

EMCC-98-03) be and hereby is approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40354; File No. SR-NASD-98-54]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Public and Non-member Access to Nasdaq's SelectNet and SOES Systems through a Member Firm's Own System

August 24, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on July 30, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") through its wholly owned subsidiaries, NASD Regulation, Inc. ("NASDR") and The Nasdaq Stock Market, Inc. ("Nasdaq"), the proposed rule change as described in Items I, II, and III below, with Items have been prepared by the NASD. On August 21, 1998, the NASD submitted to the Commission Amendment No. 1 to the proposed rule change.<sup>2</sup> The Commission is publishing this notice to solicit comments 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 NASD is proposing to clarify in a Notice to Members the requirements for members to provide electronic access to Nasdaq's SelectNet service and

its Small Order Execution System ("SOES") to public customers and non-members through the member firm's own system.

The text of the proposed Notice to Members is included in Appendix I.

#### 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 NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposal. The text of these statements may be examined at the places specified in Item IV below. The NASD 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

With the advent of enhanced software and telecommunications capabilities, NASD members are able to provide their customers with efficient electronic access to SelectNet and SOES. Several members have asked NASD staff about the requirements for allowing such access. NASD staff envisions that this access capability would operate much the same way that the New York Stock Exchange has allowed its members to offer access to NYSE's DOT system. NASD staff is publishing a Notice to Members, attached as Appendix I, to clarify the NASD's interpretation of its rules and its contract with members and outline issues that NASD members must be aware of in offering their customers electronic access to Nasdaq's execution services. This Notice to Members follows up on an interpretive letter that Nasdaq staff issued to a member in April 1998 regarding non-member access to SelectNet.<sup>3</sup> The Notice to Members provides details not contained in the interpretive letter and expands the discussion to address non-member access to SOES as well as SelectNet. Because the services differ, the NASD has discussed issues regarding each system separately.

The NASD believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act,<sup>4</sup> which requires, among other things, that the NASD's rules promote just and equitable

principles of trade, facilitate securities transactions, and protect investors.

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

The NASD 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, as amended.

##### 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

The foregoing rule change has become effective upon filing pursuant to Section 19(b)(3)(A) of the Act<sup>5</sup> and Rule 19b-4(e)(1)<sup>6</sup> thereunder in that it constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of a self-regulatory organization.

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 whether 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, N.W., Washington, D.C. 20549. 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

<sup>7</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> U.S.C. 78s(b)(1).

<sup>2</sup> In Amendment No. 1, the Exchange made technical corrections to the proposed Notice to Members. See Letter from John Ramsay, Vice President and Deputy General Counsel, NASDR, to Richard Strasser, Assistant Director, Division of Market Regulation ("Division"), Commission, dated August 20, 1998 ("Amendment No. 1"). On August 24, 1998, additional technical amendments were made to the Notice to Members to correct typographical errors. Telephone conversation between David A. Spotts, Office of General Counsel, NASDR, and Kenneth Rosen, Attorney, Division, Commission (August 24, 1998).

<sup>3</sup> Letter from Eugene A. Lopez, Vice President, Trading and Market Services, Nasdaq, to Lloyd H. Feller, Morgan, Lewis & Bockius, dated April 15, 1998.

<sup>4</sup> 15 U.S.C. 78o-3(b)(6).

<sup>5</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>6</sup> 17 CFR 240.19b-4(e)(1). In reviewing this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-98-54 and should be submitted by September 21, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Jonathan G. Katz,**  
Secretary.

### Appendix I—NASD Notice to Members 98-66

#### *NASD Clarifies Acceptable Customer Access To SelectNet And SOES*

##### Executive Summary

In response to several inquiries from National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) members regarding their ability to provide electronic access to The Nasdaq Stock Market's<sup>®</sup> (Nasdaq<sup>®</sup> SelectNet<sup>SM</sup> to non-member broker/dealers or customers, Nasdaq clarifies that, in the circumstances described below, members that are Nasdaq Workstation II<sup>®</sup> subscribers may choose to provide an electronic transmission of a non-member's order through their own systems into SelectNet.

In addition, members have also raised questions regarding the ability of a Small Order Execution System<sup>SM</sup> (SOES<sup>SM</sup>) order entry firm to provide public customers electronic access to Nasdaq's SOES system. This Notice clarifies that, in the circumstances described below, members that are SOES order entry firms may choose to provide an electronic interface for public customer orders through their own SOES order entry system.

Questions regarding this Notice should be directed to Thomas Gira, Vice President, Market Regulation, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>), at (301) 590-6895 or Gene Lopez, Vice President, Trading and Market Services, Nasdaq, at (202) 728-6998.

##### Background—SelectNet And SOES

Nasdaq provides a service known as SelectNet that permits NASD member firms to enter buy or sell orders in Nasdaq securities into the system, directing those orders to a single Market Maker (directed orders) or broadcasting the order to market participants (broadcast orders). SelectNet facilitates the communication of trading interest between members, the negotiation of orders with the possibility of price improvement, and the dissemination of last sale reports after execution of SelectNet orders. Trades executed

through SelectNet are submitted for clearing as locked-in trades. SelectNet is available for execution of orders from 9 a.m. until 5:15 p.m., Eastern Time.

Nasdaq allows Nasdaq Workstation II subscribers to enter SelectNet orders from a Nasdaq Workstation or through an electronic means known as an Application Programming Interface (API). As mentioned above, there are two types of SelectNet orders: (1) directed orders; or (2) broadcast orders. SelectNet orders may be directed to a particular market participant displaying a quotation in the Nasdaq quote montage or the SelectNet order may be generally broadcast to all participants. Orders entered into SelectNet have a minimum life of 10 seconds; in other words, they cannot be canceled by the order entry firm until 10 seconds have elapsed. In the case of directed orders, the participant reviewing the order has up to three minutes to respond to the order, unless the party entering the order specified a longer time period. While directed orders generally have a lifespan of three minutes, directed orders sent to a participant at or up to the participant's quoted price and size impose liability on the recipient's part on receipt of the SelectNet order pursuant to the Securities and Exchange Commission's (SEC) firm quote rule, unless an exception to the rule applies.<sup>1</sup> Traditionally, SelectNet has been used by members, Market Makers, and order entry firms alike, to access the quotations of other Market Makers and electronic communication networks (ECNs).

Nasdaq also provides a service known as SOES that enables order entry firms and Market Makers to execute size-limited orders (agency and risk-less principal) in Nasdaq securities on behalf of public customers. SOES enables participants, among other things, to lock in their trades with designated clearance and settlement instructions, thereby providing an automated execution system to public customers.

Only agency orders from public customers no larger than the maximum order size, as defined in NASD Rule 4710(g), may be entered by a SOES order entry firm into SOES for execution against a SOES Market Maker. Agency orders in excess of the maximum order size may not be divided into smaller parts for purposes of meeting the size requirements for SOES orders. The SOES rules currently contain a specific provision, NASD Rule 4720(c)(4), that requires SOES order entry firms to maintain the physical security of Nasdaq equipment located on the premises of the firm to prevent unauthorized entry of information into

SOES. The NASD has, to date, interpreted this provision as barring firms from providing direct electronic entry to public customers.

##### Electronic Access To Nasdaq Systems

With the advent of enhanced software and telecommunications capabilities, members are able to provide their customers with efficient electronic access to Nasdaq's execution services, SelectNet and SOES. This Notice clarifies the NASD's interpretation of its rules and its contract and outlines the issues that members must be aware of in offering their customers electronic access to Nasdaq's execution services. Because each service is different, we have provided two separate discussions for each execution service, SelectNet and SOES.

##### Customer Access To SelectNet

Recently, several members have inquired about the permissibility under NASD rules and the Nasdaq Workstation II Subscriber Agreement (NWII Agreement) for a member to permit its customers to enter orders into the member's own electronic system and to re-transmit those orders directly and electronically, without the manual entry of such order by a person associated with the member, into the SelectNet system through an API arrangement. In other words, certain members that connect to Nasdaq through an API want to be able to build an electronic access link that the member provides to certain customers. The customer is then able to enter orders through this member-provided electronic entry point that flow through the member's network that electronically connects through the Nasdaq API to the Nasdaq SelectNet application. This Notice clarifies that such activity is permissible under NASD rules and the NWII Agreement, provided that the member undertakes measures to ensure that all relevant NASD rules and system protections are followed, as described below.

1. Notice to Nasdaq Acknowledging Responsibility for Orders: Members providing a SelectNet electronic pass-through service to customers must provide a letter to Nasdaq that acknowledges that they are acting as agents for the non-member in submitting the order through their facilities and that they are responsible for the order sent through SelectNet. Any member providing this service must submit all such orders as an agent on behalf of the customer inputting the order. All orders submitted by customers into SelectNet will have the member's Market Participant Identifier

<sup>7</sup> 17 CFR 200.30-3(a)(12).

(MPID) attached to them, and the member (Market Maker or ECN) receiving the order through SelectNet will know only that another member has attempted to access its Nasdaq-published price.

Further, the member should provide a system description of its facility that allows non-members access to SelectNet. Such a system description must provide details on the manner in which orders are received and re-transmitted, including the security and capacity of the member's system, the manner in which the member's system connects to Nasdaq's service, and any internal system protocols designed to fulfill a member's "know your customer" obligations and other regulatory obligations.

The letter and system description should be submitted to: Market Regulation, NASD Regulation, Inc., 9513 Key West Ave., Rockville, MD 20850.

2. Compliance With NASD Rules: Any member that chooses to offer this service to a customer must ensure that orders submitted through this member-provided service comply with SEC and NASD rules. For example, the member must ensure that rules related to the Short-Sale Rule, including the Affirmative Determination Rule, are complied with. Similarly, the member must ensure that any obligations regarding limit order protection and display and the ECN Rule are met. In particular, if customers use this mechanism to broadcast SelectNet orders, a Market Maker allowing customers to do so must be cognizant that SelectNet broadcast is an ECN that is not linked to Nasdaq's quote montage, and accordingly requires the Market Maker to reflect such price in its quote.

3. Internal System Controls Regarding a Member's Procedures for Supervision of Submission of Orders: Members that provide non-members with SelectNet access should have in place adequate written procedures and controls that permit the member to effectively monitor and supervise the entry of electronic orders. Among the items that should be addressed in such written controls and procedures are: (1) the entry of unauthorized orders; (2) orders that exceed or attempt to exceed credit and other parameters, such as order size, that the member has established for a particular customer; (3) activity by a customer that could be considered manipulative or an attempt to improperly affect the price of the security or related products; and (4) violations of the affirmative determination and Short-Sale Rules. Whenever possible, these controls should be automated and system driven.

A member providing SelectNet access to non-members should have a signed agreement with the non-member customer that outlines the responsibilities of the member and the customer with respect to the use of this means of access.

4. Acknowledgment of Responsibility for Orders: Any members that provides its customers with access to SelectNet should understand that the member remains responsible for honoring all executions that may occur. Consequently, any member that chooses to provide such service must make appropriate determinations under NASD rules prior to providing the service that the customer is capable of using the means of access being provided by the firm. In particular, the "know your customer rule" embedded in the NASD Conduct Rules requires that the member providing customer electronic access to SelectNet assess the ability of the customer to use such access. Further, a member's customer agreement that permits the customer to access SelectNet should inform the customer that he or she is subject to potential prosecution under the federal securities laws for illegal activity and that the NASD will monitor all such trading activity so as to detect any such improper activity. Further, the member should inform the customer that if the NASD detects improper activity through the customer's use of SelectNet, the member's link to Nasdaq may be terminated if at any time, activity harmful to the integrity of The Nasdaq Stock market or its systems is detected.

5. Nasdaq's Liability: In allowing members to provide their customers access to SelectNet, Nasdaq—pursuant to its NWII Agreement—assumes no liability for any order entered into the member's system, or through the API, into Nasdaq's system.

6. Nasdaq's Right to Terminate: In the event that the member's use of the API to allow the entry of SelectNet orders by non-members threatens the integrity of Nasdaq's systems, Nasdaq continues to reserve the right under the NWII Agreement to unilaterally and immediately terminate the member's access.

7. Right to Examine: The member acknowledges that, as a self-regulatory organization (SRO) responsible for examining the activity of a member, NASD Regulation may examine the member's books, records, and facilities to determine whether a violation of NASD rules and/or federal securities laws, rules, and regulations may have occurred. Such examination may include an examination of the electronic system itself, as well as the member's

records regarding its customers and their activity.

8. Clearing Responsibility: The member providing the electronic connection must be a member of a clearing agency registered with the SAE through which system-compared trades may be settled; or the member must have a correspondent clearing arrangement with a member that can do so. The member providing access must accept and settle each trade executed through this connection or, if settlement is to be made through another clearing member, the clearing member must guarantee the acceptance and settlement of such trades.

9. Fees for Execution of SelectNet Orders: All orders entered by customers into SelectNet are subject to the same fee schedule that Nasdaq has established for the entry of orders by members. For example, Nasdaq currently charges a member \$1 for each execution of a SelectNet order. As long as that fee is in place, Nasdaq will bill the member entering the customer pass-through order that amount for an execution that the customer receives. Similarly, if a customer using a member's pass-through service enters a broadcast order that is executed, Nasdaq will bill the member \$2.50 for the execution. Under the SEC's Order Handling Rules, the SEC has permitted ECNs the right to charge members that use SelectNet to access the ECN's priced orders displayed in Nasdaq. Members should be aware that if they provide customers with SelectNet access and a customer accesses the order of an ECN that charges for such access, the ECN will bill the member for such access.

10. System Setup: Members providing an electronic pass-through of SelectNet orders must use the Nasdaq API between the member's system and Nasdaq's system. Members may use service bureaus to develop and operate the electronic access capability. All such API connections must be set up on an eight presentation device to one service delivery platform ratio. If a member chooses to use a service bureau to develop the service, the member is nonetheless responsible for ensuring that all NASD rules and NWII Agreement requirements are complied with. No service bureau is permitted to operate a service on behalf of a member unless the service bureau has entered into an agreement with Nasdaq.

#### Public Customer Access To SOES

Members have inquired about the permissibility under NASD rules for an NASAD SOES order entry firm to permit public customers to enter SOES agency orders into the member's electronic

system that provides an electronic SOES interface. Such facilities allow the public customer to enter orders into a member-provided electronic entry device, which flows through the member's network into the member's own computer system and then, without manual intervention, into SOES. This Notice clarifies that such activity is permissible under the NASD rules, provided that the member undertakes measures to ensure that all relevant NASD rules and system protections are followed, as described below.

1. Compliance With NASD Rules, Including SOES Rules (NASD Rules 4710-4770): Any member that chooses to offer SOES access to a public customer must ensure that orders submitted through this member-provided service comply with SEC and NASD rules, including the SOES rules and its interpretations.<sup>2</sup> For example, the member must ensure that agency orders for public customers are within the maximum order size as required by NASD Rule 4730(c)(3). In addition, agency orders involving a single investment decision in excess of the maximum order size may not be divided into smaller parts for purposes of meeting the size requirements for orders entered into SOES. Thus, any trades entered within any five-minute period in accounts controlled by an associated person or customer will be presumed to be based on a single investment decision.

Furthermore, members must ensure that rules related to the Short-Sale Rule, including the Affirmative Determination Rule, are complied with. Finally, members must also be able to continue to meet their obligations to comply with the SEC's Confirmation Rule, Rule 10b-10.

2. Internal System Controls Regarding a Member's Procedures for Supervision of Submission of SOES Orders: NASD SOES order entry firms that provide public customers with SOES access should have in place at the time they offer such access to public customers adequate written procedures and controls that permit the member to effectively monitor and supervise the entry of electronic orders.

Among the items that should be addressed in such written controls and procedures are controls to monitor for: (1) the entry of unauthorized orders; (2) orders that exceed or attempt to exceed credit or SOES order size and other parameters that the member has established for a particular public customer; (3) activity by a public customer that could be considered manipulative or an attempt to improperly affect the price of the

security or related products; (4) violations of the Affirmative Determination and Short-Sale Rules. Wherever possible, such controls should be automated and system driven.

In addition, the firm's procedures must provide for the identification of locations where the firm makes SOES order entry devices available to its public customers and provides ongoing technical support and maintenance. If such site does not qualify as a branch office or office of supervisory jurisdiction (OSJ) of the member under NASD rules, a member must still supervise such activity by providing for periodic visits to such locations to ensure that certain restrictions on activities are in place and that the site is not conducting a securities business at such locations. For guidance on what constitutes a branch office or OSJ in member off-site locations, please see the interpretive letter dated March 17, 1998, and listed under NASD Rule 3010 on the NASD Regulation Web Site ([www.nasdr.com](http://www.nasdr.com)—from the Home Page, click on "Members Check Here," then click on "Interpretive Letters").

3. Acknowledgment of Responsibility for Orders: Any member that provides its public customers with access to SOES should understand that the member is responsible for honoring all executions that may occur. Consequently, any member that chooses to provide such service must make appropriate determinations under NASD rules, including the SOES rules, prior to providing the service to a particular public customer that the public customer is capable of using the means of access being provided by the firm. In particular, the "know your customer rule" embedded in the NASD Conduct Rules requires that the member providing customer electronic access to SOES assess the ability of the customer to use such access.

4. Right to Examine: The member acknowledges that, as an SRO responsible for examining the activity of a member, NASD Regulation may examine the member's books, records, and facilities to determine whether a violation of NASD rules and/or the federal securities laws, rules, and regulations may have occurred. Such examination may include an examination of the electronic system itself, as well as the member's records regarding its public customers and their activity.

5. Fees for Execution of SOES Orders: All orders entered by public customers into SOES are subject to the same fee schedule that Nasdaq has established for the entry of orders by members. For example, Nasdaq currently charges 50

cents per order executed by the member entering a SOES order for a public customer. As long as that fee is in place, Nasdaq will bill the member entering the public customer pass-through order that amount for an execution that the public customer receives.

Endnotes

- 1 SEC Rule 11Ac1-1(c).
- 2 NASD Notice to Members 88-61.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40360; File No. SR-NASD-98-61]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Reporting Transactions in Exchange-Listed Securities

August 25, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act"),<sup>1</sup> notice is hereby given that on August 12, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly-owned subsidiary, Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III 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.

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

Nasdaq is proposing to amend a rule of the NASD, to eliminate an unnecessary provision relating to the reporting of transactions in exchange-listed securities traded in the third market. Below is the text of the proposed rule change. Proposed deletions are in [brackets].

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#### 6420. Transaction Reporting

- (a) through (c) No Change
- (d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all

<sup>1</sup> 15 U.S.C. 78s(b)(1).