

The composition provisions of the Executive Committee and the new Nasdaq Committees ensure public participation in the Committees' decision-making process and provide for the fair representation of NASD members. Like the proposed changes to the structure and composition of the Board, the requirement that the number of Non-Industry Directors equal or exceed the number of Industry Directors, and the requirement that Public Directors be present helps to ensure that the decisions by the Executive Committee and the new Nasdaq committees take into account the public interest.

The Commission notes that the composition of the new Management Compensation, Audit, and Nominating Committees, are consistent with the specific compositional requirements for the mirror NASD committees, as set forth either in the Delegation Plan or the 1996 Order, and as implemented by the NASD By-Laws. For example, the composition of the proposed Management Compensation Committee fulfills the compositional requirements set forth in the 1996 Order that a majority of the committee members shall be Non-Industry Directors. The Management Compensation Committee also reflects other compositional requirements as set forth in the Delegation Plan, which designates that Nasdaq's CEO will be an ex-officio, non-voting member of the committee and that each committee member will hold office for one year.

The composition of the proposed Audit Committee fulfills the compositional requirements set forth in the 1996 Order that a majority of the committee members shall be Non-Industry Directors. In addition, the provisions of the Audit Committee mirror those of the NASD By-Laws, which also requires that a majority of the Audit Committee members shall be Non-Industry Directors; that the Audit Committee shall include two Public Directors; and that a Public Director shall serve as chair of the Committee.²⁴

Finally, the Nasdaq Nominating Committee's compositional requirements would mirror the compositional requirements for the NASD Nominating Committee and comply with the requirements of the 1996 Order. The composition of the proposed Nominating Committee would continue to fulfill the compositional requirements

set forth in the 1996 Order that a majority of the committee members shall be Non-Industry Directors. In addition the Nasdaq Nominating Committee reflects the mirror NASD Committee, where the number of Non-Industry members on the Nominating Committee equals or exceeds the number of Industry members on the Nominating Committee.²⁵

The Commission therefore finds that the composition and operation of these Nasdaq committees are consistent with section 15A(b)(2) and 15A(b)(4) of the Act, which require that the Association, and through the Delegation Plan, Nasdaq, be so organized and have the capacity to carry out the purposes of the Act, and that Nasdaq's key committees provide for the fair representation of all members. The Commission notes further that the Nasdaq Committees mirror the equivalent NASD committee requirements as set forth in the Delegation Plan and 1996 Order and as reflected in the applicable NASD By-Laws, and are consistent with Section 15A(b)(2) and 15A(b)(4) of the Act. The Commission emphasizes that all actions undertaken by these Nasdaq committees remain subject to the review, ratification, or rejection by the NASD Board in accordance with procedures set forth and implemented pursuant to the Delegation Plan.²⁶

The Commission also finds that the proposed amendments, reflecting the new corporate relationship between the NASD and Nasdaq, deleting unused terms, and conforming the Nasdaq By-Laws to recent amendments to Delaware law, are consistent with Section 15A(b)(2) and (4) of the Act.²⁷ The changes to the By-Laws reflect Nasdaq's new ownership structure and institute procedures necessary for Nasdaq to operate as a corporation. For example, Nasdaq proposes to delete section 4.3 of Article IV, which requires that certain Directors be drawn from candidates proposed to the National Nominating Committee by a majority of the non-NASD stockholders of Nasdaq. This provision is no longer operative because Nasdaq has already solicited the recommendations of the non-NASD stockholders and has mailed a ballot to non-NASD stockholders asking them to vote on such candidates. In addition, definitions for "Amex Floor Governors," "Nasdaq-Amex," and "Amex Board" are deleted because the terms are no longer used in the Nasdaq By-Laws. Other

amendments, such as permitting Directors to take action without a meeting (Article IV, Section 4.16 of the Nasdaq By-Laws); permitting resignations in a form other than writing (Article IV, section 4.5 and Article VII, section 7.5 of the Nasdaq By-Laws);" no longer requiring a waiver of certain notices to be in writing (Article X, section 10.3 of the Nasdaq By-Laws); and no longer requiring that resolutions be adopted by a majority vote of the whole Board (e.g., to appoint a committee, fill vacancies on the committee, fix the term of office of a committee member, or remove a committee member), conform the Nasdaq By-Laws to applicable Delaware law.²⁸ The Commission finds that these proposed changes are generally consistent with the purposes of the Act.

IV. Conclusion

It is Therefore Ordered, pursuant to section 19(b)(2) of the Act,²⁹ that the proposed rule change (SR-NASD-00-78) is approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁰

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44175; File No. SR-NYSE-00-62]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Specialists' Specialty Stock Option Transactions

April 11, 2001.

I. Introduction

On December 22, 2000, the New York Stock Exchange, Inc. ("NYSE" 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"),¹ and Rule 19b-4 thereunder,² a proposed rule to amend paragraph (1) of the Guidelines to NYSE Rule 105 and paragraph (a) of NYSE Rule 98. The proposed rule change was

²⁸ The Commission notes that the Nasdaq Board's power to delegate authority to a committee will still require a vote of the majority of the whole Board. Article IV, section 4.13(b) of the Nasdaq By-Laws.

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

to have balancing requirements for Industry, Non-Industry, and Public Directors, but no such requirements would apply to the Finance Committee.

²⁴ See NASD By-Laws, Article IX, Section 5.

²⁵ See NASD By-Laws, Article VII, Section 9.

²⁶ The NASD must retain the authority to oversee and control Nasdaq until Nasdaq registers as a national securities exchange.

²⁷ 15 U.S.C. 78o-3(b)(2) and (4).

published in the **Federal Register** on January 26, 2001.³ No comments were received on the proposal. On January 31, 2001, the NYSE filed Amendment No. 1 to the proposed rule change.⁴ This order approves the proposed rule change, as amended.

II. Background

NYSE Rule 105 restricts specialists' transactions in options based on the stock for which the specialist is registered as such ("specialty stock"). Specifically, NYSE Rule 105(b) prohibits specialists from directly or indirectly holding, acquiring, granting or having an interest in any options to purchase or sell or to receive or deliver shares of the specialist's specialty stock, except as expressly permitted in the Guidelines to the rule. Generally, the Guidelines permit specialists to engage in certain hedging transactions in options based on the specialist's specialty stock. Guideline (1) to NYSE Rule 105, however, expressly prohibits specialists from acting in any market making capacity in any option that is a derivative of the specialist's specialty stock.

The restrictions in NYSE Rule 105 extend to the specialist's member organization, other members, allied members, and approved persons in such member organization, and any officer or employee thereof. An "approved person" is an individual or entity that controls a member organization, or is engaged in the securities business and is either controlled by, or is under common control with, a member organization.⁵ Approved persons affiliated with a specialist are subject to a number of Exchange rules, including NYSE Rule 105, that place restrictions on the approved person's ability to trade in the specialty stocks and options based on the specialty stock of the related specialist. Thus, pursuant to Rule 105, an approved person associated with a specialist is prohibited from engaging in transactions in options based on the specialist's specialty stock except for the limited hedging

transactions permitted in the Rule 105 Guidelines.

NYSE Rule 98 provides exemptions for specialists and approved persons from certain NYSE trading restriction rules. NYSE Rule 98 exempts approved persons associated with a NYSE specialist from the Rule 105 trading restrictions as long as the approved person and the specialist organize their respective operations in such a way that the activities of each entity are clearly separate and distinct. This is accomplished by the entities when they establish organizational separation and informational barriers that conform to NYSE Rule 98 Guidelines and have their proposed structure approved by the Exchange. NYSE Rule 98, however, does not exempt an approved person from the market making restriction set forth in Guideline (1) to NYSE Rule 105. Therefore, an approved person associated with a specialist may not act as a market maker in any option that is based on the specialist's specialty stock.

In the Notice, the NYSE explained that these prohibitions were intended to address potential conflict-of-interest concerns raised by side-by-side trading of equity securities and their related options by a specialist and a specialist affiliate.⁶ The prohibitions were adopted in the early 1980s when options overlying a security were traded on one exchange only, unlike today's environment where options are frequently traded on more than one exchange.⁷ According to the Exchange, conflict-of-interest concerns can be adequately addressed through the use of

⁶ Side-by-side trading refers to the practice of trading an equity security and its related options at the same physical location. The Commission notes that the NYSE's restrictions also address concerns raised by integrated market making, which refers to the same person or firm making a market in an equity security and its related options. The Commission historically has viewed integrated market making and side-by-side trading as implicating many of the same regulatory concerns, such as the potential for market participants to misuse non-public market information and to engage in manipulative and improper trading conduct. In addition, the Commission has identified potential conflicts of interest inherent in side-by-side trading and integrated market making and has questioned the ability of the markets to effectively surveil market participants. See Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. (Comm. Print No. 96-1FC3), December 22, 1978 (examining the major issues of market structure in standardized options markets, including integration of stock and options trading) ("Options Study").

⁷ See Securities Exchange Act Release No. 21710 (February 4, 1985), 50 FR 5708 (February 11, 1985) (approving SR-NYSE-82-20). The Commission notes that at the time the Commission approved these restrictions, the NYSE traded standardized options on its floor. NYSE subsequently sold its options business to the Chicago Board Options Exchange, Inc. in 1997.

information barriers. Therefore, the NYSE proposes to permit, in a limited context, integrated market making involving NYSE specialists and approved persons associated with the specialist.

III. Description of the Proposed Rule Change

The NYSE proposes to amend paragraph (1) of the Guidelines to NYSE Rule 105 and paragraph (a) of NYSE Rule 98 to permit an approved person of a specialist to act as a competitive market maker or perform other similar non-primary/supplemental market-making activities⁸ in any option that is a derivative of the related specialist's specialty stock. The proposal would permit this limited form of integrated market making as long as the entities are organized as clearly separate and distinct entities with informational barriers, approved by the Exchange, established between them.

While NYSE Rule 105, Guideline (1) would permit an approved person associated with a specialist to act as a competitive market maker or perform other similar non-primary/supplemental market-making activities in any option based on the specialist's specialty stock, it would continue to prohibit a specialist, its member organization, other members, allied members, or other approved persons of such specialist from acting as a primary market maker in any option based on the specialist's specialty stock.

Under the proposed rule change, if an approved person acts as a competitive market maker in an option overlying a specialty stock of its associated specialist, neither it, nor any other approved person associated with the specialist, may act as a market maker in any equity stock in which the associated specialist is registered as such and which underlies an option as to which the approved person acts as a market maker. The Exchange proposed the additional restriction to prevent a non-primary market maker in the options

⁸ The NYSE distinguishes primary market makers and competitive (or non-primary) market makers based on their differing obligations. Generally, primary market makers ("PMMs"), also called Designated Primary Market Makers ("DPMs"), Lead Market Makers ("LMMs"), and Registered Equity Market Makers, are market makers with significant responsibilities, similar to specialists on the Exchange, including overseeing the opening and closing of trading in option classes, and providing continuous, two-sided quotations in all of their assigned options. Competitive Market Makers ("CMMs"), also called competitive options traders, registered options traders, and non-primary market makers, however, are market makers who quote independently and add depth and liquidity to the market, but do not have the primary responsibility to maintain a fair and orderly market.

³ See Securities Exchange Act Release No. 43859 (January 18, 2001), 66 FR 7945 ("Notice").

⁴ See letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Sapna Patel, Attorney, Division of Market Regulation ("Division"), SEC, dated January 30, 2001 ("Amendment No. 1"). In Amendment No. 1, the NYSE made minor technical changes to the rule text that do not need to be published for comment.

⁵ NYSE Rule 98 Guideline (a). NYSE Rule 2 defines "control" as the power to direct or cause the direction of the management or policies of a person whether through ownership of securities, by contract or otherwise. A presumption of control is made in certain circumstances outlined in the rule.

market from relaying information obtained on the floor (due to time and place advantage) to an approved person of the specialist who trades the stock underlying the option on a regional exchange or in another market.

As described above, NYSE Rule 98 exempts approved persons of specialists from the trading restrictions of NYSE Rule 105 if the approved person and the specialist organize their operations in such a manner that each entity is clearly separate and distinct. In addition, the entities must establish information barriers that prevent the possibility that privileged information would be made available for use in any way to influence a particular trading decision by a specialist or the approved person. Accordingly, the Guidelines require, among other things, confidentiality of trading information including information about the specialist's book, separate books and records, separate financial accounting, and separate capital requirements. The approved person and the specialist must submit a written statement to the Exchange describing the internal controls they intend to adopt for the establishment of procedures sufficient to restrict the flow of privileged market information and the Exchange must approve the structure to enable the entities to enjoy the Rule 98 exemption.

IV. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁹ In particular, the Commission believes that the proposal is consistent with section 6(b)(5) of the Act,¹⁰ 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 to protect investors and the public interest.

The Exchange has proposed to permit limited integrated market making of stocks listed on the Exchange and the options released to such Exchange-listed stocks by affiliated entities. Historically, the Commission has been concerned about permitting such practices.¹¹ Integrated market making raises numerous regulatory issues, such as the concern that an integrated entity could

unfairly use non-public market information to its advantage, or that an integrated entity could easily engage in improper conduct, such as manipulating the price of either the stock or the option to create unfair advantages that would be hard, if not impossible, to surveil.¹² The Commission has also been concerned about the potential conflicts of interest that may arise when an integrated entity has an obligation to make markets in both an option and its underlying equity. In addition, the Commission has expressed concern about an exchange's ability to effectively surveil the trading practices of integrated entities.

When considering an integration proposal, the Commission must balance the potential improvements in the quality of the markets for the stocks and their related options against the competitive, regulatory, and surveillance concerns.¹³ In this regard, the Commission must consider whether an integration proposal would permit the integrated entities to possess undetectable, material non-public market information, which could give either the specialist or the related options market maker a trading advantage over other market participants. Thus, the Commission must evaluate the extent of the proposed integration, as well as the characteristics of the market center putting forth the proposal.

In the proposed rule change, the Exchange seeks to permit a limited kind of integrated market making. Approved persons of Exchange specialists will be permitted to act as competitive market makers in options based on the specialist's specialty stock. However, these integrated entities as well as any other approved persons affiliated with the specialist will be required to organize their respective operations in such a way that the activities of each entity are clearly separate and distinct. The Guidelines to Rule 98 set forth the requirements to be followed by the related entities to be considered clearly separate and distinct. For example, Guideline (b)(i) requires organizational separation of the specialist and approved person and that the specialist must function as an entirely free standing entity responsible for its own

trading decisions. Guideline (b)(ii) requires the respective management structures of the specialist and the approved person to be organized in such a manner as to prevent the management of the approved person from exerting any influence on a particular trading decision of the specialist. Guidelines (b)(iii) and (b)(iv) require the establishment of procedures to preserve confidentiality of trading information. In addition, Guideline (b)(iii) specifically requires the establishment of procedures to ensure the confidentiality of the specialist's book. Finally, the Guidelines require that the specialist and approved person maintain, among other things, separate books and records, financial accounting and capital requirements.

The Commission believes that the Exchange has established appropriate procedures in the Guidelines to address the regulatory issues related to the proposed rule change. The requirement of clearly separate and distinct organizations, along with the other informational barriers and restrictions, should prevent Exchange specialists and their related options market makers from sharing restricted, non-public market information. Further, Rule 98 requires the Exchange to review and approve the organizational structure and information barriers of the integrated entities. The Commission notes that the Exchange has had extensive experience reviewing Rule 98's organizational requirements and information barriers and thus should be able to ensure that the integrated entities are sufficiently separate and distinct. In addition, the Exchange has verified that organizational separation and information barriers will be maintained between the Exchange specialist, the approved person of the specialist acting as a competitive market maker in the overlying option, and any other persons affiliated with them.¹⁴

The Commission expects that the Exchange will assess, as it gains experience with the limited form of integrated market making permitted by this proposal, whether any other informational barriers are necessary to

¹⁴ The Commission notes that a specialist may be associated with more than one approved person. For example, a specialist may be controlled by a parent organization, which may also control other organizations. If any other organization controlled by the parent engages in market making activities in options based on the specialist's specialty stock, organizational separation and information barriers would have to be established between all entities, i.e., the specialist, the parent company and the related options market making entities. Telephone conversation between Jeff Rosenstock, Senior Project Specialist, Rule Development, NYSE, and Kelly Riley, Special Counsel, Division, SEC, on March 28, 2001.

⁹ 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).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ See Options Study, *supra* note 6.

¹² In the Options Study, the staff noted that substantial profits could be made from options positions as a result of small movements in the price of the underlying. Further, the staff noted the relative ease by which the price of the underlying security could be moved and the difficulty in detecting improprieties associated with small price movements.

¹³ See Options Study, *supra* note 6k, *See also* Securities Exchange Act Release No. 22026 (May 8, 1985), 50 FR 20310 (May 15, 1985).

prevent the flow of market information between the related entities. Of course, any new information barriers proposed would have to be submitted to the Commission for approval. The Commission also expects that the Exchange will surveil the integrated entities to ensure that the information barriers and organizational structure continue to prevent the flow of non-public market information.

The Commission notes that because the NYSE is the primary market for many equity securities underlying options, concerns are raised about an integrated organization being able to dominate the markets of both the specialty stock and its related options. Specifically, an integrated entity may by virtue of its positions as specialist and market maker in related securities could control the pricing and liquidity of both markets. The Commission, however, believes that the instant proposal is sufficiently limited to prevent an integrated entity from becoming dominant. For example, the instant integration proposal would permit approved persons to act only as competitive options market makers. Thus, while the approved person acting as a competitive options market maker may receive order flow in the specialty stock option, it most likely would not receive order flow or participate in trades to the same extent as a primary market maker. Further, a competitive market maker is required to compete, on price and size, with other market makers on the options floor for order flow. By having to compete on both price and size for orders, a competitive market maker should not be able to dominate the price or liquidity of a specialty stock option. Thus, the Commission believes that concerns that an integrated entity may become dominant in options and its underlying specialty stock are minimal in this case.

The Commission believes that the proposal should provide benefits to the markets. For example, the number of entities that may act as competitive market makers in options based on a specialist's specialty stock may increase as a result of this proposal. Now, entities that have been prohibited from acting as competitive options market maker because of the restrictions in NYSE Rule 105(l) will be permitted to act in this capacity. This could lead to increased competition and liquidity in the options market.

In conclusion, the Commission believes that the Exchange has sufficiently minimized the potential for manipulative and improper trading conduct by requiring strict organizational separation and

information barriers. Therefore, the Commission believes that the potential improvements to liquidity and quality of the markets outweigh the potential regulatory concerns. For these reasons, the Commission finds that the proposed rule change is consistent with section 6(b)(5) of the Act.¹⁵

V. Conclusion

It Is Therefore Ordered, pursuant to section 19(b)(2) of the Act,¹⁶ that the proposed rule change (SR-NYSE-00-62), is approved.

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

Margaret H. McFarland,

Deputy Secretary.

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SMALL BUSINESS ADMINISTRATION

Notice of Action Subject to Intergovernmental Review Under Executive Order 12372

AGENCY: Small Business Administration.

ACTION: Notice of action subject to intergovernmental review under Executive Order 12372

SUMMARY: The Small Business Administration (SBA) is notifying the public that it intends to grant the pending applications of 22 existing Small Business Development Centers (SBDCs) for refunding on October 1, 2001, subject to the availability of funds. Four states do not participate in the EO 12372 process; therefore, their addresses are not included. A short description of the SBDC program follows in the supplementary information below.

The SBA is publishing this notice at least 120 days before the expected refunding date. The SBDCs and their mailing addresses are listed below in the address section. A copy of this notice also is being furnished to the respective State single points of contact designated under the Executive Order. Each SBDC application must be consistent with any area-wide small business assistance plan adopted by a State-authorized agency.

DATES: A State single point of contact and other interested State or local entities may submit written comments regarding an SBDC refunding within 30 days from the date of publication of this notice to the SBDC.

Addresses:

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ 17 C.F.R. 200.30-3(a)(12).

Addresses of Relevant SBDC State Directors

- Mr. Robert McKinley, Region Director, Univ. of Texas at San Antonio, 1222 North Main Street, San Antonio, TX 78212, (210) 458-2450
- Mr. Dennis Gruell, State Director, University of Connecticut, 2 Bourn Place, U-94, Storrs, CT 06269-5094, (860) 486-4135
- Mr. Joe Ciccarello, Acting State Director, West Virginia Development Office, 950 Kanawha Boulevard, East, Charleston, WV 25301, (304) 558-2960
- Mr. Clinton Tymes, State Director, University of Delaware, Suite 005—Purnell Hall, Newark, DE 19711, (302) 831-2747
- Mr. Michael Young, Regional Director, University of Houston, 2302 Fannin, Suite 200, Houston, TX 77002, (713) 752-8425
- Ms. Liz Klimback, Regional Director, Dallas Community College, 1402 Corinth Street, Dallas, TX 75212, (214) 860-5835
- Mr. Craig Bean, Region Director, Texas Tech University, 2579 South Loop 289, Suite 114, Lubbock, TX 79423-1637, (806) 745-3973
- Ms. Becky Naugler, State Director, University of Kentucky, 225 Gatton College of Business Economics, Lexington, KY 40506-0034, (606) 257-7668
- Ms. Rene Sprow, State Director, Univ. of Maryland @ College Park, 7100 Baltimore Avenue, Suite 401, Baltimore, MD 20742, (301) 403-8163
- Ms. Diane Wolverton, State Director, University of Wyoming, P.O. Box 3922, Laramie, WY 82071, (307) 766-3505
- Mr. Max Summers, State Director, University of Missouri, Suite 300, University Place, Columbia, MO 65211, (573) 882-0344
- Mr. James L. King, State Director, State University of New York, SUNY Plaza, S-523, Albany, NY 12246, (518) 443-5398
- Mr. Donald L. Kelpinski, State Director, Vermont Technical College, P.O. Box 422, Randolph Center, VT 05060, (802) 728-9101
- Ms. Carmen Marti, SBDC Director, Inter American University, Ponce de Leon Avenue, #416, Edificio Union Plaza, Suite 7-A3, Hato Rey, PR 00918, (787) 763-6811
- Mr. Ronald Manning, State Director, Iowa State University, 137 Lynn Avenue, Ames, IA 50010, (515) 292-6351
- Ms. Holly Schick, State Director, Ohio Department of Development, 77 South High Street, Columbus, OH 43226-1001, (614) 466-2711