

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-46305; File No. SR-AMEX-2001-106)

August 2, 2002

Self-Regulatory Organizations; American Stock Exchange LLC; Order Granting Approval to a Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 2 and 3 Thereto Relating to Unlisted Trading Privileges in Nasdaq National Market Securities

I. Introduction and Description of the Proposal

On December 17, 2001, the American Stock Exchange LLC ("Amex" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "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 adopt Amex Rule 118 and to amend Amex Rules 1, 3, 7, 24, 115, 170, 175, 190, 205 and Section 950 of the Amex Company Guide to provide for the trading of Nasdaq Stock Market, Inc. ("Nasdaq") National Market ("NNM") securities pursuant to unlisted trading privileges ("UTP"). On January 14, 2002, the Amex filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended by Amendment No. 1, was published in the Federal Register on February 6, 2002.<sup>4</sup> The Commission received two comment letters and a response. On April 19, 2002, the Amex filed Amendment No. 2 to the proposed rule change<sup>5</sup>

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

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

<sup>3</sup> See letter from Geraldine Brindisi, Vice President and Corporate Secretary, Amex, to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission (January 11, 2002) ("Amendment No. 1").

<sup>4</sup> See Securities Exchange Act Release No. 45365 (January 30, 2002), 67 FR 5626.

<sup>5</sup> See letter from Claire P. McGrath, Senior Vice President and Deputy General Counsel, Amex, to Katherine England, Assistant Director, Division, Commission (April 18, 2002) ("Amendment No. 2"). In Amendment No. 2, the Exchange amended the proposed

and on July 26, 2002 filed Amendment No. 3 to the proposed rule change.<sup>6</sup> This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comment on and is simultaneously approving, on an accelerated basis, Amendment Nos. 2 and 3 to the proposal.

The Exchange is proposing rules to accommodate trading of NNM securities on the Exchange pursuant to UTP, in accordance with provisions of the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis (“Plan”). The Exchange is a participant in the Plan. Exchange trading in NNM securities will be governed primarily by Amex Rule 118, Trading in Nasdaq National Market Securities. The Exchange intends to limit Nasdaq UTP trading to NNM issues and not to include Nasdaq SmallCap issues at this time.

Proposed Rule 118:

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Amex Rule 118, Trading in Nasdaq National Market Securities, to provide that orders sent via telephone from other market centers to the Floor and executed by the Amex specialist must be compared and cleared through an Exchange member or member organization or the clearing firm of a member or member organization.

<sup>6</sup> See letter from Claire P. McGrath, Senior Vice President and Deputy General Counsel, Amex, to Nancy Sanow, Assistant Director, Division, Commission (July 25, 2002) (“Amendment No. 3”). In Amendment No. 3, the Exchange deleted formerly proposed Commentary .01 to Rule 175, Specialist Prohibitions. See Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232 (July 23, 2002). In addition, in Commentary .01 to Rule 118, Trading in Nasdaq National Market Securities, the Exchange deleted a formerly proposed reference to Commentary .01 to Rule 175 due to deletion of the referenced Commentary by Amendment No. 3. Finally, the Exchange deleted formerly proposed Commentary .05 to Rule 205, Manner of Executing Odd-Lot Orders, because of a related Exchange rule filing addressing odd-lot executions in NNM securities. See Securities Exchange Act Release No. 46148 (June 28, 2002), 67 FR 45773 (July 10, 2002) (File No. SR-Amex-2002-56). SR-Amex-2002-56 proposes to add a new subsection (j) to Rule 118 that deals specifically with executions of odd-lot orders in Nasdaq securities.

- (a) Defines NNM security and Nasdaq System.
- (b) States that the Exchange Constitution and rules apply to trading NNM securities, except to the extent that Rule 118 governs or unless the context otherwise requires.
- (c) Requires Amex specialists to permit Nasdaq market makers direct telephone access to the specialist post and allows Nasdaq market makers to use telephone access to transmit orders for execution on the Amex.
- (d) Provides that quotations distributed by Nasdaq market makers will be displayed on the Floor, that Amex specialists may send orders from the Floor for execution via telephone to Nasdaq market makers, and that quotations in Nasdaq securities from other market centers have no standing on the Floor.
- (e) Provides that the Exchange will report intermarket transactions in which the Exchange member is the seller to the Nasdaq UTP Securities Information Processor (“SIP”).
- (f) Provides that intermarket transactions in NNM securities must be compared and cleared through an Exchange member or member organization or the clearing firm of a member or member organization.
- (g) Provides that specialists in Nasdaq securities must be registered and qualified, and includes specified testing and training requirements.<sup>7</sup>
- (h) Provides for a disclaimer of Exchange liability with respect to transactions on the Exchange in NNM securities, in accordance with Article IV, Section 1 (e) of the

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<sup>7</sup> The Commission notes that under Amex Rule 175, specialists registered as such in securities admitted to dealings pursuant to UTP may be affiliated with specialists, registered options traders, and other market makers in options on the specialty UTP securities provided that information barriers are established, approved, and maintained pursuant to Amex Rule 193 between the stock and options specialist units. However, side-by-side trading of stocks and related options is not permitted. See Securities Exchange Act Release No. 46213 (July 16, 2002).

Exchange Constitution.

- (i) Provides that the specialist financial requirements of Rule 171, Commentary .04 apply to specialists in Nasdaq securities. Rule 171, Commentary .04 currently provides that a specialist in a security principally traded or priced in another U.S. market must maintain a cash or net liquid asset position sufficient to assume a position of 20 trading units. For Amex-listed securities, the requirement is 60 trading units.

The following existing Amex rules also would be amended to accommodate Nasdaq UTP trading:<sup>8</sup>

Rule 1, Comm. .05

Provides that the hours of business for securities traded on the Exchange pursuant to UTP are the same as the hours of trading in the primary market for such securities.<sup>9</sup>

Rule 3

Exempts trading with non-member Nasdaq market makers from the prohibition on trading with non-members.

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<sup>8</sup> The Commission has separately approved allocation procedures applicable to NNM securities. See Securities Exchange Act Release No. 45698 (April 5, 2002), 67 FR 18051 (April 12, 2002).

<sup>9</sup> The Commission notes that the Plan defines Primary Market. However, in Plan Amendment No. 13, the Plan participants propose to delete the Primary Market definition and add a Listing Market definition. If the Primary Market definition is ultimately deleted and the Listing Market definition is added to the Plan, the Exchange should reflect this change in its rules where applicable. See Securities Exchange Act Release No. 46139 (June 28, 2002), 67 FR 44888 (July 5, 2002) (Notice of Filing and Partial Summary Effectiveness of Amendment No. 13 of the Plan).

## Rule 7

States that Rule 7, which includes the short selling “tick-test” restriction of Rule 10a-1 under the Act, does not apply to transactions in NNM securities effected under Rule 118.<sup>10</sup>

## Rule 24

Exempts NNM securities from the rule’s block transactions restrictions. Rule 24 states that, after learning about a trade executed or about to be executed on the Floor involving 10,000 shares or more, a member or employee of a member or member organization cannot initiate or transmit to the Floor an order for the account of a member or member organization for two minutes following the print of the trade on the tape. The Exchange does not believe it is appropriate to apply the restrictions in Rule 24 to NNM securities, for which Amex would not be the primary market.<sup>11</sup>

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<sup>10</sup> The Commission notes that the proposed amendment to Amex Rule 7, Short Sales, does not require an exemption from the Commission’s short sale rule, Rule 10a-1, since Nasdaq securities currently are excluded from the Rule. See 17 CFR 240.10a-1(a)(1)(ii). However, Nasdaq has applied to become a national securities exchange. See Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001). If Nasdaq becomes a registered national securities exchange, Nasdaq securities will be exchange listed and subparagraph (ii) of Rule 10a-1 will no longer be available. Accordingly, the Exchange specialists trading Nasdaq securities would be subject to Rule 10a-1 unless the Exchange obtains an exemption from the Rule. Nasdaq has requested an exemption from Rule 10a-1.

<sup>11</sup> While Nasdaq UTP trading on the Amex will be exempt from Amex Rule 24, the Commission notes that, with respect to trading in all securities on the Exchange, including Nasdaq securities traded pursuant to UTP, it is a violation of just and equitable principles of trade, see Amex Constitution Article V, Section 4(h), for a person with material non-public information of an imminent transaction in a security to take advantage of that information by effecting trades in that security or related securities. The Exchange’s frontrunning prohibition currently applies not only to trading options ahead of a block of stock, but also to trading activity in the same stock (“stock to stock frontrunning”). The Exchange has procedures in place to examine for stock to stock frontrunning activity, and these procedures will be applied to Amex trading in Nasdaq securities traded pursuant to UTP. See letter from Richard T. Chase, Executive Vice President, Member Firm Regulation, Amex, to Nancy Sanow,

### Rule 115

Amends Commentary .01(3) to provide for notification to the SIP for NNM securities in the event unusual market activity or an unusual condition exists that prevents the specialist from updating quotations on a timely basis.

### Rule 170, Comm. .11

Exempts specialists from Rule 170, paragraph (e) and specified Commentary to the rule. Rule 170(e) restricts members or persons affiliated with a specialist or the specialist's member organization from purchasing or selling a specialty security for an account in which such person or party has an interest, except when the specialist is acting pursuant to Rule 170(c) or (d) (e.g., is engaged in dealings reasonably necessary to maintain a fair and orderly market, and to maintain price continuity and reasonable depth). Amex as a primary market for listed securities imposes the requirements of Amex Rule 170. However, the proposed exemption provides regulatory parity with other markets trading Nasdaq securities.<sup>12</sup> The Exchange notes that the requirements of Rules 150 and 155 will apply to orders entered with a specialist in NNM securities from affiliates of the specialist.

### Rule 190

Provides that paragraph (b) shall not apply to NNM securities. Paragraph (b) prohibits specialists from accepting an order to buy or sell the specialist's specialty securities directly from specified entities, including the issuer; an officer, director or 10% shareholder in the issuer; a pension fund; or a bank, insurance company or investment company. The Exchange does not

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Assistant Director, Division, Commission, dated July 31, 2002.

<sup>12</sup> The Commission notes that Amex members remain subject to Section 11(a) under the Act, 15 U.S.C. 78k, and the rules thereunder.

view the potential abuses addressed by paragraph (b) as raised by trading in NNM securities insofar as the Exchange would not be the primary market for these securities, and restrictions such as those in Rule 190(b) are not imposed by regional exchanges or Nasdaq.

## Company Guide

### Section 950

Adds Commentary .01 to state that the Exchange may trade NNM securities pursuant to UTP. This provision would distinguish Nasdaq UTP trading from Amex securities that were admitted to UTP and that, for the most part, were traded on the Amex before 1934.

## II. Summary of Comments and Response to Comments

The Commission received a comment letter on the proposed rule change from Knight Trading Group, Inc. (“Knight”) on February 28, 2002,<sup>13</sup> which expressed concern that the proposal will disrupt the national market system and undermine the Firm Quote Rule.<sup>14</sup> Specifically, Knight argued in its comment letter that the proposal will disrupt the national market system by permitting Amex members to trade NNM securities without providing automatic execution and thereby delay executions. Knight asserts that all Nasdaq market participants currently provide automatic

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<sup>13</sup> See Letter from Michael T. Dorsey, Senior Vice President, General Counsel, and Secretary, Knight, to Commission (February 28, 2002). In its comment letter, Knight incorporated by reference its comment letters previously filed with the Commission with regard to the expansion of the issues trading by means of the Plan as well as its comments regarding the admission of new entrants to the Plan. See Letter from Michael T. Dorsey (“Dorsey”), Senior Vice President and General Counsel (“SVP/GC”), Knight, to Jonathan Katz (“Katz”), Secretary, Commission (December 19, 2000); Letter from Dorsey, SVP/GC, Knight, to Katz, Secretary, Commission (December 13, 2000); Letter from Dorsey, SVP/GC, Knight, to Katz, Secretary, Commission (November 1, 2000); see also Letter from Richard B. Levin, Assistant General Counsel and Regulatory Affairs Officer, Knight, to Katz, Secretary, Commission (April 17, 2001).

<sup>14</sup> 17 CFR 240.11Ac1-1.

execution through either SuperSOES or Select Net.<sup>15</sup> Knight also contended that the proposal will permit Amex members to obtain an unfair informational advantage by monitoring the trading and quoting activity of NNM securities without accepting automatic executions. Knight also asserted that the proposal will unfairly require market participants to provide Amex specialists telephonic access to their quotes, while orders sent to the Amex by Nasdaq market makers will not be afforded any standing on the Amex floor. Further, Knight argued that the proposal will undermine the Firm Quote Rule<sup>16</sup> because UTP exchange members are not required to provide automatic execution against their quotes and can enter orders that lock and cross markets. Knight states “the Commission should not permit AMEX members to trade Nasdaq issues without being subject to automatic executions.” Knight further argues that the proposal “enables AMEX members to adhere to auction market principles even though this behavior will disrupt the fair and orderly trading of Nasdaq issues within the national market system.”

The Commission received a response to Knight’s comment letter from the Amex on May 21, 2002,<sup>17</sup> which addressed various points raised in Knight’s comment letter. First, Amex argued that trading by telephone will not delay executions because the Amex does not anticipate a significant proportion of orders being telephoned to or from Amex specialists. Instead, the Amex anticipates that most orders for Nasdaq securities will be sent through the Common Message Switch for routing to specialists’ posts. Moreover, Amex believes that trading by telephone is permissible since it is explicitly contemplated under the Plan. Amex also noted that Knight’s argument is

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<sup>15</sup> The Commission notes that SelectNet is not, in fact, an automatic execution system.

<sup>16</sup> 17 CFR 240.11Ac1-1.

<sup>17</sup> See letter from Michael J. Ryan, Jr., Executive Vice President & General Counsel, Amex, to Katz, Secretary, Commission (May 21, 2002).

unfounded because of the Nasdaq rule that automatically permits SuperSOES to trade through the quotes of Plan participants. Second, the Amex argued that UTP specialists will have no informational advantage by slowing the execution process, viewing quotation messages, and adjusting their quotes and positions accordingly. Amex asserted that Amex UTP specialists will not have any additional information that is not also available to other Plan participants and Nasdaq market makers. Finally, Amex averred that UTP trading will not have a detrimental impact on the Firm Quote Rule<sup>18</sup> and that Knight's assertion otherwise is unsupported. Amex stated that any increase in the number of inter-market locked and crossed markets subsequent to the Commission approving the Amex's UTP trading rules would likely be caused by Nasdaq's trading rules. Specifically, Amex referenced the Nasdaq trading rule that permits trading through of quotes of UTP participants that do not use Nasdaq automatic execution systems.

The Commission also received a comment letter from a Congressional panel ("Panel") on May 30, 2002.<sup>19</sup> In its comment letter, the Panel expressed its concern that the proposal would not be "consistent with the maintenance of fair and orderly markets and the protection of investors" as is required by Section 12(f)(2) of the Act.<sup>20</sup> Specifically, the Panel argued that the lack of an automatic execution requirement could increase the incidence of "locked" and "crossed" markets. Moreover, the Panel stated that without automatic executions the result would be an unequal playing field favoring those market participants with the least sophisticated technology. Such unsophisticated market participants could gain an advantage by monitoring market activity without

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<sup>18</sup> 17 CFR 240.11Ac1-1.

<sup>19</sup> See letter from Congresswoman Judy Biggert, Congressmen Mike Ferguson, Walter B. Jones, Mike Rogers, Ed Royce, and Patrick Tiberi to The Honorable Harvey Pitt, Chairman, Commission (May 29, 2002).

<sup>20</sup> 15 U.S.C. 78l(f)(2).

being subject to automatic executions. As discussed above, the Amex substantially addressed the Panel's comments in the Amex response to Knight's comment letter.

### III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations promulgated thereunder applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b)<sup>21</sup> of the Act. Specifically, the Commission finds that approval of the proposed rule change is consistent with Section 6(b)(5)<sup>22</sup> of the Act because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.<sup>23</sup>

Moreover, the Commission, pursuant to Section 19(b)(2)<sup>24</sup> of the Act, finds good cause for approving Amendment Nos. 2 and 3 prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. The Commission notes that granting accelerated approval to Amendment No. 2 will allow the Amex to implement its intermarket trade comparison and clearing procedures and commence trading of NNM securities on a UTP basis in a timely

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<sup>21</sup> 15 U.S.C. 78f(b). 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>22</sup> 15 U.S.C. 78f(b)(5).

<sup>23</sup> The Amex has informed the Commission that its systems are not capable of reporting or clearing transactions in sub pennies. If an Amex specialist were to effect a trade in sub pennies, the Amex has represented that it will advise specialists to effect the trade with the customer at a rounded price. See Information Circular (7/02). The Commission expects the Amex to address this system limitation in the near future.

<sup>24</sup> 15 U.S.C. 78s(b)(2).

fashion. In addition, Amex discussed the substance of Amendment No. 2 with the Plan Participants at meetings of the Operating Committee. The Commission notes that granting accelerated approval to Amendment No. 3 will harmonize the instant proposal with other Amex proposals that have been approved or will be contemporaneously approved.

The Commission has carefully considered all the issues raised by the commenters and is not persuaded by their arguments. Knight and the Panel essentially argued that accepting automatic execution is a pre-condition to trading Nasdaq securities pursuant to UTP and the only way to comply with the Firm Quote Rule.<sup>25</sup> In addition, the commenters argued that telephone access provides Amex specialists an advantage over other Plan participants who are required to accept automatic execution. According to Knight, an Amex specialist could “obtain an unfair informational advantage by monitoring the trading and quoting activity of Nasdaq issues in the national market system without accepting automatic executions like all other market participants trading Nasdaq issues.”<sup>26</sup>

First, participating in Nasdaq’s automatic execution facility is not a requirement for exchanges to trade Nasdaq issues. The Commission has not required competitors to participate in a Nasdaq trading facility or required Nasdaq to provide access to its trading facilities to its competitors. Each of the UTP participants has independently decided whether to participate in Nasdaq’s automatic execution facility. Two of the participants, in addition to the Amex, have chosen not to participate – the Philadelphia Stock Exchange, Inc. and the Cincinnati Stock Exchange, Inc. Second, providing automatic executions – rather than operating an auction market – is not a precondition to competing in Nasdaq securities. The very essence of UTP is to

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<sup>25</sup> 17 CFR 240.11Ac1-1.

<sup>26</sup> See Knight letter page 2.

permit competition among markets and market structures. Requiring one market structure for trading Nasdaq securities would defeat this purpose. Third, while compliance with the Firm Quote Rule<sup>27</sup> is easier to monitor in an automatic execution environment, the Firm Quote Rule does not require market participants to be subject to automatic execution. Indeed, the Firm Quote Rule has always applied to exchange trading as well as over-the-counter trading.

The Commission is unconvinced by the assertion of Knight and the Panel that Amex specialists will have an informational advantage because they will be able to monitor trading and quoting activity of Nasdaq securities while not being subject to automatic execution. Amex specialists, as well as the specialists of all other Plan participants, will be able to see the market for Nasdaq securities. They will have no special advantage. As noted above, two other participants have chosen not to participate in Nasdaq's automatic execution system. Furthermore, Amex specialists must comply with the Firm Quote Rule. If an Amex specialist quotes the best bid or offer for a security and receives an order, it must fill the order in compliance with the Firm Quote Rule. To be sure, it will generally take longer to receive a fill from an Amex specialist than it will to receive a fill from a Nasdaq member that is subject to automatic execution. This does not, however, make trading pursuant to UTP under the Plan impermissible under the Act and the rules and regulations thereunder.

In November of 2001, the Commission approved the most recent amendment to the Plan.<sup>28</sup> Among other things, the 12<sup>th</sup> Amendment extended UTP to all Nasdaq securities, SmallCap as well as NNM. The 12<sup>th</sup> Amendment also admitted the Amex as a participant. As has been the case since the inception of the Plan, exchange participants are required to provide

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<sup>27</sup> 17 CFR 240.11Ac1-1.

<sup>28</sup> See Securities Exchange Act Release No. 45081 (November 19, 2001), 66 FR 59273 (November 27, 2001).

telephone access to Nasdaq market makers. This proposed rule change, SR-Amex-2001-106, spells out the rules that an Amex specialist must follow if it trades Nasdaq securities on the Exchange. The commenters' concerns appear to be with the extension of UTP to the regional exchanges and the choice of some of the regional exchanges not to participate in Nasdaq's automated execution system. The Commission believes that the commenters' concerns are more appropriately raised in the context of the approval and amendment process of the Plan, rather than in the context of a single Plan participant's rules related to trading under the Plan and that are consistent with the Plan.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 2 and 3, including whether the amendments are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. 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 Amex. All submissions should refer to File No. SR-Amex-2001-106 and should be submitted by [insert date 21 days from date of this publication].

#### V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>29</sup> that the proposed rule change (SR-Amex-2001-106), as amended, is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>30</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>29</sup> 15 U.S.C. 78s(b)(2).

<sup>30</sup> 17 CFR 200.30-2(a)(12).