

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52576; File No. SR-NSX-2005-06)

October 7, 2005

Self-Regulatory Organizations; National Stock Exchange; Notice of Filing of Proposed Rule Change, and Amendment Nos. 1 and 2 Thereto, to Amend the Exchange's Customer Priority Rule to Require Designated Dealers to Implement and Maintain Automated Compliance Systems

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 19, 2005, the National Stock ExchangeSM ("NSX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NSX. On October 5, 2005, the Exchange filed Amendment No. 1 to the proposed rule change. On October 7, 2005, the Exchange filed Amendment No. 2 to the proposed rule change. Amendment Nos. 1 and 2 are incorporated into this notice. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to amend the text of Exchange Rule 12.6 ("Customer Priority Rule") to require the Exchange's Designated Dealers to implement and maintain automated systems reasonably designed to ensure compliance with the Customer Priority Rule. The text of the proposed rule change is set forth below. Proposed new language is in italics.

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¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

RULES
OF
NATIONAL STOCK EXCHANGE

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CHAPTER XII

Trading Practice Rules

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Rule 12.6. Customer Priority

(a) — (c) No change to text

(d) (Reserved).

(e) Designated Dealers executing customer orders on the Exchange are required to implement and maintain automated systems reasonably designed to ensure compliance with this Rule. The Exchange will allow any Designated Dealer to comply manually with the provisions of this Rule for a reasonably limited duration in the event that such Designated Dealer's automated systems become inoperative as a result of any act, condition or cause beyond the reasonable control of the Designated Dealer, including, but not limited to, an act of God, fire, flood, extraordinary weather conditions, war, insurrection, riot, strike, accident, action of government, communications or power failure, or any equipment or software malfunction. Designated Dealers shall not otherwise disable or disengage their automated systems. Designated Dealers shall promptly notify the Exchange of any changes in the operating status of their automated systems.

Interpretations and Policies

.01 If 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's automated system shall systemically cross them without interpositioning itself as a dealer.

.02 No change to text

.03 A member or any associated person of a member responsible for entering orders for its own account or any account in which it is directly or indirectly interested shall be presumed to have knowledge of a particular unexecuted customer order. Such presumption can be rebutted by adequate evidence which effectively demonstrates, to the Exchange's satisfaction, that the member has implemented a reasonable system of internal policies and procedures and has an adequate system of internal controls to prevent the misuse of information about customer orders by those responsible for entering such proprietary orders.

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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 proposal and discussed any comments it received on the proposed rule change, as amended. The text of these statements may be examined at the places specified in Item IV below. The Exchange 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. Purpose

The Customer Priority Rule provides, in pertinent part, that no member of the Exchange 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.

On May 19, 2005, the Exchange consented to the entry of an order by the Commission instituting administrative and cease-and-desist proceedings pursuant to Sections 19(b) and 21C of the Act.³ The Settlement Order found, among other things, that the Exchange failed to enforce compliance by its members with the Customer Priority Rule. As part of its undertakings in the Settlement Order, the Exchange agreed to propose rule changes requiring Designated Dealers to implement systems enhancements to comply with the Customer Priority Rule.

In late 2004, the Exchange implemented automated daily surveillance for potential violations of the Customer Priority Rule. The Exchange believes that requiring Designated Dealers to have automated systems reasonably designed to comply with the Customer Priority Rule before and during the process of executing a proprietary trade would effectively complement the Exchange's post-trade surveillance. Accordingly, the Exchange proposes to require its Designated Dealers to implement and maintain automated systems reasonably designed to meet

³ See Exchange Act Release No. 51714 (May 19, 2005) ("Settlement Order").

this goal. Moreover, the Exchange believes that the proposed amendment is designed to further ensure that executable public orders on the Exchange are protected to the fullest possible extent.

The Exchange has long recognized the utility of information barriers in preventing the misuse of information by an associated or affiliated person of a member when such information is acquired or generated by another associated or affiliated person of such member under an obligation to protect such information. For example, Exchange Rule 5.5 provides for the establishment by Designated Dealers of procedures reasonably designed to prevent misuse by the firms' associated and affiliated persons of the information associated with the firms' specialist operations.⁴ While Rule 5.5 by its terms is applicable only to Designated Dealers, the Exchange believes that any member may establish appropriate functional separation to prevent the misuse of information about customer orders by those responsible for entering proprietary orders. Members with effective information barriers can avoid violations of the Customer Priority Rule because such information barriers would prevent the members from having the requisite knowledge that they are holding an unexecuted customer order. In order to clarify and codify this interpretation, the Exchange is proposing to add a new interpretation to the Customer Priority Rule. This proposed Interpretation .03 to Rule 12.6 indicates that a member or associated persons of a member responsible for entering proprietary orders presumptively has knowledge of a particular customer order. Any member or associated person of a member can rebut this presumption by providing evidence to the Regulatory Services Division of the Exchange demonstrating that the member has

⁴ The Exchange's Examination Department regularly examines those Designated Dealers that previously obtained Exchange approval under Rule 5.5 for the functional separation of such firm's specialist operations from the firm's associated and affiliated persons. These examinations help ensure the existence of the Designated Dealers' compliance and audit procedures reasonably designed to maintain functional separation as evidenced by such things as separate physical locations and limitations on traders' access to information while at the firms.

a system of internal policies and procedures and an adequate system of internal controls in place to prevent the misuse of information about customer orders by those responsible for entering proprietary orders.⁵ The evidence provided by the member or the associated person of the member may be subjected to further scrutiny, investigation and examination by the Regulatory Services Division to determine whether the presumption has been adequately rebutted.⁶

2. Statutory Basis

The Exchange believes the proposed rule change, as amended, is consistent with Section 6(b) of the Act⁷ in general, and furthers the objectives of Section 6(b)(5)⁸ in particular, in that it is designed to promote just and equitable principles of trade and to remove impediments to and perfect the mechanism of a free and open market and a national market system and, generally, in that it protects 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, as amended, will impose any inappropriate burden on competition.

⁵ The Exchange believes that this proposal is consistent with the way in which other self-regulatory organizations interpret their trading ahead rules. See, e.g., Supplementary Material .10 of NYSE Rule 92 and NASD Notice to Members 95-43 (interpreting NASD IM-2110-2).

⁶ It is important to note that the Exchange only conducts routine examinations of its Designated Dealers. Any member that is not the subject of a routine examination and that seeks to rely on proposed Interpretation .03, when confronted with an inquiry concerning its trading practices under the Customer Priority Rule, must be prepared to provide evidence to the Exchange of its information barrier policies and procedures for review so the Exchange can determine whether such evidence rebuts the presumption of knowledge of a particular unexecuted customer order.

⁷ 15 U.S.C. 78f(b).

⁸ 15 U.S.C. 78f(b)(5).

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may 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 Exchange consents, the Commission will:

- (a) by order approve such proposed rule change, as amended; or
- (b) institute proceedings to determine whether the proposed rule change, as amended, 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, as amended, 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
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NSX-2005-06 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NSX-2005-06. 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, as amended, that are filed with the Commission, and all written communications relating to the proposed rule change, as amended, 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 also will be available for inspection and copying at the principal office of the NSX. 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 File Number SR-NSX-2005-06 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.⁹

Jonathan G. Katz
Secretary

⁹ 17 CFR 200.30-3(a)(12).