

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45954; File No. SR-NASD-2002-12]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to a Proposed Rule Change and Amendment No. 1 Thereto Relating to the Establishment of a Subordination Agreement Investor Disclosure Document

May 17, 2002.

On January 17, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly-owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to require, as part of a subordination agreement, the execution of a Subordination Agreement Investor Disclosure Document ("Disclosure Document"). On March 21, 2002, NASD Regulation filed Amendment No. 1 to the proposed rule change with the Commission.<sup>3</sup> The proposed rule change, as amended by Amendment No. 1, was published for comment in the *Federal Register* on April 16, 2002.<sup>4</sup> The Commission received no comment letters on the proposal. This order approves the proposed rule change, as amended.

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association and, in particular, the requirements of section 15A of the Act<sup>5</sup> and the rules and regulations thereunder. Specifically, the Commission believes that the proposed rule change is consistent with section 15A(b)(6) of the Act,<sup>6</sup> which, among other things, requires that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect

investors and the public interest. The Commission believes that the Disclosure Document should provide investors with an understanding of the key risks associated with loaning money or securities to a broker-dealer under a subordination agreements.<sup>7</sup>

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>8</sup> that the proposed rule change and Amendment No. 1 thereto (File No. SR-NASD-2002-12) are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Margaret H. McFarland**

*Deputy Secretary*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45930; File No. SR-PCX-2001-13]

### Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Amendment No. 1 Thereto by the Pacific Exchange, Inc. Relating to its Auto-Ex System

May 15, 2002.

#### I. Introduction

On January 30, 2002, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change<sup>3</sup> relating to disengagement of the Exchange's Automatic Execution System for

<sup>7</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>8</sup> 15 U.S.C. 78s(b)(2).

<sup>9</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The Exchange filed this proposed rule change pursuant to the requirements of Section IV.B.h.(i)(bb) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Act, which required the PCX (as well as the other floor-based options exchanges) to adopt new, or amend existing rules concerning automatic quotation and execution systems which specify the circumstances, if any, by which automated execution systems would be disengaged or operated in any manner other than the normal manner set forth in the exchange's rules; and, requires the documentation of the reasons for each decision to disengage an automatic execution system or operate it in any manner other than the normal manner. See Securities Exchange Act Release No. 43268 (September 11, 2000), Administrative Proceeding File No. 3-10282.

Options ("Auto-Ex"), increasing or decreasing Auto-Ex order size, and declaring quotes from away markets unreliable. PCX submitted Amendment No. 1 to the proposed rule change on April 9, 2002.<sup>4</sup> The proposed rule change, as amended by Amendment No. 1, was published for comment in the *Federal Register* on April 15, 2002.<sup>5</sup> The Commission received no comments on the amended proposal. This order approves the proposed rule change, as amended by Amendment No. 1.

#### II. Description of the Proposal

The Exchange proposes to modify PCX's Automatic Execution System Rule (Rule 6.87) to include provisions regarding: (1) Disengaging Auto-Ex and increasing or decreasing the Auto-Ex eligible order size, (2) declaring quotes from away markets unreliable, and (3) documenting these actions. The Exchange also proposes to clarify PCX Rule 6.28.

#### *Disengaging Auto-Ex and Increasing or Decreasing the Auto-Ex Eligible Order Size*

The Exchange proposes to define the unusual market conditions that may permit suspending Auto-Ex or increasing or decreasing the size of orders that may be automatically executed over the Auto-Ex as follows: (1) High volatility (when a stock or the entire market is experiencing rapid and extreme price fluctuations usually accompanied by doublewide spreads); (2) large influx of orders (when volume is two or more times the average daily volume in an issue, or when an extraordinarily large options order is executed on the PCX and reported); or (3) unreliable quote feed (when the Exchange is unable to accurately collect, process and/or disseminate quotation data). Such unusual market conditions may be caused by news announcements (e.g., announcements relating to earnings speculation, economic news, reports of mergers or takeovers, or disasters).

The Exchange's current Rules 6.87(h)(1) and (2) permit suspension of Auto-Ex in the event of floor-wide and non-floor wide Pacific Options Exchange Trading System ("POETS")<sup>6</sup>

<sup>4</sup> See letter from Cindy Sink, Senior Attorney, Regulatory Policy, PCX, to Deborah L. Flynn, Assistant Director, Division of Market Regulation, Commission, dated April 8, 2002 ("Amendment No. 1").

<sup>5</sup> See Securities Exchange Act Release No. 45712 (April 9, 2002), 67 FR 18285 (April 15, 2002).

<sup>6</sup> POETS is the Exchange's automated trading system comprised of an options order routing system, an automatic execution system, an on-line

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> In Amendment No. 1, NASD Regulation made certain clarifications to the Disclosure Document ("Amendment No. 1"). Letter from Patrice M. Cliniecki, Vice President and Acting General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated March 21, 2002.

<sup>4</sup> Securities Exchange Act Release No. 45721 (April 10, 2002), 67 FR 18661.

<sup>5</sup> 15 U.S.C. 78o-3.

<sup>6</sup> 15 U.S.C. 78o-3(b)(6).

malfunction. Current PCX Rule 6.87(h)(3) permits the suspension of Auto-Ex in other unusual situations not involving POETS malfunction. For consistency and clarity, the Exchange proposes to move current PCX Rule 6.28(c)(6) concerning suspension of Auto-Ex and place it in PCX Rule 6.87(h)(3)(B). PCX Rule 6.28(c)(6) provides that if there are unusual market conditions not involving a POETS System malfunction, two Floor Officials may suspend Auto-Ex for a period of time not to exceed five minutes if, because of unusual market conditions or circumstances, the Floor Officials determine that such action is appropriate in maintaining a fair and orderly market. Whenever such action is taken, Floor Officials or senior Exchange Staff must immediately notify a Floor Governor. Thereafter, the suspension of Auto-Ex may be ended, or may be continued for more than five minutes, based on a determination of two Floor Officials and one Floor Governor (or a senior operations officer if no Floor Governor is available).

For consistency and clarity, the Exchange proposes to move and revise current PCX Rule 6.28(c)(8) (concerning the procedure for increasing the permissible size of orders that may be automatically executed over Auto-Ex up to 100 contracts) and place it in PCX Rule 6.87(h)(3)(C). The Exchange also proposes new PCX Rule 6.87(h)(3)(C) which addresses the procedure for decreasing the size of orders that may be automatically executed over Auto-Ex. The proposed procedure provides that two Floor Officials would be permitted to: (1) Increase the size of orders that may be automatically executed over the Auto-Ex system up to 100 contracts; or (2) decrease the size of orders eligible for automatic execution. Such an increase or decrease would be permitted to be approved by two Floor Officials in one or more option issues when they believe that unusual market conditions exist, provided that the decision is made for no more than one trading day. To the extent the conditions exist on the following trading day, two Floor Officials would be required to review the situation again and make an independent decision of whether to increase or decrease the Auto-Ex eligible order size for that subsequent day. Any decisions made by two Floor Officials to increase or decrease the Auto-Ex eligible order size for a particular option issue for two or more consecutive days would be reviewed by the Options Floor Trading Committee at its next regularly

limit order book system, and an automatic market quote update system.

scheduled meeting. Whenever two Floor Officials decrease the size of orders eligible for automatic execution, the lowest number of contracts that would be permitted to be established would be five.

Additionally, the Exchange proposes to amend PCX Rule 6.87(h)(2) to provide for decreasing the guaranteed Auto-Ex size in one or more option issues when a non floor-wide POETS malfunction occurs but the Exchange is able to process and disseminate quotes accurately. In such circumstances, two Floor Officials would be permitted to decrease the guaranteed Auto-Ex size in one or more option issues pursuant to the procedures set forth in PCX Rule 6.87(h)(3)(C).

#### *Declaring Away Markets Unreliable*

The Exchange proposes PCX Rule 6.87(h)(4), which would provide a Floor Official discretion to determine that quotes in one or more particular options classes in a market are not reliable only when: (1) A market's quotes in a particular options class are not firm based upon direct communication to the Exchange from the market or the dissemination through OPRA of a message indicating that disseminated quotes are not firm; or (2) a market has directly communicated to the Exchange or otherwise confirmed that the market is experiencing systems or other problems affecting the reliability of its disseminated quotes.

If one or more of these factors occurs, then the following procedures would be required to be followed. First, an LMM would contact an Order Book Official ("OBO") and request that the away market be declared unreliable. Second, the OBO would contact the control room and request a declaration that the away market is unreliable. Third, if the control room confirmed that an away market is unreliable, then the OBO would contact a Floor Official and request a declaration that the away market is unreliable. Fourth, the Floor Official would review and verify the circumstances and determine whether the away market should be declared unreliable. The OBO would notify the control room that the away market is unreliable and should be removed from the NBBO calculation. Fifth, the Floor Surveillance Unit would contact the away exchange, and notify the away market that one or more of its quotes have been removed from the NBBO calculation. Sixth, the Floor Official would continue to monitor the away market that has been declared unreliable and notify the control room to return to firm mode when appropriate.

Any determination to exclude a market or any of its quotes from the Auto-Ex determination of the NBBO pursuant to the proposed rule would expire at the end of the trading day, or at the time that the quotes are confirmed by the market to be reliable again, whichever occurs first. Exclusion of a market or its quotes from the Auto-Ex determination of the NBBO would be reported to Exchange member firms.

#### *Documentation*

The Exchange proposes to require documentation of any action taken to suspend Auto-Ex, increase or decrease the size of Auto-Ex eligible orders or to operate Auto-Ex in a manner other than the usual manner with an Unusual Activity Report ("UAR"). The UAR would be required to be signed by two Floor Officials and would be required to state the system problem or market activity that led to the Floor Officials' ruling. The UAR information would be recorded in the Floor Surveillance log, which would document the option issues affected by the action, the time the action was taken, the Exchange officials who undertook the action, and the reasons why the action was taken.

Specifically, the following documentation would be required when an away market is declared unreliable: (1) The OBO would be required to log the issue(s) and time of the LMM's request for a declaration that the away market was unreliable; (2) the OBO would be required to prepare a UAR documenting the facts giving rise to the LMM's request, the date, time, and duration of the exclusion and the reasons for placing the away market back into the NBBO calculation; (3) the Floor Official would be required to sign the UAR; and (4) the control room would maintain a log of the time the away market was taken out of the NBBO calculation and the time that the away market was placed back into the NBBO calculation.

#### **III. Discussion**

After careful review, the Commission finds that the proposed rule change, as amended by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>7</sup> and, in particular, the requirements of Section 6 of the Act<sup>8</sup> and the rules and regulations thereunder. The Commission finds specifically that the proposed rule

<sup>7</sup> In approving this proposed rule change, the Commission notes that it has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>8</sup> 15 U.S.C. 78f.

change is consistent with Section 6(b)(5) of the Act<sup>9</sup> because it provides objective criteria and well-defined procedures for: (1) Disengaging and reengaging AUTO-X, which should increase the likelihood that AUTO-X will not be disengaged in a discriminatory manner; and (2) excluding another market's quote from the PCX's NBBO, which should increase the likelihood that PCX's NBBO will more accurately reflect the actual state of the market at a given time. Specifically, the Commission notes that the determination of a Floor Official to exclude unreliable quotes is limited to circumstances in which the away market has either directly communicated or confirmed that its quotes are unreliable. In this way, the discretion afforded to PCX officials to determine that another market's options quotes are unreliable is appropriately limited. Moreover, the record keeping requirements and other proposed procedures are not unreasonable.

#### IV. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>10</sup> that the proposed rule change (SR-PCX-2001-13), as amended by Amendment No. 1, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-45937; File No. SR-PCX-2002-13)

### Self-Regulatory Organization; Order Approving Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Priority of Bids and Offers on the Options Floor and the Manner in Which Orders Must Be Allocated in Connection With Options Transactions

May 15, 2002.

#### I. Introduction

On February 15, 2002, the Pacific Exchange, Inc. ("PCX" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a

proposed rule change relating to priority of bids and offers on the options floor and the manner in which orders must be allocated in connection with options transactions. On March 12, 2002, the PCX submitted Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the **FEDERAL REGISTER** on April 2, 2002.<sup>3</sup> The Commission received no comments on the proposed rule change. This order approves the proposed rule change.

#### II. Description of Proposal

The PCX is proposing to adopt new rules, and to amend existing rules, to include practices and procedures whereby option orders are allocated on the Exchange's Options Trading Floor to address situations where the rules are currently silent. This rule filing is being submitted to the Commission pursuant to subparagraph IV.B.j. of the Commission's Order of September 11, 2000.<sup>4</sup>

The proposed rule change includes provisions that concern several areas, as described below:

##### a. Obligations of Market Makers

The Exchange is proposing to adopt new PCX Rule 6.37(e)(2), which would prohibit any practice or procedure whereby Market Makers trading any particular option issue determine by agreement the allocation of orders that may be executed in that issue.

##### b. Simultaneous Bids and Offers

Currently, PCX Rule 6.75(a) provides that the highest bid has priority, but where two or more bids for the same option contract represent the highest price and one is displayed by the Order Book Official, that bid receives priority over any other bid at the post. If two or more bids represent the highest price and a bid displayed by an Order Book Official is not involved, the rule provides that priority is afforded to those bids in the sequence in which they are made. PCX Rule 6.75(b) applies the same priority principles to offers.

The Exchange is now proposing to adopt new PCX Rule 6.75(c), entitled "Simultaneous Bids and Offers." This proposed provision states that, except as

otherwise provided, if the bids (or offers) of two or more members are made simultaneously, or if it is impossible to determine clearly the order of time in which they were made, such bids (or offers) will be deemed to be on parity and priority will be afforded to them, insofar as practicable, on an equal basis.

##### c. Order Allocation Procedures

###### 1. In General: Determination of Priority Sequence

Proposed PCX Rule 6.75(f)(1) states that a Floor Broker is responsible for determining the sequence in which bids or offers are vocalized on the Trading Floor in response to the Floor Broker's bid, offer, or call for a market. It further states that any disputes regarding a Floor Broker's bid, offer, or call for a market. It further states that any disputes regarding a Floor Broker's determination of time priority sequence will be resolved by the Order Book Official, provided that such determinations of the Order Book Official are subject to further review by two Floor Officials, pursuant to PCX Rule 6.77.

Proposed PCX Rule 6.75(f)(2) provides that when a Floor Broker's bid or offer has been accepted by more than one member, that Floor Broker must designate the members who were first, second, third, and so forth. It further states that, except as otherwise provided, the member with first priority is entitled to buy or sell as many contracts as the Floor Broker may have available to trade. If there are any contracts remaining, the member with second priority will be entitled to buy or sell as many contracts as there are remaining in the Floor Broker's order, and so on, until the Floor Broker's order has been filled entirely.

Proposed PCX Rule 6.75(f)(3) provides that a Market Maker is responsible for determining the sequence in which bids and offers are vocalized on the Trading Floor in response to that Market Maker's bid, offer, or call for a market. Likewise, an Order Book Official is responsible for determining the sequence in which bids and offers are vocalized on the Trading Floor in response to the Order Book Official's bid, offer, or call for a market. The proposed rule further provides that the order allocation procedures for Market Makers and Order Book Officials, including the determination of time priority sequence, are the same as those for Floor Brokers as set forth in proposed PCX Rule 6.75(f)(1) as described above.

<sup>3</sup> See Securities Exchange Act Release No. 45634 (March 22, 2002), 67 FR 15649 (April 2, 2002) ("Notice"). Although the Notice stated that the date of filing of the proposed rule change was February 19, 2002, the proposal was deemed filed on February 15, 2002.

<sup>4</sup> See Order Instituting Public Administrative 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. 43268 (September 11, 2000).

<sup>9</sup> 15 U.S.C. 78f(b)(5).

<sup>10</sup> *Id.*

<sup>11</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).