

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52807; File No. SR-NSX-2005-06)

November 18, 2005

Self-Regulatory Organizations; National Stock Exchange; Order Approving 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

I. Introduction

On July 19, 2005, the National Stock ExchangeSM ("NSX" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend the text of NSX Rule 12.6 ("NSX's Customer Priority Rule") to require the Exchange's Designated Dealers³ to implement and maintain automated systems reasonably designed to ensure compliance with the NSX Customer Priority Rule.⁴ 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. Notice of the proposed rule change, as amended,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ NSX Rule 5.5(a) defines "Designated Dealer" as a specialist.

⁴ The Exchange filed this proposed rule change, in part, pursuant to the provisions of the Commission's Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 19(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Sanctions entered May 19, 2005. See In the Matter of National Stock Exchange and David Colker, Securities Exchange Act Release No. 51715 (May 19, 2005) ("Administrative Order"). In Section III.F.6. of the Administrative Order, NSX undertook to file proposed rule changes to require its designated dealers to implement system enhancements, to the extent practicable, such that when a dealer is in the process of executing a proprietary trade while in possession of a customer order that could trade in place of some or all of the dealer's side of the trade, the designated dealer's system will systemically allocate the execution to the customer's order unless the trade meets a specified exemption in NSX's rules. Pursuant to the undertaking, the proposed rule changes must also require that the required system enhancements cannot be disabled by NSX's designated dealers.

was published for comment in the Federal Register on October 18, 2005.⁵ No comments were received regarding the proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

The NSX Customer Priority Rule, currently provides, in 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.⁶

NSX proposes to amend the text of the NSX Customer Priority Rule to require the Exchange's Designated Dealers to implement and maintain automated systems reasonably designed to ensure compliance with the NSX Customer Priority Rule.⁷ The proposed rule change would also prohibit Designated Dealers from disabling or disengaging their automated systems, except under limited circumstances.⁸ Furthermore, the proposed rule would make clear that, if a Designated Dealer holds for execution on the Exchange a customer buy order and a

⁵ See Securities Exchange Act Release No. 52576 (October 7, 2005), 70 FR 60594 ("Notice").

⁶ See NSX Rule 12.6(a).

⁷ See Proposed NSX Rule 12.6(e).

⁸ Id.

customer sell order that can be crossed, the Designated Dealer's automated system shall systemically cross them.⁹

NSX also proposes to provide that, for purposes of Rule 12.6, 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 customer order.¹⁰ The proposed interpretation would also provide that such presumption can be rebutted by adequate evidence that 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.¹¹

III. Discussion and Commission Findings

The Commission has reviewed the proposed rule change, as amended, and finds that it is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.¹² Specifically, the Commission finds that the proposed rule change, as amended, furthers the objectives of Section 6(b)(1)¹³ of the Act, which requires the Exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to comply, and to enforce compliance by its members, with the Act and the rules of the Exchange. In addition, the Commission finds that the proposed rule change, as amended, is consistent with

⁹ See Proposed Interpretations and Policies .01 to NSX Rule 12.6.

¹⁰ See Proposed Interpretations and Policies .03 to NSX Rule 12.6.

¹¹ Id.

¹² In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹³ 15 U.S.C. 78f(b)(1).

Section 6(b)(5) of the Act,¹⁴ which requires, among other things, that the rules of a national securities 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.

Currently, NSX Rule 12.6 prohibits an NSX member from trading ahead of its customers' orders. Customer order protection ensures that members consider the orders of their customers when executing their own orders and thus prevents the isolation of customer orders that might otherwise occur if a member were freely able to trade ahead of its customers' orders. The Commission believes that the proposed rule change should enhance investor confidence by helping to improve the quality of executions for customers. By ensuring a customer order's priority over the member's proprietary trading, more trade volume should be available to be matched with the customer's order, resulting in quicker and more frequent executions for customers. Specifically, the Commission believes that proposed NSX Rule 12.6(e) and Interpretations and Policies .01 to NSX Rule 12.6 should enhance the customer protections already provided by NSX Rule 12.6 by requiring NSX specialists to implement and maintain automated systems reasonably designed to ensure compliance with NSX Rule 12.6 and requiring that if an NSX specialist is able to cross two customer orders, such specialist's automated system shall systemically cross such order without the specialist interposing itself as a dealer.

Proposed Interpretations and Policies .03 to NSX Rule 12.6 would define what constitutes knowledge for purposes of NSX Rule 12.6 to provide that 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

¹⁴ 15 U.S.C. 78f(b)(5).

unexecuted customer order and would provide that such knowledge can be rebutted by adequate evidence that the member has implemented a reasonable system of internal policies and procedures and has an adequate system of internal controls to prevent misuse of information about customer orders by those responsible for entering such proprietary orders. The Commission believes that the proposed interpretation is substantially similar to a rule of the New York Stock Exchange, Inc. interpreting its trading ahead rules,¹⁵ and that such proposed interpretation raises no new issues or regulatory concerns.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁶ that the proposed rule change (File No. SR-NSX-2005-06) and Amendment Nos. 1 and 2, thereto be, and hereby are, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Jonathan G. Katz
Secretary

¹⁵ See Securities Exchange Act Release No. 44139 (March 30, 2001), 66 FR 18339 (April 6, 2001) (approving proposed rule change SR-NYSE-94-34, including Supplementary Material .10 of NYSE Rule 92).

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ 17 CFR 200.30-3(a)(12).