

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49913; File No. SR-NSX-2004-04)

June 24, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Stock Exchange to Extend an Existing Pilot Rule that Stipulates the Price Increment by which Designated Dealers Must Better Customer Orders

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> notice is hereby given that on June 17, 2004, the National Stock Exchange ("Exchange")<sup>3</sup> filed with the Securities and Exchange Commission ("Commission") the proposed rule change, as described in Items I and II, below, which Items have been prepared by the Exchange. The Exchange has filed this proposed rule change pursuant to Section 19(b)(3)(A) of the Act<sup>4</sup> and Rule 19b-4(f)(6) thereunder,<sup>5</sup> which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comment 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 Exchange proposes to extend the termination date of pilot Exchange Rule 12.6, Interpretation .02, which requires an Exchange Designated Dealer ("Specialist") to

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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> The Exchange recently changed its name and was formerly known as The Cincinnati Stock Exchange or "CSE". See Securities Exchange Act Release No. 48774 (November 12, 2003), 68 FR 65332 (November 19, 2003) (SR-CSE-2003-12).

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>5</sup> 17 CFR 240.19b-4(f)(6).

better the price of a customer limit order held by the Specialist if the Specialist decides to trade with an incoming market or marketable limit order.<sup>6</sup> Pursuant to Interpretation .02(a), the Specialist is required to better a customer limit order at the national best bid or offer ("NBBO") by at least one penny. Pursuant to Interpretation .02(b), if the customer limit order is outside the current NBBO, the Specialist is required to better the customer limit order by at least the nearest penny increment.

The Exchange seeks to extend the pilot through June 30, 2005.<sup>7</sup> The Exchange does not seek to make substantive changes to the pilot at this time. The text of the proposed rule change is available at the Exchange's Office of the Secretary and at the Commission's Public Reference Room.

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 Exchange 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 and is set forth in sections A, B, and C below, of the most significant aspects of such statements.

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<sup>6</sup> See Securities Exchange Act Release Nos. 46274 (July 29, 2002), 67 FR 50743 (August 5, 2002) (establishing pilot); 46554 (September 25, 2002), 67 FR 6276 (October 4, 2002) (first extension of pilot); 46929 (November 27, 2002), 67 FR 72711 (December 6, 2002) (second extension of pilot); 47941 (May 29, 2003), 68 FR 33751 (June 5, 2003) (third extension of pilot).

<sup>7</sup> The Exchange understands that the Commission's proposed Regulation NMS may have an impact on this pilot program. Accordingly, the Exchange has stated that it will undertake to work with the Commission to ensure that the pilot program would be consistent with the rules and regulations contained in Regulation NMS, when it is adopted.

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

1. Purpose

The Exchange proposes to extend its pilot Interpretation .02 under Exchange Rule 12.6,<sup>8</sup> which relates to the trading of securities in subpenny increments.<sup>9</sup> Interpretation

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<sup>8</sup> Exchange Rule 12.6 provides, in pertinent part, that no member shall: (i) personally buy or initiate the purchase of any security traded on the Exchange for its own account or for any account in which it or any associated person of the member is directly or indirectly interested while such member holds or has knowledge that any person associated with it holds an unexecuted market or limit price order to buy such security in the unit of trading for a customer, or (ii) sell or initiate the sale of any such security for any such account while it personally holds or has knowledge that any person associated with it holds an unexecuted market or limit price order to sell such security in the unit of trading for a customer.

<sup>9</sup> In connection with pilot Interpretation .02, the Exchange also has received a Commission exemption from Rules 11Ac-1, 11Ac1-2, and 11Ac1-4 under the Act, 17 CFR 240.11Ac-1, 240.11Ac1-2, and 240.11Ac1-4, that allows Exchange members to display their quotes for Nasdaq National Market securities in whole penny increments while trading in subpenny increments. See letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation ("Division"), Commission, to Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, dated July 26, 2002 (granting initial exemption) in response to letter from Jeffrey T. Brown, Senior Vice President and General Counsel, the Exchange, to Annette Nazareth, Director, Division, Commission, dated November 27, 2001 (requesting initial exemption); letter from Robert L.D. Colby, Deputy Director, Division, Commission, to Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, dated September 25, 2002 (amending and extending initial exemption) in response to letter from Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, to Annette Nazareth, Director, Division, Commission, dated September 18, 2002 (requesting first extension); letter from Alden S. Adkins, Associate Director, Division, Commission, to Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, dated November 27, 2002 (grating second extension) in response to letter from Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, to Annette Nazareth, Director, Division, Commission, dated November 20, 2002 (requesting second extension); letter from Robert L.D. Colby, Deputy Director, Division, Commission, to Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, dated May 29, 2003 (granting third extension) in response to letter from Jeffrey T. Brown, Senior Vice President and General Counsel, Exchange, to Annette Nazareth, Director, Division, Commission, dated May 19, 2003 (requesting third extension); letter from Robert L.D. Colby, Deputy Director,

.02 of Exchange Rule 12.6 requires a Specialist to better the price of a customer limit order held by the Specialist by at least one penny (for those customer limit orders at the NBBO) or at least the nearest penny increment (for those customer limit orders that are not at the NBBO) if the Specialist determines to trade with an incoming market or marketable limit order.<sup>10</sup>

The purpose of the Interpretation is to prevent a Specialist from taking unfair advantage of customer limit orders held by that Specialist by trading with incoming market or marketable limit orders ahead of such orders. Although a Specialist may price-improve incoming orders by providing prices superior to that of the customer limit orders that he or she holds, customers should have a reasonable expectation to have their orders filled at their limit order prices. This expectation should be reflected in reasonable access to incoming contra-side order flow, unless other customers place better-priced limit orders with the Specialist or the Specialist materially improves upon the prices of the customer limit order that he or she holds (not the customers' quoted prices).

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Division, Commission, to Jennifer M. Lamie, Assistant General Counsel and Secretary, Exchange, dated December 1, 2003 (granting fourth extension) in response to letter from Jennifer M. Lamie, Assistant General Counsel and Secretary, Exchange, to Annette Nazareth, Director, Division, Commission, dated November 21, 2003 (requesting fourth extension). In conjunction with the proposed rule change, the Exchange has requested that the Commission extend its exemption from Rules 11Ac1-1, 11Ac1-2, and 11Ac1-4 under the Act to allow subpenny quotations to be rounded down (for buy orders) and rounded up (for sell orders) to the nearest penny for quote dissemination for Nasdaq and listed securities. See letter from James C. Yong, Senior Vice President, Regulation and General Counsel, Exchange, to Annette Nazareth, Director, Division, Commission, dated May 20, 2004.

<sup>10</sup> Interpretation .01 to Rule 12.6 provides that "[i]f a Designated Dealer holds for execution on the Exchange a customer buy order and a customer sell order that can be crossed, the Designated Dealer shall cross them without interpositioning itself as a dealer."

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with the provisions of Section 6(b) of the Act<sup>11</sup> in general and Section 6(b)(5) of the Act<sup>12</sup> in particular, which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, 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.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

The Exchange has neither solicited nor received written comments on the proposed rule change.

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

The Exchange asserts that the proposed rule change is immediately effective pursuant to Section 19(b)(3)(A) of the Act<sup>13</sup> and Rule 19b-4(f)(6) thereunder<sup>14</sup> because it: (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for

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<sup>11</sup> 15 U.S.C. 78f(b).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

<sup>13</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>14</sup> 17 CFR 240.19b-4(f)(6).

30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with protection of investors and the public interest.<sup>15</sup>

The Exchange has requested that the Commission waive the 30-day operative date in this case, and the Commission hereby grants this request.<sup>16</sup> The Commission believes that waiving the 30-day pre-operative period is consistent with the protection of investors and the public interest because it will allow the pilot to continue uninterrupted. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such proposed rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### 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 Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

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<sup>15</sup> In addition, to submit a filing pursuant to Rule 19b-4(f)(6) under the Act, paragraph (f)(6)(iii) thereof also requires the Exchange to give the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange complied with this requirement. See letter from James C. Yong, Senior Vice President, Regulation and General Counsel, Exchange, to Nancy Sanow, Assistant Director, Division, Commission, dated May 20, 2004.

<sup>16</sup> For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include SR-NSX-2004-04 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to SR-NSX-2004-04. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to SR-NSX-2004-04 and should be submitted on or before  
[insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated  
authority.<sup>17</sup>

Margaret H. McFarland  
Deputy Secretary

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