

IV. 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 CBOE, and in particular Section 6(b)(5).

It is therefore ordered, Pursuant to Section 19(b)(2) of the Act,¹⁰ that the proposed rule change (File No. SR-CBOE-96-70) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹¹

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[Release No. 34-38294; File No. SR-NASD-97-07]

Self-Regulatory Organizations; Notice of Filing and Order Granting Temporary Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Rule 4612, Primary Nasdaq Market Maker Standards Through October 1, 1997

February 14, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on January 31, 1997, the Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to grant accelerated approval to the proposal.

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

Pursuant to the provisions of Section 19(b)(1) under the Act, Nasdaq, a wholly owned subsidiary of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), is herewith filing a proposed rule change to temporarily suspend the use of the Primary Nasdaq Market Maker qualification criteria found in Rule 4612 (a) and (b) of the Nasdaq Market Maker Requirements of the NASD Rules for all Nasdaq National Market securities for the remainder of the current pilot period of the Nasdaq Short Sale Rule or until such earlier time when new primary

market maker qualification criteria can be devised and adopted.

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

In its filing with the Commission, Nasdaq 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. Nasdaq 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

After the first week of trading under the new SEC rules regarding a Nasdaq market maker's order handling obligations, *i.e.*, Rule 11Ac1-4 (the customer limit order display rule) and amended Rule 11Ac1-1 (amendments to the firm quote rule regarding the display of priced orders entered by market makers or specialists into electronic communications networks ("ECNs")),² Nasdaq has re-evaluated its existing qualification criteria in the primary market maker standards rule, Rule 4612 (a) and (b), in those stocks that are not subject to the primary market maker standard suspension approved in SR-NASD-96-55.³ In that rule filing, Nasdaq noted that because of the potential changes in quotation and trading activity in Nasdaq securities when the new SEC Rules became effective, the existing numerical criteria used to qualify a registered market maker as a primary market maker would be significantly affected. Because the precise effects on market maker quotes and trades were not possible to predict until Nasdaq could develop practical experience with new patterns of activity under the new rules, Nasdaq believed that it should attempt to minimize the possible harmful unintended consequences that could occur by leaving the current standards in place. Accordingly, Nasdaq proposed, and the SEC approved, that the existing standards would be temporarily suspended on the same schedule for the phase in of the SEC Rules requirements.

However, based upon trading experience in the first week of trading under the new SEC and NASD Rules, Nasdaq believes that the primary market maker standards should be suspended immediately for *all* National Market securities and all registered market makers in those securities should be designated as primary market makers. Nasdaq bases this proposed rule change on three factors that were not readily apparent at the time it filed SR-NASD-96-55: (1) many market makers have voluntarily chosen to display customer limit orders in their quotes even though the SEC's Limit Order Display Rule does not yet require it; (2) SOES decrementation for all Nasdaq stocks has significantly affected market maker ability to meet several of the primary market maker standards; and (3) with the inability to meet the existing criteria for a larger number of securities, a market maker may be prevented from registering as a primary market maker in an initial public offering because it fails to meet the 80% primary market maker test contained in Rule 4612(g)(2)(B).

Under existing Rule 4612, a registered Nasdaq Market Maker may be deemed to be a Primary Market Maker in National Market securities if the market maker meets two of three criteria: (1) the market maker maintains the best bid or best offer as shown on Nasdaq no less than 35% of the time; (2) a market maker maintains a spread no greater than 102% of the average dealer spread; and (3) no more than 50% of a market maker's quotation changes occur without a trade execution. In addition, if a registered market maker meets only one of the above criteria, it may nevertheless qualify as a primary market maker if the market maker accounts for volume at least 1½ times its proportionate share of overall volume in the stock. The review period for meeting any of these criteria is one calendar month. Nasdaq notifies a market maker at the beginning of the new calendar month if it does not meet the tests, and one business day following the notification, Nasdaq withdraws the "p" designator.

The changes to market maker quotation and trading activities have been dramatic in the first week of trading in the new environment. To provide their customers with the greater transparency, many market makers have begun to display customer limit orders in *all* Nasdaq securities, not only those subject to the phase-in of the Limit Order Display Rule, Rule 11Ac1-4. With the voluntary display of customer limit orders in stocks not yet subject to Rule 11Ac1-4, Nasdaq market makers are changing their quotes when they are in

¹⁰ 15 U.S.C. 78s(b)(2).

¹¹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(b)(1).

² See Securities Exchange Act Release No. 37619A (September 6, 1996); 61 FR 48290 (September 12, 1996) (Order Handling Rules Adopting Release).

³ See Securities Exchange Act Release No. 38175 (January 23, 1997); 62 FR 3548.

receipt of customer limit orders that improve upon their current quotations. Because more dealer quotes are now being driven not merely by the market maker's proprietary interests, but also the interests of customers that place limit orders with the market maker, Nasdaq believes that a market maker's ability to meet the 102% of average dealer spread test may be more difficult to meet. For example, because a quote of a market maker driven by a customer limit order is indistinguishable from that of a quote driven by a customer order, it is impossible to tell when market maker quote changes are being driven by customer interests that are entered and then subsequently canceled without any execution. In addition, the test regarding the percentage of time in which the market maker's quote is at the inside will also be driven to some extent by customer limit order interest.

Moreover, the SOES decrementation feature is having a significant impact on individual market maker quotations. Under the new SOES rules, which apply to all securities, when SOES executes against a quotation, whether it is on behalf of a customer or not, Nasdaq's system decreases the quotation size. If the quote is decreased to zero, and the market maker has the Nasdaq auto-refresh feature turned on, the market maker's quote is changed pursuant to that execution. However, because the auto-refresh moves only one side of the market maker's quote, the market maker's quote is spread wider than many market makers want. Therefore, market makers then change the quote to a narrower spread. While Nasdaq believes that narrower spreads are beneficial for investors overall, in this instance, the quote movement without a corresponding trade causes the market maker to exceed the 50% quote to trade ratio established in the primary market maker standards. If the market maker, on the other hand, chooses not to narrow its quote after the auto-refresh, that market maker runs the risk that it may not meet the 102% of the average spread test. Finally, Nasdaq notes that if a market maker fails to meet the standards and falls below the test regarding being a primary market maker in 80% or more of the securities for which it is registered as a market maker, it will not be allowed to register as a primary market maker in an initial public offering, even if it is an underwriter of that security and may be required to play an important liquidity providing role in that stock's initial trading activity.

Nasdaq believes that it is in the public investor's best interests to temporarily suspend the operation of the primary

market maker standards that currently exist. If the standards are not suspended, the significant shift in the patterns of quotation and executions that Nasdaq is beginning to experience is going to cause primary market makers operating under the existing standards to lose that status. Loss of the designation would mean that market makers without the designator would not be permitted to avail themselves of the short sale exemption for primary market makers. If a significant number of registered market makers were to lose the short sale exemption, or if a single market maker that handled a significant portion of the order flow in a security were to lose the exemption, liquidity in that particular stock could be seriously harmed.

Therefore, as of February 3, 1997, any registered market maker would be able to avail itself of the short sale exemption for qualified market makers found in Rule 3350(c)(1). In seeking to temporarily suspend the use of the primary market maker qualification criteria, Nasdaq believes that the suspension of the criteria is an appropriate balance between the need for limitations on the market maker short sale exemption and the potential for loss of liquidity and market disruption in a period when new patterns and practices of trading are first being developed. Nasdaq believes that the period of time in which the new SEC Rules are first being implemented may be a period of uncertainty for market makers and investors alike and that the prudent course of action would be to identify and eliminate as many potential areas for increasing that uncertainty as possible. Nasdaq has identified this issue as a critical area of uncertainty and believes that the suspension of the market maker qualification standards on a temporary basis is an appropriate market quality response. This relief will enable Nasdaq market makers to better satisfy investor liquidity demands and could help to promote pricing efficiency.

Nasdaq also plans to develop new standards as soon as practicable so that Nasdaq can obtain experience with the manner in which the new SEC Rules affect market makers. The plan is to analyze the data from January and February and discuss the practices among staff and with the Quality of Markets Committee.

Nasdaq believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act in that it is designed to prevent fraudulent and manipulative acts and facilities transactions in securities. In particular, this temporary amendment to the

existing rule should provide market makers with certainty regarding whether they are entitled to an exemption under the rule which should promote market efficiency and enhance the orderliness of the market during a transition period. It should also help in reducing investor confusion at this time and thereby promote efficient and fair markets.

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

Nasdaq 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, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

III. Commission's Findings and Order Granting Temporary Accelerated Approval of Proposed Rule Change

The Commission has reviewed carefully Nasdaq's proposed rule change and believes, for the reasons set forth below, that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD and, in particular, the requirements of Section 15A(b)(6), 15A(b)(9), and 15A(b)(11). In addition, the Commission finds that the rule change is consistent with the Congressional objectives for the equity markets, set out in Section 11A of the Act, of achieving more efficient and effective market operation, fair competition among brokers and dealers, and economically efficient execution of investor orders in the best market. In particular, this temporary amendment to the existing rule should avoid frustrating the operation of the Order Handling Rules in light of the existence of market factors not readily apparent at the time the NASD requested more limited relief with respect to the suspension of primary market maker standards.⁴ The Commission is approving the rule change on a pilot basis through October 1, 1997. During this time, however, the Commission expects that, as with the NASD's excess spread rule,⁵ the NASD must develop

⁴ *Id.*

⁵ As with the primary market maker standards, there is also a dealer spread test that is part of the NASD's "excess spread rule," Rule 4613(d). The Commission recently approved a proposed rule change on a pilot basis through July 1, 1997, providing that a registered market maker in a security listed on the Nasdaq stock market shall be precluded from being a registered market maker in that issue for twenty business days if its average

new primary market maker standards well before the expiration of the pilot.

Nasdaq has requested that the Commission find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Commission finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof in that accelerated approval will accommodate the Order Handling Rules, which went into effect January 20, 1997.⁶

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-97-07 and should be submitted by March 17, 1997.

spread in the security over the course of any full calendar month exceeds 150 percent of the average of all dealer spreads in such issue for the month. See Securities Exchange Act Release No. 38180 (January 16, 1997), 62 FR 3725. Although the Commission approved the proposed rule change on a temporary basis to facilitate compliance with the Commission's Order Handling Rules, the Commission stated that during this time period, the NASD should monitor the effects of the pilot, as well as study alternative methods that would enhance market making performance while completely fulfilling the NASD's obligation regarding the excess spread rule before the August 8, 1997, deadline contained in the Commission's Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act Release No. 37538 (August 8, 1996).

⁶The Division of Market Regulation issued an interim no-action letter to the NASD and Nasdaq with respect to the enforcement of the NASD's primary market maker standards during the consideration of this proposed rule change. The approval of this rule change supersedes that no-action position. See Letter from Howard Kramer, Associate Director, Division of Market Regulation, SEC, to Eugene A. Lopez, Assistant General Counsel, Nasdaq, dated February 3, 1997.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁷ that the proposed rule change be, and hereby is, approved on an accelerated basis, effective February 14, 1997 through October 1, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34-38292; File No. SR-Phlx-96-36]

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Notice of Filing of, and Order Granting Accelerated Approval to, Amendment No. 1 to the Proposed Rule Change Relating to Index Value Calculations by the Index Calculation Engine ("ICE") System

February 14, 1997.

On October 3, 1996, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") 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 permit the Phlx to act as the reporting authority for its index options under certain circumstances.

The proposed rule change was published for comment in the Federal Register on October 10, 1996.³ No comments were received on the proposal. Subsequently, the Phlx amended the proposed rule change.⁴

⁷ 15 U.S.C. 78s(b)(2).

⁸ 17 U.S.C. 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 37782 (Oct. 3, 1996), 61 FR 53254.

⁴ See Letter from Theresa McCloskey, Vice President, Regulatory Services, Phlx, to Sharon Lawson, Senior Special Counsel, Division of Market Regulation, Office of Market Supervision, SEC, dated January 23, 1997, and letter from Theresa McCloskey, Vice President, Regulatory Services, Phlx, to Sharon Lawson, Senior Special Counsel, Division of Market Regulation, Office of Market Supervision, SEC, dated January 29, 1997 (collectively "Amendment No. 1"). Amendment No. 1 withdraws that portion of the proposal seeking "interim authority" to utilize the ICE system value. Interim authority, in this case, refers to the Exchange's ability to continue to utilize the ICE system during that interim time period after a temporary operational problem at the designated reporting authority is corrected, but before receiving Commission approval to appoint a different reporting authority. In addition, Amendment No. 1 clarifies that designation of ICE as the reporting authority for a particular options product must be

This order approves the proposal, including Amendment No. 1 on an accelerated basis.

Currently, three market (broad-based) index options, seven industry (narrow-based or sector) index options, and the Super Cap Index option trade on the Exchange. The reporting authority for each index option is currently Bridge Data. For each index option listed on the Exchange, the specifications and descriptions filed with the Commission detail how the index value is calculated and that the calculation is conducted by Bridge.

In the course of reviewing inconsistencies in index value calculations, as well as the disaster recovery implications of using a single, outside reporting authority, the Exchange decided to create its own internal system for the calculation and dissemination of index values—the Index Calculation Engine ("ICE") system. Recently, this system was completed, tested, and implemented as a surveillance tool for Phlx Regulatory Services and Market Surveillance staff monitoring Exchange index options trading. In an effort to make use of the capabilities of the ICE system, the Phlx proposes to utilize the ICE system value as the official index value in two situations.

First, the ICE system value would act as the official index value in the event the reporting authority designated by the Phlx is experiencing difficulties in disseminating an accurate value (e.g., computer failure, line problem). Under these circumstances, the Exchange would automatically switch to using the ICE system value as the official index value, but only for the time period that is necessary for the designated agent to correct its problem.

Second, the Phlx, when determining which entity to utilize as the permanent reporting authority for its index options, would like to be able to select the ICE system as the designated reporting authority.⁵ Economic and efficiency considerations are the impetus for this request.

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, and, in particular, with the

filed pursuant to Section 19(b) of the Act and that the Phlx's request for using ICE as the reporting authority for FLEX options will be incorporated into the FLEX options proposal (SR-Phlx-96-38).

⁵ Any request to utilize ICE as the permanent reporting authority for a particular options product will have to be submitted to the Commission for approval under Section 19(b) of the Act. See Amendment No. 1, *supra* note 4.