limit order protection. The Commission recognizes, however, that market makers may require some flexibility with respect to larger orders and institutional investors. Accordingly, it is appropriate to permit market makers to negotiate specific terms and conditions for handling certain orders. The exception for institutional orders recognizes the ability of institutions to negotiate specific order handling procedures and their desire to have the ability to negotiate special procedures for orders of less than 10,000 shares or less than $100,000 in value. In this regard, the Commission notes that the NASD interprets the ''institutional account'' definition in Article III, Section 21(c)(4) of the NASD Rules of Fair Practice to apply to any account managed by a registered investment adviser.

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[31] Dealers may attempt to compensate for lost income with wider spreads or with higher commissions. Customers would be able to compare such charges among dealers. *See* Market 2000 Study, *supra* n. 10, at V–8–9.

[32] *See* Letter from Richard T. Chase, Senior Vice President and Chief Counsel, Lehman Brothers Inc. (''Lehman'') to Jonathan G. Katz, Secretary, SEC, dated November 16, 1994 (''Lehman Letter''). The Lehman Letter was submitted in response to the Commission Proposal.

[33] *See* Letter from Richard G. Ketchum, Executive Vice President, NASD to Holly H. Smith, Associate Director, Division of Market Regulation, SEC, dated March 31, 1995 (available in Commission's Public Reference Room). *See also* Special NASD Notice to Members 94–58, Answer to Question #11 (July 15, 1994) (''[i]t has never been the NASD's position that members can trade ahead of their customer's limit orders when not acting as a market maker.'').

[34] The Commission Proposal would require a superior priced execution in the circumstance where a market maker trades for its own account at a price better than the customer's limit order price. *See* Release 34–34753, *supra* n. 14.

[35] The Commission notes that a market maker may have executed a trade for its own account at a price better than the customer's limit price because the inside market has moved. Under these circumstances, the limit order may have become marketable. A market maker's best execution obligations in such circumstances may require the marker maker to execute the limit order at a price more favorable to the customer than the limit price.

[36] *See* Release 34–34279, *supra* n. 9.

Nonetheless, the Commission would be concerned if market makers uniformly attempt to negotiate the terms and conditions for execution of smaller-sized institutional orders in order to trade ahead of these orders. In addition, it may be appropriate to reconsider at a later date whether the proposed rule change approved today provides sufficient protection to market participants and, if necessary, to extend the scope of limit order protection beyond the classes of orders and customers protected by the rule change approved today.[37]

In this regard, the Commission also is sensitive to the concerns expressed by Amex about extending the protections envisaged by the rule to limit orders placed with Nasdaq market makers by other broker-dealers, including options specialists and registered options traders. The Commission recognizes the importance in terms of price discovery and market efficiency and liquidity for options specialists and market makers to have efficient and economical opportunities for laying off risk in the Nasdaq market.[38] Given that market makers can refuse to accept a limit order, and recognizing that the NASD could allow market makers the flexibility to negotiate terms and conditions for the handling of options market maker limit orders, the Commission questions why, once accepted, a market maker should not be required to protect that limit order. Accordingly, the Commission also expects the NASD to consider extending the scope of limit order protections to orders of options specialists and market makers.

C. Other Issues

Key to Herzog's objection to the rule change is its assertion that wholesale firms do not charge commissions and do not have the retail customer relationships that would permit them to charge commissions. The Commission notes that there are no legal impediments that prevent wholesale firms from charging commissions or establishing other clearly disclosed compensation arrangements with respect to limit order execution. Furthermore, Herzog neither asserted nor offered evidence to demonstrate that wholesale firms would be precluded from utilizing other methods, apart from widening spreads, to ensure that they are compensated for executing limit orders.

The Commission notes that market makers are not required to accept limit orders to buy at the bid or limit orders to sell at the offer. Market makers are not precluded from acting in an agency capacity by matching incoming limit orders with market orders. Indeed, the Commission notes that to the extent that market makers act in an agency capacity, their inventory and capital requirements are lessened.

The Commission also does not believe that market makers would be required to fill limit orders at spreads narrower than those naturally resulting from competition. As noted above, the Commission believes that limit order protection will enhance quote competition in the Nasdaq market; therefore, the rule change should facilitate narrower spreads that reflect a full range of competition. The Commission believes that limit orders will provide market makers with increased competition. Indeed, if market makers expanded their spreads beyond what was reasonable for a particular security, the rule approved today enhances the ability of customers to enter limit orders to improve the market.

The Commission also believes that the rule change approved will not have a significant deleterious impact upon market participation. The Commission notes that market makers who cease market making also must forego certain legal benefits available only to market makers.[39] Furthermore, as broker-dealers, these market makers would not be entitled to limit order price protection.[40]

The Commission also does not believe that the rule change will reduce competition for listings among different types of markets. Rather, the Commission believes that limit order protection is a feature that will attract investors and ultimately issuers to the Nasdaq market; the rule may in fact increase competition among market makers to attract limit orders so that they can match incoming limit orders on an agency basis and reduce the amount of capital that they must commit to transactions. This, in turn, may permit market makers to make markets in a larger number of securities, which would lead to enhanced opportunities for small issuers to raise capital.

The Commission does not agree with Herzog that the rule change will favor more sophisticated limit order traders over traders who enter market orders. The Commission believes that market orders will benefit if they have the opportunity to interact with limit orders as well as market maker quotes. Thus, small investors maybe among the primary beneficiaries of the rule change, contrary to Herzog's assertions.

The Commission does not believe that a market maker is required to execute a limit order without compensation. The Commission does believe, however, that the terms of compensation should be clear to the customer. The Commission believes that a market maker who accepts and holds a limit order from a customer must execute the transaction at the limit order price set by the customer, not at a ''net'' price that obfuscates the amount of compensation that the market maker is receiving.[41]

For example, assume that the best inter-dealer market for a particular security is $10 bid, $10¼ ask. A market maker accepts and holds a retail limit order to sell that security at $10 3⁄16. The Commission believes that if that market maker sells the security to another person at $10¼, it must also fill the limit order to sell at $10 3⁄16, because the sale at $10¼ constitutes a transaction at a price that would satisfy the customer's limit order. Any costs incurred by the market maker in connection with the execution of the transaction are irrelevant in determining whether a transaction has occurred at a price that would satisfy the customer's limit order. The Interpretation calls for market makers to execute limit orders whenever they execute a transaction for their market making account at a *price* that would satisfy the customer's limit order. The Commission emphasizes that ''price'' is determined from the vantage point of the customer, not by reference to ''net proceeds'' received by the firm on a sale or the purchase price paid plus costs incurred in connection with a purchase.[41]

[37] The Commission has determined not to withdraw the Commission Proposal at this time. It will review the operation of the rule change approved today before it determines whether to approve, amend or withdraw the Commission Proposal.

[38] *See, e.g.,* Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994) (approving short-sale rule for Nasdaq National Market securities); Division of Market Regulation, SEC, The October 1987 Market Break, 8–18–20 (1988).

[39] *See, e.g.,* 17 CFR 200.12(d) (providing favorable margin treatment for market makers).

In addition, Rule 15c3–1(a)(6)(i) provides favorable net capital treatment for wholesale market makers. A wholesale firm that withdraws from market maker status no longer would be entitled to compute its net capital pursuant to that provision. 17 CFR 240.15c3–1(a)(6)(i).

[40] *See supra* text an accompanying note 15.

[41] See Special NASDA Notice to Members 94–58, *surpa* n. 29, Answer to Question #2.

[42] The Commission believes it is permissible for a customer to instruct a market maker to purchase (sell) a security for it such that the total costs (proceeds) to the customer (including any commissions, markups or other charges) are not greater (less) than a single net price per share. Thus, for example, if a customer enters a limit order to

Finally, the Commission believes that the rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. As noted above, Herzog asserted that the rule change will have a disparate impact upon wholesale firms, because such firms allegedly lack the ability of vertically integrated firms to directly charge customers higher commissions, markups or other fees to compensate for the loss of spread income. The Commission recognizes that as a consequence of the rule change, some wholesale firms may seek to establish alternative sources of revenue, including charging commissions. The Commission believes that any burden imposed by shifts in fee structures is outweighed by the improved price discovery, execution and pricing advantages that customers will realize as a result of the rule change. In addition more customers will be accorded treatment that satisfies reasonable expectations of fairness and investor protection.

V. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the NASD and, in particular, Sections 15A(b)(6), and 15A(b)(9) and 11A(a)(1)(C) of the Act.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change SR–NASD–94–62 be, and hereby is, approved, effective June 21, 1994.

By the Commission.

Jonathan G. Katz,

Secretary.

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purchase security XYZ and requests that its total costs not exceed $10 per share, and the customer is informed that the market maker charges a markup of 1/4, then a market maker may continue to purchase for its own account at $10 without also executing the customer order. The customer order would be deemed a limit order at $9 3/4. The Commission emphasizes that ''the price at which the limit order is to be protected must be clearly explained to the customer.'' *See id.*

[Release No. 34–35745; File No. SR–CBOE–95–26]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Board Options Exchange, Incorporated Relating to the Content Outline for the General Securities Sales Supervisor (Series 8) Examination

May 19, 1995.

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 May 12, 1995, the Chicago Board Options Exchange, Incorporated (''CBOE'' 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 CBOE proposes to use a revised Content Outline for the General Securities Sales Supervisor (Series 8) Examination (''Series 8'').

The text of the proposed rule change is available at the CBOE and 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 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 Series 8 examination is an industry-wide qualification examination for securities sales supervisors. The Series 8 examination is generally required under rules of the self-regulatory organizations (''SROs'') for persons who are engaged in the supervision of general securities branch offices (*i.e.,* branch office managers) and of general securities registered representatives. The Series 8 examination tests a candidate's knowledge of securities industry rules and regulations and certain statutory provisions applicable to general securities sales supervision. The Series 8 Content Outline details the subject coverage and question allocation of the examination.

Revision of the Series 8 examination and Content Outline was recently undertaken by an industry committee composed of representatives from SROs (the New York Stock Exchange, the American Stock Exchange, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, the National Association of Securities Dealers, and the Philadelphia Stock Exchange) and representatives from broker-dealers, including branch office managers, compliance personnel, and corporate executives, in order to update the examination in view of changes in relevant laws, rules, and regulations, the development of new products, and to reflect various changes in industry practices. The committee reviewed the examination specifications, content areas, and item bank and developed some new questions in new areas.

The revised examination continues to cover the areas of knowledge required to supervise sales activities in securities. However, the focus of the content of the examination has been shifted to concentrate more closely on supervisory duties. Accordingly, certain questions have been deleted from the examination that deal with routine calculations and basic product knowledge, and questions on new federal and SRO rules and regulations have been incorporated into the examination, as well as questions on new products, supervision, and changes in industry practices. The Content Outline reflects the revised content of the examination. The examination will remain a six-hour, two-part, 200 question examination.

2. Statutory Basis

The statutory basis for the Series 8 examination lies in Section 6(c)(3)(B) of the Act. Under that Section, it is the Exchange's responsibility to prescribe standards of training, experience, and competence for persons associated with Exchange members and member organizations. Pursuant to this statutory obligation, the Exchange has developed examinations that are administered to establish that persons associated with Exchange members and member organizations have attained specific levels of competence and knowledge.