(File No. SR–DTC–97–09) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'').[1] Notice of the proposal was published in the **Federal Register** on September 19, 1997.[2] No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

## I. Description

DTC currently operates a custody service which offers custodian, transaction, and related processing services to participants in connection with certain securities that are not depository eligible (*e.g.*, securities with certain transfer restrictions).[3] The rule change permits DTC to enter into contracts with individual participants to provide customized processing services under the custody service. Under the rule change, DTC will not be obligated to enter into any such contracts with participants or to offer the same terms under any such contracts to all participants. DTC has advised the Commission that it will charge fees for customization of custody service based on a consistently applied methodology.

## II. Discussion

Section 17A(b)(3)(F) of the Act[4] requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes that DTC's proposed rule change is consistent with DTC's obligations under Section 17A of the Act because the rule change will allow DTC participants to remove certain certificates that are not depository eligible from their vaults and to deposit them into DTC's custody service. Depositing certificates into the custody service along with use of the custody service's securities processing services should help to reduce the costs, inefficiencies, and risks associated with the physical safekeeping of securities outside of DTC and thereby should promote the prompt and accurate clearance and settlement of transactions in securities. Moreover, the Commission believes that the proposal is consistent with DTC's obligations to safeguard securities and funds under its control because securities deposited into the custody services will be under DTC's usual procedures for the safekeeping of securities.

## III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act and the rules and regulations thereunder.

*It is therefore ordered,* pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR–DTC–97–09) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[5]

**Margaret H. McFarland,**

*Deputy Secretary.*

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

[2] Securities Exchange Act Release No. 39071 (September 12, 1997), 62 FR 49279.

[3] For a more detailed description of DTC's custody service, refer to Securities Exchange Act Release Nos. 38561 (April 30, 1997), 62 FR 25008 [File No. SR–DTC–97–01] (order approving proposed rule change implementing the dividend processing phase of DTC's custody service) and 37314 (June 14, 1996) 61 FR 31989 [File No. SR–DTC–96–08] (order approving proposed rule change establishing DTC's custody service).

[4] 15 U.S.C. 78q–1(b)(3)(F).

[5] 17 CFR 200.30–3(a)(12).

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# SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–39760; File No. SR–NASD–98–21]**

## Self-Regulatory Organizations; Notice of Proposed Rule Change by the National Association of Securities Dealer, Inc., Relating to an Expansion of the NASD's Rule Permitting Market Makers To Display Their Actual Quotation Size

March 16, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act'' [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on March 5, 1998, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. (''Nasdaq''), filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

[2] 17 CFR 240.19b–4.

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

The NASD proposes to amend NASD Rule 4613(a)(1)(C) to allow permanently market makers to quote their actual size by reducing the minimum quotation size requirement for market makers in all securities listed on Nasdaq to one normal unit of trading (''Actual Size Rule''). As discussed below, the Actual Size Rule presently applies to a group of 150 Nasdaq securities on a pilot basis. The text of the proposed rule change is as follows (additions are italicized; deletions are bracketed).

* * * * *

NASD Rule 4613 Character of Quotations

(a) Two-Sided Quotations.

(1) No change.

(A)–(B) No change.

(C) [As part of a pilot program implemented by The Nasdaq Stock Market, during the period January 20, 1997 through at least March 27, 1998, a] *A* registered market maker in a security listed on The Nasdaq Stock Market [that became subject to mandatory compliance with SEC Rule 11Ac1–4 on January 20, 1997 or identified by Nasdaq as being otherwise subject to the pilot program as expanded and approved by the Commission,] must display a quotation size for at least one normal unit of trading (or a larger multiple thereof) when it is not displaying a limit order in compliance with SEC Rule 11Ac1–4, provided, however, that a registered market maker may augment its displayed quotation size to display limit orders priced at the market maker's quotation.

* * * * *

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

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Summary of Proposal

Currently, quotations in most Nasdaq securities are required to be displayed in a minimum size of 1,000 shares (200 or 500 shares for less active stocks). The requirement is different from that of any of the stock exchanges, which require only the display of actual size of at least 100 shares. This difference results from the requirements of the Small Order Execution System (''SOES''), which was originally conceived and developed to provide individual investors with a fast, efficient, and cost-effective means of executing small orders in Nasdaq securities in a quote-based dealer market.

On August 29, 1996, the SEC promulgated a new rule and adopted amendments to other SEC rules that are designed to enhance the quality of published quotations for securities and promote competition and pricing efficiency in U.S. securities markets (these rules are collectively referred to hereafter as the ''Order Handling Rules'').[3] The Order Handling Rules have changed Nasdaq's market structure to a more order-driven hybrid market, which include quotes from investors (in the form of displayed limit orders), market makers, and Electronic Communications Networks (''ECNs''). The implementation of these rules has enhanced market quality and benefited investors significantly by substantially reducing Nasdaq quoted spreads, without evidence of a material reduction of liquidity or increased volatility. In connection with these changes, Nasdaq implemented the Actual Size Rule pilot program (originally including 50 Nasdaq stocks, but subsequently expanded to 150 stocks) to allow market makers to display their actual, freely-determined quotation size when not displaying a customer order.

Given the changes brought about by the Order Handling Rules, the economic theory suggesting several long-term benefits of the Actual Size Rule, and the empirical research indicating no adverse impact on investors or the Nasdaq market, the NASD has concluded that artificial minimum quotation sizes are no longer necessary and should be removed for all Nasdaq stock. Specifically, the Actual Size Rule affords market makers more flexibility to manage risk and quote prices that are more favorable for small retail orders. In addition, requiring a minimum commitment of market maker capital while allowing the display of customer and ECN orders without a similar commitment could severely impair the ability of market makers to set competive quotations. The adoption of sixteenths could heighten the debilitating effect of the quote size minimum, as could future reduction in Nasdaq's minimum quote price invement if the minimum size increment is not equivalent reduced. Moreover, rigorous empirical analysis of the original pilot program and the pilot as expanded, including a study of the extreme market conditions of October 27 and 28, 1997, demonstrate that the Actual Size Rule has not materially affected Nasdaq market quality, as measured by spread, volatility, quoted depth, and liquidity, and that investors continue to have substantial access to a reasonable amount of market maker capital in pilot stocks.

2. Background

*a. SEC Order Handling Rules.* With respect to securities listed on Nasdaq, the Order Handling Rules were implemented according to a phased-in implementation schedule: 50 Nasdaq securities became subject to the rules on January 20, 1997 (''First Fifty''); fifty more became subject to the rules on February 10, 1997 (''Second Fifty''), and an additional fifty became subject to the rules on February 24, 1997. The remaining Nasdaq securities were phased in pursuant to a specified time table established by the Commission, with the last remaining securities phased in on October 13, 1997.[4]

In particular, the SEC adopted Rule 11Ac1–4, (''Limit Order Display Rule''), which requires the display of customer limit orders: (1) That are priced better than a market maker's quote;[5] or (2) that add to the size associated with a market maker's quote when the market maker is at the best price in the market.[6] By virtue of the Limit Order Display Rule, investors now have the ability to directly advertise their trading interest to the marketplace, thereby allowing them to compete with market maker quotations and affect the size of bid-ask spreads.[7] The other rule changes adopted by the SEC involve amendments to SEC's firm quote rule, Rule 11Ac1–1. The most significant change requires market makers to display in their quote any better priced orders that the market maker places into an electronic communications network such as SelectNet or Instinet (''ECN Rule''). Alternatively, instead of updating its quote to reflect better priced orders entered into an ECN, a market maker may comply with the display requirements of the ECN Rule through the ECN itself, provided the ECN: (1) ensures that the best priced orders entered by market makers into the ECN are communicated to Nasdaq for public dissemination; and (2) provides brokers and dealers access to orders entered by market makers into the ECN, so that brokers and dealers who do not subscribe to the ECN can trade with those orders.

*b. Actual Size Rule Pilot for First Fifty Stocks.* In order to facilitate implementation of the SEC's Order Handling Rules and reflect the more order-driven nature of the Nasdaq market that was brought about by implementation of these rules, on January 10, 1997, the Commission approved a variety of amendments to NASD rules and Nasdaq's SOES and SelectNet Service.[8] In particular, one of the NASD rule changes approved by the Commission provides that Nasdaq market makers in the First Fifty stocks subject to the Commission's Limit Order Display Rule are required to display a minimum quotation size of one normal unit of trading when quoting solely for their own proprietary account (*i.e.,* the Actual Size Rule).[9] For Nasdaq stocks outside of the First Fifty, the minimum quotation size requirements remained the same.[10]

The NASD submitted the proposal for the Actual Size Rule because it believed,

[3] See Exchange Act Release No. 37619A (September 6, 1996) 61 FR 48290 (September 12, 1996) (''Order Handling Rules Adopting Release'').

[4] See Exchange Act Release No. 38870 (July 24, 1997) 62 FR 40732 (July 30, 1997), corrected in 62 FR 45289.

[5] For example, if a market maker's quote in stock ABCD is 10–10¼ (1,000 × 1,000) and the market maker receives a customer limit order to buy 200 shares at 10⅛, the market maker must update its quote to 10⅛–10¼ (200 × 1,000).

[6] For example, if a market maker receives a limit order to buy 200 shares of ABCD at 10 when its quote in ABCD is 10–10¼ (1,000 × 1,000) and the NBBO for ABCD is 10–10⅛, the market maker must update its quote to 10–10¼ (1,200 × 1,000).

[7] There are seven exceptions to the Limit Order Display Rule: customer limit orders that are (1) executed upon receipt; (2) placed by customers who expressly request that they not be displayed; (3) odd-lots; (4) block size orders (10,000 shares or $200,000), unless the customer requests that the order be displayed; (5) delivered immediately upon receipt to an exchange or association-sponsored system, or an ECN that complies with Rule 11Ac1–1(c)(5)(ii) with respect to that order; (6) delivered immediately upon receipt to another exchange member or OTC market maker that complies with Rule 11Ac1–4 with respect to that order; or (7) all-or-none orders. *See* 17 CFR 240.11Ac–1–4(c).

[8] See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415 (January 16, 1997) (order partially approving SR–NASD–96–43) (''Actual Size Rule Approval Order'').

[9] Thus, the Actual Size Rule does not affect a market maker's obligation to display the full size of a customer limit order. If a market maker is required to display a customer limit order for 200 shares or more, it must display a quote size of at least 200 shares absent an exemption from the Limit Order Display Rule.

[10] In particular, NASD Rule 4613(a)(2) requires each market maker in a Nasdaq issue other than those in the First Fifty to enter and maintain two-sided quotations with a minimum size equal to or greater than the applicable SOES tier size for the security (*e.g.,* 1,000 500, or 200 shares for Nasdaq National Market issues and 500 or 100 shares for Nasdaq SmallCap Market issues).

and continues to believe, that the new and more order-driven nature of Nasdaq brought about by the Limit Order Display Rule obviates the regulatory justification for minimum quote size requirements. In particular, while the NASD believed it was once desirable and appropriate to impose the mandatory quote size requirements to ensure an acceptable level of market liquidity and depth in an environment where Nasdaq market makers were the only market participants who could impact quotation prices, the Limit Order Display Rule now permits investors to directly impact quoted prices. As a result, the NASD believes that it is no longer necessary to subject market makers to minimum quote size requirements when they are not representing customer orders. In addition, economic theory indicates that permitting dealers to quote in size commensurate with their true trading interest could further narrow quoted spreads and enhance the pricing efficiency of the Nasdaq marketplace.

Furthermore, Nasdaq believes that a disincentive for some market makers would be removed, thus attracting additional liquidity and pricing efficiency in the Nasdaq market. Indeed, the Commission noted in its approval of the Actual Size Rule pilot that ''the 1,000 share minimum quote size represents a barrier to entry for market making. Lowering this barrier to entry could attract more market makers, thereby increasing liquidity and competition across the market.'' [11] This is especially important for smaller market making firms, which may otherwise have difficulty competing on a price basis in an environment with minimum quote size requirements.

In sum, with the successful implementation of the SEC's Order Handling Rules, the NASD believes that mandatory quote size requirements impose unnecessary regulatory burdens on market makers that are not consistent with the Exchange Act.

At the same time, the NASD does not believe that implementation of the Actual Size Rule in an environment where limit orders are displayed has or will compromise the quality of the Nasdaq market. First, the display of customer limit orders enhances the depth, liquidity, and stability of the market and contributes to narrower quoted spreads, thereby mitigating the effects of the loss of displayed trading interest, if any, by market makers. Second, removing artificial quote size requirements may lead to narrower market maker spreads, thereby reducing investors' transaction costs. Third, permitting market makers to quote in size commensurate with their own freely-determined trading interest will enhance the pricing efficiency of the Nasdaq market and the independence and competitiveness of dealers' quotations. Fourth, removing quotation size requirements will facilitate greater quote size changes, thereby increasing the information content of market maker quotes by facilitating different quote sizes from dealers who have a substantial interest in the stock at a particular time and those who do not.

Indeed, in its order approving the Actual Size Rule, the Commission noted that it ''preliminarily believes that the proposal will not adversely affect market quality and liquidity'' [12] and that it ''believes there are substantial reasons * * * to expect that reducing market makers' proprietary quotation size requirements in light of the shift to a more order-driven market would be beneficial to investors.'' [13] In addition, the Commission stated that, ''based on its experience with the markets and discussions with market participants, [it] believes that decreasing the required quote size will not result in a reduction in liquidity that will hurt investors.'' [14]

Nevertheless, in light of concerns raised by commentators opposed to the Actual Size Rule regarding the potential adverse impacts of the rule on market liquidity and volatility, the Commission determined to approve the rule on a three-month pilot basis to afford the Commission, the NASD and Nasdaq an opportunity to gain practical experience with the rule and evaluate its effects.[15] The factors identified by the Commission to be considered in this evaluation include, among others, the impact of reduced quotation sizes on liquidity, volatility and quotation spreads.[16]

*c. Findings of NASD Economic Research and Proposal to Expand Actual Size Rule Pilot to 150 Stocks.* On April 11, 1997, the NASD filed with the Commission Filing No. SR–NASD–97–26 to extend and expand the Actual Size Rule.[17] Specifically, the NASD proposed to extend the pilot until at least December 19, 1997, and to expand the number of stocks to include the next 100 stocks subject to the Order Handling Rules. The filing was subsequently amended to change the extension date from December 19, 1997, to March 27, 1998, and to change the selection methodology for the next group of 100 stocks to be subject to the pilot, discussed further below.

This finding cited findings of research concerning the implementation of the Order Handling Rules and the Actual Size Rule pilot. Specifically, the NASD found that implementation of the Order Handling Rules had significantly improved the quality of the Nasdaq market by creating a market structure where customer limit orders provide liquidity and compete effectively with market maker quotations. In this type of environment, the NASD stated its belief that the regulatory necessity for the mandatory quote size requirements no longer exists. Accordingly, the NASD proposed to both extend and expand the rule.

In particular, the research conducted by the NASD's Economic Research Department in early 1997 indicated three general findings concerning implementation of the Order Handling Rules and the Actual Size Rule: (1) The Order Handling Rules have dramatically improved the quality of the Nasdaq market, particularly with respect to the narrowing of quoted spreads; (2) among those securities subject to the Order Handling Rules, there is no appreciable difference in market quality between those stocks subject to the Actual Size Rule and those stocks subject to mandatory quote size requirements; [18]

[11] See Actual Size Rule Approval Order, *supra*, note 8, at 2425.

[12] *Id.*

[13] *Id.* at 2423.

[14] *Id.* at 2424.

[15] See Actual Size Rule Approval Order, *supra* note 8.

[16] Specifically, the Commission stated that the NASD's study should include an analysis of (1) The number of market makers in each of the 50 securities, and any change in the number over time; (2) the average aggregate dealer and inside spread by stock over time; (3) the average spread for each market maker by stock; (4) the average depth by market maker (including limit orders), and any change in the depth over time; (5) the fraction of volume executed by a market maker who is at the inside quote by stock; and (6) a measure of volume required to move the price of each security one increment (to determine the overall liquidity and volatility in the market for each stock). The Commission also stated its expectation that these factors should be contrasted over the time period immediately preceding the pilot and after the beginning of the pilot. In addition, the Commission stated that the NASD should compare the First Fifty stocks (to which the Rule applied) with the Second Fifty stocks (stocks subject to the SEC's Order Handling Rules but not the Actual Size Rule).

[17] See Exchange Act Release No. 38513 (April 15, 1997) 62 FR 19369 (April 21, 1997) (''Notice of Proposal to Expand Actual Size Rule to 150 Stocks'').

[18] The First Fifty stocks include Nasdaq's top ten issues by dollar volume plus 40 issues chosen from Nasdaq's top 500 issues; 8 ranked between 11 and 100; 8 ranked between 101 and 200; 8 ranked between 401 and 300; 8 ranked between 401 and 500. The ''second fifty'' stocks include the ten Nasdaq stocks ranked between 11 and 20 by dollar volume plus 40 stocks chosen from Nasdaq's top 500 stocks in the same manner explained above. Because the ten largest Nasdaq stocks have no comparable peer group among Nasdaq stocks and the next ten largest Nasdaq stocks included in the

and (3) implementation of the Actual Size Rule has not resulted in any significant diminution of the ability of investors to receive automated executions through SOES, SelectNet, or proprietary systems operated by broker-dealers. The specific findings of this analysis were published in the original notice of filing SR–NASD–97–26.[19]

On June 3, 1997, the NASD supplemented its proposal to extend and expand the Actual Size Rule by submitting to the SEC a study entitled ''Effects of the Removal of Minimum Sizes for Proprietary Quotes in The Nasdaq Stock Market, Inc.'' (''June 1997 Study''). The June 1997 Study, which provides greater detail of the NASD's analysis, became a part of the NASD filing with the Commission and was made available to the public through Nasdaq's web site. The June 1997 Study presented a thorough empirical analysis that produced no evidence that the implementation of the Actual Size Rule had affected the market quality of pilot stocks. This study analyzed standard measures of market quality, including spread, volatility, and depth. In addition, the study reflected an examination of the ability of investors to access market maker capital through SOES and proprietary autoexecution systems and calculated the normalized effective depth, a measure of market liquidity. The study revealed that for stocks subject to the Actual Size Rule, investors continued to have reasonable and substantial access to market maker capital through automatic execution systems.

To provide the public with an opportunity to review and comment on the June 1997 Study, the Commission extended the comment period on Filing No. SR–NASD–97–26 until July 3, 1997.[20] On July 17, 1997, the NASD amended the filing at the Commission's request to extend the pilot until March 27, 1998, to provide the Commission with additional time to evaluate economic studies on the proposal and to review comments on the June 1997 Study.[21]

Notwithstanding the results of the June 1997 Study, commenters expressed concerns on the proposal to expand the Actual Size Rule. In particular, it was noted that the pilot had been limited to only 50 Nasdaq securities. Further, these securities generally represent the most liquid Nasdaq stocks. In addition, the proposed expansion of the Actual Size Rule would apply to the 100 stocks that were next to be phased in under the Order Handling Rules. These stocks were also drawn from the most liquid Nasdaq stocks. Thus, it was argued, even an expanded pilot would still be skewed toward larger, more active issues.

In response to these concerns expressed by SEC staff and commenters,[22] the NASD amended the proposed rule change on September 15, 1997, to change the selection methodology for the next group of securities to be subject to the pilot to provide an enhanced sample more representative of the entire Nasdaq market.[23] Specifically, the remaining Nasdaq National Market issues were divided into deciles based on average daily dollar volume, and 110 stocks were chosen by randomly selecting approximately the same number from each decile.[24] Thus, as expanded, the pilot would provide the Commission, NASD, and market participants with additional data across a range of securities, thereby allowing a more enhanced evaluation of the effects of the rule.

*d. SEC Approval to Expand Actual Size Rule Pilot to 150 Stocks.* On October 29, 1997, the Commission approved the NASD proposal to expand the Actual Size Rule pilot to include 150 stocks, as amended to provide for a sample more representative of the entire Nasdaq market.[25] The pilot also was extended until at least March 27, 1998. In approving the proposal, the Commission stated its belief that the data preliminarily indicates that the pilot has not resulted in any degradation to Nasdaq market quality, and that the Actual Size Rule appears to be a reasonable means to provide market making obligations that reflect the new market dynamics produced by the Order Handling Rules.[26] Nonetheless, the Commission decided that it would be appropriate to gather further data using the more representative sample of Nasdaq stocks before reaching a final decision as to whether or not to extend the Actual Size Rule to the entire Nasdaq market.

The Commission requested that the NASD continue to evaluate the effects of the Actual Size Rule and identified several areas of analysis to be covered.[27] The Commission also requested that the NASD compare data among deciles, focusing attention on active versus inactive stocks. In response, the NASD conducted an additional study of the effects of the Actual Size Rule, as expanded (''January 1998 Study'')

3. January 1998 Study

Summary results of the January 1998 Study are described below. The complete study is attached as Exhibit 2 to this filing and will be available through Nasdaq's web site.

*a. Methodology of January 1998 Study.* To assess the effect of the expansion of the pilot, this study compared measures of market quality for a group of stocks that joined the pilot (the ''Next 103'') to a control group of peer stocks (the ''Non-ASR 3,207'') that remained subject to mandatory minimum quote sizes.[28] Similar to the June 1997 Study, a thorough analysis reveals the Actual Size Rule has had no material effect on Nasdaq market quality.

Importantly, it should be noted that the January 1998 Study may be viewed as a more straightforward analysis of the Actual Size Rule. This is because in the June 1997 Study, the analysis was complicated by the fact that, with respect to the First 40 stocks presented therein, the Order Handling Rules were implemented at the same time as the Actual Size Rule. Thus, the pre-Actual Size Rule implementation period of review for those stocks did not reflect the impact of the Order Handling Rules. In contrast, in the January 1998 Study,

Second Fifty (*i.e.*, Nasdaq stocks ranked 11–20 in size) are not comparable to the ''bottom 40'' of either the First Fifty or Second Fifty, those stocks have been excluded from the analysis comparing the First Fifty and the Second Fifty. Accordingly, the ''first forty'' stocks are the ''bottom 40'' stocks within the First Fifty stocks and the ''second forty'' stocks are the ''bottom 40'' stocks within the ''second forty'' stocks.

[19] See Notice of Proposal to Expand Actual Size Rule to 150 Stocks, at note 15.

[20] See Exchange Act Release No. 38720 (June 5, 1997) 62 FR 31856 (June 11, 1997).

[21] See Exchange Act Release No. 38872 (July 24, 1997) 62 FR 40879 (July 30, 1997).

[22] See *e.g.*, letter from David K. Whitcomb, Professor of Finance, Rutgers University, to Jonathan Katz, Secretary, SEC, dated July 3, 1997.

[23] See letter from Robert E. Aber, Vice President and General Counsel, to Katherine A. England, Assistant Director, Market Regulation, dated September 15, 1997.

[24] 110 stocks were chosen to make up for four of the original stocks that were delisted, and as reserves in case any others delist in the interim. This ensured that a total of 150 stocks were available under an expanded Actual Size Rule.

[25] See Exchange Act Release No. 39285 (October 29, 1997) 62 FR 59932 (November 5, 1997) (''Actual Size Rule Expansion Approval Order'').

[26] Actual Size Rule Expansion Approval Order, at 59936.

[27] In particular: (1) The number and composition of the market makers in each stock; (2) the average aggregate dealer and inside spread; (3) the average spread of each market maker by stock; (5) the fraction of volume executed by a market maker who is at the inside quote per stock; and (6) a measure of volume required to move the price of each security one increment.

[28] The study reviews data for 18 trading days between October 13 and November 7 (October 27 and 28 are excluded and analyzed separately) and compares it to 20 trading days between November 10 and December 9.

the pre-Actual Size Rule implementation period of review did reflect the Order Handling Rules, which were fully phased in by October 13, 1997. In other words, the January 1998 Study assessed only one significant policy change for the subject securities, that being the implementation of the Actual Size Rule. Furthermore, as indicated above in Section A.3., the NASD amended Filing No. SR–97–26 to change the sample design to a more representative cross section of Nasdaq securities.

*b. Actual Size Rule Has No Material Effect on Nasdaq Market Quality.* Several measures of market quality were analyzed in the January 1998 Study: spread, volatility, depth, and liquidity. Each of these measures are discussed below.

i. Spread Measures. The quoted dollar spread [29] of the Next 103 fell 3.8% post implementation, while the quoted spread for the control group Non-ASR 3,207 similarly fell 4.8%. Multivariate regression analysis, which is used to control for stock-specific changes in volume, price, and interday volatility, shows that this differential is immaterial. Thus, there is no statistically significant evidence of a differential change in quoted spreads associated with implementation of the Actual Size Rule.

The effective spread [30] (for trades of all sizes) of the Next 103 fell 2.6% post implementation, while the effective spread for the control group Non-ASR 3,207 fell 5.7%. Multivariate regression analysis shows that, consistent with the effect on quoted dollar spreads, effective spreads have not changed materially for either group. Thus, there is no statistically significant evidence of a differential change in effective spreads associated with implementation of the Actual Size Rule.

ii. Volatility. Volatility [31] decreased slightly between the pre- and post-implementation periods for both the Next 103 and the Non-ASR 3,207. For the Next 103, mean volatility fell 5.8%, while volatility for the Non-ASR 3,207 fell 3.4%. Again, based on multivariate regression analysis, the differential cannot be attributed to implementation of the Actual Size Rule.

iii. Depth. Mean aggregate depth [32] provided by market makers at the inside market dropped by 5.2% for the Next 103, and 5.8% for the Non-ASR 3,207. When ECNs are included, aggregate depth fell by 2.0% for the Next 103 and 2.7% for the Non-ASR 3.207. Again, based on Multivariate regression analysis, these differentials are not statistically significant. Thus, implementation of the Actual Size Rule is not associated with a change in aggregate quote depth.

Furthermore, neither (1) the mean number of market makers, nor (2) the mean number of market makers at the inside changed significantly for either stock group after implementation.

iv. Liquidity. While liquidity is an important market quality concept, it is difficult to measure empirically. One such measure of liquidity is ''effective depth,'' and a refinement called ''normalized effective depth'' that makes the measure more robust across varying stock prices. These measures integrate the spread, or price, and depth components of the liquidity concept using trading activity in place of quoted depth. These measures are described fully in the study, which indicate that there was no statistically significant association between effective depth and the Actual Size Rule.

*c. Actual Size Rule Does Not Impair Ability of SOES to Provide Access to Market Maker Capital.* An analysis of measures of market maker accessibility via Nasdaq's SOES system or proprietary systems shows that the implementation of the Actual Size Rule has not impacted the operation of these systems. Specifically, 98.5% of SOES orders in Next 103 stocks were fully executed after these stocks became subject to the Actual Size Rule. Indeed, the average size of a SOES trade in Next 103 stocks fell only 18 shares after the expansion of the pilot program. Clearly, the effect of the Actual Size Rule on the ability of investors to achieve executions via SOES has been minimal.

The extreme market conditions of October 27 and 28, 1997 provided another test of the effect of the Actual Size Rule on the Nasdaq marketplace. This study includes a comparison of both the market quality and SOES accessibility of a group of the original pilot stocks (the First 36) to a group of peer stocks subject to minimum quote size requirements (the Second 36). There is no significant evidence that the Actual Size Rule impacted either market quality or SOES accessibility during these periods of market stress.

4. Conclusion and Proposal To Expand the Actual Size Rule to All Nasdaq Stocks on a Permanent Basis

The implementation of the Order Handling Rules, which have moved Nasdaq toward a more order-driven market by integrating customer and ECN limit orders into the marketplace, called into question the propriety of requiring market makers to post a minimum depth for proprietary quotes. No other equity market requires such a minimum.

The NASD believes that the Actual Size Rule will have a positive impact on market quality. First, removing artificial quote size requirements may lead to narrower market maker spreads, thereby reducing investors' transaction costs. This could result because market makers would be afforded more flexibility to manage risk and quote prices that are more favorable for small retail orders. Second, permitting market makers to quote in size commensurate with their own freely-determined trading interest should enhance the pricing efficiency of the Nasdaq marketplace and the independence and competitiveness of dealer quotations. Third, removing quotation size requirements will facilitate greater quote size variability, which would increase the information content of market maker quotes by facilitating different quote sizes from dealers who have a substantial interest in the stock at a particular time and those who do not. In addition, removal of minimum quote size requirements may also eliminate a barrier to entry into the market for smaller market making firms, thus attracting more firms into the market, increasing both price competition and liquidity, thereby benefiting investors.

Furthermore, requiring a minimum commitment of market maker capital while allowing customer and ECN orders entry without a similar commitment could severely impair the ability of market makers to set competitive quotations. The adoption of quotation increments of sixteenths could have heightened the debilitating effect of the quote size minimum, as could future reductions in Nasdaq's minimum quote price increment if the minimum size increment is not equivalently reduced.

Finally, while economic theory suggests there may be several long term benefits derived from the removal of minimum quotation size, empirical research indicates that removal of the

[29] Quoted dollar spread is the difference between the inside ask and inside bid. Individual dollar spreads are weighted by the amount of time each spread was in effect for the day, *i.e.*, the spread's duration.

[30] Effective spread is a trade-based measures defined as twice the absolute difference between the trade price and the bid-ask midpoint (''BAM''). Thus, effective spread accounts for trades executed at prices inside the spread.

[31] Intraday volatility is measured using the standard deviation of the logarithm of the BAM.

[32] Quoted depth is the size of a market maker quote, or the number of shares at the quote that a market maker is required to transact under the Firm Quote Rule. Aggregated quoted depth is the sum of the quoted depths of all market makers quoting at the prevailing inside market.

regulatory minimum has not had any adverse impact on investors or the Nasdaq market. In the absence of a compelling reason to the contrary, economic theory clearly indicates that the imposition of a potentially damaging regulatory constraints, such as the minimum quote size, on the market is inadvisable. This position is consistent with Section 15A of the Exchange Act, which prohibits the NASD from imposing ''any burden on competition not necessary or appropriate'' in furtherance of the purposes of the Exchange Act. This Section, among others within the Exchange Act, codifies a Congressional intent that the U.S. securities markets be free from competitive restraints to the furthest extent possible consistent with the other goals of the Exchange Act.[33] Accordingly, the NASD believes that these minimums should be removed via the implementation of the Actual Size Rule for all Nasdaq securities on a permanent basis.

5. Statutory Basis

For the reasons noted above, the NASD believes the proposed rule change is consistent with Sections 11A(a)(1)(C), 15A(b)(6), 15A(b)(9), and 15A(b)(11) of the Exchange Act. Section 11A(a)(1)(C) provides that it is in the public interest to, among other things, assure the economically efficient execution of securities transactions and the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities. Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. Section 15A(b)(9) requires that rules of an Association not impose any burden on competition not necessary or appropriate to furtherance of the purposes of the Exchange Act. Section 15A(b)(11) requires the NASD, as a registered securities association, among other things, to formulate rules designed to produce fair and informative quotations.

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

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

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

Comments were neither solicited nor received.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the NASD consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., 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–98–21 and should be submitted by April 13, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[34]

**Margaret H. McFarland,**

*Deputy Secretary.*

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[33] See Senate Comm. on Banking, Housing & Urban Affairs, Report to Accompany S.249, S.Rep. No. 94–75, 94th Cong., 1st Sess. 7, 13, reprinted in 1975 U.S. Code Cong. & Admin. News 179.

[34] 17 CFR 200.30–3(a)(12).

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## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–39762; File No. SR–NASD–98–22]**

## Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to Small Order Execution System Tier Size Classifications

March 16, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on March 9, 1998, the National Association of Securities Dealers (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''SEC'' or ''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 NASD is submitting this filing to effectuate The Nasdaq Stock Market, Inc.'s (''Nasdaq'') periodic reclassification of Nasdaq National Market (''NNM'') securities into appropriate tier sizes for purposes of determining the maximum size order for a particular security eligible for execution through Nasdaq's Small Order Execution System (''SOES''). Specifically, under the proposal, 547 NNM securities will be reclassified into a different SOES tier size effective April 1, 1998. Since the NASD's proposal is an interpretation of existing NASD rules, there are no language changes.

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

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the

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