

Act, which requires, among other things, that the Association's rules must 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 proposed rule change clarifies certain practices with respect to Web CRD.

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

NASDR does not believe that the proposed rule change will result in any 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

Written comments were neither solicited nor received.

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

Because the foregoing rule change constitutes a stated policy, practice, or interpretation with respect to the meeting, administration, or enforcement of an existing rule, it has become effective pursuant to Section 19(b)(3)(A)(i) ⁶ of the Act and subparagraph (f)(1) of Rule 19b-4 thereunder.⁷ At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such 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 the proposed rule change is 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 at the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-99-50 and should be submitted by October 28, 1999.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41970; File No. SR-PCX-99-24]

Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Granting Accelerated Approval of Proposed Rule Change and Amendments 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to Proposed Rule Change Relating to Automated Opening Rotations

September 30, 1999.

I. Introduction

On July 13, 1999, the Pacific Exchange, Inc. ("PCX" 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 adopt a new Automated Opening Rotation ("AOR") system for handling customer orders and executing option transactions during the opening rotation. On August 4, 1999, the Exchange filed with the Commission Amendment No. 1 to the proposed rule change.³ Notice of the proposed rule change, as amended, appeared in the **Federal Register** on August 30, 1999.⁴ The Commission received no comments regarding the proposal. On September 1, 1999, the PCX filed Amendment No. 2 to the proposal.⁵ Notice of Amendment

⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Michael A. Walinskas, Associate Director, Division of Market Regulation ("Division"), Commission, dated August 3, 1999 ("Amendment No. 1").

⁴ See Securities Exchange Act Release No. 41774 (August 20, 1999), 64 FR 47210.

⁵ See Letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Richard Strasser,

No. 2 appeared in the **Federal Register** on September 10, 1999.⁶ On September 27, 1999, the Exchange filed Amendment No. 3.⁷ This Order approves the proposed AOR pilot until October 1, 2000, as amended. In addition, the Commission is publishing this notice to solicit comments on Amendment No. 3 and is simultaneously approving the Amendment No. 3.

II. Description of Proposal

The Exchange is proposing to adopt a new procedure that will allow the Order Book Official ("OBO") to establish electronically, for eligible options series, a single price opening for executing eligible market and marketable limit orders in the POETS system. The PCX proposes to implement the new procedure on a one-year pilot basis until October 1, 2000.⁸ In the event of an imbalance, any remaining orders in the system that are eligible to be executed will be assigned to market makers participating on the Auto-Ex System. The new process involves three basic steps: first, the markets are established; second, the opening rotation is automatically processed for the majority of series; and finally, any series with manual orders or complication is opened manually, *i.e.*, pursuant to the current procedures for opening rotations.⁹

More specifically, under the new AOR process, opening rotations on the PCX will occur in the following manner: Prior to the opening the OBO will determine whether there are any orders in the trading crowd to be executed at the opening.¹⁰ Once the underlying

Assistant Director, Division, Commission, dated September 1, 1999 ("Amendment No. 2").

⁶ See Securities Exchange Act Release No. 41824 (September 1, 1999), 64 FR 49263 (noticing additions to the proposed rule change and granting partial accelerated approval for the implementation of AOR for 16 issues on a thirty day pilot basis). The Commission notes that the PCX has represented that the Exchange has not experienced any problems with AOR on the 16 pilot issues. Telephone conversation between Michael D. Pierson, Director, Regulatory Policy, PCX, and Terri Evans, Attorney, Division, Commission, on September 30, 1999.

⁷ In Amendment No. 3, the Exchange proposes to implement the AOR system for all issues on a one-year pilot basis. See Letter from Michael D. Pierson, Director, Regulatory Policy, PCX, to Richard C. Strasser, Associate Director, Division, Commission, dated September 24, 1999 ("Amendment No. 3").

⁸ *Id.*

⁹ See Securities Exchange Act Release No. 41774, *supra* note 4.

¹⁰ These may include, for example, orders that cannot be represented in POETS, such as contingency orders, broker/dealer orders, orders designated "not held," orders for spreads or straddlers, combination orders, all-or-none orders, as well as any order the floor broker determines to represent manually.

⁶ 15 U.S.C. 78s(b)(3)(A)(i).

⁷ 17 CFR 240.19b-4(f)(1).

security has opened and the Auto-Quote values are established,¹¹ the OBO will request from the trading crowd bids and offers in the specific option issue. The trading crowd may determine that the posted bids and offers are accurate, or alternatively, may request by public outcry that certain quotes be modified.

Once the bid and asking price in each series has been ascertained, the OBO and AOR System will identify all series that are eligible for the AOR and that can be opened immediately, and will also identify all series that are not eligible for the AOR. Those that are not eligible for the AOR must be opened manually. Procedures for automatic and manual opening are discussed below.

A. Automatic Opening

To prepare for an automated opening the AOR will first exclude series for which there are no market or marketable limit orders in the system, as well as all series deemed ineligible for AOR. The series eligible for AOR will be promptly opened in accordance with the following principles and procedures: First, the system will determine a single price at which the series will be opened.¹² Second, orders in the system will maintain priority over market maker bids and offers, so orders in the system will be matched up with on another, if possible, before executing against the accounts of market makers. Third, if there is an imbalance in the number of contracts to buy or sell at the opening, then the imbalance will be "cleaned up" by the market makers who are participating on the Auto-Ex system,

¹¹ Telephone conversation between Michael D. Pierson, Director, Regulatory Policy, PCX and Terri Evans, Attorney, Division Commission on September 21, 1999.

¹² The appropriate price that is used in a single price opening is determined in the following manner: Once the bid and offering prices in a particular series have been determined, the OBO will identify the number of contracts available to sell at the bid price and the number of contracts available to buy at the offering price. If the number available to sell at the bid price is greater than the number available to buy at the offering price, then the opening price will be the bid price, and vice versa. If the number of contracts to sell is equal to the number to buy, then the opening price will be established halfway between the bid and offering price. However, if there is no trading increment available at the halfway point between the bid and offering prices (e.g., as in the case of a market 2 bid, 2¹/₁₆, asked), then the opening price will be established at the price closest to the last sale price of option contracts of that series.

If market and marketable limit orders can be completely satisfied by trading against other orders in the Book, then the market may open between the established bid and ask prices, with no market maker participation. For example, if the market is 22¹/₄, with an order in the Book to sell 20 contracts at 2¹/₈, and a market order to buy 5 contracts, the single price opening will occur with 5 contracts trading at 2¹/₈ (public customer to public customer). The market quote at the opening will then be 22¹/₈.

i.e., the system will assign a set number of contracts to each participating market maker until the imbalance has been exhausted. Under the proposal, the imbalance will be allocated to the members of the trading crowd using the Exchange's existing Auto-Ex system.

Under the proposal, orders may participate in the AOR regardless of size. An order will not be prohibited from participating in the automated opening rotation on the ground that the order is ineligible from being executed over the Auto-Ex System due to its size.

The proposed rule change also provides for the manual accommodation of certain non-bookable orders represented in the trading crowd and disclosed to the OBO prior to an AOR. Generally, if the order is either a market order or a limit order with a limit price equal to the opening price of the particular series, then that order will be entitled to an execution immediately following the opening of that series. If the order is a market order or limit order for a public customer, the order will be filled in its entire size by the market makers in the trading crowd. If the order is a limit order for a broker-dealer, the order will be entitled to be filled up to a number of contracts equal to a pro rata share of the number of contracts that the Auto-Ex system assigns to the market makers. If a broker is holding more than one order to trade at the same limit price, then that broker is limited to no more than one pro rata share of the number of contracts that the Auto-Ex System assigns to the market makers.

B. Manual Opening

The Exchange intends to use the AOR in all issues traded on the PCX. The Exchange also expects that particular series will only be designated for manual opening (i.e., "de-selected" from the automated procedure) in unusual circumstances. The Exchange does not anticipate any situations where all series of a given issue will be opened manually when the AOR is operational. The Exchange also does not anticipate that any particular series will be de-selected and opened manually on a routine or regular basis.

As noted above, all series that are not eligible for AOR will have been identified before any series are opened automatically. The OBO can designate a series as ineligible for the AOR by deliberately not entering a quote into the system for that series. Series not eligible for the AOR include series for which: (a) There are orders requiring special handling;¹³ (b) there is an

¹³ The following types of orders are ineligible to participate in the automated opening rotation: (1)

imbalance of contracts exceeding an established threshold; or (c) the trading crowd and OBO determine that the series should be opened manually.

1. Manual Orders Requiring Special Handling

A series will be deemed ineligible for AOR if a broker in the crowd is holding an order¹⁴ that is likely to be executed during the opening. In general, manual orders to buy at relatively low prices or to sell at relatively high prices generally will not likely participate in the opening.

2. Imbalance of Contracts Exceeding Established Thresholds

The Exchange will establish, for each option issue, a number of contracts that constitutes an imbalance threshold. Initially, each option issue will have a minimum imbalance threshold of 20 contracts. However, a Lead Market Maker in an issue may increase the imbalance threshold in that issue to a number greater than 20, but not exceeding 999 contracts (due to system constraints). The decision to change the imbalance threshold will be made as follows. Prior to the opening the OBO, in conjunction with the Lead Market Maker in the issue, will set for each option issue a number of contracts that constitute an imbalance threshold. This number will attempt to reflect the relative liquidity in the trading crowd and size of the following crowd.¹⁵ The AOR will calculate imbalances on a series-by-series basis and flag those series for which the imbalance threshold has been exceeded.

Broker/dealer orders; (2) contingency orders; (3) spreads; (4) straddles; (5) not held orders; and (6) combination orders. These types of orders are defined in PCX Rule 6.62. If any of these types of orders are being represented in the trading crowd and are likely to participate in the opening based on price, a manual opening rotation will be held in that series. Market orders are plain limit orders (i.e., limit orders with no contingencies) are eligible to participate in the AOR.

¹⁴ The Exchange clarified that brokers hold orders as agent. Telephone conversation between Michael D. Pierson, Director, Regulatory Policy, PCX, and Kenneth Rosen, Attorney, Division, Commission, on September 14, 1999.

¹⁵ The Options Floor Trading Committee will monitor and supervise the general process of designating imbalance thresholds on the trading floor. The Exchange believes that it is necessary to provide a reasonable amount of flexibility in the process of establishing particular thresholds. The Exchange also believes that there is little risk of abuse in providing flexibility because if low thresholds are established, then the series will have to be opened manually. Although the Exchange does not anticipate that there will be any problems in this area, the Exchange will study the process during the first six months of use of the new system. If a rule change appear necessary, the Exchange will file a rule filing with the Commission to effect the changes necessary.

3. Crowd's Request for Manual Opening

A member or members of a trading crowd may request a particular series to be opened manually, and the OBO will honor reasonable requests. These requests may typically be made in a series with a large amount of open interest or for other reasons.¹⁶ Although the Exchange does not anticipate problems resulting from such requests, in the event of a dispute the matter would be resolved by floor officials.

C. Obligations and Eligibility of Market Makers

Market makers may participate in the AOR if they are otherwise eligible to participate on the Auto-Ex system during the trading day pursuant to PCX Rule 6.87. Generally, to participate on Auto-Ex, a market maker must be present in the trading crowd and that trading crowd must be included within that market maker's appointment zone. If there is adequate participation in a particular option issue, two floor officials may require market makers who are members of the trading crowd, as defined in subsection (6) of PCX Rule 6.87, to log on to Auto-Ex, while present in the trading crowd, absent reasonable justification or excuse for non-participation. The Exchange proposes that these rules will apply to market maker participation in the AOR with respect to contracts allocated to market makers during the opening rotation process.

D. Surveillance of Market Maker Procedures

The market makers participating on AOR will be required to price the contracts fairly, in a manner consistent with their obligations under PCX Rule 6.37. In conjunction with the implementation of the AOR system, the Exchange will publish a regulatory bulletin to remind market makers of their obligation to set Auto-Quote fairly. The Exchange believes that a number of factors, including scrutiny by customers and firms representing customer orders, will ensure that market makers adjust the Auto-Quote values consistent with their obligation. Moreover, market

makers are required to vocalize their changes to Auto-Quote, which allows OBO's to oversee the markets and alerts market makers who may want to improve the markets. In addition, if an OBO notices any unusual activity in the setting of Auto-Quote values the OBO must fill out an OBO Unusual Activity Report which will be investigated by the Exchange. Finally, the Exchange's Auto-Quote has an audit trail log that details every quote change resulting from the use of Auto-Quote. This audit trail report can be studied in the event of any concerns with the way the Auto-Quote values were established for AOR.

III. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6 of the Act. In particular, the Commission finds the proposal is consistent with Section 6(b)(5) of the Act.¹⁷ Section 6(b)(5) requires, among other things, that the rules of the exchange be designed to remove impediments to and perfect the mechanism of a free and open market and a national market system and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

The proposed rule change represents an effort to facilitate the execution of orders at the opening by providing an electronic means of establishing a single price opening. The Exchange believes that this will expedite the opening of option issues on the Exchange, which will serve all market participants. Further, the Exchange believes it will eliminate problems associated with later openings, including the elimination of blacklogs of unexecuted orders that can result when opening rotations are conducted entirely manually and thus, improve market efficiency for all market participants. In addition, the Commission believes that the proposal should promote fair participation in openings by all market participants by providing for the participation of non-market-maker broker-dealer orders in the opening process.

The Commission recognizes that certain aspects of AOR may require heightened scrutiny by PCX to ensure that market makers are not permitted to use the flexibility they have to set an opening price to the disadvantage of investors and other market participants. The Exchange has assured the Commission that it will ensure that

market-makers exercise their discretion in a manner consistent with their obligation to price options fairly. The Commission expects that the PCX will develop objective, quantifiable standards for ensuring that the market-makers are satisfying those obligations and to surveil for such compliance. The pilot offers an opportunity for the Commission to evaluate the Exchange's efforts at surveilling market-maker activities associated with AOR. Prior to permanent approval, the Commission expects to review the results of the applied surveillance program. The Exchange has also stated that it intends to monitor the process by which imbalance thresholds are established.¹⁸ The Commission expects to review the results of the Exchange's surveillance of the establishment of the imbalance thresholds.

Although AOR is likely to greatly improve the opening on PCX, the Commission believes that the system can and should be improved to permit participation by non-bookable orders. The Commission does not view the manual handling of non-bookable orders as the optimal solution for ensuring that those orders are fairly incorporated into the opening. It would be preferable for such orders to be electronically incorporated into an AOR opening. Prior to permanent approval, the Commission expects the Exchange to develop a workable plan for incorporation non-bookable orders on AOR.

The Commission finds good cause for approving the proposal, as amended, prior to the thirtieth day after the date of publication of notice of filing of the proposed rule change in the **Federal Register**. The Commission finds that the proposed rule change is designed to remove impediments to and perfect the mechanisms of a free and open market and a national market system by expediting the opening of option issues on the Exchange.

The Commission also finds good cause for approving proposed Amendment No. 3 prior to the thirtieth day after the date of publication of notice of filing of the amendment in the **Federal Register**. The amendment merely proposes to implement AOR on a pilot basis.¹⁹ By implementing AOR on a pilot basis, the Exchange can immediately address difficulties associated with lengthy opening rotations and study AOR under market conditions while giving the Commission an opportunity to view the operation of

¹⁶ Generally, a series will not be eligible for an AOR if one or more members of the trading crowd has reasonably requested a manual opening rotation in that series. The Exchange anticipates that such requests will fall into two general categories. The first category involves mergers and takeovers. The second category would cover system problems or system limitations. For example, the POETS system may be unable to generate an accurate market because it is unable to take into account the fact that a takeover will occur on the following day, and as such, the system is unable to factor in the correct model. In these situations, the series will be opened manually.

¹⁷ 15 U.S.C. 78f(b)(5). In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁸ See *supra* note 15.

¹⁹ See Amendment No. 3, *supra* note 7.

AOR under market conditions before approving it permanently.

The Commission expects the PCX to study issues related to the Commission's concerns during the pilot period and to report back to the Commission at least sixty days prior to seeking permanent approval of AOR. In addition to issues discussed above, among the issues that the Exchange should explore are: The effect of AOR on the quality of customer executions, any effects on existing order execution priority, and the handling of non-bookable orders.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 is 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 Exchange. All submissions should refer to File No. SR-PCX-99-24 and should be submitted by October 28, 1999.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁰ that the proposed rule change (SR-PCX-99-24), as amended, is approved on a pilot basis until October 1, 2000, on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41921; File No. SR-PCX-99-21]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Definition of Local Securities

September 27, 1999.

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 June 16, 1999, the Pacific Exchange, Inc. ("PCX" or "Exchange") 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 self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to grant accelerated approval to the proposed rule change.

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

The PCX proposes to revise its current definition of "Local Security" as defined in PCX Rule 4.1(m). The text of the proposed rule follows. New text is in italics; deletions are in brackets.

¶ 3697 Definitions and Trading Hours

Rule 4.1 (a)-(1) No Change.

(m) "Local Security" [shall] means a security admitted to dealings on the Exchange which is not also admitted to dealings on [either the New York or American Stock Exchanges] any other national securities exchange or national association as those entities are defined or recognized under the terms of the Securities Exchange Act of 1934.

(n) No Change.

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 self-regulatory organization 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. The self-regulatory organization 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 exchange proposes to revise its current definition of "Local Security" as defined in PCX Rule 4.1(m). Currently, PCX Rule 4.1(m) defines "Local Security" as "security admitted to dealings on the Exchange which is not also admitted to dealings on either the New York Stock Exchange ("NYSE") or the American Stock Exchange ("AMEX")."

The Exchange proposes to revise Rule 4.1(m) to narrow the definition of local security to include only securities admitted to dealings on the Exchange that are not also admitted to dealings on any other national securities exchange or national securities association. Specifically, under the proposed rule change, "local security" is defined as "a security admitted to dealings on the Exchange which is not also admitted to dealings on any other national securities exchange or national securities association as those entities are defined or recognized under the terms of the Securities Exchange Act of 1934." The Exchange believes this rule change more accurately reflects the intended definition of local security as a security traded exclusively on the PCX. Thus, the new definition excludes securities currently within the local securities definition that are actually traded in marketplaces other than the PCX, NYSE or AMEX.

2. Basis

The Exchange believes the proposed rule change is consistent with Section 6(b)³ of the Act, in general, and furthers the objectives of Section 6(b)(5)⁴ in particular, 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 and perfect the mechanisms of a free and open market and a national market system and 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 burden on competition that is not

²⁰ 15 U.S.C. 78s(b)(2).

²¹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78f(b).

⁴ 15 U.S.C. 78f(b)(5).