

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42536; File No. SR-NASD-99-75]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change Relating to ECN and ATS Participation in the ITS/CAES System

March 16, 2000.

I. Introduction

On December 27, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to permit Electronic Communication Networks ("ECNs") and Alternative Trading Systems ("ATSs")³ to register as market makers in listed securities using Nasdaq quotation and trading facilities.

The proposed rule change was published for comment in the **Federal Register** on February 1, 2000.⁴ One comment was received on the proposal.⁵

This order approves the proposed rule change.

II. Description

Nasdaq operates a trading system known as the Computer Assisted Execution System ("CAES"), which allows NASD member firms to direct orders in Consolidated Quotation System ("CQS") securities ("i.e., listed securities) to market makers for execution. Through CAES, NASD order-entry firms and market makers can participate in the "third market"⁶ by entering market and limit orders in exchange-listed securities to be executed against other market makers quoting in those securities. CAES also serves as the NASD's interface with the Intermarket Trading System ("ITS"), which links the national securities exchanges.⁷

Traditional market makers actively make markets in a large number of New York Stock Exchange and American Stock Exchange listed stocks in the third market. While many NASD member firms act as third market makers today, Nasdaq believes that certain enhancements to CAES could provide additional benefits to all NASD members. The enhancements would allow CAES Market Makers to compete more effectively with all markets by providing the best possible executions for investors, thereby improving the national market system.

Accordingly, Nasdaq proposes to allow ECNs and ATSs to choose to be ITS/CAES Market Makers by amending NASD Rules 5210(e), 5220 and 6320, to include ECNs and ATSs within the definition of "ITS/CAES Market Maker" and "CQS Market Maker," and to require the execution of an ECN and ATS addendum to the ITS/CAES Market Maker application agreement. These changes would allow ECNs and ATSs to compete on an equal basis with other market makers, yet also require ECNs and ATSs to assume the additional obligations and restrictions imposed upon ITS/CAES Market Makers by the ITS Plan and NASD rules. An ECN or ATS that chooses to exercise this option of registration, consequently, would be required to post two-sided quotations,

be firm for the price and size of those quotations, and participate in CAES on the same terms as other ITS/CAES Market Makers.⁸ This selection would also impose the additional compliance duties traditionally required of market makers participating in ITS/CAES, including, for example, the rules concerning pre-opening application, trade through, locked and crossed markets, and block transactions.⁹ ECNs and ATSs would assume the added responsibility for implementing all technological and programming modifications to their internal systems to demonstrate compliance with these requirements.

In registering as ITS/CAES Market Makers, ECNs and ATSs will be required to operate on terms that are the same as traditional CAES Market Makers. In particular, within the ITS/CAES market, there will be an absolute prohibition against quote access fees. Nasdaq believes that, because of the CAES interface with ITS, the implementation on quote access fees would be infeasible within CAES and would not be consistent with the terms of the ITS Plan.

In addition, as discussed above, the NASD intends to modify the operation of CAES to accommodate ECN and ATS participation. In the current CAES environment, all orders are executed against market makers through an automatic executive process. The system delivers a report of a completed execution at the market maker's quoted price and size when another CAES market maker or exchange chooses to access that market maker's quote. Because ECNs and ATSs are reluctant to participate within the current automatic execution environment, Nasdaq is working on modifications to CAES to facilitate order delivery interaction for any ITS/CAES Market Maker that chooses to operate in an order delivery mode (with an automated response to the delivered orders). The change would make it clear that all ITS/CAES Market Makers could receive the delivery of an order (as opposed to an execution report), and immediately accept or decline that delivery by automated

⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The term ECN is defined, with certain exceptions, as any electronic system that widely disseminates to third parties orders entered into the ECN by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part. See Exchange Act Rule 11Ac1-1(a)(8). The term ATS is defined more broadly as any organization, association, person, group of persons, or system: (1) That constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Exchange Act Rule 3b-16; and (2) that does not: (i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading. See Regulation ATS, Sec. 242.300(a). Essentially, an ECN is a type of ATS.

⁴ See Securities Exchange Act Release No. 42353 (January 20, 2000), 65 FR 4857.

⁵ See letter to Jonathan G. Katz, Secretary, Commission, from Sam Scott Miller, Orrick,

Herrington & Sutcliffe, LLP, on behalf of MarketXT, dated March 3, 2000 ("MarketXT Letter").

⁶ The third market refers to over-the-counter trading of exchange-listed securities.

⁷ ITS is a communications network designed to facilitate intermarket trading in exchange-listed securities by linking the NASD and the national securities exchanges. Operation of ITS is governed by a national market system plan known as the "Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934" ("ITS Plan").

⁸ With respect to the two-sided quotation obligation, ECN and ATS ITS/CAES Market Makers will be permitted to auto-quote in 100 share lots away from the national best bid and offer ("NBBO") to the extent that a particular ECN or ATS does not have a customer order to represent. If an ECN or ATS ITS/CAES Market Maker quotation is accessed because such quotation becomes the NBBO or is subject to another rule requiring its execution, the ECN or ATS ITS/CAES Market Maker will be required to assume a proprietary position in that security.

⁹ NASD Rules 5240, 5262, 5263, and 5264, respectively.

means.¹⁰ A decline would be permissible only if it were consistent with the Commission's and the NASD's firm quote rules.

Nasdaq contends that this modification will allow market makers to operate effectively and rapidly in fast moving markets. In comparing the proposed CAES order delivery system with the ITS configuration, Nasdaq anticipates that CAES order delivery market makers will be capable of responding to CAES and ITS orders in approximately 2–5 seconds.¹¹

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the Association, and, in particular, with the requirements of Section 15A(b)(6).¹² Section 15A(b)(6) requires that the rules of a registered 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; and the rules are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

In addition, the Commission believes that the proposed rule change is consistent with the provisions of Sections 11A(a)(1)(C), 11A(a)(1)(D), and 11A(a)(2) of the Exchange Act. Section 11A(a)(1)(C) provides that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure: (1) Economically efficient execution of securities transactions; (2) fair competition among brokers and dealers; (3) the availability to brokers, dealers and investors of information

with respect to quotations and transactions in securities; (4) the practicability of brokers executing investors' orders in the best market; and (5) an opportunity for investors' orders to be executed without the participation of a dealer. Section 11A(a)(1)(D) states that the linking of all markets for qualified securities through communications and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and investors, facilitate the offsetting of investor's orders, and contribute the best execution of such orders. Section 11A(a)(2) directs the Commission to facilitate the establishment of a national market system for qualified securities. Overall, the Commission believes that the proposed rule promotes the objectives of these sections of the Exchange Act by encouraging participation in the national market system for listed securities and providing fair access for all NASD members, ultimately benefiting investors and the public interest.

Because ITS remains the primary link between the registered exchanges and Nasdaq for listed securities, ECN and ATS access to ITS is an important Commission goal. Specifically, the Commission seeks to make information non prices, volume, and quotes for securities in *all* markets available to *all* investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell, and not sell for less than the highest price a buyer is prepared to offer. The Commission notes, however, that information alone is not enough. There must be an avenue for accessing markets disseminating market information. Integrating ECNs and ATSs into ITS provides access from other ITS/CAES Market Makers and other markets to the quotes displayed by the ECNs and ATSs.¹³

The number of ECNs and ATSs has increased significantly over the past several years, as has their share of the market in Nasdaq securities. This increased competition has benefited the marketplace in many ways—among other things, it has encouraged the existing exchanges to improve their services, and has given institutional investors additional venues in which to trade. In addition, ECNs have helped to contribute to narrower spreads to the benefit of investors, including retail investors, who have enjoyed significant cost savings when trading Nasdaq

securities. While these benefits have accrued to Nasdaq securities, ECNs have not traded in great measures in securities listed on traditional exchanges.

Linking ECNs and ATSs to ITS by permitting them to register as ITS/CAES Market Makers will improve investors' ability to obtain best execution of their orders in listed stocks. Furthermore, the Commission believes that ECN and ATS participation in CAES should have a positive impact upon the third market, as well as trading in listed securities overall, by adding new competitive quoting vehicles, thereby contributing to a more dynamic and competitive market.

The Commission believes it is appropriate to require ECNs and ATSs that register as ITS/CAES Market Makers to fulfill the same intermarket obligations as are required of traditional market makers. The Commission expects the NASD to ensure that ECN and ATS ITS/CAES Market Makers (as well as non-ECN and non-ATS ITS/CAES Market Makers) carry out necessary technical and programming modifications to their internal systems to demonstrate an ability to comply with these obligations.

ECNs and ATSs that register as ITS/CAES Market Makers will be required to post and maintain two-sided quotations, as well as be firm for the price and size of those quotations, as required in the ITS Plan. In addition, ECN and ATS ITS/CAES Market Makers will be permitted to autoquote in 100 share lots away from the NBBO when they do not have a customer order to represent. The Commission finds it consistent with the Exchange Act to require ECNs and ATSs that participate in ITS/CAES to display two-sided quotes at all times and to be firm for their displayed quotes, including those quotes that do not represent customers orders. In the Commission's view, it is reasonable to permit an ECN or ATS ITS/CAES Market Maker to autoquote in 100 share lots away from the NBBO when it does not have a customer order to represent because ECNs and ATSs typically do not take proprietary positions. An ECN or ATS ITS/CAES Market Maker, however, will be required to be firm for its displayed quote, in accordance with Commission and NASD firm quote rules for any orders that seek to trade with that quote. ECNs and ATSs could reduce the likelihood of an execution at that quote by quoting away from the best market price. Although ECNs and ATSs do not generally assume proprietary positions in the securities they trade, the Commission believes it is appropriate to require them to comply

¹⁰ If order delivery is selected, the ITS/CAES Market Maker (ECN or non-ECN) would be required to demonstrate to Nasdaq its ability to conform to system specifications, which would mandate an automated and immediate acceptance or rejection, consistent with Commission and NASD firm quote obligations.

¹¹ The ITS Plan does not have any requirement related to response times. In fact, in ITS, when one participant forwards a commitment to another, the commitment has a life of one minute or two minutes. The obligation to respond to an ITS commitment comes from the Commission Firm Quote Rule. 17 CFR 240.11Ac1–1.

¹² 15 U.S.C. 780–3(b)(6).

¹³ ECNs also are accessible through becoming a subscriber to the system, and by telephone.

with the same ITS requirements as other market makers if they voluntarily choose to register as an ITS/CAES Market Makers.

The Commission notes that ECN and ATS ITS/CAES Market Makers will also be required to follow the NASD's rules, as well as the terms of the ITS Plan, concerning the pre-opening application, trade throughs, locked and crossed markets, and block transactions.¹⁴ These market integrity provisions provide for continuity of transaction among the various market centers.

The Commission also believes it is appropriate to prohibit ECNs and ATSS that choose to register as ITS/CAES Market Makers from charging quote access fees for trades effected through CAES. Market Makers are prohibited under NASD rules from charging access fees when trading through CAES. Moreover, trades in ITS between markets are not subject to market fees, even though these markets charge fees to their members for executing trades on that market.¹⁵

The Commission also believes it is not inconsistent with the Exchange Act to allow the CAES functionality to operate in order delivery mode, as opposed to automatic execution mode, in accessing an ITS/CAES Market Maker's quote. ECNs, which, to date, have functioned only within order delivery systems (*e.g.*, SelectNet for Nasdaq securities), have been reluctant to participate in CAES due to the automatic execution feature. The proposed rule change will allow all ITS/CAES Market Makers, including ECNs and ATSS that choose to register as such, to operate in CAES in either order delivery mode or automatic

execution mode. The Commission believes that requiring ITS/CAES Market Makers that choose to operate in order delivery mode to have an automated response to an incoming order should ensure that transactions done through CAES, as well as those done through the ITS/CAES interface, are executed efficiently. The ability of an ITS/CAES Market Maker to select the mode of operation in which it receives orders of ITS commitments addresses the ECNs' concerns over exposure to double executions.¹⁶ Specifically, allowing an ITS/CAES Market Maker to operate in order delivery mode will permit it to suspend acceptance of orders when it is in the process of updating its quote, providing such action is in compliance with the Commission's and NASD's firm quote rules.

Finally, the Commission believes that the proposed rule change is not inconsistent with the terms of the ITS Plan. Specifically, under the proposed rule change, ITS/CAES Market Makers will continue to be required to provide automated responses to all ITS commitments sent by other exchange participants to the third market. The Commission notes that, although the proposed rule change may affect the operation of the ITS pre-opening application,¹⁷ no amendment to the ITS Plan is technically required. Specifically, the ITS Plan defines "ITS/CAES Market Maker" as an "NASD member that is registered as a market maker with the NASD * * * with respect to one or more specified ITS/CAES securities." Thus, the NASD's proposed definition of "ITS/CAES Market Maker" does not conflict with or

violate the ITS Plan. Furthermore, nothing in the ITS Plan requires that ITS/CAES Market Maker automatically execute commitments received through ITS.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (SR-NASD-99-75) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,
Deputy Secretary.

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DEPARTMENT OF STATE

[Public Notice 3260]

Culturally Significant Objects Imported for Exhibition Determinations: "Michelangelo to Picasso: Master Drawings From the Collection of the Albertina, Vienna"

DEPARTMENT: United States Department of State.

ACTION: Notice.

SUMMARY: Notice is hereby given of the following determinations: Pursuant to the authority vested in me by the Act of October 19, 1965 [79 Stat. 985, 22 U.S.C. 2459], the Foreign Affairs Reform and Restructuring Act of 1998 [112 Stat. 2681 *et seq.*], Delegation of Authority No. 234 of October 1, 1999 [64 FR 56014], and Delegation of Authority No. 236 of October 19, 1999, as amended by Delegation of Authority No. 236-1 of November 9, 1999, I hereby determine that the objects to be included in the exhibit, "Michelangelo to Picasso: Master Drawings from the Collection of the Albertina, Vienna," imported from abroad for the temporary exhibition without profit within the United States, are of cultural significance. These objects are imported pursuant to a loan agreement with the foreign lender. I also determine that the temporary exhibition or display of the exhibit objects at the Frick Collection, New York, NY, from on or about April 17, 2000, to on or about June 18, 2000, is in the national interest. Public Notice of these determinations is ordered to be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: For further information, including a list of exhibit objects, contact Paul W.

¹⁴ A trade through occurs when a transaction is effected at a price below the best prevailing bid, or above the best prevailing offer. The NASD's rules and the ITS Plan require price protection among the various markets by ensuring that the best national bids and offers are provided opportunities to trade with other markets effecting trades outside the best national quote. The NASD's rules and the ITS Plan also contain a block trade policy that provides special rights to any market displaying the best national bid or offer when block-size transactions are occurring in another market.

¹⁵ The Commission received one comment letter from an ECN regarding the proposed rule change. See MarketXT Letter. MarketXT believes that ECNs should be permitted to charge fees in the ITS/CAES market because Nasdaq has proposed a rule change that would permit market makers to charge an access fee for agency quotes in the Nasdaq market. See Securities Exchange Act Release No. 41343 (April 28, 1999), 64 FR 24430 (May 6, 1999) (File No. SR-NASD-99-16). ECN fees have been permitted in the Nasdaq market since ECNs were first linked to that market in 1997. The Commission has stated that it is considering options to reduce or eliminate ECN fees in the Nasdaq market. The Commission does not believe that investors' interests are best served by permitting ECN fees in the ITS market, where fees are not permitted among existing participants.

¹⁶ Double execution could occur if an ECN displays a customer order to buy and an order to sell comes in through ITS, while another order to sell comes into the ECN at the same time. Automatic execution would force the ECN to honor both sell orders.

¹⁷ Generally, under ITS rules, an exchange specialist is required to accept those pre-opening responses sent to the exchange by market makers from other participant markets prior to the opening of their markets for trading in the security. If, however, one or more market makers from other participant markets have already opened trading in a security, the exchange specialist is not required to (but may in his discretion) accept pre-opening responses from the other participant market for the purpose of including them in the opening transaction. Because a pre-opening response from the ITS/CAES market is sent in aggregate form—that is, pre-opening third market buy and sell interest from all third market makers—is sent as one response, it is possible that an ECN and ATS ITS/CAES Market Maker trading a security before the opening will trigger the exception to the requirement that the exchange specialist accept a pre-opening response from the third market. The same procedure applies of re-openings following trading halts. See Exhibit A of the ITS Plan, "Pre-Opening Application rule," Sec. (b)(iii)(B).

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).