

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-37619A; File No. S7-30-95]

RIN 3235-AG66

### Order Execution Obligations

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final Rules.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is adopting a new rule requiring the display of customer limit orders and amending a current rule governing publication of quotations to enhance the quality of published quotations for securities and to enhance competition and pricing efficiency in our markets. These rules have been designed to address growing concerns about the handling of customer orders for securities.

Specifically, the Commission is adopting new Rule 11Ac1-4 ("Display Rule") under the Securities Exchange Act of 1934 ("Exchange Act") to require the display of customer limit orders priced better than a specialist's or over-the-counter ("OTC") market maker's quote or that add to the size associated with such quote. The Commission also is adopting amendments to Rule 11Ac1-1 ("Quote Rule") under the Exchange Act to require a market maker to publish quotations for any listed security when it is responsible for more than 1% of the aggregate trading volume for that security and to make publicly available any superior prices that a market maker privately quotes through certain electronic communications networks ("ECNs") ("ECN amendment"). Finally, the Commission is deferring action on proposed Rule 11Ac1-5 ("Price Improvement Rule").

**EFFECTIVE DATE:** January 10, 1997. For specific phase-in dates for the Display Rule, see section III.A.3.d of this Release.

**FOR FURTHER INFORMATION CONTACT:** Elizabeth Prout Lefler or Gail A. Marshall regarding amendments to the Quote Rule and David Oestreicher regarding the Display Rule at (202) 942-0158, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5-1, Washington, D.C. 20549.

### SUPPLEMENTARY INFORMATION:

#### I. Introduction and Summary

On September 29, 1995, the Commission issued a release<sup>1</sup> proposing for comment new Rules 11Ac1-4 and 11Ac1-5 and amendments to Rule 11Ac1-1<sup>2</sup> under the Exchange Act.<sup>3</sup> As proposed, new Rule 11Ac1-4 would require the display of customer limit orders that improve certain OTC market makers' and specialists' quotes or add to the size associated with such quotes. The proposed amendments to the Quote Rule would require OTC market makers and specialists who place priced orders with ECNs to reflect those orders in their published quotes. The proposed Quote Rule amendments also would require OTC market makers and specialists that account for more than 1% of the volume in any listed security to publish their quotations for that security ("Mandatory Quote Rule"). The Price Improvement Rule would have required OTC market makers and specialists to provide their customer market orders an opportunity for price improvement; it also would have included a non-exclusive safe harbor to satisfy the price improvement obligation.

The Commission received 152 comment letters (from 145 commenters) in response to the Proposing Release.<sup>4</sup> Commenters generally supported the Display Rule and the Mandatory Quote Rule, with some commenters suggesting specific modifications or alternatives to the proposed rules. Commenters also supported the objectives of the ECN amendment, but many expressed concerns that diminishing the anonymity of such systems would threaten their viability. Most commenters believed the Price Improvement Rule would be costly to implement and would not be necessary if the other proposals were adopted.

After considering the comments and relevant economic research, and based

on the Commission's experience with the development of the national market system ("NMS") and its knowledge of current market practices, the Commission is adopting the Display Rule and the proposed amendments to the Quote Rule, with certain modifications. The Commission believes that these modifications are consistent with the proposals and responsive to many of the concerns voiced by the commenters.

The Display Rule adopted today requires OTC market makers and specialists to display the price and full size of customer limit orders when these orders represent buying and selling interest that is at a better price than a specialist's or OTC market maker's public quote. OTC market makers and specialists also must increase the size of the quote for a particular security to reflect a limit order of greater than *de minimis* size when the limit order is priced equal to the specialist's or OTC market maker's disseminated quote and that quote is equal to the national best bid or offer.

The Commission has modified the proposed Display Rule in some respects in response to comments. The proposal included an exception to permit a specialist or OTC market maker to deliver a limit order to an exchange or registered national securities association ("association") sponsored system that complies with the Display Rule. This exception has been expanded to permit delivery to ECNs that display and provide access to these orders. Additionally, with regard to implementation of the rule, the Commission has provided for a phase-in over a one year period for non-exchange-traded securities covered by the Display Rule.

Today, the Commission also is adopting two significant amendments to the Quote Rule. These amendments are designed to ensure that more comprehensive quotation information is made available to the public. The first amendment requires a specialist or OTC market maker to make publicly available the price of any order it places in an ECN if the ECN price is better than the specialist's or OTC market maker's public quotation. The Commission has adopted this amendment as proposed, with an alternative ("ECN display alternative") that deems OTC market makers and specialists in compliance with the Quote Rule if prices these OTC market makers and specialists enter into an ECN are publicly disseminated and the ECN provides access to other broker-

<sup>1</sup> Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995) ("Proposing Release").

<sup>2</sup> 17 CFR 240.11Ac1-1.

<sup>3</sup> 15 U.S.C. 78a to 78ll (1988).

<sup>4</sup> The comment letters and a summary of comments have been placed in Public File No. S7-30-95, which is available for inspection in the Commission's Public Reference Room. The Commission received comments on the proposals from 77 individual investors, ten industry associations, seven exchanges and the National Association of Securities Dealers ("NASD"), eight academics, 41 market participants and the United States Department of Justice. In addition, the Commission met with representatives of broker-dealers, self-regulatory organizations ("SROs"), industry associations, and the U.S. Department of Justice to discuss the proposals. The Commission has conducted its own economic analysis of the likely economic effects of the various proposals.

dealers to trade at those prices.<sup>5</sup> Thus, OTC market makers and specialists may comply directly with the ECN amendment by changing their public quote to reflect their ECN order, or by using an ECN that facilitates their compliance with the rule as described above.

Implementation of the ECN display alternative requires the cooperation of the SROs in order to include the ECN prices in the public quotation system and to provide equivalent access to these quotations. The Commission expects the SROs to work expeditiously with ECNs that wish to avail themselves of this alternative to develop rules or understandings of general applicability. The Commission is prepared to act if necessary to ensure implementation of the ECN display alternative prior to the effective date of the Quote Rule.

The second amendment to the Quote Rule expands the categories of securities covered by the Mandatory Quote Rule. As amended, the Quote Rule will require that OTC market makers and specialists publish quotes in any listed security if their volume in that security exceeds 1% of the aggregate volume during the most recent calendar quarter. Previously, these requirements applied only to certain listed securities.<sup>6</sup>

The Commission is deferring final action on the Price Improvement Rule at this time. The Commission will consider the effect of the new Display Rule and the amendments to the Quote Rule adopted today before determining the appropriate course of action on that proposal.

In a parallel action, the Commission today is proposing for comment an additional amendment to the Quote Rule. The proposed amendment would require OTC market makers and specialists that account for more than 1% of the volume in any Nasdaq security to publish their quotations for that security.<sup>7</sup>

## II. Basis and Purpose of the Display Rule and Quote Rule Amendments

Twenty years ago, Congress directed the Commission—having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets—to use the

Commission's authority granted under the Exchange Act to facilitate the establishment of a national market system for securities.<sup>8</sup> Congress further determined that the public interest, investor protection and the maintenance of fair and orderly markets required the NMS to feature:

- (i) Economically efficient executions;
- (ii) Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- (iii) Public availability of quotation and transaction information;
- (iv) An opportunity to obtain best execution; and
- (v) An opportunity to obtain execution without dealer intervention to the extent consistent with economically efficient executions and the opportunity to obtain best execution.<sup>9</sup>

The years since the 1975 Amendments have witnessed dramatic developments in the U.S. securities markets. Last sale reporting, which enables investors to determine the current market for a security, has been extended to OTC-traded securities. The Consolidated Quotation System ("CQS"), which allows investors to view in a single source quotes disseminated from dispersed market centers, did not exist in 1975. The Intermarket Trading System ("ITS"), which permits investors' orders in certain exchange-listed securities to be routed to the market center displaying the best quotation, has greatly facilitated quote competition. Moreover, technological developments not envisioned twenty years ago have enabled market centers to handle volume levels many times greater than those that led to the "back office" crisis of the late 1960s and early 1970s. Taken together, these and other developments have made it possible for investors' orders to be executed much more rapidly and at far lower cost.

The Commission recognized that U.S. equity markets had undergone significant changes since passage of the 1975 Amendments and were likely to undergo further changes of equal magnitude.<sup>10</sup> Accordingly, the Commission announced in July 1992 that its Division of Market Regulation ("Division") would undertake a study of

the structure of the U.S. equity markets and of the regulatory environment in which those markets operate.<sup>11</sup>

In January 1994, the Division published a study,<sup>12</sup> which reviewed, among other things, market practices and structures that could affect the ability of customers to obtain opportunities for better prices. The Market 2000 Study noted that U.S. equity markets had evolved since 1975 to provide a much wider array of trading venues to meet the diverse needs of investors and made a series of recommendations intended to facilitate the further development of a national market system. As expected, U.S. equity markets have continued to evolve since the Market 2000 Study was published.

This evolution of the markets is reflected in part by comparing trading volumes and the venues in which orders are executed. In 1976, the New York Stock Exchange ("NYSE") average daily trading volume was approximately 21.2 million shares.<sup>13</sup> By 1995, average daily trading volume exceeded 346 million shares.<sup>14</sup> Third market trading, *i.e.*, OTC trading of listed securities, in NYSE-listed issues accounted for 4.57% of consolidated volume in 1976.<sup>15</sup> By 1995, third market trading increased to 7.94% of consolidated volume.<sup>16</sup> In 1987, the NYSE handled almost 74% of trades of NYSE-listed issues reported on the consolidated tape; in 1995, it handled 70.22% of such trades.<sup>17</sup>

Comparable figures for The Nasdaq Stock Market ("Nasdaq") are even more

<sup>11</sup> *Id.*

<sup>12</sup> Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (January 1994) ("Market 2000 Study" or "Study").

<sup>13</sup> 1982 NYSE Fact Book.

<sup>14</sup> 1995 NYSE Annual Report.

<sup>15</sup> 1982 NYSE Fact Book.

<sup>16</sup> 1995 NYSE Fact Book.

<sup>17</sup> Regional exchanges, namely, the Boston Stock Exchange ("BSE"), the Philadelphia Stock Exchange ("Phlx"), the Cincinnati Stock Exchange ("CSE"), the Chicago Stock Exchange ("CHX"), and the Pacific Stock Exchange ("PSE"), have captured a significant share of volume in NYSE-listed issues, particularly with respect to smaller investor orders. In 1995, the regional exchanges accounted for 9.96% of consolidated volume in NYSE-listed issues but accounted for 19.01% of trades of NYSE-listed issues reported on the consolidated tape. *Id.* They also accounted for approximately 35% of share volume in trades of 100 to 2,099 shares. Shapiro, *U.S. Equity Markets: Recent Equity Developments*, in *Global Equity Markets: Technological, Competitive, and Regulatory Challenges* 21 (R. Schwartz ed. 1995). In January 1996, trades of 100–499 shares represented between 65–72% of all trades in NYSE-listed issues on regional exchanges; such trades represented only 37% of all trades on the NYSE. Ross, Shapiro and Smith, *Price Improvement of SuperDOT Market Orders on the NYSE* (NYSE Working Paper 96-01) (March 11, 1996 draft) (prepared for the NYSE Conference for the Search for Best Price) ("Ross, Shapiro and Smith").

<sup>5</sup> This alternative means of compliance with the ECN amendment is referred to hereinafter as the "ECN display alternative".

<sup>6</sup> Additional amendments to the Quote Rule adopted today provide that certain Quote Rule provisions that previously applied to market makers that elected to quote a Nasdaq National Market security now also will apply to market makers electing to quote a Nasdaq SmallCap security. See section III.B.d.iii.

<sup>7</sup> See Securities Exchange Act Release No. 37620 (August 28, 1996) ("Companion Release").

<sup>8</sup> Pub. L. No. 94–29, 89 Stat. 97 (1975) ("1975 Amendments").

<sup>9</sup> Exchange Act section 11A(a)(1), 15 U.S.C. 78k–1(a)(1). This Section also recites the Congressional findings that: The securities markets are an important national asset which must be preserved and strengthened; and new data processing and communications techniques create the opportunity for more efficient and effective market operations.

<sup>10</sup> See Securities Exchange Act Release No. 30920 (July 14, 1992), 57 FR 32587 (July 22, 1992) ("Market 2000 Concept Release").

dramatic. In 1975, Nasdaq annual volume was approximately 1.39 billion shares.<sup>18</sup> By 1995, Nasdaq annual volume increased to 101.2 billion shares,<sup>19</sup> which means that more shares traded hands on three average trading days in 1995 than in all of 1975. In 1993, volume in all proprietary trading systems combined represented 13% of the total volume in Nasdaq/National Market securities;<sup>20</sup> by January 1996, volume on Instinet alone represented approximately 15% of total Nasdaq volume and 20% of total volume for the 250 Nasdaq stocks with the highest median dollar volume.<sup>21</sup>

The Study addressed the development of certain practices, such as internalization,<sup>22</sup> payment for order flow<sup>23</sup> and the non-disclosure of certain customer trading interest to all market participants, that raise a variety of market structure and customer order handling concerns. For example, brokers today may quote one price publicly to retail customers, while showing a better price privately to other investors and dealers on an ECN. In addition, the quotes displayed to public investors may not accurately reflect the best price for a security because limit orders, which specify the price at which customers will buy or sell a security, are not uniformly required to be included in the quote.

The Study recommended that the exchanges and the NASD consider taking action to respond appropriately to certain of these developments. Since that time, Nasdaq market makers holding customer limit orders have been prohibited from trading ahead of those orders,<sup>24</sup> and some market makers have

begun to offer price improvement opportunities in OTC transactions to their retail customers.<sup>25</sup> In addition, the NYSE now requires almost all limit orders transmitted through SuperDOT to be displayed to the market.<sup>26</sup> Further, Commission rules require enhanced disclosure of payment for order flow practices on customer confirmations and account statements, as well as upon opening new accounts.<sup>27</sup>

Notwithstanding the progress achieved in this period, the Commission believes that further regulatory initiatives are warranted at this time. These changes, as indicated in the Proposing Release, are intended to address current market practices that inhibit opportunities for order interaction and that are inconsistent with Congress's vision of the national market system. These changes also address certain problems in Nasdaq. The Commission recently reported that, among other things: (i) Nasdaq market makers widely followed a pricing convention concerning the increments they used to adjust their displayed quotes; (ii) adherence to the pricing convention was not the result of natural economic forces, often impacted the fairness and accuracy of public quotation information and interfered with the economically efficient execution of customer transactions; (iii) the pricing convention impaired the ability of investors to ascertain the best market for their trades, increased the costs of transactions, and resulted in unfair discrimination among classes of market participants; (iv) numerous market makers collaborated in ways that misled and disadvantaged their customers and other market participants and frequently failed to honor their price quotations; and (v) many market makers have not consistently reported their trades on time or appropriately designated them as late as required by NASD rules.<sup>28</sup>

The Commission has taken specific regulatory and enforcement actions to address these problems.<sup>29</sup> The Display Rule and Quote Rule amendments

(“Manning I”); Securities Exchange Act Release No. 35751 (May 22, 1995), 60 FR 27997 (May 26, 1995) (“Manning II”).

<sup>25</sup> See, e.g., Louis, *Schwab Debuts New Trading System*, San Francisco Chronicle, October 17, 1995, at D1.

<sup>26</sup> Securities Exchange Act Release No. 36231 (September 14, 1995), 60 FR 48736 (September 20, 1995).

<sup>27</sup> See Payment for Order Flow Release *supra* note 23.

<sup>28</sup> Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD, the Nasdaq Market, and Nasdaq Market Makers, Securities Exchange Act Release No. 37542 (August 8, 1996) (“21(a) Report”).

<sup>29</sup> See *id.*

adopted today should bring about other, significant changes in the operation of Nasdaq, by ensuring the disclosure of customer and market maker buying and selling interest that heretofore has been hidden from many market participants. At the same time, the new rules will benefit investors in the exchange markets by increasing transparency in those markets and improving opportunities for the best execution of customer orders.

The Commission firmly believes that the actions it is taking today are consistent with the regulatory framework for a national market system established by Congress in the 1975 Amendments. Congress envisioned a national market system supported by accurate and reliable public quotation and transaction information, and fair competition among market centers. Congress also believed that linking all markets for qualified securities through communication and data processing facilities would foster efficiency, enhance competition, increase information available to market participants and contribute to the best execution of customer orders.<sup>30</sup>

The Commission recognizes that investors will lose confidence in the fairness of the markets unless market structures and practices treat all investors fairly. The regulatory initiatives adopted today address current market practices that hinder competition among markets and affect the prices at which customer orders are executed. The Display Rule and Quote Rule amendments enhance transparency and facilitate best execution of customer orders in a manner that preserves maximum flexibility for the markets to design and implement trading and communication systems that are consistent with the objectives of the national market system. These rules contribute to the achievement of the full potential of the national market system as envisioned by Congress. They represent one more step to facilitate the development of an efficient, competitive and transparent national market system in which all market participants can achieve best execution of their orders.

### III. Discussion

#### A. Display of Customer Limit Orders

##### 1. Introduction

As discussed above, the 1975 Amendments contain an explicit statutory mandate for the establishment of a national market system. Congress considered mandating certain minimum

<sup>30</sup> See Exchange Act section 11A(a)(1)(D), 15 U.S.C. 78k-1(a)(1)(D).

<sup>18</sup> 1992 Nasdaq Fact Book.

<sup>19</sup> 1995 NASD Annual Report.

<sup>20</sup> Market 2000 Study at Appendix IV-2.

<sup>21</sup> The Introduction of NAQcess into the Nasdaq Stock Market: Intent and Expectation, NASD Economic Research Staff, June 6, 1996 (“NASD Study”), Exhibit D to Securities Exchange Act Release No. 37302 (June 11, 1996), 61 FR 31574 (June 20, 1996) (Notice of Filing of Amendment No. 2 to Proposed Rule Change by National Association of Securities Dealers Relating to the NAQcess System and Accompanying Rules of Fair Practice) (“NAQcess Release 2”).

<sup>22</sup> Internalized orders are customer orders routed by a broker-dealer to an affiliated specialist or executed by that broker-dealer as a market maker.

<sup>23</sup> The Commission now requires enhanced disclosure of payment for order flow practices on customer confirmations and account statements, as well as upon opening new accounts. Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006 (November 2, 1994) (adopting rules requiring enhanced disclosure of payment for order flow practices on customer confirmations, and account statements, as well as upon opening new accounts) (“Payment for Order Flow Release”). See also Securities Exchange Act Release No. 35473 (March 10, 1995), 60 FR 14366 (March 17, 1995).

<sup>24</sup> Securities Exchange Act Release No. 34279 (June 29, 1994), 59 FR 34883 (July 7, 1994)

components of the national market system, but instead created a statutory scheme granting the Commission broad authority to oversee the implementation, operation and regulation of the national market system.<sup>31</sup> At the same time, Congress charged the Commission with the responsibility to assure that the national market system develop and operate in accordance with specific goals and objectives.<sup>32</sup> The Commission believes that the adoption of a limit order display rule furthers these goals and objectives determined by Congress.

Specifically, the display of customer limit orders advances the national market system goal of the public availability of quotation information, as well as fair competition, market efficiency, best execution and disintermediation. The enhanced transparency of such orders increases the likelihood that limit orders will be executed because contra-side market participants will have a more accurate picture of trading interest in a given security. Further, this increased visibility will enable market participants to interact directly with limit orders, rather than rely on the participation of a dealer for execution.

Moreover, as noted in the Proposing Release, the display of limit orders that are priced better than current quotes addresses at least three regulatory concerns. First, displaying customer limit orders in the quotation can increase quote competition. If the quotes from a market or market maker represent only market maker buying and selling interest in a given security, the market or market maker faces less price competition than if customer buying and selling interest is made public. As a result, the price discovery process may be constrained. Second, the display of limit orders can narrow quotation spreads. Third, because many markets and market makers offer automatic executions of small orders at the best displayed quotes, the display of limit orders that improve the best displayed quotes can result in improved executions for these orders.

Limit orders currently are handled differently in the various auction and dealer markets. Generally, the rules of

most exchanges require that a limit order be displayed in the quotation for a security when it improves the best bid or offer. NYSE specialists, for example, must reflect a customer limit order in their quotations at the limit price when requested to do so.<sup>33</sup> In addition, the NYSE's order handling procedures assume that all limit orders routed to a specialist through SuperDOT contain a display request.<sup>34</sup> Therefore, except in the unusual and infrequent circumstance where a specialist believes market conditions suggest the likelihood of imminent price improvement, a limit order received by a specialist through SuperDOT should be reflected in the specialist's quote as soon as practicable following receipt of the order.<sup>35</sup> According to the NYSE, 93% of all SuperDOT limit orders that improve the best bid or offer displayed are reflected in the specialist's quote within two minutes of receipt, while 98% of such limit orders are reflected within five minutes of receipt.<sup>36</sup>

A recent NYSE policy statement requires specialists to display the full size of all orders received through SuperDOT as well as orders received by specialists manually that are subsequently entered into the electronic book.<sup>37</sup> When a member requests that less than the full size of the order be shown, the specialist is obligated to show the size requested. Specialists must display as soon as practicable any order that, in relation to current market conditions in a particular security, represents a material change in the supply or demand for that security. This

<sup>33</sup> See NYSE Rule 79A.10 (when a limit order is presented to the specialist by a floor broker, the floor broker must affirmatively request that the specialist display the limit order; failure to so request leaves the decision whether to display the limit order to the discretion of the specialist); see also NYSE Rule 60 (requiring specialists to promptly report, inter alia, the best bid and offer in the trading crowd in each reported security in which the specialist is registered).

<sup>34</sup> NYSE Information Memo 93-12 (Mar. 30, 1993).

<sup>35</sup> *Id.*

<sup>36</sup> Telephone Conference between Edward A. Kwalwasser, Executive Vice President, NYSE, and Holly H. Smith, Associate Director, Division of Market Regulation, SEC, January 9, 1995.

Other exchanges also have rules regarding dissemination of bids and offers. However, no uniform standard has been adopted among the exchanges. Generally, the rules either cite, in whole or in part, language from the Quote Rule, or are drafted in such a manner as to allow for broad interpretation with respect to the display of limit orders. See, e.g., BSE Guide, Rules of the Board of Governors, Chapter II, Sec. 7, (CCH) ¶ 2020; PSE Guide, Rules of the Board of Governors, Rule 5.6(f), (CCH) ¶ 3979; American Stock Exchange Guide, General and Floor Rules, Rule 115, (CCH) ¶ 9265; CHX Guide, Article XX, Rule 7, (CCH) ¶ 1688; Phlx Guide, Rules 105 and 229 (CCH) ¶ 2105 and 2229; Cincinnati Stock Exchange Rules, Rule 11.9.

<sup>37</sup> See *supra* note 26.

requirement includes increasing the size of a quotation for orders at the same price as the current bid or offer. If the quotation already reflects significant supply or demand, and the specialist receives an order that is *de minimis* in relation to such supply or demand, the specialist may take a reasonable time (generally not more than two minutes) before updating the size of the quotation.<sup>38</sup>

Currently in the OTC market, the quote for any security typically represents a dealer's own bid and offer. The rules of the NASD do not require market makers to display customer limit orders, whether or not they better the best bid or offer for the security.<sup>39</sup> Generally, customer limit orders in OTC securities either will be routed to a broker-dealer's market making desk or to another market maker for execution if the customer's firm does not make a market in the security. In the past, market makers typically did not execute limit orders until the best bid (for sell orders) or offer (for buy orders) displayed on Nasdaq reached the limit price. This practice has changed, however, in recent years. In June 1994, the Commission approved a rule change filed by the NASD that prohibits broker-dealers from trading ahead of their customers' limit orders.<sup>40</sup> This rule was expanded in May 1995, to prohibit broker-dealers from trading ahead of customer limit orders they accept from other brokers.<sup>41</sup> The NASD also has filed a proposed rule change that would require, in certain circumstances, the display of customer limit orders for exchange-listed securities traded OTC.<sup>42</sup>

<sup>38</sup> The NYSE provides the following example of when a specialist may take a reasonable time to update the size of the quotation: If the market in XYZ security is 20 (5,000)—20¼ (50,000), and the specialist receives an order to sell 200 shares at 20¼, such order would be considered *de minimis* and the specialist would be permitted to wait a reasonable period of time (but not more than two minutes) before changing the size of the offer to 50,200.

<sup>39</sup> See *NASD Manual*, Rule 4613.

<sup>40</sup> See Manning I, *supra* note 24.

<sup>41</sup> See Manning II, *supra* note 24.

<sup>42</sup> See Securities Exchange Act Release No. 35471 (March 10, 1995), 60 FR 14310 (March 16, 1995). The NASD proposal, applicable to exchange-listed securities traded OTC, generally would require a market maker either to execute immediately a limit order of less than the minimum quotation size priced better than the market maker's quotation, or display the order in its quotation for an amount equal to the minimum quotation size. Market makers would have to display a limit order greater than the minimum quotation size for that security but would not have to display the full size of the order. Any portion of the order not displayed, however, would have to be executed at a price at least as favorable as the displayed price if the displayed portion is executed in its entirety. At the NASD's request, the Commission has postponed

<sup>31</sup> S. Rep. No. 75, 94th Cong., 1st Sess. 8-9 (1975) ("Senate Report").

<sup>32</sup> *Id.* at 9. Among other things, Congress found it in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure an opportunity for investors' orders, in both dealer and auction markets, to be executed without the participation of a dealer, to the extent that this was consistent with economically efficient executions of such orders in the best market. Exchange Act Section 11A(a)(1)(c), 15 U.S.C. 78k-1(a)(1)(C).

The exchanges and the NASD use automated trading systems to route and, in some instances, execute orders up to a predetermined size. Some of these systems accept limit orders. Each system, however, may differ in its handling of limit orders that are not executed immediately upon receipt. For example, the NYSE's SuperDOT system routes limit orders to the specialists' posts where they are handled in accordance with NYSE rules governing specialist representation of such orders. The American Stock Exchange's ("Amex") PER system routes limit orders in the same manner as SuperDOT and the orders are handled in accordance with Amex rules. The NASD's Small Order Execution System ("SOES") treats limit orders priced at the current inside market as market orders that are immediately executed.<sup>43</sup> All other limit orders reside in a limit order file that can be viewed only by market makers.<sup>44</sup> SOES does not provide an opportunity for limit orders to interact with incoming market orders. The Commission has published for comment an NASD proposal to replace SOES with "NAqcess," a system that would include a limit order file designed to display certain customer limit orders.<sup>45</sup>

The disparate treatment of limit orders across markets was raised as an issue in the Market 2000 Study. The

final action on the NASD's proposal in order to permit the NASD to evaluate its proposal in light of the Commission's actions on the proposals it is adopting today.

<sup>43</sup> Preferred orders (*i.e.*, orders routed to a specific market maker pursuant to a pre-existing agreement) are executed immediately at the inside quote. Unpreferred orders are executed against market makers in a security in rotation. SOES, however, does not execute an unpreferred order against a single market maker more than once every 15 seconds.

<sup>44</sup> The current SOES rules have been extended, with certain changes that do not affect the handling of limit orders, through January 31, 1997. Securities Exchange Act Release No. 37502 (July 30, 1996), 61 FR 40869 (August 6, 1996).

<sup>45</sup> See Securities Exchange Act Release No. 36548 (December 1, 1995), 60 FR 60392 (December 8, 1995) ("NAqcess Release 1"); NAqcess Release 2, *supra* note 21. As proposed, NAqcess would act as an order delivery system with a limited public limit order file.

Limit orders up to 9,900 shares would be permitted in NAqcess for the top 250 Nasdaq National Market securities, defined by median daily dollar volume, and for 1,000 shares for all other Nasdaq securities. Market makers would be allowed to query the entire limit order file. All other market participants would be limited to viewing the top of the NAqcess limit order file (*i.e.*, the best priced buy and sell limit orders, and the size associated with those orders—the NAqcess inside market). This inside market would be factored into the calculation for the inside quote for each Nasdaq security. Although use of NAqcess would be voluntary, limit orders not entered in NAqcess would be provided with market-wide price protection under the proposal.

Commission received numerous comments concerning whether the optimal degree of pre-trade disclosure of limit orders was being achieved within the U.S. equity markets. Some commentators alleged that specialists and third market dealers sometimes fail to display limit orders priced better than the displayed quotation.<sup>46</sup> Questions also were raised about the lack of limit order exposure on Nasdaq. After considering these comments, the Division recommended in the Study that the securities exchanges consider whether to encourage the display of all limit orders in listed stocks priced better than the best intermarket quotes, unless the ultimate customer requests that the order not be displayed. The Market 2000 Study also recommended the display of limit orders in Nasdaq stocks when the orders are at prices better than the best Nasdaq quotes, unless the customer requests that the order not be displayed.<sup>47</sup>

## 2. Discussion

### a. Basis for Adoption of the Rule

After carefully considering all of the comments as well as economic research regarding the Display Rule, and based on the Commission's experience and knowledge of current market practices and conditions, the Commission believes that adoption of the Display Rule will promote transparency and enhance execution opportunities for

<sup>46</sup> See generally Thomas H. McInish & Robert A. Wood, *Hidden Limit Orders on the NYSE*, 21 J. Portfolio Mgmt. 19 (No. 3, Spring 1995) ("McInish & Wood Study"). The authors asserted that NYSE specialists only display about 50% of limit orders that better existing quotes. In their opinion, this practice represents a serious policy issue because it places both public investors and regional exchanges at a disadvantage. They asserted that hiding limit orders impedes strategic decisions on order placement; results in publicly submitted market orders receiving inferior prices; hampers the monitoring of order executions; reduces the probability of a limit order being executed; results in a delay in reporting limit order executions; interferes with the ability of the regional exchanges to execute public orders; and artificially improves NYSE performance relative to the regional exchanges using a common benchmark. The authors also claimed that NYSE Rule 60 is ambiguous in that the specialists may have some leeway in choosing what to disclose in their quotes.

In its comment letter to the Market 2000 Study, however, the NYSE asserted that its publicly disseminated best bid or offer includes all firm trading interest announced on the floor as required by the exchange's rules. See Letter from William H. Donaldson, Chairman and Chief Executive Officer, NYSE, to Jonathan G. Katz, Secretary, SEC at 25-26 (November 24, 1992). In addition, the NYSE issued a policy statement that reiterates that specialists have an obligation to reflect in their quotes certain limit orders received manually or via SuperDOT that are not executed on receipt. See *supra* note 26.

<sup>47</sup> Market 2000 Study, at IV-6.

customer orders, and encourage liquidity.<sup>48</sup>

The Commission stresses, however, that the rule is not meant to displace any SRO rules that provide additional order handling protections to customer limit orders. Instead, the Commission rule represents only a minimum display standard.

The Commission believes that limit orders are a valuable component of price discovery. The uniform display of such orders will encourage tighter, deeper, and more efficient markets. Limit orders convey buying and selling interest at a given price. The display of limit orders can be expected to narrow the bid-ask spread when this buying and selling interest is priced better than publicly disclosed prices.<sup>49</sup> Both large and small orders stand to benefit from the Display Rule's effect on price discovery.<sup>50</sup> In fact, the importance of

<sup>48</sup> See, *e.g.*, Letter from Thomas F. Ryan, Jr., President and Chief Operating Officer, Amex, to Jonathan G. Katz, Secretary, SEC, dated February 1, 1996 ("Amex Letter"); Letter from David E. Shaw, Ph.D., Chairman, D.E. Shaw & Co., to Jonathan G. Katz, Secretary, SEC, dated January 9, 1996 ("D.E. Shaw Letter") (rule will promote transparency); Letter from Paul A. Merolla, Vice President, Associate General Counsel, Goldman, Sachs & Co., to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("Goldman Sachs Letter") (rule would benefit marketplace); Letter from Craig S. Tyle, Vice President and Senior Counsel, Securities and Financial Regulation, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("ICI Letter") (increased transparency of customer limit orders in all markets could produce benefits to the markets and investors); Letter from Donald L. Crooks, Managing Director, Lehman Brothers, Inc., to Jonathan G. Katz, Secretary, SEC, dated February 26, 1996 ("Lehman Letter") (rule promotes transparency and results in improved opportunities for execution of customer orders); Letter from Bernard L. Madoff and Peter B. Madoff, Bernard L. Madoff Investment Securities, to Jonathan G. Katz, Secretary, SEC, dated January 12, 1996 ("Madoff Letter") (rule will help achieve true price discovery and fairness to investors); Letter from Andrew E. Feldman, Director and Associate General Counsel, Smith Barney Inc., to Jonathan G. Katz, Secretary, SEC, dated January 29, 1996 ("Smith Barney Letter") (rule will promote transparency and assist in achieving best execution of orders). *But see* Letter from Charles R. Hood, Senior Vice President and General Counsel, Instinet, to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("Instinet Letter") (exceptions to rule eliminate potential positive impact on transparency).

<sup>49</sup> For example, limit order trading allows investors the opportunity to trade at prices superior to those represented by the prevailing inside bid and offer. See NASD Study, *supra* note 21.

<sup>50</sup> According to SuperDOT trade data analyzed by the Commission's Office of Economic Analysis ("OEA"), customer limit orders account for 50% of all NYSE customer trades originating from orders routed through SuperDOT ("customer trades") of 100-500 shares; 66% of all customer trades of 600-1,000 shares; 71% of all customer trades of 1,100-3,000 shares; and 74% of all customer trades of 3,100-9,900 shares. The Commission believes that these high percentages are based, at least in part, on the fact that limit orders routed through SuperDOT are required to be displayed in the

limit orders in the trading process was documented in recent studies.<sup>51</sup> The author quantified the impact of exposing limit orders on quoted spreads and effective transaction costs. Using NYSE data, he determined that the quote spreads resulting from participation of the limit order book were approximately 4 to 6 cents smaller than the spreads not set by the limit order book. Further, trading costs on the NYSE were approximately 3–4 cents less per share on a “round trip” transaction when both the purchase and the sale were executed against the limit order book.<sup>52</sup>

The uniform display of limit orders also will lead to increased quote-based competition. Market makers will not only be competing amongst themselves,

specialist’s quote. The Commission believes that these percentages help demonstrate the benefits associated with limit order display for both large and small order sizes. In addition, OEA data shows that NYSE customer limit orders routed through SuperDOT narrow the NYSE quote 22% of the time and match the quote 39% of the time for customer limit orders of 100–1,000 shares; narrow the quote 17% of the time and match the quote 43% of the time for customer limit orders of 1,100–3,000 shares; and narrow the quote 14% of the time and match the quote 46% of the time for customer limit orders of 3,100–9,900. OEA data also shows that, when the NYSE bid-ask spread was ¼ point or more, customer limit orders routed through SuperDOT narrow the NYSE spread between 41% and 50% of the time, depending on the size of the customer order.

<sup>51</sup> See Jason T. Greene, *The Impact of Limit Order Executions on Trading Costs in NYSE Stocks* (An Empirical Examination), December 1995 (“Greene Study”); see also Jason T. Greene, *Limit Order Executions and Trading Costs for NYSE Stocks*, June 1996 (“Greene Study II”).

<sup>52</sup> The Commission further believes that the display requirement will improve price transparency in securities with diverse trading characteristics. Based on SuperDOT trade data, the Commission’s OEA has determined that for NYSE securities with an average daily trading value (“ADTV”) of under \$100,000, customer limit orders account for 57% of all NYSE customer trades originating from orders routed through SuperDOT (“customer trades”) of 100–500 shares; 69% of all customer trades of 600–1,000 shares; 76% of all customer trades of 1,100–3,000 shares; and 83% of all customer trades of 3,100–9,900 shares. Limit orders also are frequently used for securities with higher ADTVs. For example, for NYSE securities with an ADTV of over \$5,000,000, customer limit orders account for 48% of all NYSE customer trades of 100–500 shares; 68% of all customer trades of 600–1,000 shares; 72% of all customer trades of 1,100–3,000 shares; and 73% of all customer trades of 3,100–9,900 shares. Moreover, OEA data shows that for NYSE securities with an ADTV of under \$100,000, customer limit orders routed through SuperDOT narrow the NYSE quote 30% of the time and match the quote 32% of the time. For less liquid securities, therefore, the display of customer limit orders narrows spreads, improves price discovery, and increases market depth. For NYSE securities with an ADTV of \$5,000,000 or more, customer limit orders routed through SuperDOT narrow the NYSE quote 18% of the time and match the quote 41% of the time.

The NASD has suggested that the greater the size of the displayed spread, the greater the use of limit orders. See NASD Study, *supra* note 21.

but also against customer limit orders represented in the quote. The Commission believes that this result will reduce the possibility of certain trading behavior on Nasdaq that was recently the subject of a Commission investigation.<sup>53</sup> As reported in the 21(a) Report, Nasdaq market makers widely adhered to a “pricing convention,” whereby Nasdaq market makers maintained artificially inflexible quotations and as a result often traded with the public at prices unduly favorable to such market makers.<sup>54</sup> In addition, the Commission determined that Nasdaq market makers adhered to a “size convention” that deterred Nasdaq market makers from narrowing their quotes to create a new inside market unless the market makers were willing to trade at least 2,000 to 5,000 shares at that price, rather than the minimum quotation size as determined by NASD rules.<sup>55</sup> This practice prevented the dissemination of improved quotes when a trader sought to trade stock only at a size equal to the minimum quotation size. Thus, the true buying and selling interest in a given security was not reflected in the published quotes.

In addition to the Commission’s actions, and those of the Department of Justice in connection with its investigation of the Nasdaq market, the Commission believes the requirement to display customer limit orders in market maker quotes would inhibit market makers from engaging in the conduct described above. Moreover, the display of limit orders reduces the potential for certain other conduct described in the 21(a) Report, including market maker collaboration and coordination of trade and quote activities. Market makers will be less able to improperly coordinate such behavior due to the display of

<sup>53</sup> See 21(a) Report, *supra* note 28. The investigation identified a number of practices in the Nasdaq market that are similar to practices identified in the 1963 Special Study. See SEC, Report of Special Study of Securities Markets (1963). For example, the 1963 Special Study discussed cooperation and information sharing between traders, as well as other non-competitive practices. *Id.* at pt. 2, 576–577; See also Competitive Impact Statement of the U.S. Department of Justice Antitrust Division, *United States v. Alex. Brown & Sons, et. al.*, (S.D.N.Y. 1996).

<sup>54</sup> As a result of this convention, most Nasdaq stocks were quoted only in increments of ¼. Under the convention, stocks with a dealer spread of ¾ or more would only be quoted in even-eighths (*i.e.*, ¼, ½, ¾), thereby giving rise to a minimum inside spread of ¼. Stocks with dealer spreads less than ¾ would be quoted in both even and odd-eighths, thereby allowing a minimum inside spread of ⅛. The pricing convention significantly limited the flexibility and competitiveness of price quotations in the Nasdaq market.

<sup>55</sup> See 21(a) Report, *supra* note 28.

competing customer order flow and the resulting transparency of ultimate buying and selling interest. The Commission believes that the display requirement will both foster renewed quote-based competition among market makers and introduce new competition from customer limit orders.

The Commission also believes that overall market liquidity should be enhanced due to the increased trading volume that is expected to result from the display of limit orders.<sup>56</sup> As noted previously, customer limit orders account for a significant percentage of total customer orders on the NYSE, where customer limit orders generally are required to be displayed when they represent a better price.<sup>57</sup> Moreover, previous Commission initiatives designed to enhance transparency have resulted in increased competition and liquidity for the markets.<sup>58</sup>

Customers also will be better able to monitor the quality of their executions. Currently, the failure to display limit orders often results in inferior or missed executions for these orders. The Commission has received frequent complaints from customers whose limit orders have not been filled while other executions are reported at prices inferior to their limit order prices. Requiring the display of customer limit orders in specialist and market maker quotes, although not guaranteeing that such limit orders will be executed, will help ensure that other orders are not executed at inferior prices until better priced limit orders are executed. Similarly, customers entering market orders will be able to determine whether their orders are receiving the best price available. Customers also will be in a better position to compare the execution quality provided by different broker-dealers.<sup>59</sup>

The absence of a uniform limit order display requirement across all markets has contributed to the controversy among market participants regarding the availability of true price improvement

<sup>56</sup> See Greene Study and Greene Study II, *supra* note 51 (limit orders affect the quoted spread, provide liquidity to traders that demand immediacy of execution, and may contribute to reduced trading costs); NASD Study, *supra* note 21 (the liquidity supplied by limit orders reduces trading costs of market participants); OEA Data, *supra* notes 50 and 52 (limit orders narrow spreads, improve price discovery, and increase market depth).

<sup>57</sup> See OEA Data, *supra* notes 50 and 52.

<sup>58</sup> See Market 2000 Study at Study IV. See also discussion at section III.A.b.iii., *infra*; Simon & Colby *The National Market System For Over-The-Counter Stocks* (“Simon and Colby”), 55 *Geo. Wash. L. Rev.* 17 (1986).

<sup>59</sup> The Commission notes that if the Display Rule leads some market makers to charge commissions for handling limit orders, Commission rules require disclosure of such charges. See 17 CFR 240.10b–10.

opportunities. Many claim that "hidden" limit orders in exchange markets contribute to distorted price improvement figures for these markets.<sup>60</sup> This potential distortion also hinders a customer's ability to monitor execution quality. Pursuant to the Display Rule, the vast majority of limit orders will be publicly disclosed, thus enabling a more accurate comparison of price improvement opportunities, and enabling customers and broker-dealers to make more informed order routing decisions.<sup>61</sup>

Moreover, the Commission believes that the display of limit orders will benefit orders routed to automated execution systems. To the extent these systems execute orders at prices based on the best displayed quotation for a particular security,<sup>62</sup> customers whose orders are executed through these systems will receive the benefit of prices that more accurately reflect buying and selling interest in the market.

In sum, the Commission believes the adoption of the Display Rule is an important step in furthering the goals expressed by Congress in the 1975 Amendments. The Display Rule will provide enhanced opportunities for public orders to interact with other public orders, consistent with

congressional goals.<sup>63</sup> In addition, the display requirement will, among other things, narrow quotes, enhance market liquidity, and improve an investor's ability to monitor the quality of its executions.<sup>64</sup> This will create a better environment for execution of both limit and market orders without the participation of a dealer. The increased order interaction will result in quicker and more frequent executions of customer limit orders. The Display Rule, therefore, will increase the likelihood that limit orders will be executed, a result that the Commission believes is consistent with the duty of best execution.

#### b. Response to Comments<sup>65</sup>

The Commission proposed Rule 11Ac1-4 to establish minimum display requirements for customer limit orders that improve a specialist's or OTC market maker's best bid or offer for a particular security as well as the size of such orders. In addition, the rule requires the display of the size of certain limit orders priced at the national best bid or offer ("NBBO"). Although the rule generally would mandate the display of limit orders, market makers and specialists still would retain some flexibility in handling limit orders accepted for execution.

Specifically, the rule allows an OTC market maker or specialist, immediately upon receipt of a limit order, to: (1) Change its quote and the size associated with its quote to reflect the limit order; (2) execute the limit order; (3) deliver the limit order in an exchange- or

association-sponsored system that complies with the requirements of the rule; or (4) send the limit order to another market maker or specialist who complies with the requirements of the rule. The rule would require a specialist or OTC market maker to display a customer limit order when the order was "held" by the specialist or OTC market maker. If the specialist or OTC market maker immediately sends the order to a system or to another specialist or OTC market maker that complies with the rule, the specialist or OTC market maker that routed the order would have satisfied its obligation to display the order. These alternatives are intended to allow market makers, specialists, and market centers an opportunity to continue to provide their valuable services while offering customers the best available execution opportunities.

The Display Rule as adopted maintains these alternatives as proposed. Additionally, to better achieve its aims and to respond to comments, the Commission has made some modifications to the proposed rule. For example, the Commission has decided to permit a specialist or OTC market maker to deliver a limit order to certain ECNs as an alternative to representing the limit order in its quote. This change is an extension of the proposed exception that permits a specialist or OTC market maker to deliver a limit order to an exchange- or association-sponsored system that complies with the Display Rule. Moreover, with regard to implementation of the rule, the Commission is providing for a four-stage phase-in over a one year period for non-exchange-traded securities.

Of the commenters who specifically addressed the proposed Display Rule, an overwhelming majority strongly support the inclusion of customer limit orders in the quote.<sup>66</sup> One commenter

<sup>60</sup> See James J. Angel, *Who Gets Price Improvement on the NYSE?*, Working Paper, December 1994. In studying the availability of price improvement on the NYSE, the author noted that over 18% of the market orders that were price improved were filled by SuperDOT limit orders. Based on this percentage, the author estimated the percentage of orders price improved by "hidden" limit orders and determined that if such limit orders were represented in the specialist's quote rather than "hidden," spreads would have been narrower and NYSE price improvement statistics would have declined. See also, McNish & Wood Study, *supra* note 46; Mitchell A. Petersen & David Fialkowski, *Posted Versus Effective Spreads: Good Prices or Bad Quotes*, 35 J. Fin. Econ. 269 (1994) (the fact that so many orders execute inside the posted spreads indicates that quotes do not represent the true supply and demand of a given security, and may be based, in part, on the failure to display public limit order interest in the quote). Cf. Ross, Shapiro and Smith, *supra* note 17 (although the authors did not examine limit orders in detail, and discounted the effect of "hidden" limit orders on their statistics, the authors found that limit orders provide 27% of the price improvement afforded to SuperDOT market order volume).

<sup>61</sup> See, e.g., Amex Letter (rule would help eliminate hidden limit orders); Letter from Frederick Moss, Chairman of the Board, CSE, to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("CSE Letter") (elimination of hidden limit orders will eliminate illusion of superior price improvement); Letter from Harold S. Bradley, Vice President and Director of Trading, Investors Research Corporation, to Jonathan G. Katz, Secretary, SEC, dated January 13, 1996 ("Investors Research Letter") (hidden limit orders are not justified).

<sup>62</sup> Compare discussion of best execution at section III.C.2.

<sup>63</sup> See 15 U.S.C. 78k-1(a)(1)(C)(v).

<sup>64</sup> The Commission notes that a few commenters are concerned about the potential effects of the Commission's proposals on institutional customers. See Goldman Sachs Letter; Letter from Howard J. Schwartz, Chairman and Chief Executive Officer, and James Hanrahan, Managing Director—Trading, Lynch, Jones & Ryan, Inc., to Jonathan G. Katz, Secretary, SEC, dated February 9, 1996 ("LJR Letter"); Letter from A.B. Krongard, Chairman, SIA Board of Directors, and Bernard L. Madoff and Robert Murphy, Co-Chairmen, Order Execution Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, dated February 26, 1996 ("SIA Letter"). The Commission believes that the Display Rule will benefit both retail and institutional customers, while preserving the access to the markets that institutional customers have today. For example, an institutional customer's block size limit order would not be subject to the rule unless such customer requests that the order be displayed. Moreover, any customer, whether individual or institutional, can request that its non-block size limit order not be displayed. The Commission also notes that increased quote competition and enhanced transparency should improve the prices at which institutions and market makers begin their negotiations for the execution of institutional orders. See also 21(a) Report, *supra* note 28.

<sup>65</sup> For further discussion of the views of commenters, see the Summary of Comments, *supra* note 4.

<sup>66</sup> See, e.g., Amex Letter; Letter from Marshall E. Blume, Director, Howard Butcher Professor of Financial Management, The Wharton School of the University of Pennsylvania, to Jonathan G. Katz, Secretary, SEC, dated January 11, 1996 ("Blume Letter"); Letter from George W. Mann, Jr., Senior Vice President and General Counsel, BSE, to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("BSE Letter"); Letter from Robert H. Forney, CHX, to Jonathan G. Katz, Secretary, SEC, dated January 23, 1996 ("CHX Letter"); D.E. Shaw Letter; Letter from Antitrust Division, U.S. Department of Justice, to SEC, dated January 26, 1996 ("DOJ Letter"); Letter from Preston Estep, Estep Trading Partners L.P., to Jonathan Katz, Secretary, SEC, dated December 21, 1995 ("Estep Letter"); Goldman Sachs Letter; ICI Letter; Lehman Letter; Madoff Letter; Letter from William A. Lupien, Chairman and Chief Executive Officer, Mitchum, Jones & Templeton, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 8, 1996 ("MJT Letter"); Letter from Joseph R. Hardiman, President, National

notes that true price discovery and fairness for public investors can only be achieved when limit orders are reflected in the NBBO.<sup>67</sup> Other commenters, expressing strong support for the proposed rule, believe that market-wide limit order procedures will improve the markets by enhancing overall market transparency<sup>68</sup> and eliminating the advantages derived by some markets from hidden limit orders.<sup>69</sup> The Department of Justice states that the proposed rule encourages quote competition, which is likely to reduce spreads,<sup>70</sup> and allows customer orders to interact with one another.<sup>71</sup> In this regard, several commenters recognize that the proposed rule would assist in achieving best execution of customer orders<sup>72</sup> by increasing the opportunities for execution of limit orders, and improving the prices for market orders.<sup>73</sup> Another commenter states that the proposed rule is consistent with investor expectations and will act to protect retail customer interests.<sup>74</sup>

Other commenters oppose the proposal. Several commenters in this group have raised the following general concerns regarding the proposed rule.

#### i. Distinction Between Markets

Several commenters argue that the Display Rule does not take into account distinctions between auction and dealer markets. Some of these commenters, discussing the Proposing Release as a whole, argue that the Commission's proposals would "auctionize" the dealer market.<sup>75</sup> One commenter warns that,

Association of Securities Dealers, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("NASD Letter"); Letter from James E. Buck, Senior Vice President and Secretary, NYSE, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("NYSE Letter"); Letter from David S. Pottruck, President and Chief Operating Officer, The Charles Schwab Corporation, to Jonathan G. Katz, Secretary, SEC, dated May 7, 1996 ("Schwab Letter II"); SIA Letter; Letter from William R. Rothe, Chairman, and John L. Watson III, President, Security Traders Association, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("STA Letter"); Letter from John F. Luikart, President and Chief Executive Officer, Sutro & Co., to Jonathan Katz, Secretary, SEC, dated January 16, 1996 ("Sutro Letter").

<sup>67</sup> Madoff Letter.

<sup>68</sup> See, e.g., Amex Letter; CHX Letter; CSE Letter; D.E. Shaw Letter; ICI Letter; Investors Research Letter; Lehman Letter; Smith Barney Letter.

<sup>69</sup> See, e.g., Amex Letter (rule would help eliminate hidden limit orders); CSE Letter (elimination of hidden limit orders will eliminate illusion of superior price improvement); Investors Research Letter (hidden limit orders are not justified).

<sup>70</sup> DOJ Letter.

<sup>71</sup> *Id.*; see also Amex Letter; Lehman Letter.

<sup>72</sup> See, e.g., Lehman Letter; Smith Barney Letter.

<sup>73</sup> Lehman Letter.

<sup>74</sup> D.E. Shaw Letter.

<sup>75</sup> See, e.g., Letter from R. Steven Wunsch, President, AZX, Inc., to Jonathan G. Katz, Secretary,

because auction and dealer markets are fundamentally different, a single set of rules for both auction and dealer markets would reduce quote quality and damage overall market integrity in dealer markets.<sup>76</sup> Although the SIA reports that the consensus view of its Ad Hoc Committee on Order Execution is to require a market maker to reflect customer limit orders in the quote, the SIA argues that the adoption of the proposed rule, without suggested modifications, could adversely affect the dealer market so as to weaken competition between dealer and auction markets.<sup>77</sup>

The Commission believes that the application of the principles underlying the limit order display rule to the dealer market is neither a new nor radical concept. In 1975, Congress envisioned an NMS in which public limit orders in qualified securities would have a central role.<sup>78</sup> Congress anticipated that the NMS would make all specialists and market makers aware of public customer limit orders held anywhere in the system, and provide enhanced protection and priority for limit orders in stocks qualified for trading in a national market system.<sup>79</sup> The Commission has consistently recognized since 1975 that, in order to satisfy this Congressional vision, multiple-market display of limit orders was an important component for qualified securities.<sup>80</sup>

SEC, dated January 15, 1996 ("AZX Letter"); Goldman Sachs Letter; Letter from David Rich, Vice President, Jefferies & Company, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 25, 1996 ("Jefferies Letter"); Letter from Robert W. Murphy, President, RPM Specialist Corporation, to Jonathan G. Katz, Secretary, SEC, dated February 26, 1996 ("RPM Letter"); Letter from Robert A. Schwartz, Professor of Finance and Economics, and Yamaichi Faculty Fellow, Leonard N. Stern School of Business, New York University, and Robert A. Wood, Distinguished Professor of Finance, Fogelman College of Business and Economics, University of Memphis, to Jonathan G. Katz, Secretary, SEC, dated January 23, 1996 ("Schwartz & Wood Letter"); SIA Letter.

<sup>76</sup> RPM Letter.

<sup>77</sup> SIA Letter. *Cf.* Letter from A.B. Krongard, Chairman, SIA Board of Directors, and Bernard L. Madoff, Chairman, Trading Committee, to Jonathan G. Katz, Secretary, SEC, dated August 1, 1996 ("SIA NAqess Letter") (the SIA, in its letter to the Commission regarding the NASD's NAqess proposal, states that the Commission's Order Execution Obligations proposal would narrow quotation spreads, improve transparency, and provide customers with best execution of their orders, consistent with the 1975 Amendments).

<sup>78</sup> Senate Report, *supra* note 31.

<sup>79</sup> *Id.* The Senate Report stressed the need to establish a mechanism by which specialists and market makers could be made aware of customer orders within the NMS. The Senate Report was "satisfied that [the legislation] grant[ed] the Commission complete and effective authority to implement a system for the satisfaction of public limit orders." *Id.* at 18.

<sup>80</sup> See Securities Exchange Act Release No. 15671 (March 22, 1979), 44 FR 20360 (April 4, 1979)

More recently, the Market 2000 Study recommended that the SROs, including the NASD, consider requiring the display of customer limit orders,<sup>81</sup> and the NASD, in a proposed rule change filed with the Commission, proposed that CQS market makers display in their quotes certain customer limit orders for exchange-listed securities traded OTC.<sup>82</sup> The NASD also has proposed a mechanism for the display and protection of customer limit orders in Nasdaq securities.<sup>83</sup>

Although some commenters claim that the Commission is attempting to "auctionize" the dealer market, the display requirement is based on transparency and agency concerns, including a broker-dealer's obligation to provide its customers with best execution.<sup>84</sup> The display of customer limit orders will act to narrow spreads, improve price discovery, and increase market depth. The enhanced transparency resulting from the Display Rule will increase the likelihood that customer limit orders will be executed, improve the execution prices of market orders, and strengthen an investor's ability to monitor the quality of executions.<sup>85</sup> These results further several Congressional goals.

In keeping with Congressional intent, the Commission believes the treatment of limit orders should reflect the very real changes in market structure that have taken place since the enactment of the 1975 Amendments. These changes include the development of a robust, liquid OTC dealer market that attracts significant investor trading interest, that trades at many multiples of the volume extant in 1975, and that is characterized by the inclusion of thousands of securities that meet the NMS designation.<sup>86</sup> In addition, the

(Development of a National Market System Status Report). See also Securities Exchange Act Release No. 18738 (May 13, 1982), 47 FR 22376 (May 24, 1982) (proposing limit order display requirement for Rule 19c-3 securities).

<sup>81</sup> Market 2000 Study, at IV-6.

<sup>82</sup> See *supra* note 42.

<sup>83</sup> See *supra* note 45.

<sup>84</sup> See NASD Study, *supra* note 21 (enhancements to limit order handling, within the dealer market structure, will create significant benefits for investors). See also Manning II, *supra* note 24 (Commission's extension of limit order protection to Nasdaq does not suggest an intention to "auctionize" the dealer market).

<sup>85</sup> See Senate Report, *supra* note 31 at 16-18 (discussing desirability of incorporating certain auction market principles, such as limit order display and protection, for certain qualifying securities in dealer markets).

<sup>86</sup> To date, approximately 4,000 Nasdaq securities have qualified for the NMS designation. In order to qualify as an NMS security, transaction reports are required to be reported on a real-time basis pursuant to an effective transaction reporting plan

Continued



Commission believes that application of the Display Rule should also benefit investors in those securities that do not yet meet the NMS designation.<sup>87</sup> As noted earlier, the Commission believes that the increased use of limit orders in these securities will lead to a narrowing of spreads and ameliorate certain anti-competitive practices that have developed in the Nasdaq market.<sup>88</sup> The Commission has determined that certain practices on Nasdaq have contributed to artificially wide spreads for OTC securities.<sup>89</sup> The display of customer limit orders in all Nasdaq securities will promote accurate pricing and convey the true buying and selling interest in such securities.

A few commenters believe that the Display Rule was proposed solely to address problems in the OTC market, and accordingly there is no need for a uniform rule applicable to exchange markets.<sup>90</sup> As noted previously, the Commission's intention is to create a minimum standard for the handling of limit orders across all markets, consistent with market transparency, competition, and best execution principles. Currently, the national securities exchanges do not handle limit orders uniformly, and in fact the non-display of retail-size limit orders is permitted under certain circumstances. The rule will ensure that investors benefit from the display of limit orders, no matter where an order is sent for execution.<sup>91</sup> A minimum standard also addresses concerns regarding the prevalence of hidden limit orders.<sup>92</sup> The

approved by the Commission. See 17 CFR 240.11Aa2-1 and 11Aa3-1.

<sup>87</sup> As discussed below, the Display Rule will apply only to "covered securities." At the present time, the Commission does not believe the rule should be extended to securities for which market makers are not required to quote continuous firm two-sided markets, such as OTC Bulletin Board securities.

<sup>88</sup> See *supra* discussion at section III.A.2.a.

<sup>89</sup> 21(a) Report, *supra* note 28.

<sup>90</sup> See, e.g., BSE Letter; NYSE Letter; RPM Letter; Letter from David E. Humphreville, Executive Director, The Specialist Association, to Jonathan G. Katz, Secretary, SEC, dated February 2, 1996 ("Specialist Assoc. Letter").

<sup>91</sup> See, e.g., Greene Study & Greene Study II, *supra* note 51.

<sup>92</sup> See generally McInish & Wood Study, *supra* note 46 (hidden limit orders result in, among other things, artificial price improvement statistics and inferior order executions); *Traders Accuse Specialists of Holding Back Limit Orders*, Investment Dealers' Digest, 8, (February 14, 1994) (some traders have continued to accuse NYSE specialists of hiding limit orders even after the NYSE issued an Information Memo reminding specialists of their duties); Greene Study and Greene Study II, *supra* note 51 (one explanation for the significantly lower bid-ask spreads in the 1994-95 sample than in the 1990 sample, and the increase in the percentage of transactions at the quoted prices from the 1990 sample to the 1994-95 sample, may be that NYSE specialists were more

Commission believes, therefore, that a market-wide limit order display requirement is most consistent with the duty of best execution and the expectations of investors.

#### ii. Distinction Between Quotes and Orders

Some commenters maintain that the rule blurs the distinction between quotations and orders.<sup>93</sup> One commenter states that limit orders represent only a finite trading interest while quotes represent the "actual" market for a security; thus, displaying limit orders would not reflect the "true" state of the market and impair the quality of quotation information.<sup>94</sup> The commenter suggests that a separate limit order file would be more appropriate in light of these distinctions.<sup>95</sup> In this vein, several commenters mention the NASD's proposed NAqcess system,<sup>96</sup> suggesting that the Commission postpone implementation of the Display Rule until the Commission has an opportunity to assess the effects of NAqcess.<sup>97</sup> A few commenters suggest the implementation of an industry-wide consolidated limit order book as an

diligent in reflecting the limit order book in their quotes as per Information Memo 93-12); Amex Letter (rule would help eliminate hidden limit orders); CSE Letter (elimination of hidden limit orders will eliminate illusion of superior price improvement); Investors Research Letter (hidden limit orders are not justified).

<sup>93</sup> See, e.g., Letter from Raymond L. Aronson, Senior Managing Director, Bear, Stearns & Co. Inc., to Jonathan G. Katz, Secretary, SEC, dated February 1, 1996 ("Bear Stearns Letter"); Instinet Letter; Letter from Carol L. Cunniff, Executive Vice President, Ruane, Cunniff & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated February 23, 1996 ("Ruane Letter"); Letter from Charles R. Schwab, Chairman and Chief Executive Officer, The Charles Schwab Corporation, to Jonathan G. Katz, Secretary, SEC, dated January 25, 1996 ("Schwab Letter"). *But see* Schwab II Letter (supporting the Display Rule).

<sup>94</sup> Ruane Letter.

<sup>95</sup> *Id.* See also Bear Stearns Letter (discussion of proposed central limit order file for The Nasdaq Stock Market so as to preserve distinction between dealer quotes and agency or proprietary orders).

<sup>96</sup> See *supra* note 45.

<sup>97</sup> See, e.g., Letter from A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Inc., to Jonathan G. Katz, Secretary, SEC, dated February 29, 1996 ("Alex. Brown Letter"); Letter from Albert G. Lowenthal, Chairman of the Board, Fahnstock & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("Fahnstock Letter"); Jefferies Letter; Letter from Gerard S. Citera, Deputy General Counsel, First Vice President, PaineWebber Incorporated, to Jonathan G. Katz, Secretary, SEC, dated February 9, 1996 ("PaineWebber Letter"); Schwab Letter; STA Letter; Letter from Charles Snow, Counsel, Securities Traders Association of New York, to Jonathan G. Katz, Secretary, SEC, dated January 30, 1996 ("STANY Letter"); *see also* Letter from C. Robert Paul, III, Associate General Counsel, Dean Witter Reynolds, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 31, 1996 ("Dean Witter Letter"); Goldman Sachs Letter.

alternative or a logical outgrowth of the Display Rule.<sup>98</sup>

The Commission believes that the display of limit orders is an essential component of accurate price discovery. A quote provides market participants with information regarding a market maker's or specialist's trading interest at a given price. A market maker or specialist could be willing to purchase or sell additional shares above its quoted size.<sup>99</sup> Entry of a customer limit order that improves the quote serves a similar purpose. A limit order accurately represents trading interest for a specific volume of a security at the limit price. There are few practical differences between customer limit orders and a market maker's quotation that is firm only for its quoted size. Nonetheless, the proposed rule was not intended to equate customer limit orders with market maker quotes. Instead, the proposed rule was designed to facilitate greater transparency of customer trading interest, with the expectation that orders would have an increased opportunity for best execution without the interaction of a dealer. In the Commission's opinion, these objectives are more difficult to achieve if customer trading interest is not routinely represented in publicly displayed quotes. The Commission notes that the Display Rule provides other means by which a market maker or specialist may comply with the requirements of the rule in the event a specialist or market maker elects not to display customer trading interest in its quote.<sup>100</sup>

Further, the Commission does not agree with the suggestion that the Commission postpone the adoption of the Display Rule until the Commission has had an opportunity to evaluate the NASD's NAqcess proposal.<sup>101</sup> Although

<sup>98</sup> See, e.g., DOJ Letter; MJT Letter; Schwab Letter; Letter from Junius W. Peake, Monfort Distinguished Professor of Finance, University of Northern Colorado, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("Peake Letter"); Letter from Jeffrey P. Ricker, CFA, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("Ricker Letter"); Letter from Peter W. Jenkins, Chairman, and Holly A. Stark, Vice Chairman, Institutional Committee, Securities Traders Association, to Jonathan G. Katz, Secretary, SEC, dated January 19, 1996 ("STAIC Letter").

<sup>99</sup> Under Commission rules, the market maker's quote is only required to be firm up to its published size. See 17 CFR 240.11Ac1-1(c)(2).

<sup>100</sup> For example, a market maker or specialist may deliver a customer limit order immediately upon receipt to another market maker or specialist, or to an ECN or an exchange or association sponsored system pursuant to the rule. Section 240.11Ac1-4(c)(5) and (6).

<sup>101</sup> The Commission notes that the proposed NAqcess system is a significant and controversial proposal which has generated approximately 1,100 comment letters. The Commission is in the process

the NASD has argued that limit orders entered into NAqcess, as proposed, would result in greater display of OTC limit order prices, there is no assurance that market makers will enter such orders into NAqcess rather than hold the orders internally.<sup>102</sup> Therefore, the Commission believes that the Display Rule is necessary to ensure display of these orders in the OTC market.<sup>103</sup> If approved, NAqcess can assist in compliance with the Display Rule to the extent that the system incorporates customer limit orders in the consolidated quote stream, thereby allowing market makers to enter limit orders in NAqcess rather than displaying limit orders in their quotes.<sup>104</sup> As noted earlier, the Commission has identified important benefits associated with limit order display. Accordingly, the Commission believes that it is not necessary to observe the effects of NAqcess in order to determine the benefits of the limit order display requirement.

### iii. Liquidity

Several commenters assert that application of the Display Rule to Nasdaq securities could reduce liquidity in the Nasdaq market.<sup>105</sup> These commenters believe that market maker profits may decline due to narrowed spreads or increased compliance costs, with the result that many firms will decide not to make the necessary capital commitment to continue their market making operations. The commenters conclude that as the number of market makers in a security declines, liquidity will be adversely affected, leading to wider spreads. Moreover, some commenters believe that the decrease in liquidity will impair the capital formation process, especially for

of reviewing the comments and has yet to decide what action to take on the proposal.

<sup>102</sup> See NAqcess Releases, *supra* note 45. As noted above, limit orders not entered in NAqcess would be provided with market-wide price protection.

<sup>103</sup> In any event, NAqcess will not address at all the issues of disparate limit order handling practices or hidden limit orders in the exchange markets.

<sup>104</sup> See Section 240.11Ac1-4(c)(5).

<sup>105</sup> See, e.g., Alex. Brown Letter; Bear Stearns Letter; Dean Witter Letter; Letter from Robert F. Mercandino, Senior Vice President, Dillon, Read & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated March 15, 1996 ("Dillon Letter"); Jefferies Letter; Lehman Letter; Letter from Robert J. McCann, Managing Director, Co-Head, Global Equity Markets, Merrill Lynch, Pierce, Fenner & Smith Incorporated, to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("Merrill Letter"); NASD Letter; PaineWebber Letter; Letter from David P. Semak, Vice President Regulation, PSE, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("PSE Letter"); SIA Letter.

securities that are not mature enough for auction trading.<sup>106</sup>

At least one commenter states that the usefulness of limit orders could be diminished by the refusal of some market makers to accept such orders, or by the imposition of high commission costs charged to recoup lost profits on spreads.<sup>107</sup> Other commenters believe, however, that it will be difficult for market makers to increase their commissions for limit orders.<sup>108</sup> They believe commission charges would not compensate for lost trading profits or prevent the ebb of market liquidity.<sup>109</sup>

Other commenters believe the proposed rule will not have a negative impact on market liquidity. One commenter explicitly states that the benefits of the proposed rule would outweigh any potential adverse effects on liquidity.<sup>110</sup> Another commenter says that the proposed rule would not result in any significant reduction in market making activity.<sup>111</sup> The CSE notes that it has not noticed any negative effects on market liquidity as a result of the implementation of its own limit order display rule.<sup>112</sup> Yet another commenter states that although it currently does not trade OTC securities, it expects that many market participants, including the commenter, would begin trading such securities if the proposed rule was adopted, thereby increasing market liquidity.<sup>113</sup>

The display of limit orders is designed, among other objectives, to publicize accurate market interest and increase quote competition.<sup>114</sup> The Commission understands that certain costs, including a diminution in market maker profits, are associated with this increased market transparency. For example, a market maker that holds a customer limit order has, in effect, a private "option" to execute the order as principal. The longer this "option" remains open, the more time the market

maker has to determine whether it can profit from executing the order as principal.<sup>115</sup> This private market maker "option," however, is potentially detrimental to the execution opportunities for the limit order. The Display Rule will limit this "option" and expose the order to market-wide trading interest. Moreover, increased price competition from limit orders may reduce market maker profits through the narrowing of spreads.<sup>116</sup> As a result, the Display Rule may force less efficient competitors to stop making markets in some of the securities they now quote.

Although the rule could lead to a reevaluation by some market makers of the services they wish to provide, after considering the available evidence, and in light of its experience, the Commission does not believe that there will be a significant negative impact on the markets for covered securities. The Commission is not convinced that the loss of some market competitors in securities with many market makers would impair liquidity in these securities.<sup>117</sup> The Commission believes that customer orders are the ultimate source of liquidity to the markets, and that adoption of a rule that improves the handling of such orders will have the effect of enhancing market liquidity.<sup>118</sup> The Commission believes that a limit order display requirement will encourage new limit orders in securities to be entered, thus providing additional liquidity to the market from customers.<sup>119</sup> The potential of limit orders to narrow quotes also may encourage the entry of additional market

<sup>115</sup> The Commission recognizes that there is also a cost associated with holding that limit order, because a market maker is required to execute that limit order if it has engaged in a transaction for its own account that would have satisfied the limit order. See Manning I & II, *supra* note 24.

<sup>116</sup> See *supra* notes 53-55 and accompanying text (display of customer limit orders in market maker quotes will act to eliminate certain trading behavior on Nasdaq and foster quote competition).

<sup>117</sup> See, e.g., STAC Letter (limit orders are critical to market liquidity).

<sup>118</sup> The Commission does not thereby denigrate the contribution OTC market makers provide in a dealer market. The Commission notes, however, that most market makers provide primarily intra-day liquidity to customers, and generally seek to end the trading day with a limited inventory position in order to minimize inventory risk. Customer limit orders represent buying or selling interest at specified prices for their stated duration, which may be longer than intra-day. Market makers holding customer limit orders rely in part on these limit orders in quoting their own prices to buy and sell securities.

<sup>119</sup> See Greene Study & Greene Study II, *supra* note 51 (limit orders affect the quoted spread and provide liquidity); NASD Study, *supra* note 21 (limit orders, like market maker quotes, supply liquidity to the markets); OEA Data, *supra* notes 50 and 52.

<sup>106</sup> See, e.g., NASD Letter; SIA Letter.

<sup>107</sup> Letter from David K. Whitcomb, Professor of Finance and Economics, Rutgers University Graduate School of Management, to Secretary, SEC, dated January 12, 1996 ("Whitcomb Letter").

<sup>108</sup> See, e.g., Letter from Irving M. Pollack, Alan B. Levenson, and Robert H. Rosenblum, Fulbright & Jaworski L.L.P., on behalf of Herzog, Heine and Geduld, Inc., to Jonathan Katz, Secretary, SEC, dated January 16, 1996 ("HHG Letter"); STA Letter.

<sup>109</sup> *Id.*

<sup>110</sup> Lehman Letter.

<sup>111</sup> Letter from Daniel G. Weaver, Ph.D., Assistant Professor of Finance, Marquette University, to Jonathan G. Katz, Secretary, SEC, dated January 10, 1996 ("Weaver Letter").

<sup>112</sup> CSE Letter.

<sup>113</sup> The commenter noted further that it does not currently trade OTC securities because it cannot be sure that its order will be represented to the whole market. Estep Letter.

<sup>114</sup> See Market 2000 Study, at Study IV.

orders.<sup>120</sup> The Commission believes that the additional liquidity due to narrower spreads and increased customer orders will outweigh any potential loss of liquidity provided by market makers.

As noted above, some commenters expressed concern regarding the effect of the Display Rule on the availability of liquidity to small issuers.<sup>121</sup> In response to these comments, the Commission's OEA examined market maker participation in 4,839 Nasdaq issuers over a one month period in 1996. The findings indicate that: (1) the median number of market makers in a security is not appreciably lower for initial public offering ("IPO") issuers or for securities with the smallest market capitalization; (2) broker-dealers that participated in IPO underwriting syndicates were active participants in aftermarket trading, but were not alone in providing significant market maker liquidity; and (3) in Nasdaq securities with the smallest market capitalization (\$2 million or less), the single most active market maker in an issue typically participated in one-third or fewer trades. Thus, there is no convincing evidence that Nasdaq issuers, including IPO issuers, are dependent for liquidity on any one market maker. The pattern of market making activity indicates that significant liquidity is provided by market makers who are not the "most active" market makers in a security. Because there does not appear to be high concentration in market making, and because of the Commission's belief that customer order flow is a critical source of market liquidity, the Commission believes that the proposals adopted today will not unduly impact liquidity for small or new issuers.

Furthermore, Commission experience has been that enhancements to transparency result in improved liquidity.<sup>122</sup> The Commission believes

<sup>120</sup> See NASD Study, *supra* note 21 (those investors that demand immediate execution, *e.g.* those entering market orders, will pay less for executions due to the augmented liquidity supplied by limit orders); Greene Study and Greene Study II, *supra* note 51 (limit orders provide liquidity to traders that demand immediacy of execution and may contribute to reduced trading costs); OEA Data, *supra* notes 50 and 52 (display of limit orders narrows spreads, improves price discovery, and increases market depth for a variety of securities, including those NYSE securities that are thinly traded).

<sup>121</sup> This concern also was raised in the context of the ECN Amendment to the Quote Rule.

<sup>122</sup> In several instances in the past, commenters have claimed that other Commission initiatives to increase transparency would act to reduce liquidity; others have warned that such initiatives would decrease the competitiveness of the U.S. markets in relation to foreign counterparts. These claims, however, have not been borne out. For example, many industry participants argued that the NASD's

that these improvements are attributable, at least in part, to the impact of transparency on market integrity and investor confidence. In addition, while market maker profits per trade may be reduced as spreads are narrowed, increased volume over time may result in stable profit levels.<sup>123</sup>

It also may become feasible for market makers to charge customers commissions for handling limit orders, even if that is not the current practice today. As noted earlier, some commenters claim that the Display Rule will have a disparate impact on wholesale Nasdaq market makers in that such market makers would not be able to offset the increased costs associated with limit order display through charges or commissions.<sup>124</sup> The Commission believes, however, that the systems costs associated with the Display Rule should not be overly burdensome,<sup>125</sup> nor should systems costs or any reduced market maker profitability from declining spreads be more extensive for wholesale market makers than for integrated market makers. Although

adoption of its "Manning" rules would severely impact market liquidity. See Market 2000 Study. However, there has been no evidence offered to the Commission of adverse liquidity consequences caused by these limit order protections, and the Commission is not aware of any significant diminution in liquidity. Further, as discussed in the Market 2000 Study, other transparency initiatives, such as the adoption of real-time transaction and quotation reporting, have resulted in increases in the competitiveness and liquidity of both listed and OTC equity markets despite market maker protestations to the contrary prior to adoption of these initiatives. See *Id.* at Study IV. See also Simon & Colby, *supra* note 58. Even the creation of Nasdaq itself was met with much opposition. The result of this major structural change was far from the predicted "death knell" of the OTC market. Rather, OTC market strength and liquidity have flourished since Nasdaq's inception. Based on the Commission's experience with other market structure initiatives, therefore, the Commission believes that improvements in order handling, market transparency, and efficiency will likely improve market liquidity.

<sup>123</sup> Although the display requirement may decrease a market maker's per trade profit due to narrowed spreads, the Commission believes that this decrease will be made up for in part by expected increases in trading volume attributable to enhanced liquidity and pricing efficiency. See *supra* note 24. The Commission believes this potential impact on market maker profits is justified in light of the benefits that will accrue to investors and the markets as a whole. Moreover, even if market makers' profits from trading do decline, market makers may be able to obtain increased revenues from commissions or other fees charged directly to customers. Because these other revenue sources are more transparent to customers than are revenues from market maker trading with customers on a proprietary basis, increased reliance on these other revenue sources will enable customers to make more informed trading decisions.

<sup>124</sup> See, *e.g.*, HHG Letter.

<sup>125</sup> See Memorandum from Stephen L. Williams, S.L. Williams Co. to Richard R. Lindsey, Director, Division of Market Regulation, SEC (July 29, 1996) ("Williams Study").

exchange specialists and integrated firms may find it easier than wholesale firms to charge commissions initially, the Commission notes that wholesale firms are not prohibited from attempting to compensate for handling limit orders, either through negotiated fee arrangements, or reducing any payment made for order flow for limit orders.<sup>126</sup>

#### iv. Discretion

Several commenters are concerned that the Display Rule would eliminate their discretion to determine the best way in which to execute a customer's order. The commenters also claim that customers rely on the judgment of a market professional in choosing whether to display a limit order.<sup>127</sup> For example, the NYSE believes that its current procedures allow broker-dealers to achieve the best prices for their customers.<sup>128</sup> Other commenters suggest that if the rule were amended to require the display of representative size, a dealer would retain some discretion on

<sup>126</sup> The level of these fees, of course, would be determined by competitive forces in the marketplace. Any fees passed on to non-broker-dealer customers would have to be disclosed in a clear fashion to the customer, and otherwise comply with applicable law. For example, NASD Rule 2440 states, in part, that if a member acts as agent for a customer in a transaction, the customer shall not be charged more than a fair commission or service charge, taking into consideration all relevant circumstances. See also NASD Regulatory & Compliance Alert Vol. 7, No. 4 (December 1993). At least one commenter argued that because spreads are ascertainable from public quotations and commissions are not, a rule that encourages charging commissions does not satisfy the goal of increased transparency. See Letter from Bruce C. Hackett, Managing Director, Salomon Brothers Inc., to Jonathan G. Katz, Secretary, SEC, dated January 25, 1996 ("Salomon Letter"). The Commission notes, however, that Rule 10b-10 under the Exchange Act requires customer confirmations to disclose commissions and, for listed and Nasdaq securities, the difference between the reported price and the price to the customer. Based on this disclosure, execution costs could actually become better known to customers if explicit fees are charged. Therefore, the Commission believes that the Display Rule will allow a customer to more easily monitor the execution quality of its limit orders, even if subject to fees for limit order executions. In addition, this situation should foster competition with respect to the amount, if any, firms will charge for the execution of a customer limit order.

<sup>127</sup> See, *e.g.*, NYSE Letter; RPM Letter; Specialist Assoc. Letter.

<sup>128</sup> See, *e.g.*, NYSE Letter; Specialist Assoc. Letter. According to the NYSE, a customer can choose to benefit from the display of its order or to benefit from relying on the specialist's discretion, depending on whether the order is sent to the post via SuperDOT, or is manually submitted. The NYSE also notes that enabling a specialist to use discretion in the handling of limit orders is important in light of the fact that the NYSE defines a limit order as an order to buy or sell at a specified price, or at a better price, if obtainable after the order is represented in the trading crowd. See NYSE Rule 13.

how best to execute the order.<sup>129</sup> To preserve discretion, at least one commenter argues that the rule should apply only when the customer requests that its order be displayed.<sup>130</sup>

The Commission believes that the rule appropriately establishes a presumption that limit orders should be displayed, unless such orders are of block size, the customer requests that its order not be displayed, or one of the exceptions to the rule applies. The exception allowing a customer to request that its limit order not be displayed gives the customer ultimate control in determining whether to trust the display of the limit order to the discretion of a market professional, or to display the order either in full, or in part, to other potential market interest.<sup>131</sup>

#### v. Systems Burdens

Based on their belief that compliance with the Display Rule would result in a large increase in quotation traffic, a number of commenters maintain that the rule would require major overhauls of the order handling systems used by brokers, market makers and markets. For example, one commenter believes that it would be impossible to comply with the rule without additional automated systems.<sup>132</sup> The commenter concludes that the costs associated with new systems and additional staff necessary to monitor a more volatile market would contribute to wider spreads and higher commissions.<sup>133</sup> In addition, one SRO claims that quotation traffic must be kept at manageable levels in order to allow entities to continue to manually process limit orders, thus eliminating the need for entities to bear the costs associated with automation of such orders.<sup>134</sup> Other commenters also note their concern over the potential operational costs associated with the rule.<sup>135</sup> The STA states that an in-depth review is needed to determine the costs

for new equipment and technology necessary to comply with the rule.<sup>136</sup>

A few commenters are concerned that the increased quotation traffic that may be associated with the rule could pose a threat to the integrity of the central quotation system.<sup>137</sup> One commenter suggests that the rule be suspended for the first 30 minutes of trading.<sup>138</sup> Another commenter argues that modifying the rule to require only the display of representative size could act to alleviate some of the traffic concerns.<sup>139</sup>

The Commission recognizes that achieving greater transparency for limit orders depends upon the existence of systems that are capable of the smooth and efficient display of trading interest. The Commission believes that the Display Rule will not substantially increase the quotation burden for exchange markets, where systems currently exist for the display of quotes.<sup>140</sup> In the OTC market, the Display Rule will result in additional quotation entries for market makers that display customer limit orders in their quotes. The Commission believes, however, that current systems can handle the additional volume, or can be expanded at moderate cost to handle the additional volume.<sup>141</sup> Further, the

<sup>136</sup> STA Letter.

<sup>137</sup> See, e.g., Letter from Thomas J. Jordan, Financial Information Forum, to Jonathan G. Katz, Secretary, SEC, dated January 12, 1996 ("FIF Letter"); PaineWebber Letter; PSE Letter. This concern was expressed with respect to the proposal that the Commission adopt both the Display Rule and Price Improvement Rule. The fact that the Commission has deferred action on the Price Improvement Rule, as discussed below, should substantially diminish any system capacity concerns. Moreover, the Commission's decision not to require display of *de minimis* orders also should minimize system capacity concerns.

<sup>138</sup> FIF Letter. According to FIF, the heaviest traffic volume usually occurs within the first 30 minutes of trading.

<sup>139</sup> PSE Letter. The PSE notes, however, that the rule, even if modified, still may result in an increase in staffing costs. *Id.*

<sup>140</sup> For example, SuperDOT data indicates that 57% of all customer trades originating from orders routed through SuperDOT are limit orders. Of these limit orders, 20% narrowed the NYSE quote. See *supra* note 52. According to the NYSE, 93% of such orders are reflected in the NYSE quote within two minutes of receipt. See *supra* note 36 and accompanying text (teleconference). See also CSE Letter (costs associated with implementing such a system are minimal, especially in light of the benefits to the public); Paperwork Reduction Act discussion at section VII, *infra*.

<sup>141</sup> The Commission notes that many small to medium broker-dealers utilize shared trading systems that enable such broker-dealers to streamline their OTC market making and back office responsibilities. Subscribers to such systems benefit by sharing costs associated with the application of improved technologies, rather than creating and updating systems of their own. Therefore, it is assumed that any changes deemed necessary to these shared systems to facilitate efficient

Commission notes that the Display Rule contains an exception to the display requirement for limit orders of *de minimis* size priced at the NBBO when the market maker's or specialist's quote matches the NBBO.<sup>142</sup> The Display Rule also allows a specialist or OTC market maker several ways to comply with the rule by routing the order elsewhere without displaying the limit order in its own quote by transmitting a customer limit order to an exchange-or association-sponsored system or to a qualifying ECN.

Additionally, a few commenters believe that the Commission should give more consideration to the Display Rule's impact on automatic execution systems.<sup>143</sup> These commenters express concern that a market maker could be exposed to multiple transactions from its own customers in the firm's automatic execution system, which executes orders at the NBBO, even if the NBBO represents a customer limit order as opposed to the price at which a market maker is willing to trade. They claim this result is unfair, especially if the automatic system has a minimum share requirement that exceeds the customer limit order.

The Commission acknowledges the concern of some commenters regarding the rule's interaction with automated execution systems. However, because customer limit orders reflect actual trading interest, it has been the Commission's intention to enhance customer order executions throughout the markets by requiring the display of these customer limit orders.<sup>144</sup> Where a limit order represents the best quote, a

compliance with the Display Rule also would be shared by all subscribers.

In addition, the Commission specifically evaluated the costs associated with implementation of the Display Rule. Based on this evaluation, the Commission concluded that most market makers will not be required to invest substantial amounts of money in systems development in order to comply with the Display Rule as adopted. See Williams Study, *supra* note 125. See also CSE Letter (costs of implementing a system for display of limit orders are minimal).

<sup>142</sup> See, § 240.11Ac1-4(b)(1)(ii). See also § 240.11Ac1-4(b)(2)(ii).

<sup>143</sup> See, e.g., Dillon Letter; HHG Letter; Merrill Letter; PaineWebber Letter; Schwab Letter.

<sup>144</sup> The Commission recognizes that SROs may have rules regarding the minimum quotation sizes associated with a specialist's or market maker's quote. The Commission believes that SROs should consider amending such rules and modifying certain systems to allow a specialist or market maker to quote in sizes smaller than the minimum quotation size when such quote represents a customer limit order. With these changes, a specialist or market maker that displays a customer limit order in its quote pursuant to the Display Rule would not be responsible for executing as principal any additional shares at the limit price where the size of the customer limit order is less than the minimum quotation size set by the SRO.

<sup>129</sup> See, e.g., Madoff Letter; NASD Letter; SIA Letter.

<sup>130</sup> Jefferies Letter.

<sup>131</sup> See discussion of the exceptions to the Display Rule at section III.A.3.c., *infra*. See also § 240.11Ac1-4(c)(2); § 240.11Ac1-4(c)(4) (permitting a customer with a block size limit order to request that the order be displayed pursuant to the Display Rule). The Commission does not mean to imply that a specialist or OTC market maker that is not displaying a limit order pursuant to the request of its customer may not change its quotation in that security based on the specialist's or market maker's own trading interest.

<sup>132</sup> PaineWebber Letter.

<sup>133</sup> *Id.*; see also Bear Stearns Letter (noting that the display rule would increase the volatility of quotes and, as a result, market makers would have a difficult time keeping up with the rapid changes in bids, offers, and quote sizes).

<sup>134</sup> PSE Letter.

<sup>135</sup> See, e.g., Alex. Brown Letter; Bear Stearns Letter; Jefferies Letter.

market maker can respond by sending its customer order to the market maker displaying the limit order at the NBBO, thereby attempting to execute the limit order setting that price and removing it as the NBBO.<sup>145</sup> Moreover, where the size of a limit order represented in the best quote is smaller than the size eligible for execution in an automated execution system, the Commission believes that it is not inconsistent with best execution principles for market makers and specialists using automated execution systems to take into account the size of the limit order quote in determining the price at which an order, or portions thereof, should be automatically executed. The Commission believes, however, that in such a case the market maker or specialist should provide the customer order an execution at the displayed price at least up to the displayed size of the limit order.<sup>146</sup> For example, if customer limit orders compose the NBBO of 10 1/4–10 1/2 (100 × 300), and a market maker receives a market order to sell 1,000 shares via an automatic execution system, the market maker may automatically execute 100 shares of the order at 10 1/4, and the remaining portion of the order at the next best bid.

### 3. The Operation of the Rule as Adopted<sup>147</sup>

The rule as adopted applies to: (i) every member of an exchange that is registered by that exchange as a specialist or has been authorized by an exchange to perform functions substantially similar to that of a specialist ("specialist"); and (ii) OTC market makers.<sup>148</sup> The rule as adopted applies to specialists that trade on the floor of an exchange;<sup>149</sup> third market makers;<sup>150</sup> members of a national securities association that are OTC

market makers;<sup>151</sup> and specialists that trade an OTC security pursuant to unlisted trading privileges ("UTP").<sup>152</sup> These market makers are required to reflect immediately in their bid or offer the price and the full size of each customer limit order they hold at a price that would improve their bid or offer in the security.<sup>153</sup> In addition, all market makers covered by the rule are obligated to reflect in their quotes the full size of a customer limit order that: (1) is priced equal to their bid or offer; (2) is priced equal to the national best bid or offer for the security; and (3) represents more than a *de minimis* change in relation to the size associated with their bid or offer.<sup>154</sup>

#### a. "Covered Securities" and "Customer Limit Orders"

Rule 11Ac1-4 applies to "customer limit orders" in "covered securities." A covered security is defined as any reported security and any other security for which transaction reports, last sale data or quotation information is disseminated through an automated quotation system that is sponsored by a registered securities association. This definition is designed to encompass all exchange-listed securities, Nasdaq National Market securities and Nasdaq SmallCap securities.<sup>155</sup>

<sup>145</sup> Section 240.11Ac1-4(b)(2).

<sup>152</sup> Section 240.11Ac1-4(b)(1).

<sup>153</sup> Section 240.11Ac1-4(b)(1)(i) and (b)(2)(i). The Commission wants to clarify that references to a specialist's or OTC market maker's bid or offer include instances where the bid or offer is a proprietary quote, as well as instances where the bid or offer represents a customer limit order. Further, if a market maker is not quoting publicly (e.g., a market maker that does not meet the 1% threshold of the Quote Rule), it still must publish a quotation that displays the limit order, or avail itself of one of the exceptions. Moreover, the Commission notes that some commenters suggest that the rule should require broker-dealers that are not specialists or OTC market makers to immediately transmit limit orders they receive to an entity or system that will display the orders in a manner consistent with the rule. See, e.g., CSE Letter; Madoff Letter; Whitcomb Letter. Also, at least one commenter believes that institutional firms trading in block size should be considered "OTC market makers" for purposes of the rule and subject to the display requirement. Amex Letter. See generally *infra* notes 191–193 and accompanying text. The fact that the Commission has not adopted these suggestions as part of the Display Rule does not relieve broker-dealers which receive such orders from compliance with their obligation to obtain best execution for those orders.

<sup>154</sup> Section 240.11Ac1-4(b)(1)(ii) and (b)(2)(ii).

<sup>155</sup> Securities listed on regional exchanges that do not substantially meet NYSE or Amex original listing criteria do not satisfy the definition of "covered security." Such securities are not "reported securities" as that term is defined, nor do they meet the other elements of the definition of covered security. OTC Bulletin Board ("OTCBB") securities also do not satisfy the definition of covered security. The Commission has determined not to extend the display requirement to any of those securities at the present time.

The Commission received several comments regarding the application of the rule to Nasdaq securities. Some commenters believe that the rule should not extend to all Nasdaq securities, and that some measure of liquidity should be used to determine which Nasdaq securities should be subject to the rule.<sup>156</sup> For example, one commenter suggests limiting the rule's application to the top 250 Nasdaq National Market securities with the highest average daily trading volume over the previous calendar quarter.<sup>157</sup> In contrast, another commenter favors the inclusion of Nasdaq SmallCap securities within the definition of "covered security."<sup>158</sup> Further, at least one commenter suggests that the rule apply not only to all Nasdaq securities, but also to OTCBB securities.<sup>159</sup>

As noted above, the Commission believes that the Display Rule should apply equally to exchange-traded as well as non-exchange-traded securities. In addition, the Commission believes it is appropriate to include all Nasdaq securities within the definition of "covered security." The Commission believes that, regardless of the current trading volume of a particular security, the investors in any security can benefit from the uniform display of customer buying and selling interest if all quotations in that security are required to be firm. As noted previously,<sup>160</sup> data analyzed by the Commission shows that limit orders are used frequently for transactions in NYSE securities with ADTVs under \$100,000. On average, 63% of customer orders in such securities are limit orders. Of those limit orders, 30% narrowed the NYSE quote and 32% matched the quote. This data indicates that the display requirement may lead to increased customer trading interest in securities that are currently thinly traded.<sup>161</sup>

The Commission reiterates that limit order display is not solely an issue of improved transparency. The Display Rule will improve the handling of customer orders across all markets and increase the probability that a customer limit order will be executed. Therefore, the Commission believes that a uniform limit order display requirement is

<sup>156</sup> See, e.g., Bear Stearns Letter; Lehman Letter; Merrill Letter; NASD Letter; SIA Letter.

<sup>157</sup> SIA Letter.

<sup>158</sup> PSE Letter.

<sup>159</sup> Ricker Letter.

<sup>160</sup> See *supra* notes 50 and 52.

<sup>161</sup> As stated previously, because dealers are not required to register as OTC market makers in OTCBB securities and are not required to enter and maintain continuous firm two-sided quotations in OTCBB securities, the Commission does not believe that the Display Rule should be extended to such securities at this time.

<sup>145</sup> The Commission notes that the NASD's NAcqess system, as proposed, would permit market makers to send orders, including proprietary orders, to other market makers through the system. See *supra* note 45. See also ITS Plan. Moreover, the Commission believes that the NASD should consider modifying its SOES system to allow OTC market makers to route customer orders for execution against limit orders displayed by another market maker in the same security.

<sup>146</sup> If the market maker or specialist attempted but was unable to execute the displayed limit order through a reasonable and efficient means, such as sending an order through an automated system for an OTC security, the market maker or specialist would not be expected to give that limit order price to its customer.

<sup>147</sup> SRO rules that impose more stringent standards would continue to apply.

<sup>148</sup> Although the Commission consolidated certain sections of the proposed rule for clarity, the rule as adopted applies to the same entities identified in the proposed rule.

<sup>149</sup> Section 240.11Ac1-4(b)(1).

<sup>150</sup> Section 240.11Ac1-4(b)(2).

closely related to a broker-dealer's ability to obtain best execution for limit orders.

The Commission recognizes, however, that the rule represents a significant change for the OTC market. The Commission, therefore, has determined to provide a phase-in period for application of the rule to customer limit orders in Nasdaq securities.<sup>162</sup> The Commission believes that the phase-in period will allow the Commission to monitor the effects of the rule on the most liquid Nasdaq securities first, while ensuring that customer limit orders in all Nasdaq securities will receive the benefits of the rule within one year of its adoption. This schedule also will provide OTC market makers with time to adjust their systems to comply with the rule's requirements.<sup>163</sup>

Under the rule, a customer limit order includes any order to buy or sell a covered security at a specified price not for the account of a broker or dealer. Customer limit orders transmitted from one broker-dealer to another for execution are included in the definition. Although some commenters believe that the rule should be extended to orders for the account of a broker or dealer, the Commission does not believe such extension is appropriate at this time. The Commission acknowledges that the display of all limit orders, including those of a broker or dealer, would further enhance transparency.<sup>164</sup>

Requiring the display of broker-dealer limit orders, however, would be a significant extension of the rule that could change its impact on market maker participation and increase its operational burdens. Therefore, the Commission believes that the effects of the rule should be observed, and additional comment should be solicited, before the rule is expanded.<sup>165</sup>

#### b. Size

As noted above, some commenters expressed concern regarding the requirement that specialists and OTC market makers display the full size of a customer limit order. These commenters suggest that the rule only require the

display of representative size.<sup>166</sup> They argue that the use of representative size would preserve the ability of a specialist or OTC market maker to exercise some discretion in determining the best execution of the order.<sup>167</sup>

Other commenters, however, believe that the full size of a customer limit order should be required to be displayed.<sup>168</sup> Such commenters argue that the display of full size is an important element in the Commission's effort to improve transparency and, therefore, no dealer discretion should be permitted unless a customer expressly requests that its order not be displayed, or expressly grants discretion, pursuant to the Display Rule.<sup>169</sup>

The Commission continues to believe that the display of full size is important to improved transparency. The display of full size will provide the most accurate picture of the depth of the market at a particular price.<sup>170</sup> The Commission believes that size, as well as price, is a factor in attracting order flow and that the display of full size increases the likelihood that a limit order will be executed. The Commission, however, understands that there may be instances where a customer would not want its order displayed, or does not want the full size of its order displayed. The Display Rule, therefore, still contains an exception for a customer that decides to rely on the

discretion of a broker-dealer rather than to take advantage of the display requirement for its limit order.<sup>171</sup> The Display Rule also permits a customer to state explicitly what portion, if any, the customer wants displayed.<sup>172</sup> Furthermore, the Display Rule contains other exceptions to the display requirement that will ease any potential operational burdens associated with the display of full size.<sup>173</sup>

The following example illustrates the application of the Display Rule where a customer limit order improves the price of a specialist's or market maker's quote. Assume that a market maker covered by the rule is quoting 10-10 $\frac{1}{2}$  (2,000x2,000) when it receives a customer limit order in a covered security to buy 4,000 shares at 10 $\frac{1}{4}$ . Under the rule, the market maker must change the price and size associated with its quote to 10 $\frac{1}{4}$ -10 $\frac{1}{2}$  (4,000x2,000). If this new quote represents the NBBO, the Display Rule would require the market maker to increase the size associated with the quote upon the receipt of additional customer limit orders. For example, if the market maker subsequently accepts another customer limit order to buy 4,000 shares at 10 $\frac{1}{4}$ , the market maker must change its quote to 10 $\frac{1}{4}$ -10 $\frac{1}{2}$  (8,000x2,000).

The rule as adopted contains a *de minimis* standard applicable in situations where a customer limit order equals a specialist's or market maker's displayed price and that price is equal to the NBBO. One commenter states that the use of representative size would eliminate the Commission's need to rely on a *de minimis* standard.<sup>174</sup> Another commenter believes that the rationale underlying the *de minimis* standard demonstrates that the display of size does not benefit public customers.<sup>175</sup> Some commenters also believe that the *de minimis* standard should be clarified or even eliminated.<sup>176</sup>

The Commission proposed the *de minimis* standard to strike a balance

<sup>162</sup> See description of the phase-in at section III.A.3.d., *infra*.

<sup>163</sup> See, e.g., Amex Letter.

<sup>164</sup> The Commission also is sensitive to the fact that providing suitable opportunities for broker-dealers, including options market makers, to lay off risk is an important component of overall market liquidity and efficiency. See Manning II, *supra* note 24.

<sup>165</sup> The Commission notes that other actions recently taken by the Commission address certain anti-competitive behavior in the Nasdaq market that heretofore may have negatively impacted the ability of some broker-dealers, including options market makers, to efficiently perform their market making function. See 21(a) Report, *supra* note 28.

<sup>166</sup> See, e.g., BSE Letter; CSE Letter; Madoff Letter; NASD Letter; NYSE Letter; PSE Letter; SIA Letter; Specialists Assoc. Letter; see also LJR Letter (questioning whether the display of size, at least with respect to institutional orders, would be consistent with best execution obligations).

<sup>167</sup> See, e.g., Madoff Letter; NASD Letter; NYSE Letter; SIA Letter; Specialists Assoc. Letter.

<sup>168</sup> See, e.g., Amex Letter; CHX Letter; D.E. Shaw Letter.

<sup>169</sup> See, e.g., Amex Letter; CHX Letter; D.E. Shaw Letter; ICI Letter.

<sup>170</sup> A few commenters believe that all customer limit orders should be displayed, including the size of those orders that equal the specialist's or OTC market maker's bid or offer, but are not equal to the NBBO. See, e.g., CHX Letter; Letter from Edward J. Johnsen, Vice President and Counsel, Morgan Stanley & Co., to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("Morgan Stanley Letter"); Peake Letter; Weaver Letter. The Commission believes, however, that the burden associated with the commenters' suggestion would outweigh the corresponding benefit to market transparency. Of course, the rule represents a floor, rather than a ceiling. An exchange, association, or broker-dealer may determine to adopt more stringent display requirements. Requiring display of size when the limit order is away from the NBBO and equals the market maker's or specialist's quote would provide some additional market information but also would require market makers not quoting at the NBBO to change their quote size on an ongoing basis. Although some market makers or specialists may choose to do so to be prepared if their quotation becomes the NBBO, on the whole the Commission believes the increased transparency that would result from this updating would not outweigh the burdens imposed by a display requirement.

<sup>171</sup> Section 240.11Ac1-4(c)(2).

<sup>172</sup> *Id.*

<sup>173</sup> As noted above, a specialist or OTC market maker has the ability to execute a customer limit order upon receipt; transmit the order to another exchange member or OTC market maker that will display the limit order in accordance with the rule; or transmit the order to an exchange or association sponsored system pursuant to the rule. Additionally, a specialist or OTC market maker may transmit an order to an ECN that provides for public display of limit orders and provides access to these orders. Moreover, the rule contains an exception to the display requirement for certain orders of *de minimis* size.

<sup>174</sup> CSE Letter.

<sup>175</sup> Dean Witter Letter.

<sup>176</sup> See, e.g., Amex Letter; CHX Letter; Schwab Letter.

between the benefits of increased transparency and operational burdens that might arise under the display requirement in displaying limit orders irrespective of size. The *de minimis* standard was intended to reduce the burdens of displaying the smallest of limit orders where the frequent updating of the quote for smaller orders would not result in significant improvements in quotation size. The Commission believes that the size of a customer limit order should be considered *de minimis* if it is less than or equal to 10% of the displayed size associated with a specialist's or OTC market maker's bid or offer.<sup>177</sup>

The Commission believes that this *de minimis* standard will ease potential operational burdens associated with the display of additional size in a specialist's or OTC market maker's quote. The following example illustrates the application of the *de minimis* standard.

Assume a market maker's quote is 10-10½ (1,000×1,000), and the NBBO is 10-10¼ when the market maker receives a customer limit order to buy 2,000 shares at 10. Under the rule, the market maker is obligated to change the size of its quote immediately to 10-10½ (3,000×1,000).<sup>178</sup> In this case, the 2,000 share order size is more than *de minimis* in relation to the size associated with the market maker's quote. If the limit order was for 100 shares, however, the market maker would not be required to change its quotation size because the order is *de minimis* in relation to its quote.<sup>179</sup> Alternatively, the market

<sup>177</sup> Any SRO may set more stringent display requirements through its own rules.

<sup>178</sup> If the original 1,000 shares displayed represents the market maker's proprietary quote and, consistent with Rule 11Ac1-1, the market maker no longer wishes to trade for its own account at 10, the market maker may quote at 10-10½ (2,000×1,000).

<sup>179</sup> The Commission stresses that all other orders previously considered *de minimis* and not displayed must be added to the order under consideration for purposes of the *de minimis* calculation. Therefore, in the case of a 100 share limit order to buy at 10, where the market maker had a previous 100 share limit order to buy at 10 that was not displayed pursuant to the *de minimis* standard, both orders must be considered together for purposes of making the *de minimis* calculation. Because 200 shares is more than 10% of the displayed size of 1,000, the market maker must include the 200 shares in its quote.

The Commission notes that if an OTC market maker chooses not to display a *de minimis* limit order, the NASD's interpretation regarding limit orders would prohibit the market maker from trading ahead of the limit order. See Manning I & II, *supra* note 24. In addition, the NASD has indicated that market makers must establish and consistently follow policies regarding the priority in which limit orders received from customers, which would include *de minimis* orders, will be executed. See Special NASD Notice to Members 95-43 (June 5, 1995).

maker could voluntarily display the additional 100 shares.

#### c. Exceptions

The rule requires the "immediate" display of certain customer limit orders. To satisfy this requirement, a specialist or OTC market maker must display the limit order immediately upon receipt unless there exists an applicable exception to the display requirement. Some commenters have asked for clarification of the "immediate" display requirement.<sup>180</sup> The Commission is mindful that some measure of time is needed for specialists or market makers to display limit orders in the quote. Assuming that a specialist or OTC market maker does not rely on one of the exceptions to the Display Rule, however, such specialist or OTC market maker must display the order as soon as is practicable after receipt which, under normal market conditions, would require display no later than 30 seconds after receipt.<sup>181</sup>

There are seven exceptions to the general requirements of the rule. The first exception applies to any customer limit order that is executed upon receipt of the order.<sup>182</sup> If the order is executed upon receipt, then no duty arises under the rule.

The second exception applies to any limit order that is placed by a customer who expressly requests that the order not be displayed.<sup>183</sup> This request may take place on an order by order basis, or may be agreed to prospectively. Most commenters that addressed the issue were in favor of the exception.<sup>184</sup> The Commission included this exception because there could be instances in which a customer prefers to exclude its order from public display. For example, a customer with a large limit order could wish to let its broker work the order rather than display the entire order. This exception gives the customer the right to decide if the order should be displayed in its entirety, in part, or not at all.<sup>185</sup> The Commission notes that

<sup>180</sup> See, e.g., Amex Letter; D.E. Shaw Letter; NYSE Letter; PSE Letter.

<sup>181</sup> The Commission stresses that specialists and OTC market makers still are under an obligation to protect the customer limit order even during the time the limit order is not displayed. See, e.g., Manning I & II, *supra* note 24 (prohibiting trading ahead of customer limit orders). It should also be noted that this standard would supersede SRO rules that are less stringent with regard to the time in which limit orders are to be displayed. Those rules that impose more stringent standards may continue to apply.

<sup>182</sup> Section 240.11Ac1-4(c)(1).

<sup>183</sup> Section 240.11Ac1-4(c)(2).

<sup>184</sup> But see, e.g., Madoff Letter; Morgan Stanley Letter.

<sup>185</sup> Any portion of a customer limit order that is not displayed pursuant to this exception shall not

under this exception, a customer may leave the decision to display an order to the discretion of a broker-dealer. Therefore, rather than instructing a broker-dealer not to display an order, a customer, consistent with this exception, may instruct the broker-dealer to use its discretion in determining whether to display the order. Although allowing some orders to not be displayed or to be displayed partially in the system reduces transparency, the Commission believes this exception is appropriate to give investors flexibility in deciding how their orders should be handled.

The exception to the rule requires a customer to expressly request that an order *not* be displayed.<sup>186</sup> A customer request that an order be placed in a particular non-public trading system would not, by itself, be deemed to be a non-display request. The Commission expects that most retail customers will want their limit orders displayed pursuant to the rule. Thus, the Commission has written the rule to require specialists and OTC market makers to assume that retail customers wish to have their orders displayed unless the customer specifically requests that the order not be displayed.

The exception also permits any customer to negotiate with its broker-dealer an individual agreement regarding the display of its limit orders either on an order-by-order basis or prospectively. Standardized disclaimers or contractual language in broker-dealer new account agreements, however, would not be deemed to be an individual request by a customer that its order or orders not be displayed.

The third exception applies to odd-lot orders.<sup>187</sup> The rule does not require the display of an order for less than a unit of trading as established by the rules of the exchange or association. In the event that a round-lot limit order represented in the quote is partially filled and, as a result, the remainder of the order would then be deemed an odd-lot order, the remainder of the order may be treated as an odd-lot for purposes of this exception. For example, assume a

be included in the calculation for determining whether any other limit order is *de minimis*. See *supra* note 179.

<sup>186</sup> At least one commenter believes that documentation of such customer requests should be required. CHX Letter. Although the Commission does not believe it necessary to mandate a particular method of record keeping, the Commission expects the compliance departments of individual firms to discharge their responsibilities in such a manner as to allow adequate supervision of compliance with the customer's request not to display or to display pursuant to discretionary authority provided by the customer.

<sup>187</sup> Section 240.11Ac1-4(c)(3).

market maker is quoting at the NBBO ( $10\frac{1}{4}-10\frac{3}{8}$  ( $200 \times 1000$ )) and is representing a 200 share customer limit order to buy when a market order to sell 150 shares is received. Upon execution of 150 shares of the 200 share customer limit order, the market maker is not required to display the remaining 50 shares of the order at  $10\frac{1}{4}$ .<sup>188</sup>

The fourth exception applies to block size orders.<sup>189</sup> Orders of at least 10,000 shares or for a quantity of stock having a market value of at least \$200,000 need not be displayed in accordance with the rule, unless the customer so requests.<sup>190</sup> The Commission recognizes that the display of block size orders would add to market transparency. In practice, however, the handling of block size orders differs from other orders. For example, in the OTC market, market makers often negotiate terms and conditions with respect to the handling of block size orders, and display of block size orders may impact market maker quotations in a security more than would smaller limit orders.<sup>191</sup> Further, one of the major objectives in proposing the Display Rule was to improve the handling and execution opportunities afforded to customers that lack the power to negotiate better terms. Because most investors that trade in block size have such power, the Commission has chosen not to mandate the display of block size orders, unless the customer so requests.<sup>192</sup> The Commission is satisfied that the current definition strikes an appropriate regulatory balance by requiring a presumption in favor of display for those orders requiring enhanced

protection, while not extending the presumption to those orders less likely to need such protection. Of course, the Commission may reevaluate its treatment of block size orders at a later date.

As proposed, the fifth exception would have applied to a limit order that is delivered immediately to an exchange or association sponsored system that displays limit orders and complies with the requirements of the rule with respect to that order.<sup>193</sup> This exception did not relieve a specialist or OTC market maker from its display obligation for orders it received through exchange or association facilities, unless the facility itself displayed the order.<sup>194</sup>

In the Proposing Release, the Commission requested comment on whether to extend this exception from display to instances where customer limit orders are sent to ECNs or PTSs by a specialist or OTC market maker.<sup>195</sup> As discussed below in connection with the amendments to the Quote Rule, the Commission is amending the Quote Rule to require specialists and OTC market makers to include priced orders they enter into ECNs in the bids and offers they communicate to their exchange or association for reflection in their published quotations, when such orders improve their published quotations.<sup>196</sup> In recognition of the concerns raised by commenters, the Commission also has included an alternative to the amendment designed to preserve the anonymity of specialists and OTC market makers that is

<sup>193</sup> Section 240.11Ac1-4(c)(5). A facility would not be deemed to comply with the requirements of the Display Rule if the highest priced buy orders and lowest priced sell orders entered by a specialist or OTC market maker in the facility for a particular security were not included in calculating the best bid and offer for the market and incorporated in the consolidated quote.

<sup>194</sup> One commenter argues that the exception permits specialists and OTC market makers to become "fair weather dealers," effectively allowing them to selectively withdraw from the national market system, which creates a misleading picture of liquidity. Madoff Letter. The Commission believes, however, that the exception provides a specialist or OTC market maker with an appropriate amount of discretion in handling a customer limit order while ensuring that orders at the best price are displayed to the marketplace.

<sup>195</sup> See, e.g., Letter from James Lynch, General Counsel, ITG, Inc., to Jonathan G. Katz, Secretary, SEC, dated, January 15, 1996 ("POSIT Letter") (not supporting the extension of the exception); PSE Letter (extension of exception should be contingent on access provided by ECNs); Whitcomb Letter (doubtful that exception could be extended in today's environment); see also Madoff Letter (market makers and specialists should be able to represent a portion of the size of a customer limit order in other markets or ECNs, but the best price and some size should be reflected in their quote).

<sup>196</sup> See § 240.11Ac1-1(c)(5)(i)(A); see also Amendments to the Quote Rule discussion at section III.B.2.c.ii., *infra*.

currently provided by certain ECNs, while still publicizing in the public quotation stream better prices entered into ECNs. The ECN display alternative in the Quote Rule is available only if the ECN provides for public dissemination of the price and full size of the orders entered by specialists and OTC market makers to an exchange or association and provides access to other broker-dealers to trade at those prices which is equivalent to that provided in the market where the prices are disseminated.<sup>197</sup>

The Commission believes that ECNs that provide their best specialist and market maker prices to the public quotation system and provide ready access to their prices can provide an effective means for specialists and OTC market makers to ensure that customer limit orders are handled in a manner consistent with the Display Rule. In view of the ECN display alternative in the Quote Rule, the Commission believes it is appropriate to extend the exception in the Display Rule to orders entered into ECNs that comply with the Quote Rule alternative.<sup>198</sup> Accordingly, a specialist or OTC market maker that delivers a customer limit order to an ECN will be deemed to have satisfied its display obligation with regard to that order if the ECN complies with the requirements of the new alternative in the Quote Rule.<sup>199</sup> The proposed exception for limit orders entered into exchange or association sponsored systems contemplated that such orders would be transparent and accessible. Therefore, expanding the exception to include the use of ECNs that provide for the requisite transparency and accessibility is consistent with the rule as proposed.

The Commission notes that this exception to the Display Rule maintains the benefits, including increased transparency, provided to customer limit orders under the rule. The

<sup>197</sup> As discussed, the Commission expects the SROs to work expeditiously with ECNs that wish to avail themselves of this alternative, and is prepared to act if necessary to ensure the effectiveness of the ECN display alternative, prior to the effective date of the Quote Rule amendments. See Introduction and Summary, *supra*; see also § 240.11Ac1-1(c)(5)(ii); Amendments to the Quote Rule discussion at section III.B.2.c.iii., *infra*.

<sup>198</sup> See Amendments to the Quote Rule discussion at section III.B.2.c.i., *infra*, for a description of the ECN definition; see also § 240.11Ac1-1(a)(8); § 240.11Ac1-4(a)(8).

<sup>199</sup> Section 240.11Ac1-4(c)(5). See also, Amendments to the Quote Rule discussion on accessibility at section III.B.2.c.iii., *infra*. Additionally, a specialist or OTC market maker may be relieved of its display obligation if it delivers the customer limit order to an exchange or association sponsored system that complies with the new alternative in the Quote Rule. Section 240.11Ac1-4(c)(5).

<sup>188</sup> The market maker still will have best execution obligations with respect to the remaining odd-lot portion of the customer limit order.

<sup>189</sup> Section 240.11Ac1-4(c)(4).

<sup>190</sup> This block definition is consistent with the current definition used in NYSE Rule 127.10. Some commenters, however, suggest that the parameters for such orders be increased or made flexible depending on the liquidity of a particular security. See, e.g., D.E. Shaw Letter; PSE Letter; Schwab Letter. Still others believe that there should be no exception for orders of block size. Instead, these commenters want such orders to be included within the scope of the rule so as to add to market transparency. See, e.g., Amex Letter; ICI Letter; Lehman Letter; Peake Letter; Ricker Letter. One commenter suggests the use of a "block indicator" to give a specialist or OTC market maker the option of displaying the full size of the order or using the indicator to identify the quote as representing a block size order. Lehman Letter.

<sup>191</sup> See, e.g., Manning II, *supra* note 24.

<sup>192</sup> Customers placing block orders, however, may request that the order be displayed in accordance with the requirements of the rule; a specialist or OTC market maker that accepts the order will be obligated to honor such a request. Section 240.11Ac1-4(c)(4). The Commission expects that adequate procedures will be developed to ensure compliance with a customer request. See *supra* note 186.



exception ensures that customer limit orders will have equivalent public disclosure whether they are sent to an ECN that complies with the alternative or displayed directly in a specialist's or OTC market maker's quote.<sup>200</sup>

The sixth exception applies to a limit order that is delivered to another exchange member or OTC market maker that complies with the display requirements of the rule with respect to that order.<sup>201</sup> For example, a market maker that receives a limit order subject to the display requirement under the rule may immediately send the order to another market maker in the security if the other market maker will display the order in accordance with this rule.<sup>202</sup>

The seventh exception applies to "all-or-none limit orders." An "all-or-none limit order" is an order accompanied by the customer's instruction that the order is to be executed in its entirety or not at all.<sup>203</sup> Although this exception was not included in the proposed rule, the Commission believes that exempting all-or-none limit orders is necessary to avoid operational difficulties regarding partial executions at the public quote.<sup>204</sup> In this regard, all-or-none limit orders typically are not displayed in the exchange markets today.<sup>205</sup> The Commission believes, therefore, that this exception is consistent with the goals and objectives of the Display Rule.

Finally, a new provision has been included that enables the Commission to exempt, conditionally or unconditionally, any transactions that may determine are not encompassed within the purposes of the Display Rule. The Commission believes that this exemptive authority provides flexibility in applying the Display Rule.<sup>206</sup>

#### d. Effective Date and Phase-In

The Display Rule will become effective on January 10, 1997. As of this

<sup>200</sup> An OTC market maker or specialist choosing to enter customer limit orders for display through an ECN must still evaluate whether the customer order is likely to obtain best execution through display in that ECN. See section III.C.2., *infra*.

<sup>201</sup> Section 240.11Ac1-4(c)(6).

<sup>202</sup> One commenter believes that the rule should require a specialist or OTC market maker to obtain assurances that a customer's limit order will be displayed in accordance with the rule before such an order is sent. MJT Letter. *But see* PSE Letter; Salomon Letter. As noted earlier, the Commission believes that it is best left to a firm's compliance department to decide on the necessary assurances that the order will be displayed in conformance with the rule.

<sup>203</sup> See, e.g., NYSE Rule 13.

<sup>204</sup> For example, if an all or none order to buy 1,000 shares at 10<sup>1</sup>/<sub>4</sub> were displayed in the quote and represented the NBBO, a subsequent market order to sell 500 shares could not be matched against the all or none order.

<sup>205</sup> See, e.g., NYSE Rule 13.

<sup>206</sup> Section 240.11Ac1-4(d).

date, the Display Rule will apply to exchange-traded securities. Moreover, this date will mark the beginning of the first phase-in for Nasdaq securities. As of this date, the Display Rule will apply to the 1,000 Nasdaq securities with the highest average daily trading volume in the previous quarter.

The second phase-in date will be on March 28, 1997. From this date forward, the Display Rule will apply to the next 1,500 Nasdaq securities with the highest average daily trading volume over the previous quarter.<sup>207</sup>

The third phase-in date will be on June 30, 1997. From this date forward, the Display Rule will apply to the next 2,000 Nasdaq securities with the highest average daily trading volume over the previous quarter.

The final phase-in date will be on August 28, 1997. From this date forward, the Display Rule will apply to all remaining Nasdaq securities.

Although the Commission believes that the Display Rule should apply equally to exchange-traded and non-exchange-traded securities, the Commission understands that the Display Rule will more significantly impact current order handling procedures for Nasdaq securities in light of existing practices in that market. The phase-in period will allow the Commission to monitor the effects of the Display Rule on successive groups of Nasdaq securities while ensuring that all covered securities receive the benefits of the display requirement within one year of the Display Rule's adoption.

### B. Amendments to the Quote Rule

#### 1. Background

Public quotation reporting for equity securities is governed by the Commission's Quote Rule,<sup>208</sup> as well as by exchange and NASD rules. These rules require registered exchanges and securities associations to file quotation reporting plans with the Commission that provide for the collection and transmission of quotation information on a real-time basis for securities

<sup>207</sup> Any security already covered by the rule will not be included as part of the calculation of the securities to be included in any subsequent group. Therefore, if a security is included as one of the 1,000 securities in the first group, such security will not be counted as one of the next 1,500 securities in the second group (even if such security's average daily trading volume over the previous calendar quarter would otherwise place it in the second group).

<sup>208</sup> 17 CFR 240.11Ac1-1. See also Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978) ("Quote Rule Adopting Release").

covered by the Quote Rule.<sup>209</sup> Market makers and exchange specialists communicate their quotes to the NASD or to an exchange pursuant to these plans and the NASD and exchanges in turn make this information available to vendors for dissemination to the public.<sup>210</sup>

The Quote Rule requires the collection and public dissemination of the best bid, best offer, and size for each market quoting any security covered by the Quote Rule, as well as the consolidation of those markets' quotations and public dissemination of the national "consolidated" best bid and offer ("NBBO").<sup>211</sup> These quotations must be firm, and a market maker or specialist generally is obligated to execute an order at a price at least as favorable as its published bid or offer up to the size of its published bid or offer.<sup>212</sup> Broker-dealers covered by the Quote Rule, including dealers trading listed securities in the OTC market (*i.e.*, third market makers), must supply quotations to their exchange or association for dissemination to quotation vendors.

The 1975 Amendments identified the need for a prompt, accurate and reliable

<sup>209</sup> Rule 11Ac1-1(b)(1), 17 CFR 240.11Ac1-1(b)(1) (dissemination requirements for exchanges and associations).

<sup>210</sup> Rule 11Ac1-2, 17 CFR 240.11Ac1-2 ("Vendor Display Rule") requires vendors of market information to display quotation information in a non-discriminatory manner.

<sup>211</sup> Rule 11Ac1-1(b)(1), 17 CFR 240.11Ac1-1(b)(1). Pursuant to the Quote Rule and the Joint Consolidated Quotation Plan ("CQS Plan"), the inside quotations collected and calculated by the exchanges and Nasdaq for exchange-listed securities are consolidated and disseminated to vendors by SIAC, the exclusive processor for consolidated quotations in listed securities. Similarly, Nasdaq is the exclusive processor for quotations in Nasdaq National Market ("Nasdaq NMS") securities. Nasdaq collects and consolidates inside quotations furnished by OTC market makers and by exchanges pursuant to a Joint Self-Regulatory Organization Plan that provides for exchange trading of Nasdaq securities. Nasdaq then disseminates to vendors the inside bid and offer in Nasdaq NMS securities, and disseminates to various subscribers more specific information concerning the individual market maker and exchange quotes in each Nasdaq security. The terms "consolidated quote" and "publicly available quotation," when used with respect to information disseminated by exchanges and Nasdaq via their exclusive processors, refer to the quotes that SIAC or Nasdaq furnishes to vendors for dissemination to the public. The terms "public quote" or "publicly available quote," when used with respect to a specialist or market maker, refer to the bid and offer that the specialist or market maker has furnished to its exchange or association for inclusion in the consolidated quote. The term "public quotation system" refers to this entire structure through which SROs collect quotations from market participants, and the exclusive processors collect, process, and disseminate those quotations to vendors.

<sup>212</sup> Rule 11Ac1-1(c)(1), 17 CFR 240.11Ac1-1(c)(1). This is referred to as the broker-dealer's "firmness" requirement.

central quotation reporting system.<sup>213</sup> The Quote Rule, in particular, was designed to facilitate the NMS by requiring specialists and market makers publishing quotes to provide these quotes to a central system so they could be made available to the public. Congress considered the public availability of quotation information to be critical to fair and competitive markets because published quotations provide investors, their brokers, and other market participants with essential information about the condition of the market. This information assists investors in making investment decisions and in finding the best market for a security, while making it possible for investors to evaluate the quality of their executions.

Since the 1975 Amendments and the adoption of the Quote Rule, there have been dramatic changes in the markets and the technologies used by market participants. To ensure that the Quote Rule keeps pace with the evolution of the securities markets and continues to ensure the public availability of accurate, reliable, and comprehensive quotation information, the Commission has determined that certain amendments to the Quote Rule are necessary and appropriate in furtherance of the objectives of the Exchange Act.

The Commission proposed an amendment to the Quote Rule to require specialists and market makers to reflect in their public quotes any better priced orders they place in certain systems that are not currently integrated into the NMS. In particular, the ECN amendment is intended to incorporate within the public quotes any better priced orders broadly displayed by market makers and specialists through ECNs. This amendment is being adopted with modifications to address concerns raised by some commenters. Specifically, in order to provide specialists and market makers with an alternative method to meet the ECN display requirement, the Commission is adopting an alternative suggested in the proposing release that deems a specialist or market maker in compliance with the ECN amendment if the ECN provides the best prices entered into the ECN by market makers or specialists for each covered security to an exchange or association for inclusion in the public quotation system and provides access to those prices equivalent to the access currently

<sup>213</sup> Senate Report, *supra* note 31. Cf. H.R. Rep. No. 229, 94th Cong., 1st Sess. 29 (1975) ("Conference Report") (noting that the conference committee adopted the Senate's provisions on the NMS with minor revisions).

available to other quotes published by the exchange or association. In addition, the Commission is amending the Quote Rule to expand the categories of securities covered by certain existing Quote Rule provisions. The quotation requirements that previously applied to substantial specialists and market makers in only certain exchange-listed securities now will apply to substantial specialists and market makers in all exchange-listed securities. Further, certain Quote Rule provisions that previously applied to market makers electing to quote particular Nasdaq securities now will apply to market makers electing to quote any Nasdaq security. The Commission is adopting these amendments substantially as proposed, along with minor technical amendments to the Quote Rule that are discussed more fully below.

## 2. Public Dissemination of Market Maker and Specialist Prices in ECNs

### a. Basis for the ECN Amendment

Over 20 years ago, the Commission noted that an essential purpose for the establishment of the NMS was "to make information on prices, volume, and quotes for securities in *all* markets available to *all* investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell, or not sell for less than the highest price a buyer is prepared to offer."<sup>214</sup> At the time, the lack of consolidated quote information made it difficult to ascertain the different prices that were often available in the various markets for a particular security. This lack of transparency as to the best prices among competing markets was widely recognized as preventing investors and their brokers from ascertaining accurate trading interest for a security and obtaining the best prices for their orders.<sup>215</sup> To address these concerns, Congress directed the Commission to facilitate the creation of a national market system that would link the various markets trading a security. The price and quotation transparency resulting from the Commission's ensuing NMS initiatives has produced

<sup>214</sup> Securities and Exchange Commission, *Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets* (February 2, 1972) ("Future Structure Statement") at 9-10, 37 FR 5286, 5287 (February 4, 1972) (emphasis added). See also Securities and Exchange Commission, *Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System* (1973) at 25-28.

<sup>215</sup> See Senate Report, *supra* note 31.

extremely liquid, successful, and, in most cases, competitive markets.

As discussed in the Proposing Release, the Commission for many years has been concerned that the development of so-called "hidden markets," in which a market maker or specialist publishes quotations at prices superior to the quotation information it disseminates on a general basis, impedes these NMS objectives.<sup>216</sup> Over the course of the last decade, certain trading systems that allow market makers and specialists to widely disseminate significant trading interest to certain market participants without making this trading interest available to the public market at large have become significant markets in their own right. Although offering benefits to some market participants, widespread participation in these hidden markets has reduced the completeness and value of publicly available quotations contrary to the purposes of the NMS. Because these systems are not registered as exchanges or associations, they are currently not required to integrate into the public quote the prices at which their subscribers, including subscribing market makers and specialists, are willing to trade.<sup>217</sup> The use of these systems by market makers and specialists to quote prices not incorporated into the NMS has resulted in fragmented and incomplete dissemination of quotation information.

Certain markets, in particular ECNs that allow subscribers<sup>218</sup> to enter priced orders that are widely disseminated to third parties<sup>219</sup> and permit such orders to be executed in whole or in part through the system, communicate orders that are closely analogous to quotations. These ECNs, in effect, allow market makers and specialists to display different prices to different market participants.

Although these ECNs can facilitate the execution of their subscribers' orders and allow institutions to participate

<sup>216</sup> See Proposing Release at 4.

<sup>217</sup> Certain ECNs may be registered with the Commission as broker-dealers and indeed perform various brokerage functions. Nevertheless, the Commission recognizes that in providing a mechanism by which system subscribers can (1) broadcast prices to other system subscribers and (2) trade with one another at those prices, these systems also function as securities markets.

<sup>218</sup> ECN subscribers may include institutional investors, broker-dealers, and market makers. ECNs provide their services to subscribers for a fee or commission equivalent. Some ECNs (such as SelectNet) have been available only to broker-dealers and not to investors generally.

<sup>219</sup> "Third parties" in this context refers to subscribers or any other entities (such as customers of subscribers) that receive information from the ECN concerning any priced order entered into the ECN by another subscriber.

directly in price discovery, the display of better prices privately in ECNs reduces the reliability and completeness of consolidated quotations, the accuracy of which continues to be an essential element of the NMS. These private markets have resulted in fragmented quotations and a reduction in the reliability of public quotations as an accurate indicator of market makers' and specialists' best prices, the identical situation that prompted Congress to adopt the NMS amendments in 1975. The unavailability of full market maker and specialist quotation information prevents investors and their brokers from ascertaining the true trading interest for a security, and obtaining the best price for market orders, and prevents investors from monitoring the efforts of their brokerage firms to obtain best execution for their orders.

The Commission's analysis of the trading activity in these ECNs has produced clear evidence of the existence of a two-tiered market in which market makers routinely trade at one price with retail customers and at better prices with ECN subscribers.<sup>220</sup> For example, analysis of trading activity in the two most significant ECNs in the Nasdaq market, Instinet and SelectNet, reveals that approximately 85% of the bids and offers displayed by market makers in Instinet and 90% of the bids and offers displayed on SelectNet were at better prices than those posted publicly on Nasdaq.<sup>221</sup> Furthermore, approximately 77% of the trades executed on Instinet and 60% of the trades executed on SelectNet occurred at prices between the Nasdaq best bid and offer. Market makers participated on at least one side of approximately 90% of the trades in these ECNs. The trading activity in Instinet, which comprised approximately 17% of trades and 15% of the volume in Nasdaq securities, represents a significant portion of the overall market for Nasdaq securities.<sup>222</sup>

<sup>220</sup> For example, a market maker with a public offer constituting the best public offer of 20¾ might offer to sell shares in an ECN at 20%. If the market maker did not change its public offer to reflect this improved selling price, public customers buying from the market maker would pay the higher price of 20¾ for the security because they do not have access to the market maker's price in the ECN.

<sup>221</sup> The Commission's analysis is based on Instinet and SelectNet data for the months April through June 1994. See 21(a) Report at notes 48–52 and accompanying text and Appendix at notes 18–28 and accompanying text.

<sup>222</sup> More trading volume now occurs on Instinet than on any of the organized U.S. stock markets other than the NYSE and Nasdaq. In 1994, trading volume on Instinet totalled approximately 10.8 billion shares with an approximate dollar volume of \$282 billion. In comparison, Nasdaq traded approximately 74 billion shares, with an

The Commission's recent investigation into various trading practices in Nasdaq stocks revealed that the existence of this two-tiered market facilitated the maintenance of wide spreads on Nasdaq. As discussed in the 21(a) Report, Nasdaq market makers engaged in a widespread course of conduct that resulted in artificially wide spreads in a large percentage of Nasdaq stocks. The maintenance of wide spreads was made possible at least in part by the fact that ECNs like Instinet and SelectNet did not affect the prices at which market makers traded with the general public, thus allowing market makers to attract trading interest at prices inside the spread without adjusting their Nasdaq quotes. Integrating the better prices market makers quote in ECNs should significantly limit the types of uncompetitive practices identified in the investigation without limiting the usefulness of these systems as efficient alternative mechanisms for negotiating transactions.

The Commission firmly believes that *all* investors should have an opportunity to have their orders filled at the best prices made available by market makers. Consistent with Congress's goals for a NMS, these opportunities must be made available to *all customers*, not just those customers who, due to size or sophistication, may avail themselves of prices in ECNs not currently linked with the public quotation system. The vast majority of investors may not be aware of the better prices widely disseminated by market makers or specialists through ECNs and many do not have the ability to route their orders directly or indirectly to such systems. As a result, many customers, both institutional and retail, do not always obtain the benefit of the better prices entered by a market maker or a specialist into an ECN.

Brokers frequently use the consolidated quote as the benchmark for automated execution of customer orders and for the starting point in negotiating execution prices with institutional investors.<sup>223</sup> Consolidated quotations in

approximate dollar volume of \$1,449 billion. *Id.* at note 50 and accompanying text.

<sup>223</sup> Some commenters argue that the ECN amendment focuses on expanding the availability of these systems to small investors, and ignores the fact that small investors already benefit from these systems in that institutional subscribers in ECNs primarily represent the collective interests of small investors, e.g., through mutual funds and 401(k) plans. See, e.g., CALpers Letter; Dillon Letter; Instinet Letter; LJR Letter; Northern Trust Letter; SIA Letter; STAIC Letter. The objectives of the ECN amendment, however, are not limited to improving market transparency and accessibility for small investors. Comprehensive and transparent information about market conditions is critical to efficient and competitive markets for all investors,

listed stocks are provided by CQS to vendors, who then provide this information to the public. In approving the CQS as the mechanism to serve this vital function, the Commission stressed that it would expect broker-dealers to take into account pricing information made available through the CQS in fulfilling their best execution obligations.<sup>224</sup> Similarly, for OTC securities, Nasdaq disseminates to market makers, vendors, and investors multiple market maker quotations, and a "best" bid and offer derived from these quotations. As broker-dealers and markets have developed automated order-routing and order execution systems, they have relied on these consolidated quotes in pricing and executing customer orders routed through their systems.<sup>225</sup> Including the prices entered into ECNs by market makers and specialists in the consolidated quotation will help broker-dealers using these automated systems to provide their customers' orders with improved executions, and will improve institutions' ability to ascertain true market prices.

In light of the stated fundamental purposes of the 1975 Amendments and clear evidence of a two-tiered market, the Commission believes it is imperative to amend the Quote Rule to ensure the public dissemination of accurate quotes that represent the *best* prices that market makers and specialists widely disseminate. Thus, the ECN amendment is intended to integrate into the public quote the prices of market makers and specialists that are now widely disseminated to ECN subscribers but are not available to the rest of the market.<sup>226</sup>

whether retail or institutional. Indeed, while large institutional investors often have access to ECNs, the public quotes nevertheless frequently serve as a benchmark for their negotiations with market makers. In any event, while retail investors directly account for a significantly smaller percentage of trading volume than institutional investors, they still account for half of the direct equity investment in U.S. markets. *NYSE 1995 Fact Book* at 57. The Commission recognizes that direct retail participation provides critical liquidity and therefore limited access and transparency to the best prices available undermines the efficiency of our markets and jeopardizes public confidence in their fairness.

<sup>224</sup> See Securities Exchange Act Release No. 15009 (July 28, 1978), 43 FR 34851 (declaring the CQS Plan temporarily effective); Securities Exchange Act Release No. 16518 (Jan. 22, 1980), 45 FR 6521 (permanently approving the CQS Plan).

<sup>225</sup> See discussion of best execution principles, *infra* section III.C.2.

<sup>226</sup> Several commenters characterize ECNs as "wholesale" markets, and argue that the ECN rule would require market makers to trade with retail customers at wholesale prices. See, e.g., Davis Letter; Instinet Letter; LJR Letter; Merrill Letter. The Commission notes that market makers are compensated by the spread between their bid and offer prices, and nothing in the ECN rule prevents

Most commenters support the Commission's goal of improving the quality of quotation information made available to the public, although many raise questions, discussed below, about the proposal. In particular, and as discussed below, some commenters expressed concern about the potential impact of the rule on benefits provided to the market as a whole by ECNs. Upon review of the comments received, the Commission has determined that it is appropriate to adopt the proposed ECN amendment. Furthermore, in response to the concerns noted, and to facilitate compliance with the ECN amendment, the Commission has included the ECN display alternative that permits a market maker or specialist to comply with the amendment through an ECN that meets two conditions. First, the ECN into which the market maker or specialist enters its order must ensure that the best prices market makers and specialists have entered therein are communicated to the public quotation system. Second, the ECN must provide brokers and dealers access to orders entered by market makers and specialists into the ECN, so brokers and dealers that do not subscribe to the ECN can trade with those orders. The ECN display alternative therefore allows a market maker or specialist to comply with the ECN amendment directly by changing its quote, or alternatively by using an ECN that meets the above two conditions.

As discussed above, the Commission expects the SROs to work expeditiously with ECNs that wish to avail themselves of the ECN display alternative to develop rules or understandings of general applicability. The Commission is prepared to act as necessary to ensure implementation of the ECN display alternative prior to the effective date of the Quote Rule.

#### b. Response to Comments<sup>227</sup>

The Commission solicited comment on whether the proposed amendment achieves the goals of deterring fragmented markets and promoting improved quotations. The Commission also invited comment on whether there are any feasible alternatives to the rule, and on possible business or economic justifications for permitting market makers and specialists to publish prices in ECNs that differ from their public quotations. The Commission requested comment on the competitive effects of

market makers from buying at the bid from one customer and selling at the offer to another.

<sup>227</sup> This section includes a discussion of the principal arguments advanced by the commenters. A more detailed discussion of the comments is provided in the Summary of Comments.

the proposal on existing ECNs, subscribers, and users.<sup>228</sup> In addition, the Commission solicited comment on alternatives to the proposal that would minimize any negative effects, yet still achieve the Commission's goals. The Commission specifically asked whether ECNs should, as an alternative, furnish market makers' and specialists' best prices to the applicable exchange or association for further dissemination, and provide access to those prices through some form of linkage.<sup>229</sup>

#### i. General Comments

The Commission received numerous comments on the ECN proposal. Many commenters support the proposal as an important initiative designed to further investor protection by improving publicly available quotation information and assuring best execution of customer orders.<sup>230</sup> Some commenters recognize that a number of brokers and dealers have adopted the practice of placing superior priced orders in ECNs without including these better prices in their public quotes.<sup>231</sup> These commenters agree that the Commission should be concerned that some retail investors may have neither knowledge nor access to the best available prices under these circumstances.<sup>232</sup> They voice general support for the rule, and recommend one or more mechanisms<sup>233</sup> by which the Commission could ensure that public quotes contain the best prices otherwise widely disseminated by market makers and specialists.

#### ii. Impact on ECNs, Market Makers and Specialists, and Institutions

Some commenters express concern that the amendment could negatively impact services provided by ECNs and caution the Commission not to diminish the benefits provided by ECNs to the market as a whole. Some commenters argue that, under the proposal, market

<sup>228</sup> The Commission also specifically solicited comment on whether exceptions to the rule would be appropriate, particularly if a customer requests that the market maker refrain from publicly disseminating its order. The Commission also solicited comment on whether market makers should be required to disseminate publicly the full size of orders placed in ECNs. The Commission received only minimal response to these questions, which is discussed in the Summary of Comments.

<sup>229</sup> See Proposing Release at 28-29.

<sup>230</sup> See, e.g., DOJ Letter; Lehman Letter; Madoff Letter; Amex Letter; NASD Letter.

<sup>231</sup> See, e.g., Amex Letter; DOJ Letter; Madoff Letter; RPM Letter.

<sup>232</sup> See, e.g., Letter from Gerri Detweiler, Policy Director, National Counsel of Individual Investors, to Jonathan G. Katz, Secretary, SEC, dated January 22, 1996 ("NCII Letter"); Goldman Sachs Letter; PaineWebber Letter; SIA Letter; Madoff Letter; Lehman Letter; DOJ Letter.

<sup>233</sup> See discussion of alternative approaches, *infra* at section III.B.2.b.iv.

makers and specialists that use ECNs would lose the anonymity that these commenters believe is crucial to successfully execute large trades for institutional investors.<sup>234</sup> Some commenters anticipate the adoption of the ECN amendment prompting a potential decline in the use of certain ECNs.<sup>235</sup> In addition, some commenters contend that this amendment, because of the impact on ECNs and their subscribers, will lead to a loss of liquidity in both ECNs and the public markets<sup>236</sup> and to a decline in the variety of available trading options which could be detrimental to all investors.<sup>237</sup> Other commenters argue that the proposal would effectively double the risk of a specialist or market maker that enters orders into an ECN because the specialist or market maker could be simultaneously responsible for multiple executions based on its disseminated quote as well as its ECN order.<sup>238</sup> Moreover, at least one commenter argues that quotes, bids, offers, and orders have historically had different meanings and that the proposal's treatment of priced orders as quotes confuses the essence of the terms, thereby resulting in inadvertent anti-competitive effects.<sup>239</sup> Some commenters also argue that the better prices frequently available in ECNs reflect the lower costs of doing business in those systems, and therefore, it would be inappropriate to require market

<sup>234</sup> See AZX Letter; Instinet Letter; ICI Letter; Investors Research Letter; NASD Letter; Ruane Letter; STAIC Letter; Letter from Edward G. Shufro, Partner, Shufro, Rose & Ehrman, to Jonathan G. Katz, Secretary, SEC ("Shufro Letter"); Sutro Letter.

<sup>235</sup> See Goldman Sachs Letter; STA Letter; AZX Letter; Instinet Letter; Schwartz and Wood Letter; Ruane Letter.

<sup>236</sup> See DOJ Letter; STA Letter; Alex. Brown Letter; Letter from Jeffrey L. Davis, Economists Incorporated, to Jonathan G. Katz, Secretary, SEC, dated October 25, 1995 ("Davis Letter"); Dillon Letter; Instinet Letter; Merrill Letter. (citing the "deleterious effects concerning liquidating inventory and replacing necessary capital" at pp. 7-8); Schwartz and Wood Letter; Letter from Mary Kay Wright, Second Vice President and Senior Equity Trader, The Northern Trust Company, to Jonathan G. Katz, Secretary, SEC, dated February 28, 1996 ("Northern Trust Letter").

<sup>237</sup> See Letter from Anthony R. Gray, Chairman and CIO, STI Capital Management, to Jonathan G. Katz, Secretary, SEC, dated February 12, 1996 ("STI Capital Letter"); Ruane Letter; DOJ Letter; and LJR Letter.

<sup>238</sup> See, e.g., Merrill Letter.

<sup>239</sup> See Instinet Letter. Instinet also bases much of its arguments on its regulatory identification as a broker-dealer. Instinet argues that the proposal targets its ECN operations for treatment different from other broker-dealers. The Commission notes that Instinet (and similar systems) provides to its customers ECN services that are significantly different from the services provided by other broker-dealers to their customers. Specifically, Instinet, without discretion, publicizes subscriber orders and enables other subscribers to trade with these orders at their stated price.

makers and specialists to match their ECN prices in their public quotes.<sup>240</sup>

The Commission agrees with commenters that ECNs provide certain valuable benefits to their subscribers. It also recognizes the benefits competing systems bring to the market as a whole, particularly systems that take advantage of new technologies to offer improved trading opportunities. The Commission, therefore, has adopted an alternative method of compliance with the ECN requirement discussed in the proposing release to reduce the amendment's potential impact on existing ECNs and their subscribers, and to maintain incentives and opportunities for new ECNs to enter the marketplace.<sup>241</sup> The Commission continues to believe it is important that the best prices of orders entered into these markets by market makers and specialists are properly integrated into the public market so that all market participants can benefit from the price discovery taking place within these markets.

In its comment letter, the NASD stated its view that the proposal could

<sup>240</sup> See, e.g., Dillon Letter; HHG Letter; LJR Letter; Merrill Letter; STA Letter; Goldman Sachs Letter.

There appear to be counter arguments. For example, there is no reason to suppose that adverse selection costs—that is, the risks of trading with an informed trader—are any lower in ECNs, whose subscribers typically can include market makers, other broker-dealers, institutional money managers, hedge funds, momentum traders, and options market makers. Second, because traders can more easily mask their identities and thus their trading motives in ECNs than in the primary market, informed traders may prefer to trade in ECNs. These higher information asymmetries would be expected to lead to higher, rather than lower, trading costs. Finally, ECNs often impose transactions charges that may not otherwise be incurred by dealers trading in the primary market.

Furthermore, it does not appear that the better prices available in ECNs can be explained by differences in the size of orders and transactions given that the average order size and trade size in one ECN (Instinet) is substantially similar to the average size of quotes and trades in the primary market. In any event, the Commission generally would not expect larger size orders to receive better prices in view of the considerable literature suggesting that in equities markets, larger orders tend to get *worse* prices because of the risk of trading with an informed trader. See, e.g., David Easley and Maureen O'Hara, 19 J. Fin. Econ. 69, (No. 1, September 1987).

<sup>241</sup> The Commission believes that although the ECN amendment may marginally reduce the incentive of some subscribers to participate in an ECN, on the whole the effect on ECNs should not be so significant as to affect their viability. Moreover, given the availability of the ECN display alternative, which is designed to minimize any potentially detrimental effects of the rule on ECNs, the Commission believes that the benefits of the amendment to investors of publicizing the better prices entered by market makers and specialists outweigh the limited likely costs to ECNs. Many of the comments received that addressed the ECN proposal raised concern about the importance of preserving the anonymity offered by these systems. See, e.g., Alex. Brown Letter; AZX Letter; Dillon Letter; Estep Letter; ICI Letter; Instinet Letter; NASD Letter.

discourage market makers' use of ECNs because a market maker placing an order in an ECN at a better price would have to simultaneously change its quote, thereby telegraphing its interest. In proposing a solution to this situation, the NASD specifically referred to the ECN alternative noting "'\* \* \* this problem can be addressed without discouraging market maker use of ECNs through the approach suggested by the Commission as a possible alternative, i.e., by reflecting the better ECN prices in the *inside market* display, rather than in individual quotes.'" <sup>242</sup>

In response to the concerns raised by the NASD and other commenters, the ECN display alternative is designed to preserve the benefits associated with the anonymity that some ECNs currently offer to subscribing market makers and specialists and their customers.<sup>243</sup> This alternative will ensure that the best prices of market makers and specialists are publicly disseminated and that non-ECN-subscribing brokers and dealers can trade with the ECN orders represented by those prices. Under the display alternative, the best prices and sizes of orders entered into an ECN by specialists and market makers would be publicly disseminated while the specialists and market makers themselves would remain anonymous. This alternative not only preserves anonymity, but also eliminates the risk that a market maker or specialist could be exposed to multiple executions at the ECN price.<sup>244</sup>

The ECN amendment, as proposed, sought to minimize the potential impact

<sup>242</sup> NASD Letter at 14.

<sup>243</sup> The Commission recognizes that in certain securities, specific market makers or specialists may be viewed as price leaders for those securities. Therefore, if the market knows that one of those firms has changed its quote, other market makers or specialists are likely to follow that price change and frustrate the first's firms ability to obtain an execution at the improved price. The ability to place an anonymous order in an ECN allows the firm to change its price without triggering corresponding price changes from other market makers or specialists and thereby increases its potential to obtain an execution at the improved price.

<sup>244</sup> Certain commenters fear that, as originally proposed, the amendment would have an adverse impact on institutional investors which currently subscribe to ECNs. These commenters appeared to believe that the ECN amendment would seriously harm ECNs, and thus harm institutional users. See, e.g., ICI Letter; Ruane Letter. The Commission does not believe that the amendments will significantly interfere with the operations of ECNs. Moreover, the Commission believes that as adopted, particularly with the addition of the ECN display alternative, ECNs will continue to be able to provide services to institutional investors of similar value to those they provide today. The Commission also believes that the benefits of the amendments, including increased market maker competition and decreased fragmentation, will flow to all investors, institutional as well as retail. See 21(a) Report.

on market makers, specialists, and ECNs by requiring a market maker or specialist to display in its public quote only the size required by its exchange or association, rather than the actual size of any order the firm places into an ECN. This part of the amendment is being adopted as proposed for orders for the accounts of market makers and specialists. However, for customers' orders entered into an ECN by a market maker or specialist that are smaller than the quote size required by the market maker's or specialist's exchange or association, the Commission has amended the rule to allow market makers and specialists to display only the customer's order size.<sup>245</sup> The requirement to display no more than the required size for market makers' and specialists' own orders should reduce any disincentives to use ECNs that could otherwise result from the ECN amendment, and responds to the concern that disclosure of the full size of the order in the market maker's or specialist's quote could impede its ability to execute the order.<sup>246</sup> Moreover, permitting the display of customer orders of less than the minimum quote size should reduce the potential burden on a specialist or market maker of having to publish a public quote for more than the customer's order size when the customer's order is for less than the minimum quotation size required by the specialist's or market maker's exchange or association.

Market makers and specialists who avail themselves of the ECN display alternative will be required to furnish to the public quotation system the full size of the best buy and sell orders they enter into the ECN. The Commission believes that the display of full size by the ECN will help inform the public market of the true trading interest entered by specialists and market makers, without impeding the execution of these orders by disclosing the identity of the specialist or market maker placing the order. Under the ECN display alternative, the market maker or specialist will be able to continue to represent the order on an anonymous basis both in the ECN and in the public

<sup>245</sup> As discussed *supra* in footnote 144, SROs may wish to allow market makers or specialists to quote in sizes smaller than the minimum quotation increment when the quote represents a customer limit order.

<sup>246</sup> The Commission received several comments that support this aspect of the proposal. See, e.g., Lehman Letter; and Smith Barney Letter. These commenters believe that display of full size in a market maker's quote could impair the quality of an execution obtained for a customer because the display in the public quotation system is broader than the display in the ECN.

quote, substantially reducing any negative impact of the amendment on ECN users.

Where the order entered by the market maker or specialist is on behalf of a customer, the display of full size under the ECN display alternative is consistent with the requirement under the Display Rule, which requires market makers and specialists to display the full size of their customer limit orders. Therefore, the full size of customer limit orders will be displayed whether the specialist or market maker displays the order itself or enters the order into an ECN complying with the ECN display alternative.<sup>247</sup>

The Commission believes that the concerns expressed by some commenters about a potential loss of liquidity resulting from the proposal have been substantially addressed by the alternative adopted today. Because this alternative preserves the anonymity some ECNs afford to the users of their systems, the proposal maintains incentives for subscribers to continue participating in such systems. In fact, a market maker or specialist, who presumably wants its orders executed at prices it is widely displaying through the ECN, should benefit from attracting greater trading interest by having the prices of its orders displayed to the entire market.

Finally, under the proposal, priced orders of institutions and other non-market makers entered directly into ECNs would not be required to be reflected in the public quote. Some commenters criticized the proposal because it did not require the inclusion of all better priced orders in the public quote. This result, however, is consistent with existing quotation principles. Institutional bids, offers, and orders handled independent of a market

<sup>247</sup> The Commission notes that the exceptions under the Display Rule for limit orders of block size and for limit orders that a customer has asked not to be displayed will not apply to customer limit orders entered by a market maker or specialist into an ECN. If entered into an ECN, these orders must either be reflected in the market maker's or specialist's own quote or displayed via the ECN alternative. As discussed previously, the Commission believes that a customer should have discretion to permit a market maker or specialist to handle its limit order without public display, and large limit orders should not be required to be displayed unless the customer makes a request. However, the Commission does not believe these orders should be withheld from public display if they are being displayed in an ECN. The Commission believes that if these orders, when handled by market makers or specialists, are displayed widely through an ECN to the ECN's subscribers, then they should also be displayed to the public generally. Moreover, limiting display to only one market would be inconsistent with Congress's goal for a NMS in which trading interest in disparate markets would be consolidated and publicly disseminated.

maker historically have been outside the scope of the Quote Rule, and the Commission's proposal was not intended to expand the scope of the Quote Rule in this respect.<sup>248</sup> Furthermore, the Commission believes that, although institutional investors' direct orders in ECNs provide valuable liquidity, the amendments will substantially strengthen the public quotation system by publishing orders entered by market makers and specialists without creating new requirements for orders not controlled by market makers or specialists.<sup>249</sup> Nevertheless, the Commission will continue to monitor closely issues involving the display of prices published by institutions in light of the Quote Rule and its objectives.

### iii. Technology and Innovation

Some commenters predict that the proposal may have a chilling effect on technological innovation, primarily because the proposal applies only to ECNs and not to all available communication technologies that may be used for disseminating interest to buy and sell a particular number of shares at a specified price.<sup>250</sup> Some commenters argue that the proposal is anti-competitive and otherwise antithetical to the purposes of the Exchange Act because it will deter future technological advances in automated trading environments by favoring less automated trading methods (e.g., telephone transactions).<sup>251</sup>

The Commission is cognizant of the importance of the continued development of innovative trading systems and services. New technologies have expanded the ways in which investors' buying and selling interest can be brought together and have fostered additional competition in the securities markets. The Commission believes that this competition should be encouraged. Nonetheless, to promote competition, efficiency, and transparency in the securities markets, and insure the integrity of publicly available information, the Commission believes it is appropriate to set minimum standards that apply to the entry of the functional equivalent of

<sup>248</sup> The fact that ECNs will continue to contain institutional investors' orders priced better than the public quotes will provide another incentive for market participants to continue to participate in those systems.

<sup>249</sup> The Commission notes that, as described in the Commission's 21(a) Report, institutions trading with dealers or others accounted for less than 20% of trades in one ECN (Instinet). See Appendix to the 21(a) Report at A-11.

<sup>250</sup> See DOJ Letter; SIA Letter; Instinet Letter; Schwab Letter; STI Capital Letter; Sutro Letter.

<sup>251</sup> See, e.g., Instinet letter.

quotations by market makers and specialists in trading systems.<sup>252</sup> Indeed, consistent with the Commission's experience with previous NMS initiatives,<sup>253</sup> these minimum standards will permit and foster the development of new technologies that improve the public availability of trading information, while discouraging practices that are inconsistent with the purposes of the 1975 Amendments. The Commission believes that the Quote Rule as amended will not unduly diminish the beneficial services provided by existing ECNs, nor will it stifle the development of new trading technologies or new ECNs.

### iv. Alternative Approaches

In the Proposing Release, the Commission suggested alternatives to the proposal, and solicited comment on these alternatives. The Commission also invited commenters to suggest possible alternatives. The Commission specifically asked whether it should require ECNs to furnish prices to the applicable exchange or association for public dissemination and to provide some access, such as a linkage, to the prices in the ECN.<sup>254</sup> A number of commenters supported this approach.

The NASD recommended, as an alternative to the proposed rule, that the better ECN price be reflected in the inside market, rather than in individual quotes. Under the alternative described by the NASD, an ECN would report its best market maker or specialist inside prices to the SRO that is the primary market in the security. The NASD also recognizes that more assured access to orders in the ECNs would be necessary under this option.<sup>255</sup> Similarly, one commenter agreed that the inside market available to the public should reflect the best bid and offer prices whether in a market maker's quote or in a market maker's order on an ECN. The Commenter suggested that this could be accomplished by requiring quotations in ECNs to be made part of the public quotation and by separately identifying the ECN into which the order is entered rather than the market maker that

<sup>252</sup> The Commission notes that the focus of the proposal is not on any particular system or systems but, rather, on the types of orders that are the fundamental equivalent of quotations, and the fragmented market that results when the prices of these orders are not integrated into publicly available quotations.

<sup>253</sup> See Simon and Colby, *supra* note 58. The Commission also notes the growth in technologies over the past twenty years, including broker-dealer and exchange automated execution systems, that clearly rely on, and were facilitated by, successful operation of NMS and joint industry initiatives such as the Quote Rule, CTA, and the ITS Plan.

<sup>254</sup> See Proposing Release and e.g., NASD Letter.

<sup>255</sup> See NASD Letter.

placed the order.<sup>256</sup> Finally, certain commenters state that expanding ITS to include orders entered into ECNs would be a better alternative to the proposal.<sup>257</sup>

The Commission believes that the ECN display alternative adopted today is consistent with these suggested alternatives and will minimize many of the asserted negative effects of the rule. The adopted provision provides an alternative to an ECN that disseminates specialists' and market makers' best prices to the public quotation system. Thus, the amendment enables a market maker or specialist to comply with the Quote Rule either directly by sending to its exchange or association the prices of orders it places into ECNs that improve the market maker's or specialist's public quote, or indirectly by using an ECN that transmits the best prices entered therein by market makers and specialists for publication in the public quotation system.

The ECN display alternative is consistent with the alternative recommended by the NASD because the adopted provision enables the specialists' or market makers' best prices in ECNs to be consolidated with the exchange's or association's best prices for dissemination within the consolidated quotes. In addition, the adopted amendment requires the ECNs to provide an equivalent means of access to those best prices.

The Commission recognizes that this alternative may reduce the content of information that is publicly available because under the ECN display alternative, the identity of the market maker or specialist that entered the better priced order in the ECN will be withheld.<sup>258</sup> The Commission believes this result is justified because the inside prices and full sizes of orders entered by market makers and specialists will be in the public quotation system to inform the entire market of these prices and ECNs will provide equivalent access to those prices. Moreover, the Commission believes the benefits of facilitating the use of ECNs, by permitting the continued anonymity of market makers and specialists, more than offset the

<sup>256</sup> Morgan Stanley Letter. See also, PaineWebber Letter (recommending that priced orders in ECNs be included in the NBBO).

<sup>257</sup> See, e.g., STAIC Letter; ICI Letter.

<sup>258</sup> The Commission also notes that under the alternative, a specialist or market maker that puts an order into an ECN that is priced better than that specialist's or market maker's public quote, but is not the best priced quote from any specialist or market maker in the ECN, will not have its better priced order reflected in the public quote. The prices will be displayed, however, if the better price in the ECN is executed or withdrawn and the lower specialist's or market maker's priced quote then becomes the best priced quote.

reduced information available on the identity of a particular market maker or specialist.

As an alternative to the ECN amendment, certain commenters suggested that enforcement of best execution principles would be sufficient to protect public investors.<sup>259</sup> As discussed in more detail in section III.C.2., the Commission does not believe this is a practical alternative because ECNs do not provide broker-dealers with automated links and thus may not be reasonably available for the handling of retail orders on an automated basis. Furthermore, investors and their brokers cannot efficiently ascertain if they have received the best prices for their orders if publicly available prices do not reflect the best prices at which specialists and market makers are willing to trade. Under these circumstances, providing customers the best executions available can be achieved most effectively by ensuring that the consolidated quotes systematically include the better prices that market makers and specialists have entered into an ECN.

Finally, certain commenters argue that, as an alternative to adopting the ECN proposal, the Commission should defer any action until further study is completed on the use of ECNs because the Proposing Release provides insufficient data regarding whether customers currently get the best available price, or market maker and specialist use of ECNs results in harm to customers.<sup>260</sup> The Commission has determined to go forward with the amendments now because of compelling concerns presented by two-tiered markets. Many of the commenters to the proposed rules also recognize these concerns. Furthermore, as part of its recently concluded Nasdaq investigation, the Commission has conducted an extensive analysis since the proposals were published that supports the Commission's proposal and clearly evidences the existence of a "two-tiered" market in which customer orders are executed at publicly available prices inferior to prices contemporaneously available in existing ECNs.<sup>261</sup> Moreover, Commission data

<sup>259</sup> See, e.g., Instinet Letter.

<sup>260</sup> See, e.g., Instinet Letter, asserting that the Commission should obtain and study data on this matter and that, absent such data, adoption of the proposed amendment is unwarranted.

<sup>261</sup> As discussed previously, the Commission believes the data it has reviewed supports the need for prompt adoption of the ECN amendment to the Quote Rule. See *supra* notes 222 and 223, and accompanying text. Given the strong evidence that investors would benefit from public dissemination of the hidden prices that are broadly disseminated to subscribers in these systems, the Commission

shows that the pricing opportunities available in at least two ECNs (Instinet and SelectNet) are not limited to block trades, but extend to smaller orders executed in the system.<sup>262</sup> The Commission believes, therefore, that further study is not necessary to address a structural disparity in market information that disadvantages investors who lack access to ECNs.

#### c. Operation of the Rule Amendment

##### i. Definition of the Term "Electronic Communications Network"

The proposed amendment did not specifically define the term "electronic communications network." The Commission did state, however, that priced orders that market makers and specialists enter into certain ECNs are bids and offers for the purposes of the Quote Rule.<sup>263</sup> The proposal applied to systems that widely disseminate priced orders to third parties and permit such orders to be executed against in whole or in part. The Commission further explained that the term "electronic communications network" was intended to include continuous auction trading systems, but was not intended to include crossing systems or broker-dealer internal order routing systems.

Several commenters suggested the need for a definition of the term "electronic communications network."<sup>264</sup> The Commission agrees that it is appropriate to define the term in the Quote Rule and has decided to adopt a definition that reflects the fundamental characteristics of an ECN as discussed in the Proposing Release.

As discussed earlier, the objective of the ECN amendment is to incorporate within the consolidated public quote firm prices quoted by market makers and specialists in securities markets that widely disseminate those prices but are not registered as exchanges or associations and thus are not integrated

believes that it is appropriate to adopt the amendments to the Quote Rule.

<sup>262</sup> As noted above, the Appendix to the 21(a) Report states that average trade size for Nasdaq NMS securities on Instinet was approximately 1,600 shares for the period studied, while the average trade size generally in the securities was approximately 1,900 shares. See Appendix to the 21(a) Report at A-8.

<sup>263</sup> As a result, relevant provisions of the Quote Rule, such as the obligation on exchanges and associations to disseminate quotes, and the firmness requirement placed on a market maker or specialist who furnishes the quotes, become operative with respect to a security when a market maker or specialist enters an order for that security into an ECN. See section III.B.2.c.v., *infra*.

<sup>264</sup> See Goldman Sachs Letter; Instinet Letter; Schwab Letter. In addition, one commenter argues that ECNs should include SRO stock crossing systems and all non-market-maker broker-dealers. NYSE Letter.

into the NMS. Therefore, the Commission has defined the term "ECN" as an electronic system that widely disseminates to third parties<sup>265</sup> orders entered therein by a market maker or specialist, and permits such orders to be executed against in whole or in part. The definition specifically excludes any system that crosses multiple orders at one or more specified times at a single price set by the system and that does not allow orders to be crossed or executed against directly by participants outside of such times. This exclusion is consistent with statements made in the Proposing Release that it was not the Commission's intention to cover crossing systems because these systems do not communicate to multiple market participants the prices at which system subscribers are willing to trade. Rather, the excluded crossing systems themselves establish an internal trading price for subscribers on an episodic basis.<sup>266</sup>

The ECN definition also excludes any system operated by, or on behalf of, a market maker or specialist that executes customer orders primarily for its own account as principal, other than as riskless principal. This exclusion is intended to ensure that, as discussed in the Proposing Release, internal broker-dealer order routing systems in which the market maker trades primarily with customer orders on a principal basis are not ECNs within the scope of the amendment. The exclusion would not except from the ECN definition systems that involve multiple market makers or specialists competing as principal in a security or that cross multiple market maker and customer orders.

Furthermore, the Commission believes the definition should be read broadly to include systems that match orders internally and deliver the matched order to some other market for execution. Thus, the term "permits such orders to be executed against" should not be read to exclude systems where a narrow technical reading of "executed" is the only reason that the system would not fall within the ECN definition. For example, if a system puts buy orders and sell orders together for execution, completes all necessary elements of the trade, and then sends the matched pair to an exchange or association merely to print the terms of the trade on the

<sup>265</sup> The Commission intends the term "third parties" to refer to subscribers to the ECN, other than the ECN and the market maker or specialist that is entering its priced order into the ECN. The ECN also may disseminate to others, including non-subscribers.

<sup>266</sup> The Commission notes that broker-dealers that publish quotes through a vendor are already covered by the rule.

Consolidated Tape, the system would be an ECN.

#### ii. "Priced Orders" in ECNs

Under this definition, the Commission intends to include in the public quotation system firm prices for securities entered by market makers or specialists, whether such firm prices are labeled as "quotes" or "orders." The Commission believes that priced orders entered by market makers or specialists into ECNs where the orders are widely disseminated and executable are the functional equivalent of market maker or specialist quotations, and like quotations, play a key role in the price discovery process. The Commission thus believes that these "quotation-equivalents" should be made part of the public quote.

Although some commenters argue that priced orders entered into ECNs are more closely parallel to prices communicated over the telephone to other market makers than to market quotes, the Commission recognizes a fundamental distinction between limited communication of price in bilateral telephone negotiations and broad exposure of firm prices to multiple participants in a market.<sup>267</sup> Accordingly, prices communicated by telephone are excluded because these prices generally are not widely disseminated to other parties for execution. The rule also would not cover indications of interest that do not constitute firm prices.

In this connection, the Commission intended the term "priced order," which is deemed under the ECN amendment to be a bid or offer, to encompass commitments to buy or sell a security at a particular price for a particular number of shares. The Commission also does not intend the term "priced orders" to include interest to buy or sell a security where price or the number of shares is not specified to system subscribers, unless the price or size is otherwise understood as part of the system's operation.<sup>268</sup> The ECN

<sup>267</sup> The Commission recognizes that market makers and specialists may be willing to trade with certain customers at better, negotiated prices, such as when market makers negotiate with customers over the telephone. In contrast, however, the prices quoted by market makers and specialists in ECNs are widely disseminated to market participants. In adopting the ECN amendment, the Commission is reaffirming the NMS principle that prices advertised in one market must be integrated into the national market—that is, the consolidated public quote.

<sup>268</sup> The definition of an ECN specifically excludes any system that crosses multiple orders at one or more specified times at a single price set by the ECN (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by subscribers outside of such times. See 11Ac1-1(a)(8).

amendment would, however, include priced orders entered into an ECN by a market maker or specialist that are visible only to *some* system subscribers if these orders can be executed against in the ECN. The ECN amendment is intended to require the public display of priced orders entered into ECNs by market makers and specialists where these priced orders are similar to quotations. Accordingly, the Commission does not intend the ECN amendment to apply to a priced order that is entered into an ECN by a market maker or specialist merely in order to execute against an existing order visible in the ECN, and not entered to elicit other buying or selling interest. If, however, the order entered by the market maker or specialist does not in fact execute immediately in full against an existing order but rather is itself disseminated as an open order in the ECN, the market maker or specialist must comply with the requirements of the ECN amendment with respect to the order.

In order to ensure that customers consistently receive the benefit of better prices entered into ECNs, a market maker or specialist entering an all-or-none or minimum size order for its own account into an ECN would be required to include this price in its public quote, or disseminate the price via the ECN display alternative, and thereby publicly display the order for the full number of shares for execution in whole or in part. Although the execution of an all-or-none order is typically conditioned on execution of the entire size of the order, the Commission believes that allowing market makers to avoid public display of an unconditional quote when using this type of order could seriously undermine the purposes of the rule.<sup>269</sup> The rule will permit, however, a market maker or specialist to enter an all-or-none customer order into an ECN without requiring public display of the quote for that order where the customer specifically requests that the order be executed on an all-or-none basis. This latter provision accommodates the desire of some customers to trade only at a specific size associated with a specific price.

#### iii. ECN Display Alternative

Pursuant to the amendment as adopted, a priced order entered by a market maker or specialist into an ECN that widely disseminates the order is deemed to be a bid or offer for the

<sup>269</sup> All-or-none and minimum size orders are rarely used by market makers and specialists in ECNs and are prohibited from being included in the public quotes by the registered exchanges and Nasdaq.



purposes of the market maker's or specialist's quotation reporting obligations under the Quote Rule. As a result, specialists and market makers are required to include such orders in the bids and offers they communicate to their exchange or association for inclusion in the published quotations made available by the exchange or association.<sup>270</sup>

As discussed above, in response to the concerns of some commenters, the adopted amendment includes an alternative to the specialist or market maker itself revising its public quotation to reflect its better priced order entered in an ECN. This alternative allows the ECN to act as an intermediary in communicating to the public quotation system the best price and size of orders for each security that have been entered into the ECN by a specialist or market maker. To communicate the quotations publicly, the ECN must submit the best price entered by a specialist or market maker to an exchange or association, or to a securities information processor acting on behalf of one or more exchanges or associations.

The alternative reduces the impact of the amendment on specialists and market makers because they have a choice regarding how to comply with their obligation. This alternative also reduces the impact of the amendment on ECNs by offering these systems an opportunity to provide additional services to their subscribers, and creating an opportunity to generate additional order flow from non-subscribers. At the same time, more accurate prices are provided through public quotation systems than are currently available.

Under this alternative, consistent with the goals of the initial proposal, the ECN must comply with two conditions. First, the ECN must provide the best prices and sizes that market makers or specialists have entered in the ECN to the public quotation system for inclusion in the consolidated quotation. The market maker or specialist responsible for the price does not have to be identified.<sup>271</sup> The ECN must, however, at a minimum, publicly identify itself as the originating system for these prices. Accordingly, if a market maker puts an order that improves the

<sup>270</sup> An OTC market maker that places priced orders for execution into any ECN will in effect be making an election to communicate quotations to its association bids, offers and quotation sizes in the security. See 11Ac1-1(a)(25)(ii)(B).

<sup>271</sup> An ECN that does not offer the option of anonymity to its subscribers could choose to include the identity of the market maker or specialist with the prices furnished to the SRO for public dissemination. As discussed below, the ECN also must provide access to these prices.

NBBO into an ECN and the ECN disseminates that price to the public quotation system, the disseminated price must either be identified as originating from the market maker or from the ECN.

Second, the ECN must provide non-subscriber brokers and dealers with a means of access to those prices entered in the ECN by market makers and specialists. This access must be equivalent to the access that would have been available for the relevant security if these prices had been published in the market makers' or specialists' quotation.<sup>272</sup> The extent and form of this access will depend on the form(s) of access available in the market to which the ECN supplies the bids and offers for public dissemination.<sup>273</sup>

For example, market makers in Nasdaq NMS and SmallCap securities typically can be reached through the telephone and through the NASD's Small Order Execution System. Therefore, an ECN that chooses, pursuant to the alternative, to act as an intermediary for its market maker and specialist subscribers for Nasdaq NMS and Smallcap securities would have to be prepared to receive and execute telephone orders from broker-dealers against those market makers' and specialists' orders entered in the ECN. The ECN will have to execute these orders promptly at the prices the market makers and specialists have entered into the ECN. In addition, because a market maker with the best price in a Nasdaq NMS security is subject to SOES executions, this equivalent access condition would require the ECN to provide broker-dealers who use SOES with equivalent automated access to the best priced market maker orders in the ECN. This could be accomplished either through an electronic linkage to SOES or by other means agreed upon with the NASD. For example, the ECN could supply the NASD with an identifier for the market maker who entered the best priced order, which the NASD could use in assigning SOES executions to that market maker.<sup>274</sup>

<sup>272</sup> For access to be "equivalent", the ECN must enable non-subscribing broker-dealers to execute against the ECN's published best price to the same extent as would be possible had that best price been reflected in the public quote of a specialist or market maker. The ECN, however, may impose charges for access to its system, similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers.

<sup>273</sup> The extent and form of the access will not necessarily be the same as the access available in the market to which the specialist or market maker would otherwise supply its bid and offers.

<sup>274</sup> As discussed *supra* section II., the NASD has proposed a new facility, NAQcess, which, as part of its proposed services, would widely disseminate

Similarly, in exchange-listed securities, the degree of access that the ECN must offer would depend on the current access that the market receiving the information from the ECN offers to broker-dealers in the relevant type of security. If the ECN communicates prices for exchange-listed securities to an exchange, the specialist or market maker orders in the ECN must be accessible to broker-dealers in the same manner as quotes on that exchange. This access would include any automated execution features offered to broker-dealers by the exchange. The ECN must provide to the exchange, or to the exchange specialist in each security, access to the market maker or specialist orders in the ECN. Such access must provide broker-dealers with the ability to enter and obtain executions for their orders at least as promptly as that exchange offers to its own members through its order-routing and execution systems. Because the ITS Plan applies to exchange-trading of listed securities, orders received from other markets through ITS must have the same ability to trade with ECN orders whose prices are displayed through the exchange as they have with the exchange's own quotations. For instance, if the exchange specialist typically receives incoming ITS commitments and executes them manually, the ECN must at a minimum enable the incoming ITS commitment to be manually entered into the ECN for execution.

If the ECN instead provides orders in exchange-listed securities to the NASD for inclusion in the public quotation system, the orders must be as accessible to broker-dealers as the quotes published by third market makers in

priced orders for execution in whole or in part. *Supra* note 45. As proposed, NAQcess would publish its best prices in the Nasdaq quotation system stream and would be accessible to all NASD members for order entry and execution against those orders. Thus, NAQcess, as proposed, would appear to make prices entered by market makers into NAQcess available, and provide equivalent access under the alternative. Therefore, a market maker that entered its best priced order into NAQcess would comply with the requirements of the ECN amendment without reflecting the order in the market maker's own quote. Moreover, a market maker that entered an order into another ECN at a price better than its quote could satisfy the requirements of the ECN amendment by entering an order reflecting this price into NAQcess, even if the other ECN does not directly provide the price to the public quotation system, because this use of NAQcess, as proposed, would meet the requirements of the amendment. Similarly, an ECN availing itself of the ECN display alternative could provide prices directly to NAQcess. The ECN and the NASD also could develop mechanisms to ensure public anonymity of market makers that use ECNs, while providing to the NASD the identity of the market makers that are at the inside quote solely for the purpose of direct order-routing between NAQcess and the market maker.

exchange-listed securities. At a minimum, these prices must be included as part of the third market quotation display and identified as originating from a named market maker or from a named ECN. For non-Rule 19c-3 securities, broker-dealers must be able to contact the ECN by telephone and have an order promptly entered into the ECN for execution. For Rule 19c-3 securities, the ECN also must be accessible through the ITS/CAES linkage, operated by the NASD, in the same manner as other third market maker quotes in those securities.<sup>275</sup>

Under the ECN display alternative, the ECN must furnish to an exchange or association the full size associated with the best priced orders placed in the ECN by market makers and specialists to buy and to sell a security. This full size requirement under the alternative is intended to give the public information about the depth of the market at the ECN prices, while maintaining the anonymity of market makers and specialists. For example, if an ECN is furnishing quotation information to Nasdaq under this alternative, and a market maker enters a 4,000-share order into the ECN at a price that is better than other market maker or specialist prices for that security in the ECN, the ECN will be required to provide Nasdaq that price and size of 4,000 shares as a quotation for public dissemination. If 2,500 shares of this order is executed, the ECN must display the remaining 1,500 shares. If two market makers enter 4,000-share orders for a security at the same price, which is the best price in the ECN for that security, the ECN is required to show all 8,000 shares publicly. In contrast, if a market maker enters a 100-share order for a Nasdaq security at the best price in the ECN for that security, the alternative requires the ECN to furnish the price for only 100 shares, even though NASD rules require Nasdaq market makers to display no less than 1000, 500, or 200 shares in Nasdaq, depending on the characteristics of that security.

The Commission recognizes that the means of providing equivalent access will vary for different markets, and that ECNs operating under the ECN display alternative that currently do not provide access to their systems to non-subscribers will have to develop methods to provide this access. Meeting this requirement may be achieved in a variety of ways, including a linkage between ECNs and one or more of the

<sup>275</sup> As discussed below concerning expansion of the ITS/CAES linkage, currently non-Rule 19c-3 securities may not be traded via the ITS/CAES linkage.

SROs. The Commission believes an SRO that accepts the prices provided by an ECN for publication should be authorized to impose reasonable rules related to the public dissemination of those prices upon market makers and specialists who avail themselves of this alternative. The rules an SRO imposes in this regard, however, may not establish standards for the dissemination of these prices that are more burdensome for market makers and specialists using ECNs than the SRO rules that apply to quotations delivered directly to the SRO by specialists and market makers.

The Commission looks forward to working closely with all market participants to effect the necessary market developments to ensure that this alternative method of compliance with the Quote Rule is made possible. In order to ensure prompt implementation of the necessary changes before the effective date of the rule amendments, the Commission requests each SRO, individually or jointly as signatories to the CQS Plan, to notify the Commission in writing by October 28, 1996 regarding its willingness and its plan to afford ECNs the opportunity to communicate, for inclusion in the public quotation system, the prices of market makers and specialists.

In order to implement the changes to the Quote Rule under new subsection (c)(5), the prices sent to an ECN by market makers and specialists will have to be displayed in the public quotations disseminated by SROs, and order routing or access linkages will have to be in place. After hearing from the SROs, the Commission will determine whether it will be necessary to use its authority under Section 11A(a)(3)(B) of the Exchange Act to require the SROs to act jointly to provide means to accomplish these objectives.

#### iv. Minimum Price Variations

In the Proposing Release the Commission recognized that there may be different minimum price variations in any given security between the SROs providing a market for the security and ECNs through which the security is also traded. Currently most exchange-listed securities tend to be quoted and traded with a minimum price variation of  $\frac{1}{8}$  point or  $\frac{1}{16}$  point.<sup>276</sup> Nasdaq securities can be publicly reported in variations as low as  $\frac{1}{64}$ , and can be quoted in

<sup>276</sup> NYSE Rule 62 provides that bids or offers in stocks selling above one dollar per share may not be made at a variation of less than one-eighth of a dollar or twelve and a half cents; Amex Rule 127 allows for one-sixteenth spreads for stocks priced under ten dollars, and one-eighth spreads for stocks priced ten dollars and over.

minimum variations as low as  $\frac{1}{32}$ , depending on the price at which the security trades.<sup>277</sup> Some ECNs allow priced orders in variations as low as  $\frac{1}{256}$ ; other systems provide for orders priced in decimals as small as one cent.

Most commenters did not address the issue of ECN minimum price variations. Some commenters that did address the issue, however, recommended that the ECN quote be rounded for public dissemination either downward from or upward to better prices in increments of  $\frac{1}{16}$  or smaller.<sup>278</sup> Other commenters recommended rounding in decimals,<sup>279</sup> while still others strongly opposed the use of decimals.<sup>280</sup> One commenter asserted that non-standard increments (*i.e.*, increments not approved by the primary market for the relevant security) should be prohibited in non-primary markets.<sup>281</sup> To address situations where the priced order in an ECN is at a non-standard increment, the Commission has determined that it is appropriate to interpret the ECN amendment to allow market makers and specialists to comply with the amendment (either individually or through the ECN) by rounding up or down to the nearest fraction accepted by the market disseminating the quote provided by the ECN.<sup>282</sup> The Commission believes, however, that rounding is appropriate only if the rounded public quotes are accompanied by an identifier that marks the quote as rounded.<sup>283</sup> Market makers, specialists, and ECNs will be permitted to round the prices of ECN buy orders

<sup>277</sup> The NASD does not have a minimum variation policy for Nasdaq stocks. Nasdaq, however, is designed to process quotes and trades in particular minimum variations.

<sup>278</sup> See, *e.g.*, NASD Letter; Lehman Letter; Instinet Letter.

<sup>279</sup> See, *e.g.*, Letter from Leslie M. Marx, Assistant Professor of Economics and Management, and Eugene Kandel, William E. Simon Graduate School of Business Administration, University of Rochester, to Commissioner Steven Wallman, SEC, dated November 27, 1995 ("Marx and Kandel Letter"), concluding that the markets should move toward decimal pricing.

<sup>280</sup> See CHX Letter.

<sup>281</sup> See Madoff Letter.

<sup>282</sup> The Commission believes this alternative is preferable to imposing particular trading increments on the markets. At the same time, however, this alternative will provide the markets with an incentive to voluntarily move towards finer trading increments.

<sup>283</sup> In order to facilitate compliance with the rule, it will be necessary for SROs to provide a means for rounded prices to include a "rounded" identifier that makes clear that a better price is available in the ECN. The Commission notes that SROs, and the public quotation system, may not currently have such a field available for identifying quotations as rounded. The Commission, therefore, requests that the SROs work jointly to modify the public quotation system to ensure that specialists, market makers, and ECNs that are disseminating rounded prices have the ability to distinguish those rounded quotes.

down to the nearest quote increment, and round the prices of ECN sell orders up to the nearest increment. For example, under this interpretation, if a market maker or specialist enters a priced buy order into an ECN at  $10^{5/16}$  and the market receiving the price from the ECN for dissemination has a minimum quote increment of  $1/8$ , a bid of  $10^{1/4}$  will be displayed in the public market and identified as a rounded price. This result reflects an SRO rule that prohibits dissemination of quotes in  $1/16$  variations. If the market maker or specialist already is bidding publicly at  $10^{1/4}$  when it enters the  $10^{5/16}$  buy order in an ECN, the market maker or specialist publishing a quote must reflect the ECN order by identifying its  $10^{1/4}$  bid as rounded.

In addition, market makers and specialists entering orders into ECNs that are reflected at rounded prices in the public quote will be expected to give their customers an execution at the superior non-rounded price. Thus, the market maker or specialist quoting a rounded price of  $10^{1/4}$  to reflect a  $10^{5/16}$  buy order must give a customer sell order an execution at  $10^{5/16}$  up to the published size. Similarly, an ECN providing market maker or specialist prices pursuant to the rounding alternative must execute an incoming order at the non-rounded price. The Commission recognizes that it may not be feasible for market makers or specialists that have not entered the rounded order into an ECN to determine, in an efficient manner, the actual price of the better order in the ECN. This may particularly be true with respect to market makers or specialists operating automated execution systems. The Commission believes that it is appropriate in such instances for such market makers and specialists that did not enter the rounded order to execute orders at the displayed rounded price.<sup>284</sup>

The Commission recognizes that this interpretation will allow prices in ECNs that are denominated in non-standard quotation increments not to be fully displayed, but believes this interpretation is appropriate to accommodate ECN prices in the existing public quotation system without imposing uniform trading increments.<sup>285</sup> The rounding identifier will inform investors that a better price is behind the rounded quote. Thus, even though the actual price cannot be readily

displayed, investors will be aware of, and will be able to obtain, the better price in the ECN or from the market maker or specialist.

#### v. Effect on the Voluntary Aspect of the Quote Rule

If an OTC market maker uses an ECN that does not rely on the alternative of communicating that market maker's best prices to the public quotation system, then the market maker must publish in its own quote that better priced order entered into the ECN. Once a market maker publishes a quote through its association to reflect a priced order it entered into an ECN, pursuant to Rule 11Ac-1(c)(5)(i)(A), it will be deemed to have elected to publish quotations in that security,<sup>286</sup> and will therefore be subject to the quotation provisions of the Quote Rule. Moreover, pursuant to certain existing SRO rules,<sup>287</sup> withdrawal of that quotation after the ECN order has been executed or withdrawn prevents the market maker from immediately reinstating quotes in that security.<sup>288</sup> As a practical matter, once electing to quote, a withdrawal then precludes the market maker from continuing to enter priced orders for the security in an ECN because of the SRO prohibition on re-entering quotes after withdrawal.

The Commission solicited comment on this aspect of the ECN proposal. Although most commenters were silent concerning this issue, certain comments indicate confusion as to the effect on market makers who currently use ECNs but who do not voluntarily quote under the existing Quote Rule.<sup>289</sup> The

<sup>286</sup> 17 CFR 240.11Ac1-1(b)(5), as amended. See also, 17 CFR 240.11Ac1-1(a)(25), 17 CFR 240.11Ac1-1(c)(4)(ii), and 11Ac1-1(c)(5)(ii), as amended, acting jointly to ensure that OTC market makers publish quotations pursuant to the Quote Rule in securities they trade via ECNs.

<sup>287</sup> See *NASD Manual*, Marketplace Rules, Rule 4600 *et. seq.*, Nasdaq Market Maker Requirements (requiring members to maintain continuous two-sided quotations in the Nasdaq securities for which they are registered as market makers). See also, ITS Plan, Section 6(A)(i)(B), Furnishing Quotations (requiring each ITS Participant to furnish the current bid-asked quotation emanating from its floor or, in the case of the NASD, the best bid and offer emanating from ITS/CAES market makers in eligible securities). Unexcused withdrawal of quotations violates these NASD rules and ITS provisions.

<sup>288</sup> This will be true even if the market maker traded less than 1% of the share volume in the security in the previous quarter because the 1% threshold of the Quote Rule for mandatory quotes would not exempt the market maker from disseminating quotes once the market maker has "elected" to quote the security by using the ECN.

<sup>289</sup> See, e.g., Madoff Letter; Instinet Letter. In its comment letter, Instinet notes that some market makers that make a continuous market in a security, but do not normally publish quotations in that security, will now be required to disseminate quotations for that security if the market maker

Commission, therefore, reiterates that the combined operation of the ECN amendment and SRO rules may require a market maker or specialist who enters an order into an ECN that does not rely on the ECN display alternative, and publishes a quote reflecting that price, to continue to publish quotes in the public market regardless of the number of shares traded by the market maker or specialist in the security during the previous quarter.

In determining whether a market participant will be required to publish quotes after entering orders in an ECN, the Commission notes that, with respect to any given security, the quote rule requirements only apply if the market participant falls within the definition of the term "OTC market maker" for that security. To be an OTC market maker, the participant must hold itself out as willing both to buy and sell on a regular or continuous basis.<sup>290</sup>

The "OTC market maker" definition is not intended to capture subscribers who enter orders into ECNs on one side of the market to limit or offset their risk, such as options market makers who use ECNs to hedge their positions in the securities underlying the options they trade. They would not be required to publish public quotes in a security simply because they had entered an order for the security into an ECN, unless they regularly or continuously hold themselves out as willing to buy and sell the security. An entity that holds itself out via contract, marketing, or other communications with its customers, as being willing both to buy and sell a specific security on a regular or continuous basis would be an "OTC market maker" for the security. This latter market maker's entry of a superior priced order into an ECN for a security that itself does not publish quotes would compel the market maker to publish a quote and potentially, depending on SRO rules, trigger on-going quotation obligations.

#### vi. Exemptive Relief

Finally, the Commission is amending Section (d) of the Quote Rule concerning exemptive relief. Under that section, the Commission previously could exempt from the provisions of the Quote Rule, either conditionally or on specified terms and conditions, any responsible broker or dealer (which now will include a specialist or market

places a priced order for that security on an ECN. The Commission recognizes this result, but notes the ECN display alternative of allowing such market makers to continue to place orders in a security into an ECN without having to directly publish quotes in that security.

<sup>290</sup> Rule 11Ac1-1(a)(8), as amended.

<sup>284</sup> See also, section III.C.2. for a discussion of best execution, *infra*.

<sup>285</sup> If primary markets in the future allow narrower quotation increments, these ECN prices between the existing quotation increments could be more accurately displayed in the public quote.

maker under the ECN amendment), exchange, or association if the Commission determined that such an exemption was consistent with the public interest, the protection of investors and the removal of impediments to and perfection of an NMS. The Commission is adding a provision allowing it to exempt an ECN from the definition in the rule. The Commission did not solicit comment on expanding its authority to grant exemptive relief in this manner. The Commission believes, however, that the added exemptive authority is appropriate because it provides flexibility in applying the ECN amendment.

### 3. Amendments to the Quote Rule Concerning Definitions

#### a. Introduction

In the Proposing Release the Commission proposed to expand the Quote Rule's existing requirements to include quotation information from broker-dealers that, while internalizing order flow, hold themselves out as willing to buy and sell on a regular or continuous basis. This expansion of the Quote Rule would be accomplished by amending the definition of OTC market maker. The Proposing Release also recommended that quotation requirements be imposed on substantial broker-dealers in non-Rule 19c-3 securities by amending the definition of subject security, and on broker-dealers in Nasdaq SmallCap securities by amending the definition of covered security.<sup>291</sup> In putting forward this proposal, the Commission noted that some dealers quote on a selective basis, choosing not to display quotes for securities that they actively trade because these securities are subject only to the voluntary quote provisions of the Quote Rule.

The amendments adopted by the Commission today are substantially the same as those proposed.<sup>292</sup> The

<sup>291</sup> OTC market makers and specialists are not required by the Quote Rule to provide continuous two-sided quotations for any Nasdaq security. As amended, an OTC market maker or specialist may make an election, pursuant to paragraph (b)(5)(i) of the Quote Rule, to collect, process, and make available quotations for Nasdaq NMS or Nasdaq SmallCap securities. The Commission is soliciting comment on a proposed amendment which would require continuous two-sided quotations from OTC market makers and specialists responsible for more than 1% of the aggregate transaction volume for a Nasdaq security. See Companion Release.

<sup>292</sup> The only substantive difference between the amendments as adopted today and as proposed is the definition of the term "OTC market maker." The definition as proposed read "\* \* \* sell to a customer \* \* \*" but has been modified to read "\* \* \* sell to its customers \* \* \*." Rule 11Ac1-1(a)(13), 17 CFR 240.11Ac1-1(a)(13). See *infra* note 308.

Commission believes these amendments will benefit investors by improving price discovery and liquidity, and increasing competition between OTC market makers and specialists. The Commission further believes that these amendments are in keeping with Congress's directive that the Commission use its rulemaking authority to remove impediments to competition.

#### b. Basis for Amendments to Rule 11Ac1-1(a)

##### i. Amendment to 11Ac1-1(a)(25) (Definition of a "Subject Security")

The Commission is amending the Quote Rule's definition of subject security to require continuous two-sided quotations from OTC market makers and exchanges that are responsible for more than 1% of the volume in a non-Rule 19c-3 security. The Commission believes that this amendment removes an impediment to competition that exists under the current rule. Broker-dealers that held themselves out as willing to buy and sell non-Rule 19c-3 securities on a regular or continuous basis were not previously required to disseminate quotation information unless they transacted the largest percentage of the aggregate trading volume in a particular security. Consequently, regardless of the volume transacted by other exchanges or OTC market makers, the primary market,

In addition to the amendments discussed in detail herein, the Commission is making technical, non-substantive amendments to the Quote Rule. The terms "association", "revised bid or offer", and "revised quotation size" will be separately defined in the rule. The definition of "exchange-traded security" has been revised to exclude OTC securities traded on an exchange pursuant to unlisted trading privileges. The definition of "plan processor" has been amended to reflect the appropriate cross-reference. The definition of "principal market" has been removed from the Quote Rule because it is no longer applicable. In addition, the definitions have been arranged in alphabetical order.

Paragraph (b)(1)(i) of the rule has been reorganized to separately set forth the exclusions in subparagraphs (A) and (B). Paragraph (b)(1)(iii) has been eliminated and the substance of the provision has been incorporated into paragraphs (b)(1)(i) and (b)(1)(ii).

The Commission is also amending the definition of the term "reported security" as it appears in Rule 11A3-1(a)(4). The amendment alters the form but not the meaning of the term or its application. The amendment will make the term consistent with the definition of "reported security" in the Quote Rule.

The amendments to Rule 11Ac1-1(a) are being adopted prospectively. Outstanding Quote Rule interpretations and no-action letters continue to be operative, to the extent that the positions taken therein are not materially in conflict with the amendments adopted today. Persons seeking clarification regarding the status of outstanding no-action letters should contact the Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission.

which was the market responsible for transacting the largest percentage of the aggregate trading volume, was the only market participant required to disseminate quotations in these securities.<sup>293</sup>

As noted in the Proposing Release, third market trading in non-Rule 19c-3 securities has increased considerably since the Quote Rule was last amended.<sup>294</sup> Third market trading in Rule 19c-3 securities now accounts for a greater number of stocks and a more substantial percentage of U.S. trading volume than it did when the Commission initially established disparate regulatory treatment under the Quote Rule for Rule 19c-3 securities and non-Rule 19c-3 securities.<sup>295</sup> In view of the growth of third market trading volume, the Commission believes that requiring all broker-dealers trading more than 1% of the volume in a listed security to publish quotations will provide more accurate and comprehensive quotation information for non-Rule 19c-3 securities.

The Commission believes that disparate regulatory requirements for Rule 19c-3 and non-Rule 19c-3 securities can no longer be justified by differences in the trading of the two types of securities. Moreover, the Commission finds that differences in regulatory treatment have impaired transparency. Because of the growth of third market trading in non-Rule 19c-3 securities, the absence of quotes revealing the substantial third market makers in a security and the prices they are prepared to publicly quote results in the consolidated quotations in the security being incomplete.<sup>296</sup> The Commission therefore believes that significant dealers in non-Rule 19c-3 securities should become subject to the same standards required for trading

<sup>293</sup> An OTC market maker or specialist, although not the principal market for a listed security, could elect to disseminate quotes for the security. Under the amended 11Ac1-1(a)(25) an OTC market maker or specialist may still elect to disseminate quotations if it is responsible for 1% or less of the volume in that security.

<sup>294</sup> Third market maker trading interest is more concentrated in non-Rule 19c-3 securities, as evidenced by the fact that the percentage of third market quotes in non-Rule 19c-3 securities (36%) is greater than that for Rule 19c-3 securities (28%). See *Fragmentation vs. Consolidation of Securities Trading: Evidence of the Operation of Rule 19c-3*, Office of Economic Analysis, SEC, at 5 (March 29, 1995) ("*Fragmentation vs. Consolidation*").

<sup>295</sup> Third market trading volume has grown, at least in part, because the universe of securities subject to Rule 19c-3 has increased considerably. For example, nearly 60% of the stocks listed on the NYSE are subject to Rule 19c-3, accounting for approximately 48% of the total NYSE volume. See *Fragmentation vs. Consolidation* at 4-5.

<sup>296</sup> See, e.g., *supra* note 294.

Rule 19c-3 securities.<sup>297</sup> As a result of this amendment, market participants will have more complete information about significant OTC market makers and specialists in a security and the prices at which they are willing to trade. The majority of commenters who addressed the amendment to Rule 11Ac1-1(a)(25) endorse the Commission's proposal to end the disparity between Rule 19c-3 securities and non-Rule 19c-3 securities, noting that there is no basis for continuing to draw a regulatory distinction between Rule 19c-3 and non-Rule 19c-3 securities, and that the extension of the Quote Rule will provide meaningful information about significant market makers in listed securities.<sup>298</sup> One commenter asserts that requiring quotations from all significant OTC market makers will succeed in improving the quality of the NMS for all listed securities while at the same time leveling the playing field for all market makers.<sup>299</sup>

Nevertheless, many commenters suggest modifications to the 1% volume threshold. Some commenters suggest that Nasdaq, on behalf of all third market makers, should be viewed as one market participant, and that once its volume exceeds 1% for a listed security, all OTC market makers in that security

<sup>297</sup> OTC market makers that trade a significant volume in non-Rule 19c-3 securities have not been subject to the same requirements as third market makers that meet the 1% threshold for Rule 19c-3 securities. For example, an OTC market maker meeting the 1% threshold is required to quote in a Rule 19c-3 security and therefore must register as a CQS market maker with the NASD. *NASD Manual*, Rule 6320. CQS market makers are subject to the NASD's CQS market maker rules, which include firm and continuous two-sided quote obligations and mandatory participation in the ITS through Nasdaq's Computer Assisted Execution System. *NASD Manual*, Rules 6320 and 6330.

<sup>298</sup> See, e.g., Amex Letter; Blume Letter; BSE Letter; CHX Letter; CSE Letter; NASD Letter; PSE Letter; Alex. Brown Letter; Schwab Letter; D.E. Shaw Letter; Dean Witter Letter; Lehman Letter; Madoff Letter; Merrill Letter; PaineWebber Letter; Salomon Letter; Smith Barney Letter; STA Letter.

There were some commenters who did not support the extension of the Quote Rule's requirements to non-Rule 19c-3 securities. See, e.g., NYSE Letter; and Specialists Assoc. Letter, which note that the Commission, rather than expanding the Quote Rule to include non-Rule 19c-3 securities, should re-examine the validity of Rule 19c-3. See, e.g., Letter from Alexander H. Slivka, Executive Vice-President, National Securities Corporation, to Jonathan G. Katz, Secretary, SEC, dated October 25, 1995 ("NSC Letter"); Fahnestock Letter; Letter from Samuel Lieberman, President, Rothschild Lieberman Ltd., to Jonathan G. Katz, Secretary, SEC ("Rothschild Letter"); Letter from Mark T. DeFelice, Vice President, Roosevelt & Cross, Inc., to Jonathan G. Katz, SEC, dated January 24, 1996 ("Roosevelt Letter"), which note that the extension of the quotation requirements to include non-Rule 19c-3, will have an impact on small firms. See *infra* note 307.

<sup>299</sup> Madoff Letter.

should be required to maintain continuous two-sided quotations.<sup>300</sup> Other commenters believe that the Commission should adopt a "continuousness of execution" standard rather than a rigid 1% volume threshold.<sup>301</sup> This suggestion would require a dealer to quote if it executes orders on a regular or continuous basis, even if it accounts for less than 1% of the volume, while excluding from quotation requirements a dealer that executes a few large trades that account for more than 1% of the volume. The NYSE suggests an additional threshold, to be used in the alternative with the 1% of volume threshold.<sup>302</sup> This alternative would have the effect of requiring public quotations from market makers who, while not accounting for more than 1% of the aggregate transaction volume, have an active retail business in small-sized trades.

The Commission believes that extending the 1% threshold based on quarterly aggregate trading volume to non-Rule 19c-3 securities is a reasonable method to improve the scope of quotation information to include significant OTC market makers and specialists. This 1% threshold, currently in effect for Rule 19c-3 securities, has proved effective in supplying comprehensive quotation information to the market at large. Moreover, based on the increase in third market trading volume for these securities, the Commission does not believe this standard is unduly burdensome on OTC market makers or specialists.<sup>303</sup> Rather, the Commission believes this threshold

<sup>300</sup> See PSE Letter; Specialists Assoc. Letter.

A comparable alternative is to require quotations from all OTC market makers who account for more than 1% of the Nasdaq-reported volume in a security. See Investors Research Letter.

In the same vein, two commenters suggest that once an OTC market maker or specialist displays a quotation in a listed security, it should be subject to the requirements of the rule. See BSE Letter; CSE Letter.

The NYSE and CSE suggest further application of the rule to include brokers and their private trading systems. See NYSE Letter; CSE Letter.

<sup>301</sup> See CHX Letter; Fahnestock Letter; Jefferies Letter; Salomon Brothers Letter; STA Letter. See also Rothschild Letter.

<sup>302</sup> NYSE Letter. See also RPM Letter; Specialists Assoc. Letter.

<sup>303</sup> The Commission seeks to avoid imposing burdens on market participants that are not necessary to achieve the Quote Rule's objective of reliable public quotations from all significant markets in a security. The Commission notes that the 1% threshold for quotations in Rule 19c-3 securities has not impaired trading in these securities. Since the Quote Rule was amended, OTC market makers' volume in Rule 19c-3 securities has increased. See *Fragmentation vs. Consolidation* at 4-5. The Commission has no reason to believe that imposing mandatory quotations on specialists and OTC market makers that are responsible for more than 1% of the volume in a non-Rule 19c-3 security will affect market making in these securities.

strikes a balance between requiring the dissemination of all quotation interest and accommodating those specialists and OTC market makers that are small entities. The Commission believes that OTC market makers and specialists that account for 1% or less of the aggregate volume are not active enough to justify the additional expense of providing continuous quotation display.<sup>304</sup>

Similarly, the Commission believes that applying the 1% threshold to the total over-the-counter volume in a listed security would extend the quotation requirements to inactive market makers. The Commission questions whether the added quotation information would justify the added burden.<sup>305</sup> The Commission also believes that reliance on something other than a numerical standard in this circumstance would lead to confusion in the marketplace. Accordingly, the Commission believes the "greater than 1% aggregate trading volume" threshold for mandatory quotations continues to be appropriate.

ii. Amendment to 11Ac1-1(a)(13) (Definition of an "OTC Market Maker")

Amended Rule 11Ac1-1(a)(13)<sup>306</sup> revises the definition of "OTC market maker" to include any dealer who holds itself out as willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size.<sup>307</sup> Accordingly, dealers that internalize customer order flow in particular stocks, by holding themselves out to customers as willing to buy and sell on an ongoing basis, would fall within the definition even though they may not hold themselves out to all other market participants. In addition, dealers

<sup>304</sup> A few commenters expressed concern that the amendment to the Quote Rule would have a detrimental impact on small firms. See Fahnestock Letter; NSC Letter; Roosevelt Letter; Rothschild Letter. The Commission believes the requirement that a dealer must transact greater than 1% of the volume in a security before quotations are mandated prevents the rule from becoming unnecessarily burdensome on small firms. For example, a firm would not have to publish continuous two-sided quotations in AT&T unless it transacted more than 1% of the aggregate transaction volume, which the Commission considers more than modest volume.

<sup>305</sup> In a related release issued today, the Commission is proposing an amendment that would require continuous two-sided quotations from OTC market makers and specialists provided that the OTC market maker or specialist is responsible for more than 1% of the aggregate transaction volume for a security included on the Nasdaq Stock Market. See Companion Release for a detailed discussion on the proposed amendment to the Quote Rule.

<sup>306</sup> 17 CFR 240.11Ac1-1(a)(13).

<sup>307</sup> The definition, as proposed, read " \* \* \* sell to a customer \* \* \* " but has been modified to read " \* \* \* sell to its customers \* \* \* . "

that hold themselves out to particular firms as willing to receive customer order flow, and execute those orders on a regular or continuous basis, also would fall within the definition of an OTC market maker.

This change was in response to the requests of commenters for consistency in the definition of OTC market maker between proposed Rule 11Ac1-1(a)(13) and proposed Rule 11Ac1-4(a)(9). See, e.g., NASD Letter. Additionally, the Commission stated in the Proposing Release that “[a]s in the past, broker-dealers will not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer’s request.” Proposing Release at 24. The Commission believes the new language more accurately reflects that premise.

Most commenters addressing this issue assert that it is appropriate to include in the definition of OTC market maker those dealers who internalize customer order flow because they believe that dealers that hold themselves out to their customers as willing to buy and sell securities on a continuous basis should be required to publish quotations.<sup>308</sup> One commenter asserts that the amendment will broaden the definition of who should be required to provide transparency and liquidity to the NMS to include dealers that transact business with other firms’ order flow and with their own customers, thus ensuring a minimum level of quotation commitment from those NMS participants vying for public order flow.<sup>309</sup> Some commenters, however, advocate that more than internalization of order flow should be required before a dealer is deemed an OTC market maker. These commenters suggest the Commission adopt some form of a “holding itself out” standard, so that the rule would capture the quotations of professional liquidity providers but not dealers that occasionally accommodate a customer’s request.<sup>310</sup> Other commenters, deeming the definition too inclusive, suggest the Commission add

an exception for broker-dealers that act solely as agents.<sup>311</sup>

One commenter believes that excluding firms that transact primarily block size orders and therefore account for significant volume is inconsistent with the Commission’s goals for increased transparency.<sup>312</sup> However, several commenters note that block size orders are excluded from the existing definition of OTC market maker and argue strongly that it is consistent with the purposes of the rule to continue to exclude them.<sup>313</sup>

The Commission believes that adoption of the amendment is warranted to ensure the availability of quotation information that accurately reflects the interests of all significant market participants. Increased transparency is fundamental to the fairness and efficiency of the securities markets. As noted in the Market 2000 Study, enhanced transparency helps link various market segments.<sup>314</sup> Currently, a dealer can receive order flow from internalization or pre-existing order routing arrangements but avoid publishing quotations, even when it accounts for more than 1% of the volume in a non-Rule 19c-3 security, because it is not currently deemed to be an OTC market maker.<sup>315</sup> Allowing significant market makers that deal actively in securities without publicizing their activity or making available their prices undermines the NMS goal of transparency. The Commission believes that those dealers should be classified under the rule as market makers and be required to publicize their quotations so that investors may know of, and trade on similar terms with, those market makers.

The Commission has considered commenters’ suggestions regarding alternative definitions. In fact, in response to the suggestions of some commenters, the Commission has modified the proposed amendment to make clear that more than an isolated transaction is necessary before a dealer is designated an OTC market maker.

The Commission, in regard to orders of block size, has determined to continue to exclude dealers that hold themselves out as only willing to deal in orders equal to or greater than 10,000 shares. Orders of block size are generally negotiated with the dealer and exposed upon execution. Block positioners usually do not maintain prices at which they are willing to buy and sell a particular security; rather, they make known their role of assisting in the purchase and sale of large positions in securities at some price. Consequently, these dealers do not function as typical dealers that maintain a regular or continuous price quote. The Commission has concluded that requiring quotations from these dealers would not provide useful price information and therefore a dealer that acts solely as a block positioner should remain excluded from the definition.

iii. Amendment to 11Ac1-1(a)(6) (Definition of a “Covered Security”)

As amended, Rule 11Ac1-1(a)(6)<sup>316</sup> defines “covered security” to include any security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Exchange Act.<sup>317</sup> This amendment would extend the Quote Rule provisions to OTC market makers and exchange specialists quoting in Nasdaq SmallCap securities.

The Proposing Release noted that the Quote Rule presently does not reflect certain developments in the Nasdaq market, including the large number of securities included on the Nasdaq SmallCap market. Only one commenter addressed this amendment. That commenter, MJT, expressed strong support for the proposal, noting that it is both fair and equitable to apply the Quote Rule to Nasdaq SmallCap securities.<sup>318</sup> The Commission believes it is appropriate to extend coverage of the Quote Rule to these securities in recognition of the development of a liquid trading market and increased investor demand for these securities. NASD rules concerning quotations already require firm quotations for both Nasdaq SmallCap securities and Nasdaq/National Market securities.<sup>319</sup> Thus, the amendment simply extends coverage of the Quote Rule requirements to the same range of securities as

<sup>308</sup> See Amex Letter; BSE Letter; CHX Letter; CSE Letter; D.E. Shaw Letter; Madoff Letter; NYSE Letter; PSE Letter; RPM Letter; SIA Letter; STA Letter.

<sup>309</sup> Madoff Letter.

<sup>310</sup> See NASD Letter; Jefferies Letter; SIA Letter; PaineWebber Letter; STA Letter. It should be noted that the amended definition includes a requirement that the broker-dealer hold itself out to, at a minimum, its customers on a regular and continuous basis in order to be an OTC market maker.

<sup>311</sup> See Fahnstock Letter; Salomon Brothers Letter; Rothschild Letter; Investors Research Letter.

<sup>312</sup> Amex Letter.

<sup>313</sup> See Fahnstock Letter; Dillon Letter; Goldman Sachs Letter; Merrill Letter; Salomon Brothers Letter.

<sup>314</sup> See Market 2000 Study at III-7.

<sup>315</sup> Although NASD rules require dealers who are registered as CQS market makers to provide quotations, registration is not mandated. A dealer in reported securities may elect to disseminate quotations by registering as a NASD market maker and “communicating” its best bids and offers to the association by entering two-sided quotations in the Nasdaq System. See *NASD Manual*, Rule 4611.

<sup>316</sup> Rule 11Ac1-1(a)(6), 17 CFR 240.11Ac1-1(a)(6).

<sup>317</sup> 15 U.S.C. 78c(a)(51)(A)(ii).

<sup>318</sup> MJT Letter.

<sup>319</sup> See *NASD Manual*, Rule 4613.

existing NASD firm quote requirements.<sup>320</sup>

c. Response to Other Specific Requests for Comments

In addition to the Quote Rule amendments discussed above, the Proposing Release solicited comment on whether: (1) revisions are necessary to an NASD rule that restricts certain computer generated quotations;<sup>321</sup> and (2) whether the ITS linkage should be expanded to allow NASD CAES members access to the linkage in non-Rule 19c-3 securities.

i. Automatic Generation of Quotations

Requiring active third market makers in non-Rule 19c-3 securities to quote also raises the issue of whether NASD members should continue to be prohibited from using computer systems to generate quotations automatically.<sup>322</sup> Currently, exchange specialists may use automated mechanisms to track the NBBO in a security if they maintain a quotation size of no more than 100 shares.<sup>323</sup> OTC market makers, however, are prohibited by NASD requirements from using automated quotation tracking systems.

The Commission requested comment on whether computer generated quotations should be permitted if active third market makers are required to quote in non-Rule 19c-3 securities, and if so, under what conditions. Commenters in favor of lifting the NASD's automated quotation ban believe that worthwhile computer generated quotes should be permitted.<sup>324</sup> For example, one

commenter stresses that a ban on all computer generated quotations impedes technological innovation, protecting the franchise of inefficient market makers at the expense of the investing public. Moreover, the commenter asserts, given the same regulatory environment, there is no reason to believe that firms that make automated markets will quote away from the market any more than firms posting quotes manually.<sup>325</sup>

Certain commenters, including the NASD, believe that the ban should continue in effect. In general, these commenters believe that lifting the ban could create systems capacity and data traffic problems, and result in useless quotations that are automatically maintained away from current market prices.<sup>326</sup>

Even commenters in favor of lifting the ban tend to believe that, while some types of computer generated quotes are appropriate, others, such as quotations automatically maintained away from the best market quotation, should not be permitted. The NASD, which generally favors the ban on automated quotes, believes it may be appropriate to revise its autoquote policy to permit a market maker to automatically update its quote to match either the best bid or best offer, provided liquidity is not withdrawn from the contra-side of the quotation. In this situation, the NASD believes a market maker will be exposed to an execution and will be genuinely contributing to market liquidity.

The Commission believes that a total prohibition on the use of computer generated quotes is not appropriate. Such an approach excessively limits the use of sophisticated trading strategies that rely on automation in the quotation process for their success, and it also may act as a competitive disadvantage to market makers and specialists that would otherwise rely on technology to meet their quotation obligations more efficiently. In the latter instance, broad prohibitions on the use of computer generated quotes may cause some market makers and specialists to restrict the number of stocks in which they are willing to make markets.

While the Commission recognizes traditional concerns related to the accessibility of computer generated quotes and the impact of such quotes on systems capacity, it believes that more can and should be done in this area. This is particularly true given the enhanced quotation obligations that will be imposed on some market participants under the revised Quote Rule. The

Commission urges the NASD, ITS Participants,<sup>327</sup> and other interested market participants to develop revised standards that would permit the use of computer generated quotes that contribute value to the market. Specifically, the Commission requests that the NASD and ITS Participants resolve this issue before the effective date of the Quote Rule amendments. In the absence of such progress, the Commission recognizes that it will consider invoking its own authority to address this issue.

ii. Expansion of ITS/CAES Access

As discussed in the Proposing Release, the uniform application of the Quote Rule to all exchange-listed securities raises the issue of the disparate treatment of Rule 19c-3 and non-Rule 19c-3 securities under the ITS Plan. The Commission solicited comment on this disparate treatment. The same issue arises with the provision allowing the use of an ECN as an intermediary in communicating quotes to the public quotation system if equivalent access is provided.

Currently, the ITS Plan provides access to the ITS System to any Participant in any Rule 19c-3 security in which the Participant disseminates continuous two-sided quotations, but excludes OTC market makers from ITS access for non-Rule 19c-3 securities. In the past, market makers in non-Rule 19c-3 securities were not subject to mandatory quote requirements. The amendments to the Quote Rule adopted today will subject OTC market makers and exchange specialists to the same quotation requirements for all exchange-listed securities.

The Commission requested comment on whether the Quote Rule amendments justify an expansion of the linkage between ITS and the NASD's CAES interface to provide ITS access to and from any market maker for any exchange-listed security in which that market maker disseminates continuous two-sided quotations. Numerous commenters support expanding the linkage in this manner because they believe an expansion will enhance fair competition and increase opportunities

<sup>320</sup> Section 11A(c)(1) of the Exchange Act grants the Commission the authority to prescribe, among other matters, rules and regulations to assure accurate and reliable quotations "with respect to any security other than an exempted security." The Commission believes that extending the requirements of the Quote Rule to Nasdaq SmallCap securities will further these interests. No new costs should be imposed on market participants because the NASD rules concerning quotations already treat Nasdaq/National Market and SmallCap securities similarly.

<sup>321</sup> NASD Manual, Rule 6330. The NASD, however, provides an automated quotation update capability ("auto-refresh") as part of the Small Order Execution System which market makers may elect to use. Specifically, the quote of a market maker using auto-refresh will be automatically updated when the market maker exhausts its exposure limit in the NASD's Small Order Execution System.

<sup>322</sup> See *supra* note 288, concerning the impact of the ECN amendment to the 1% rule.

<sup>323</sup> The 100-share limitation follows the ITS Plan requirement that no ITS Participant may use an automated computer tracking system to generate quotes for more than 100 shares in any security the Participant trades through the ITS system.

<sup>324</sup> See, e.g., BSE Letter; CSE Letter; D.E. Shaw Letter; Investors Research Letters; Lehman Letter; Madoff Letter; Merrill Letter; NSC Letter; NYSE Letter; Smith Barney Letter.

<sup>325</sup> D.E. Shaw Letter.

<sup>326</sup> See, e.g., Dean Witter Letter; NASD Letter; PSE Letter; RPM Specialist Letter.

<sup>327</sup> The ITS Plan also places certain restrictions on the use of computer generated quotes. See *supra* note 323. Given the technologies that have developed during the nearly 20 years that these ITS Plan restrictions have been in place, the Commission requests that the ITS Participants review these limitations and whether they continue to be appropriate, in whole or in part, and whether new limitations should replace the existing provisions or whether there should be any ITS Plan limitations on automated quotes.

for best execution.<sup>328</sup> Several commenters also assert that arguments previously made to exclude OTC market maker quotes in non-Rule 19c-3 securities from ITS are no longer valid.<sup>329</sup>

One commenter specifically argues that adoption of the Commission's proposals should end any objection to the NASD's full participation in ITS because the operation of the Quote Rule will reduce opportunities for OTC market makers to trade in ECNs while simultaneously availing themselves of the voluntary aspect of the Quote Rule, and therefore, will expand the imposition of NASD quotation requirements upon OTC market makers. These requirements, according to the commenter, are equal to those of any other market and add greater transparency and liquidity to the markets for exchange-listed securities as well as the NMS.<sup>330</sup>

Those commenters opposed to the expansion generally believe that the existing limitation on ITS access is justified in view of disparities in customer protections afforded by exchanges and exchange members when compared to customer protections mandated by NASD rules.<sup>331</sup>

The Commission recognizes that the expansion of ITS/CAES is a significant issue of concern to many market participants. The Commission therefore encourages a continuing dialogue among the ITS Participants to solve this issue on a timely basis and in a manner beneficial to the market as a whole.

#### d. Operation of the Rule With Amended Definitions

##### i. Amendment to 11Ac1-1(a)(25) (Definition of a "Subject Security")

As a result of the amendment adopted today, OTC market makers and exchange specialists who hold themselves out as willing to buy and sell non-Rule 19c-3 securities on a regular or continuous basis, and that account for more than 1% of the quarterly aggregate trading volume, will be subject to the Quote Rule and required to make continuous two-sided quotations available to the public, even

<sup>328</sup> See, e.g. D.E. Shaw Letter; Investors Research Letter; Lehman Letter; NASD Letter; NSC Letter; Madoff Letter; Rothschild Letter; Schwab Letter; STA Letter.

<sup>329</sup> See, e.g., Madoff Letter.

<sup>330</sup> *Id.* Madoff states that the NASD now requires every OTC market maker to conform with NMS principles, respect all other NMS quotations in listed securities, and not trade through better quotes in the NMS. Madoff further notes that, in contrast, exchanges do not impose similar restrictions with respect to trading through off-exchange quotations.

<sup>331</sup> See Amex Letter; BSE Letter; CHX Letter; CSE Letter; PSE Letter; Specialists Assoc. Letter.

if they have not previously elected to register as CQS market makers with the NASD. This amendment will close a significant gap in the quotation information that has been available heretofore to market participants and investors. In a parallel action, the Commission is proposing for comment an additional amendment to the Quote Rule.<sup>332</sup> The Commission believes that the additional proposal, if adopted, would further improve transparency by providing investors with quotation information on Nasdaq securities from significant OTC market makers and specialists.

##### ii. Amendment to 11Ac1-1(a)(13) (Definition of an "OTC Market Maker")

The definition of OTC market maker now includes any dealer holding itself out as willing to transact business for its own account on a regular or continuous basis, whether it transacts exclusively with its own customers or with the customers of other dealers. Those dealers that hold themselves out to customers as willing to execute orders on a regular or continuous basis, whether by the internalization of customer order flow in particular stocks or through arrangements with particular firms to execute their customer order flow, now fall within the definition of OTC market maker. Therefore, obligations under the Quote Rule will now apply to dealers that internalize customer order flow or hold themselves out to particular firms as willing to execute their customer order flow, and that execute those orders on a regular or continuous basis. As in the past, broker-dealers will not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer's request.

##### iii. Amendment to 11Ac1-1(a)(6) (Definition of a "Covered Security")

The amendment extends the coverage of the Quote Rule to all Nasdaq securities where the rule had previously applied only to Nasdaq/National Market securities. As noted previously, NASD rules already require a dealer that makes a market in a Nasdaq SmallCap security to provide quotations.<sup>333</sup> The Commission, therefore, does not believe extending the Quote Rule to include securities covered by an existing NASD rule will result in additional burdens on OTC market makers. Although the definition of covered security has been amended to include Nasdaq SmallCap

securities, an exchange specialist or OTC market maker still must make an election, pursuant to paragraphs (b)(5)(i) and (ii), respectively, of the Quote Rule.<sup>334</sup> Accordingly, although the definition has been amended, an OTC market maker or specialist is not mandated by the Quote Rule to provide quotations on Nasdaq SmallCap securities. If, however, an exchange specialist or OTC market maker makes an election to make available quotations, the firmness obligations under paragraph (c) of the Quote Rule become operative.

#### e. Effective Date

The amendments to Rule 11Ac1-1 adopted by the Commission today will become effective on January 10, 1997.

### C. Price Improvement for Customer Market Orders

#### 1. Proposed Rule

In the Proposing Release, the Commission sought comment on a market-wide Price Improvement Rule for customer market orders. The proposed rule was designed to apply across exchange and OTC markets to promote the execution quality of orders by providing increased opportunities for customer orders to interact at better prices without the intervention of a dealer. The proposal included a non-exclusive safe harbor as one means by which a specialist or OTC market maker could be assured that an order received a sufficient opportunity for price improvement for purposes of the rule.

The proposed rule was intended to encourage market participants to take advantage of current technologies and provide customer market orders with improved access to price improvement opportunities, regardless of where such orders are routed for execution. Although the proposed rule would have required specialists and OTC market makers to provide price improvement opportunities for customer orders, the Commission did not prescribe any particular method of achieving price improvement in recognition of the fact that competition can produce innovative price improvement mechanisms. The Commission proposed a non-exclusive safe harbor, however, to provide certainty regarding one alternative by which a specialist or OTC market maker would be deemed to have satisfied its price improvement obligation.

Under the safe harbor, a specialist or OTC market maker would have been deemed in compliance with the

<sup>332</sup> See Companion Release.

<sup>333</sup> See NASD Rule 4613.

<sup>334</sup> 17 CFR 240.11Ac1-1(b)(5)(i)



proposed price improvement rule if it exposed, in its quote, a customer market order at an improved price and provided the customer with a guaranteed execution at the "stop" price.<sup>335</sup> This procedure was designed to promote the interaction of exposed orders at prices better than the NBBO with orders or trading interest in other markets. The safe harbor also was intended to lead to increased competition by encouraging specialists and OTC market makers to compete more actively for order flow on the basis of their published quotations. The Commission made clear, however, that the order exposure procedures set out in the proposed safe harbor neither would be mandatory, nor the exclusive means by which to satisfy the obligation to provide an opportunity for price improvement.

Many of the 145 commenters discussed the proposed Price Improvement Rule. The commenters raise numerous questions and concerns regarding the proposed rule. For example, some commenters claim that an absolute rule would reduce the broker-dealer's fiduciary obligation of best execution to an algorithm, eliminating the exercise of professional judgment in identifying price improvement opportunities.<sup>336</sup> Instead, the commenters argue that customers and market professionals should be able to use discretion in deciding when and how price improvement should be sought.<sup>337</sup>

In addition, several commenters are concerned that the proposed safe harbor would become the industry standard. These commenters believe that, although non-exclusive, the proposed safe harbor would dictate the minimum acceptable standard to follow, thereby stifling innovation and competition.<sup>338</sup> Many commenters also are troubled by various technical aspects regarding the application of the safe harbor. For

<sup>335</sup> The proposed safe harbor provided for an order to be "stopped" at the national best bid (for a sell order) or offer (for a buy order) for the lesser of either the full size of the order, or the size associated with the national best bid (for a sell order) or offer (for a buy order).

<sup>336</sup> See, e.g., Goldman Sachs Letter; Jefferies Letter; Madoff Letter; Merrill Letter; NYSE Letter; PaineWebber Letter; PSE Letter.

<sup>337</sup> See, e.g., CSE Letter; Goldman Sachs Letter; Madoff Letter; Merrill Letter; NSC Letter; NYSE Letter; PSE Letter.

<sup>338</sup> See, e.g., AZX Letter; Blume Letter; HHG Letter; Lehman Letter; Merrill Letter; Morgan Stanley Letter; NASD Letter; Salomon Letter; Schwab Letter; Smith Barney Letter; PaineWebber Letter; Ruane Letter.

Some commenters believe their current operations would satisfy the rule and, therefore, they would not need to utilize the safe harbor procedures. See, e.g., Amex Letter; BSE Letter; CHX Letter; NYSE Letter; PSE Letter.

example, some commenters believe the 30-second exposure period would be insufficient to allow other market participants to respond to the exposed order, even with today's technology.<sup>339</sup> Other commenters are concerned with the mechanics of the "stopping" procedures.<sup>340</sup> At least one commenter argues that the requirement to stop stock blurs the distinction between price guarantees and price improvement opportunities.<sup>341</sup>

The potential costs associated with the proposed rule also concern many commenters. They claim that necessary systems upgrades would be expensive.<sup>342</sup> In addition, several commenters claim that the number of quotes generated as a result of the safe harbor would pose a serious threat to system capacity.<sup>343</sup> Many commenters warn that the increased traffic would reduce trading efficiency, decrease transparency and increase overall risk.<sup>344</sup> Some commenters also state that market price integrity would be reduced due to the proliferation of flickering, ephemeral quotations.<sup>345</sup>

A common suggestion from the commenters is that the Commission not adopt the proposed rule prior to evaluating the effects of the other initiatives contained in the proposal.<sup>346</sup> Some commenters believe that the amendments to the Quote Rule and the proposed Limit Order Display Rule should act to narrow spreads by eliciting the true market for a given security, thereby decreasing the utility and necessity of seeking better prices for customer orders. According to these commenters, if such results are achieved through the other initiatives, the

<sup>339</sup> See, e.g., Amex Letter; Blume Letter; BSE Letter; CHX Letter; CSE Letter; NYSE Letter; PSE Letter; Schwab Letter; *But see, e.g.,* Letter from Raymond E. Wooldridge, Chief Executive Officer, Southwest Securities, to Mr. Jonathan G. Katz, Secretary, SEC, dated January 9, 1996 ("Southwest Letter"); STANY Letter.

<sup>340</sup> See, e.g., Madoff Letter; MJT Letter; Smith Barney Letter.

<sup>341</sup> See Sutro Letter.

<sup>342</sup> See, e.g., Blume Letter; Dean Witter Letter; Fahnstock Letter; Goldman Sachs Letter; LJR Letter; NASD Letter; PaineWebber Letter; Ruane Letter; Salomon Letter; Schwab II Letter; SIA Letter.

<sup>343</sup> See, e.g., Bear Stearns Letter; FIF Letter; Merrill Letter; PSE Letter; STANY Letter.

<sup>344</sup> See, e.g., Amex Letter; Bear Stearns Letter; Blume Letter; FIF Letter; LJR Letter; Madoff Letter; Merrill Letter; Morgan Stanley Letter; NASD Letter; PSE Letter; Salomon Letter; STA Letter; STANY Letter; Specialist Assoc. Letter.

<sup>345</sup> See, e.g., Dean Witter Letter; ICI Letter; Merrill Letter; Morgan Stanley Letter; NASD Letter; NYSE Letter; PSE Letter; Salomon Letter; Schwab II Letter; Specialist Assoc. Letter; STANY Letter.

<sup>346</sup> See, e.g., Bear Stearns Letter; Dean Witter Letter; DOJ Letter; Goldman Sachs Letter; Lehman Letter; Madoff Letter; Morgan Stanley Letter; NASD Letter; NSC Letter; Schwab II Letter; SIA Letter; Sutro Letter.

potential costs and significant market operations changes associated with the proposed Price Improvement Rule would far outweigh any potential benefit.

Although the Commission continues to believe that the opportunity for price improvement can contribute to providing customer orders with enhanced executions, the Commission has determined to defer action on the proposed Price Improvement Rule for the present time. The Commission believes that the other initiatives adopted today will greatly improve the price discovery process and the opportunity for customer orders to receive enhanced execution prices. These initiatives should act to narrow spreads by making available to all market participants the true buying and selling interest in a given security. The Commission believes, therefore, that the most appropriate course of action is to monitor the operation of the initiatives adopted today, and assess their impact on spreads, the quality of markets, and the quality of executions. This assessment will enable the Commission to better determine the need for further Commission action regarding specific price improvement obligations.

## 2. Best Execution Obligations

The proposed Price Improvement Rule was designed to complement the long-standing duties of broker-dealers to seek to obtain best execution of their customer orders; the Commission did not intend for the proposed rule to modify this existing best execution obligation.<sup>347</sup> Therefore, the Commission's decision to defer consideration of the proposed rule in no way should be taken as an indication that the duty of best execution has been altered.

A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated both in SRO rules and, through judicial and Commission decisions, in the antifraud provisions of the federal securities laws.<sup>348</sup> This duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.<sup>349</sup> The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including

<sup>347</sup> Proposing Release at 49.

<sup>348</sup> See Market 2000 Study, Study V at V-1, 2 and sources cited therein.

<sup>349</sup> See Market 2000 Concept Release, *supra* note 10; Market 2000 Study, Study V.

opportunities to trade at more advantageous prices. As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become "reasonably available."<sup>350</sup>

In the past the Commission has recognized the practical necessity of automating the handling of small orders, and has indicated that automated routing or execution of customer orders is not necessarily inconsistent with best execution.<sup>351</sup> At the same time, the Commission has emphasized that best execution obligations require that broker-dealers routing orders for automatic execution must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.<sup>352</sup> While in the past quote-based executions in OTC securities were generally recognized as satisfying best execution obligations, the development of efficient new facilities has altered what broker dealers must consider in seeking best execution of customer orders.<sup>353</sup> The Commission thus noted the importance of the opportunity for price improvement as a factor in best execution, speaking in the context of aggregate order handling decisions for both listed and OTC stocks.<sup>354</sup> Therefore, the Commission believes that routing order flow for automated execution, or internally executing order flow on an automated basis, at the best bid or offer quotation, would not necessarily satisfy a broker-dealer's duty of best execution for small orders in listed and OTC securities.<sup>355</sup>

Both the rule and the amendments adopted today should further improve a broker-dealer's ability to obtain improved executions for customer orders. These changes will enhance the public quote by including in the public quotation system many superior prices not currently reflected there. The ECN amendment is intended to publicize superior market maker ECN prices in

the public quote, which should make these prices more easily accessible. Similarly, the Display Rule will include more customer prices in the public quote through requiring the display of customer limit orders.

Nonetheless, various markets and market makers may continue to provide opportunities for executions at prices superior to the enhanced national best bid and offer for their customer orders.<sup>356</sup> For example, some markets or market makers may continue to offer price improvement opportunities, based on internal order flow or execution algorithms. The Commission believes that broker-dealers deciding where to route or execute small customer orders in listed or OTC securities must carefully evaluate the extent to which this order flow would be afforded better terms if executed in a market or with a market maker offering price improvement opportunities. In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security.<sup>357</sup> If different markets may be more suitable for different types of orders or particular securities, the broker-dealer will also need to consider such factors.

Where material differences exist between the price improvement opportunities offered by markets or market makers, these differences must be taken into account by the broker-dealer. Similarly, in evaluating its procedures for handling limit orders, the broker-dealer must take into account any material differences in execution quality (e.g., the likelihood of execution) among the various markets or market centers to which limit orders may be routed. The traditional non-price factors affecting the cost or efficiency of executions also should continue to be considered;<sup>358</sup> however, broker-dealers must not allow an order routing inducement, such as payment for order flow or the opportunity to trade with that order as principal, to interfere with its duty of best

execution.<sup>359</sup> Of course, as the Commission has previously noted, in light of a broker-dealer's obligation to assess the quality of the markets to which it routes packaged order flow absent specific instructions from customers, the Commission does not believe that a broker-dealer violates its best execution obligation merely because it receives payment for order flow or trades as principal with customer orders.<sup>360</sup>

Prices superior to the public quote may at times be available in ECNs, even after adoption of the ECN amendment, based, for example, on orders of institutional participants and others not covered by the ECN amendment. Superior prices also may be available in other systems not classified as ECNs. As the Commission noted in the Proposing Release in September, 1995, and reiterates today, where reliable, superior prices are readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders.<sup>361</sup> The Commission recognizes that many of these systems are less accessible and involve higher costs for broker-dealers than the public markets. In addition, in many cases it is not currently feasible to efficiently obtain price information from these systems or link to these systems on an automated basis. The Commission is not suggesting that broker-dealers must engage in manual handling of small orders if necessary to access these systems.<sup>362</sup> Nonetheless, the Commission believes that because technology is rapidly making these systems more accessible, broker-dealers must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for purposes of seeking best execution of these customer orders. For example, if an ECN provides an automated link that makes it cost effective for a broker-dealer to access these systems for its retail orders on an automated basis, the broker-dealer must take the prices and other relevant costs in that system into account in handling these customer orders.

Pursuant to the Display Rule, most customer limit orders at superior prices will be required to be displayed and

<sup>350</sup> Proposing Release at 7-10.

<sup>351</sup> *Id.* at 8.

<sup>352</sup> Payment for Order Flow Release, *supra* note 23, at n. 30 and accompanying text; See Securities Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322 (April 5, 1996) ("CSE Approval Order"); Securities Exchange Act Release No. 37045 (March 29, 1996), 61 FR 15318 (April 5, 1996) ("BSE Approval Order").

<sup>353</sup> Proposing Release at 10.

<sup>354</sup> *Id.*; see also Payment for Order Flow Release, *supra* note 23 at text accompanying notes 31-33. See CSE Approval Order, *supra* note 352; BSE Approval Order, *supra* note 352.

<sup>355</sup> Proposing Release at 9-10; see also note 360 and accompanying text (factors relevant to best execution).

<sup>356</sup> *Id.*

<sup>357</sup> CSE Approval Order, 61 FR at 15329. "Price improvement" in this context is defined as the difference between execution price and the best quotes prevailing in the market at the time the order arrived at the market or market maker. Any evaluation of price improvement opportunities would have to consider not only the extent to which orders are executed at prices better than the prevailing quotes, but also the extent to which orders are executed at inferior prices.

<sup>358</sup> See Market 2000 Study, Study V at V-2, 3.

<sup>359</sup> Payment for Order Flow Release, *supra* note 23.

<sup>360</sup> *Id.*

<sup>361</sup> Proposing Release at 10.

<sup>362</sup> The Commission has recognized that it may be impractical, both in terms of time and expense, for a broker that handles a large volume of orders to determine individually where to route each order it received. Proposing Release at 8.

included in the public quote.<sup>363</sup> The display of a limit order by a market maker directly affects its responsibilities in handling other customer orders. The Commission has long said that broker-dealers must consider quotation information contained in the public quotation system in seeking best execution of customer orders.<sup>364</sup> In executing customer market orders, a market maker must give no less consideration to the price of its own displayed customer limit order than any other public quotation price. Therefore, under the new Display Rule, a market maker that has displayed a customer limit order would be expected to provide an offsetting customer market order an execution at that limit price at least up to the size of the limit order.

In addition, the Commission notes that currently, some market makers that hold a customer limit order on one side of the market, priced better than the market maker's own quote, and a customer market order on the other side of the market, will execute both orders as principal rather than crossing the two orders. As a result, the market order customer receives the best bid and offer rather than receiving the benefit of a better limit order price. In light of the increased opportunities for price improvement now available and the rules the Commission is adopting today, the Commission believes that going forward this practice is no longer appropriate given the broker-dealer's obligation, as part of its duty of best execution, to its market order customer.<sup>365</sup>

In conclusion, although the Commission has determined for the present to defer final action on the proposed Price Improvement Rule, the Commission's adoption of the Display Rule and the Quote Rule amendments should substantially improve public quotations. Moreover, the Commission firmly believes that broker-dealers, when deciding where to route or execute customer orders, must carefully consider and evaluate opportunities for obtaining improved executions.

#### IV. Authority

As discussed above, the 1975 Act Amendments to the Exchange Act set

<sup>363</sup> The Commission notes that the NASD's interpretation prohibiting market makers from trading ahead of customer limit orders applies both to displayed and nondisplayed customer limit orders held by the market maker. See NASD Conduct Rule IM 2110-2 (Trading Ahead of Customer Limit Orders).

<sup>364</sup> See Quote Rule Adopting Release, *supra* note 208.

<sup>365</sup> *Cf.*, NASD Notice to Members 96-10 (February, 1996) at 43; NASD Notice to Members 95-67 (August, 1995) at 417.

forth Congress' goals for a national market system. Several commenters argue that the proposed rules violate Congress's direction that the Commission facilitate the establishment of, rather than design, a national market system.<sup>366</sup> Many of these comments were directed at the proposed Price Improvement Rule and in particular the proposed price improvement safe harbor. The Commission today is deferring action on that rule proposal. To the extent that the comments relate to the rule and amendments adopted today, however, they reflect a fundamental misunderstanding regarding the purpose of the rules and the Commission's role in facilitating a national market system.

The Commission's adoption of these rules is fully consistent with the role that Congress envisioned in 1975 for the Commission. Congress's direction to the Commission to "facilitate" the establishment of a national market system for securities that implemented Congressionally enumerated objectives was not intended as a limitation on the Commission's authority but rather was "designed to provide maximum flexibility to the Commission and the securities industry in giving specific content to the general concept of the national market system."<sup>367</sup> Congress granted the Commission broad rulemaking authority over the national market system and market participants and this grant of specific rulemaking authority was not conditioned on the expectation that the Commission refrain from using it.

Although Congress expressed a preference that where possible the national market system evolve through the interplay of competitive forces, it recognized that "competition may not be sufficient" and that in such cases, the Commission should act "promptly and effectively to insure that the essential mechanisms of an integrated secondary trading system [be] put into place \* \* \*."<sup>368</sup> Congress specifically

<sup>366</sup> See, e.g., ABA Letter; Fahnestock Letter; HHG Letter; LJR Letter; NSC Letter; PaineWebber Letter; RPM Letter; Ruane Letter; SIA Letter.

<sup>367</sup> Conference Report, *supra* note 213, at 92. See Senate Report, *supra* note 31, at 8-9 ("the sounder approach appeared \* \* \* to be to establish a statutory scheme clearly granting the Commission broad authority to oversee the implementation, operation, and regulation of the national market system and at the same time to charging it with the clear responsibility to assure that the system develops and operates in accordance with Congressional determined goals and objectives."). The Conference Committee report on the 1975 Act Amendments indicates that the conferees adopted with minor revisions the Senate's provisions concerning the national market system. Conference Report, *supra* note 213, at 92.

<sup>368</sup> Conference Report, *supra* note 213 at 92.

identified in 1975 some of the concerns addressed today and the Commission has examined these issues on several occasions over the intervening years in response to evolving market conditions and technologies. In view of the caution and deliberation with which the Commission has proceeded over the past 21 years, its actions today cannot fairly be viewed as arresting natural competitive forces, but rather should be regarded as an attempt to foster efficiency and redress shortcomings in the national market system that have developed since then, or that the securities industry on its own has been unable to resolve over this time.

The subject matter of these rule and rule amendments is an area of the national market system in which Congress itself recognized that the Commission's expertise and authority were paramount. Indeed, Section 11A was specifically enacted to eliminate "arguments about the SEC's authority" in this area. For that reason, the Commission was given "pervasive rulemaking power" with respect to the business of collecting, processing, or publishing information relating to quotations for and transactions in securities.<sup>369</sup> The rules adopted today implement Congress' goals as to dissemination of trading information: "to insure the availability of prompt and accurate trading information, to assure that these communications networks are not controlled or dominated by any particular market center, to guarantee fair access to such systems by all brokers, dealers and investors, and to prevent any competitive restriction on their operation not justified by the purposes of the Exchange Act."<sup>370</sup>

It bears noting that the standards adopted by the Commission today are intended to allow markets to adapt and evolve in meeting the objectives of the national market system; the rules establish performance standards but do not dictate market structure. With regard to the Quote Rule, the rules do not determine how non-Rule 19c-3 market makers may make markets or how electronic communications networks may operate. Non-Rule 19c-3 market makers are free to operate as they please so long as they report their quotations to the extent they execute a certain level of volume in a security. Likewise, market makers and specialists may place priced orders in ECNs of many different designs as long as they change their quotes to reflect the orders in the ECN or the ECNs publicly report the quotes and provide access to such

<sup>369</sup> Conference Report, *supra* note 213, at 93.

<sup>370</sup> Senate Report, *supra* note 31.

priced orders. With regard to the Limit Order Display Rule, the rule does not seek to create a central limit order book or central limit order file. Broker-dealers are free to satisfy the rule in several different ways, so long as the result is that customer limit orders priced at or better than the NBBO are publicly displayed.

Some commenters also argue that the proposed rules are contrary to Congress' direction to assure fair competition between auction and dealer markets as structures for the trading of securities<sup>371</sup> and inappropriately introduce auction market principles into dealer markets. Although requiring display of superior-priced customer limit orders could be viewed as an auction market principle, such a requirement does not supplant the basic features of a dealer market or undermine competition between the exchange and OTC markets. Congress clearly intended that dealer markets would benefit from use of some auction market principles<sup>372</sup> and the 1975 Amendments specifically announce as a goal of the national market system that customer orders be able to interact without the intervention of a dealer to the extent that such a goal is consistent with other national market system objectives.<sup>373</sup> At a minimum, where feasible, customer limit orders should have a meaningful opportunity to interact with customer market orders.<sup>374</sup>

One of the main benefits contemplated by Congress was that the national market system would enable investors in dealer markets to execute against another limit order or market order at a better price than currently being quoted by a dealer for his own account.<sup>375</sup> Display of superior-priced limit orders would permit investors to compete in some cases with market makers and specialists, thereby increasing the competitiveness of dealer markets in these securities and enhancing the quality of customer limit order execution. Display of customer limit orders, however, would not compromise the essential features of dealer markets. In the absence of any superior-priced customer limit orders, dealers would continue to compete for market orders at their published quotations and would be able to execute against customer limit orders that would otherwise prevent the market maker

from trading with a market order. Further, the widespread use by OTC dealers of ECNs to trade at prices better than the dealers' published quotes is of such recent vintage that it can hardly be viewed as a necessary part of a dealer market structure.<sup>376</sup>

#### V. Summary of Final Regulatory Flexibility Act Analysis

This following discussion summarizes the Commission's analysis of the rules adopted today under the Regulatory Flexibility Act. A complete final copy of the Final Regulatory Flexibility Act is available in the Public File.

The rules adopted today by the Commission are intended to allow markets to adapt and evolve in meeting the objectives of the national market system. In this regard, the rules establish performance standards but do not dictate market structure. The Quote Rule does not dictate how market makers or specialists that trade non-Rule 19c-3 securities may conduct their market making activities or how ECNs may service their subscribers. Market makers will be able to continue their regular market making activities so long as they report their quotations if they trade more than 1% of the transaction volume in a security. Likewise, market makers and specialists may place priced orders in ECNs of many different designs as long as they change their quotes to reflect better priced orders they have entered in ECNs or, alternatively, such ECNs provide for the public reporting of these prices and provide access to such priced orders. Moreover, broker-dealers are free to satisfy the Display Rule in several different ways, so long as the result is that customer limit orders priced at or better than the NBBO are publicly displayed in accordance with the rule.

##### A. Display Rule

The Commission considered several significant alternatives to Rule 11Ac1-4 consistent with the Rule's objectives and designed to minimize the impact of the rule on small entities. The Commission solicited comment on, among other things: (i) Whether the display requirement should be based on a *de minimis* threshold; (ii) the classes of securities to which the Rule should apply; (iii) whether to permit limit orders to be delivered to an exchange-

or association-sponsored system that displays limit orders in accordance with the rule; and (iv) whether to permit limit orders to be delivered to an ECN or a PTS. The Commission believes that the rule as adopted imposes a smaller burden upon small brokers and dealers than do other alternatives considered.

The Commission believes that the ability of brokers and dealers to send a limit order to another party or system that will display that order provides all brokers and dealers, including small brokers and dealers, with the greatest possible flexibility to satisfy the NMS objectives embodied in the rule in the most economical manner. In this regard, the Commission decided to expand one of the exceptions to the display requirement that will permit market makers to comply with the rule by delivering customer limit orders to an ECN that complies with the ECN amendment to the Quote Rule. Furthermore, the Commission added a new exemptive provision that enables the Commission to exempt any responsible broker or dealer, ECN, exchange, or association from the requirements of the Display Rule.

The Commission considered allowing display of a representative size of a limit order rather than the full size, but concluded that display of the full size will provide the most accurate picture of the depth of the market at a particular price. The Commission does not believe that it is practicable to exempt small entities from the Display Rule because to do so would be inconsistent with the Commission's statutory mandate to protect investors. In that regard, the Commission believes that the pricing and size conventions documented in the 21(a) Report referenced above make it imperative that the requirements of the Display Rule apply to all market participants with equal force. The Commission notes that any exception for small brokers and dealers could create an incentive for Nasdaq market makers to create special market making subsidiaries qualifying as small broker-dealers which would be free to engage in the anti-competitive practices identified in the 21(a) Report.

##### B. Quote Rule

Allowing market makers that deal actively in securities without publicizing their activity or making available their prices undermines the NMS goal of transparency. The Commission believes that those dealers should be recognized as market makers and their quotations publicized so that investors may know of, and trade on similar terms with, those market makers. Therefore, the definition of OTC

<sup>371</sup> See, e.g., Goldman Sachs Letter; Jefferies Letter; Merrill Lynch Letter; RPM Letter; Schwab I Letter; Schwartz & Wood Letter; SIA Letter; Specialist Assoc. Letter; see also Exchange Act Section 11A(a)(1)(C)(ii), 15 U.S.C. 78k-1(a)(1)(C)(ii).

<sup>372</sup> Senate Report, *supra* note 31, at 16.

<sup>373</sup> Exchange Act Section 11A(a)(1)(C)(v).

<sup>374</sup> Exchange Act Section 11A(a)(1)(C)(v).

<sup>375</sup> Senate Report *supra* note 31, at 16.

<sup>376</sup> While the rule and rule amendments adopted today function as an integrated response to the problems the Commission has identified in the implementation of a NMS, each separately advances the Congressional goals of market efficiency, fair competition, transparency, and best execution, and accordingly the Commission intends that they be treated as severable for purposes of review.

market maker now includes any dealer holding itself out as willing to transact business for its own account on a regular or continuous basis, whether it transacts exclusively with its own customers or with the customers of other dealers. Thus, those dealers that internalize customer order flow in particular stocks or through arrangements with other firms to execute that order flow, now fall within the definition of OTC market maker and are subject to the obligations under the Quote Rule. As in the past, broker-dealers will not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer's request. In response to the suggestions of some commenters, the Commission has modified the amendment to make clear that more than one isolated transaction is necessary before a dealer is designated an OTC market maker.

In addition, the Commission believes that extending the 1% threshold based on quarterly aggregate trading volume to non-Rule 19c-3 securities is a reasonable method to improve the scope of quotation information to include significant OTC market makers and specialists. This 1% threshold, currently in effect for Rule 19c-3 securities, has proved effective in supplying comprehensive quotation information to the market at large. Moreover, based on the increase in third market trading volume for these securities, the Commission does not believe this standard is unduly burdensome on OTC market makers. Rather, the Commission believes this threshold strikes a balance between requiring the dissemination of all quotation interest and accommodating those specialists and OTC market makers that may be small entities. The Commission believes that OTC market makers and specialists that account for 1% or less of the aggregate volume are not active enough to justify the additional expense of providing continuous quotation display. Accordingly, the Commission believes the "greater than 1% aggregate trading volume" threshold for mandatory quotations continues to be appropriate. To limit a possible inconsistency in the treatment of exchange-listed and Nasdaq securities, the Commission today is proposing that the 1% test be extended from all exchange-listed securities to all Nasdaq-listed securities.

The Commission considered several significant alternatives to the proposed amendments to the Quote Rule consistent with the Rule's objectives and designed to minimize the impact of

the amendments on small entities. The Commission solicited comment on numerous alternatives to the amendments proposed to ensure that investors receive consolidated quotations that truly reflect the best prices available for a security. The Commission solicited comment on, among other issues: (i) Whether the Commission should require SROs to amend their rules to permit computer-generated quotations; (ii) whether there existed alternatives to the ECN proposal that minimized certain consequences of the rule while assuring public dissemination of the best priced orders in such systems; (iii) whether there should be exceptions to the ECN proposal and under what circumstances; and (iv) whether the objectives of the Quote Rule and the ECN amendment could be achieved by allowing ECNs to furnish prices to the applicable SRO, while providing access to the prices in their ECN. The Commission believes that the amendments as adopted impose a smaller burden upon small brokers and dealers than does any other alternative considered.

In recognition of the concerns raised by some commenters, the ECN display alternative is designed to preserve the benefits associated with the anonymity that certain ECNs currently offer to subscribing market makers and specialists. This alternative also ensures that the best market maker and specialist prices in the ECN are publicly disseminated and that non-subscribing brokers and dealers may trade with the orders represented by those prices. Under the display alternative, the price of a specialist's or market maker's order entered into an ECN would be publicly disseminated while the specialist or market maker remains anonymous. This alternative not only preserves anonymity, but also eliminates the risk that a market maker or specialist may be exposed to multiple executions at the ECN price. With the addition of the alternative, the ECN amendment permits the display of the best price either in the specialist's or market maker's quote or through an ECN that provides for the dissemination of the best market maker and specialist prices entered into the ECN.

The Commission also notes that the ECN display alternative reduces the compliance burden on broker-dealers, including small entities, by permitting specialists and market makers to comply with the ECN amendment if the ECN into which the market maker's order is entered ensures that the best market maker prices entered therein are communicated to an exchange, association or securities information

processor and the ECN provides a means for brokers and dealers to trade with the orders market makers and specialists put in the ECN.

The Commission recognizes that the ECN display alternative may reduce the content of information that is publicly available because under this alternative, the identity of the market maker or specialist that entered the better priced order in the ECN will be withheld. The Commission believes this result is justified because the inside prices and full sizes of orders entered by market makers and specialists will be in the public quotation system to inform the entire market of these prices and ECNs will provide equivalent access to those prices. Moreover, the Commission believes the benefits of facilitating the use of ECNs, by permitting the continued anonymity of market makers and specialists, more than offset the reduced information available on the identity of a particular market maker or specialist.

The Commission believes the data it has reviewed supports the need for prompt adoption of the ECN amendment to the Quote Rule. As discussed more fully in the Appendix to the 21(a) Report, an analysis of data for April through June 1994 shows that approximately 85% of bids and offers displayed by market makers on Instinet and 90% of bids and offers displayed on SelectNet (an ECN sponsored by the NASD) were at better prices than those disseminated to the public via Nasdaq. In addition, approximately 77% of trades executed on Instinet and 60% of trades executed on SelectNet were at prices superior to the Nasdaq inside spread. Given this strong evidence that investors would benefit from public dissemination of these hidden prices that are broadly disseminated to subscribers in these systems, the Commission believes that it is appropriate to adopt the amendments to the Quote Rule.

The Commission does not believe that it is practicable to exempt small entities from the Quote Rule amendments because to do so would be inconsistent with the Commission's statutory mandate to protect investors. In this regard, the Commission notes the clear evidence of a two-tiered market, in which market makers routinely trade at one price with customers and at better prices with ECN participants. The Commission believes that it is imperative to further the long-standing objectives of the 1975 Amendments to ensure reliable and accurate quotes by making these prices available to the public. The Commission believes that any exception for small brokers and

dealers could create an incentive for Nasdaq market makers to create special market making subsidiaries qualifying as small broker-dealers which would be free to engage in the anti-competitive practices identified in the 21(a) Report.

A final copy of the Final Regulatory Flexibility Act analysis is available in the Public File.

#### VI. Paperwork Reduction Act

As set forth in the Proposing Release,<sup>377</sup> the proposed amendments to Rule 11Ac1-1 and proposed Rule 11Ac1-4 contain collections of information within the meaning of the Paperwork Reduction Act ("PRA"). Accordingly, proposed amendments to Rule 11Ac1-1 and proposed Rule 11Ac1-4 were submitted to the Office of Management and Budget ("OMB") for review pursuant to Section 3507 of the PRA (44 U.S.C. 3507), and were approved by OMB which assigned the following control numbers:

Amendments to Rule 11Ac1-1, control number 3235-0461; Rule 11Ac1-4, control number 3235-0462. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid OMB control number. This is the final notice regarding the collection of information under Rule 11Ac1-4, the Display Rule. A new notice regarding the collections of information under Rule 11Ac1-1, the Quote Rule, may be found in the Companion Release (published elsewhere in the Federal Register today) which proposes an additional amendment to the Quote Rule. The PRA section in the preamble of the Companion Release provides new estimates of the burden in responding to the collections of information under the Quote Rule as a whole.

The reporting requirement in Rule 11Ac1-4 is found in 17 CFR 240.11Ac1-4. The collection of information is mandatory and responses are not confidential. The respondents are OTC market makers, as defined under the rule. (Although exchange specialists are also required to follow the rule, as noted in the Proposing Release the Commission does not anticipate any significant additional burden on exchange specialists in light of current exchange order handling practices.) The Rule requires market makers to change their published quotation to reflect the price and/or size of a customer limit order that would improve their published bid or offer or otherwise ensure that such limit order is displayed. The burden on market

makers will depend on the extent and variety of their market-making activities and their choice of the various compliance options offered by the regulations. The ability of market makers to utilize facilities of national securities exchanges, registered national securities associations, and ECNs to comply with the reporting requirement should ease the compliance burden. The proposed rule would have permitted market makers to execute a limit order or send a limit order to another market maker or exchange or association facility that would ensure display of such orders in lieu of the market makers' own display. Rule 11Ac1-4 as adopted maintains these alternatives and also permits respondents to send a limit order to an ECN meeting certain criteria. The information reported will be displayed to all persons who have access to a quotation montage as that term is defined in 17 CFR 240.11Ac1-2(a)(16).

The Commission carefully considered comments received from the NASD and SIA concerning the Commission's burden estimates.<sup>378</sup> The NASD stated that the Commission underestimated the number of limit orders to be displayed per trading day, given the NASD's view that Rule 11Ac1-4 will lead to increased limit order exposure. After considering the NASD's comment, and based upon further review of the market data, the Commission is revising its burden estimate for Rule 11Ac1-4 as follows. There are approximately 570 respondents. Each respondent on average will respond to the collection of information 42,000 times per year, based on a 252 trading day year. The total time burden for each respondent per year is estimated to be 35 hours, based on an estimate of 3 seconds per response (*i.e.*, the time it takes to update a quote to reflect a limit order, or to transmit the order for display elsewhere).<sup>379</sup> The total annual aggregate burden for all respondents is estimated to be 19,950 hours.

<sup>378</sup> The SIA noted that they join in the concerns expressed by the NASD that the Commission's estimates under the PRA are too low, and need to be revised and extended to include the proposed safe harbor under Rule 11Ac1-5. SIA Letter at 4. As noted above, the Commission is not adopting the Price Improvement Rule at this time.

<sup>379</sup> The NASD commented that it believes the PRA burden estimate should include the time market makers spend analyzing market trends and following quotation and last sale information. The Commission has determined not to revise its burden estimate based on this comment, because market makers otherwise engage in such activities apart from the collection of information requirement. For example, market makers are already required to monitor the markets to ensure that they do not trade ahead of customer limit orders.

#### VII. Effects on Competition

Section 23(a)(2) of the Exchange Act<sup>380</sup> requires the Commission to consider the anti-competitive effects of any rules it adopts thereunder, and to balance them against the benefits that further the purposes of the Act. As discussed above, several commenters raised concerns regarding the competitive implications of the order handling proposals.<sup>381</sup> The foregoing discussion contains extensive analysis of the competitive effects of both the rule and rule amendments; this section summarizes the Commission's conclusions. The Commission has considered the proposals in light of the comments and the standard embodied in Section 23(a)(2) and has concluded any burdens on competition imposed by the Display Rule and the amendments to the Quote Rule are necessary and appropriate in furtherance of the purposes of the Exchange Act, in particular, the purposes of Section 11A.

The Commission notes that the primary burden imposed by the Display Rule will be to require exchange specialists and OTC market makers to ensure that customer limit orders improving their quotes are displayed. The Commission believes that if systems upgrades are necessary, those systems upgrades reflect one-time charges. The Commission also notes that ensuring public dissemination of limit orders enhances market transparency, increases pricing efficiency, and quote-based competition, and permits investors' orders to interact with all available market interest. Moreover, the limit order display rule will provide an opportunity for investors to compete directly in the market. This additional competition should limit certain anticompetitive practices identified in the 21(a) Report and discussed *supra*. For the reasons discussed above, the Commission does not believe the Display Rule will have a significantly different effect on wholesale and retail market makers.<sup>382</sup> The Commission notes that the Antitrust Division of the U.S. Department of Justice similarly concluded that the Display Rule will promote competition and will thereby benefit the investing public.

Similarly, the Commission notes that the primary burden imposed by the ECN Amendment to the Quote Rule will be to require exchange specialists and OTC market makers to add personnel or upgrade systems to ensure that their quotes reflect priced orders entered into those ECNs that do not disseminate

<sup>380</sup> 15 U.S.C. 78w(a)(2).

<sup>381</sup> See ABA Letter; HHG Letter; NASD Letter.

<sup>382</sup> See *supra* note 124 and accompanying text.

<sup>377</sup> Proposing Release at 70.

order information to the relevant exchange or association. The Commission believes that such systems upgrades reflect one-time charges. The Commission believes that the ECN amendment to the Quote Rule will impose only limited competitive burdens on ECNs. ECNs which have attributes that differentiate them from other types of electronic order routing and order execution systems, will have a choice whether to disseminate order information to the relevant exchanges or association. While choosing this alternative will result in some system costs, the Commission believes that the alternative will provide ECNs with additional business opportunities, including increased order flow. The ECN amendment should allow ECNs to function as valuable facilities for their subscribers, and should not harm ECNs significantly in their competition with other order execution systems.<sup>383</sup> The Commission also notes that ensuring public dissemination of market makers' and specialists' priced orders entered into ECNs enhances market transparency, pricing efficiency, price competition, and allows investors' orders to interact with all available market interest.

Finally, with respect to the amendments extending the Mandatory Quote Rule to non-Rule 19c-3 securities, the primary burden imposed will be to require certain brokers and dealers to register as CQS market makers and make continuous two-sided quotes available to the public. The Commission believes that the benefit to the investing public of ensuring that available market interest is disseminated to the public will enhance competition by facilitating the routing of investor orders to the market center displaying the best quotation for a security. The Commission believes that the added transparency resulting from the amendment outweighs any burden to competition that may be imposed.

#### List of Subjects in 17 CFR Part 240

Broker-dealers, Confidential business information, Reporting and recordkeeping requirements, and Securities.

#### Text of the Rules

For the reasons set out in the preamble, the Commission amends Part

240 of Chapter II of Title 17 of the Code of Federal Regulation as follows:

#### **PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

1. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 240.11Aa3-1 is amended by revising paragraph (a)(4) to read as follows:

#### **§ 240.11Aa3-1 Dissemination of transaction reports and last sale data with respect to transactions in reported securities.**

(a) *Definitions.* \* \* \*

(4) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.

\* \* \* \* \*

3. Section 240.11Ac1-1 is revised to read as follows:

#### **§ 240.11Ac1-1 Dissemination of quotations.**

(a) *Definitions.* For the purposes of this section:

(1) The term *aggregate quotation size* shall mean the sum of the quotation sizes of all responsible brokers or dealers who have communicated on any exchange bids or offers for a covered security at the same price.

(2) The term *association* shall mean any association of brokers and dealers registered pursuant to Section 15A of the Act (15 U.S.C. 78o-3).

(3) The terms *best bid* and *best offer* shall mean the highest priced bid and the lowest priced offer.

(4) The terms *bid* and *offer* shall mean the bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, but shall not include indications of interest.

(5) The term *consolidated system* shall mean the consolidated transaction reporting system.

(6) The term *covered security* shall mean any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as

described in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)).

(7) The term *effective transaction reporting plan* shall have the meaning provided in § 240.11Aa3-1(a)(3).

(8) The term *electronic communications network*, for the purposes of § 240.11Ac1-1(c)(5), shall mean any electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part; except that the term electronic communications network shall not include:

(i) Any system that crosses multiple orders at one or more specified times at a single price set by the ECN (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by participants outside of such times; or

(ii) Any system operated by, or on behalf of, an OTC market maker or exchange market maker that executes customer orders primarily against the account of such market maker as principal, other than riskless principal.

(9) The term *exchange market maker* shall mean any member of a national securities exchange ("exchange") who is registered as a specialist or market maker pursuant to the rules of such exchange.

(10) The term *exchange-traded security* shall mean any covered security or class of covered securities listed and registered, or admitted to unlisted trading privileges, on an exchange; *provided, however*, That securities not listed on any exchange that are traded pursuant to unlisted trading privileges are excluded.

(11) The term *make available*, when used with respect to bids, offers, quotation sizes and aggregate quotation sizes supplied to quotation vendors by an exchange or association, shall mean to provide circuit connections at the premises of the exchange or association supplying such data, or at a common location determined by mutual agreement of the exchanges and associations, for the delivery of such data to quotation vendors.

(12) The term *odd-lot* shall mean an order for the purchase or sale of a covered security in an amount less than a round lot.

(13) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size.

<sup>383</sup> Although the Antitrust Division of the U.S. Department of Justice expressed concerns about the effects of the ECN amendment as originally proposed, the Commission believes that with the quote dissemination alternative, the amendment will not impose any unnecessary or inappropriate burdens on competition.

(14) The term *plan processor* shall have the meaning provided in § 240.11Aa3-2(a)(7).

(15) The term *published aggregate quotation size* shall mean the aggregate quotation size calculated by an exchange and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to a responsible broker or dealer.

(16) The terms *published bid* and *published offer* shall mean the bid or offer of a responsible broker or dealer for a covered security communicated by it to its exchange or association pursuant to this section and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(17) The term *published quotation size* shall mean the quotation size of a responsible broker or dealer communicated by it to its exchange or association pursuant to this section and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(18) The term *quotation size*, when used with respect to a responsible broker's or dealer's bid or offer for a covered security, shall mean:

(i) The number of shares (or units of trading) of that covered security which such responsible broker or dealer has specified, for purposes of dissemination to quotation vendors, that it is willing to buy at the bid price or sell at the offer price comprising its bid or offer, as either principal or agent; or

(ii) In the event such responsible broker or dealer has not so specified, a normal unit of trading for that covered security.

(19) The term *quotation vendor* shall mean any securities information processor engaged in the business of disseminating to brokers, dealers or investors on a real-time basis, bids and offers made available pursuant to this section, whether distributed through an electronic communications network or displayed on a terminal or other display device.

(20) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.

(21) The term *responsible broker or dealer* shall mean:

(i) When used with respect to bids or offers communicated on an exchange, any member of such exchange who communicates to another member on such exchange, at the location (or

locations) designated by such exchange for trading in a covered security, a bid or offer for such covered security, as either principal or agent; *provided, however*, That, in the event two or more members of an exchange have communicated on such exchange bids or offers for a covered security at the same price, each such member shall be considered a "responsible broker or dealer" for that bid or offer, subject to the rules of priority and precedence then in effect on that exchange; and further provided, That for a bid or offer which is transmitted from one member of an exchange to another member who undertakes to represent such bid or offer on such exchange as agent, only the last member who undertakes to represent such bid or offer as agent shall be considered the "responsible broker or dealer" for that bid or offer; and

(ii) When used with respect to bids and offers communicated by a member of an association to another broker or dealer or to a customer otherwise than on an exchange, the member communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

(22) The term *revised bid or offer* shall mean a market maker's bid or offer which supersedes its published bid or published offer.

(23) The term *revised quotation size* shall mean a market maker's quotation size which supersedes its published quotation size.

(24) The term *specified persons*, when used in connection with any notification required to be provided pursuant to paragraph (b)(3) of this section and any election (or withdrawal thereof) permitted under paragraph (b)(5) of this section, shall mean:

(i) Each quotation vendor;

(ii) Each plan processor; and

(iii) The processor for the Options Price Reporting Authority (in the case of a notification for a subject security which is a class of securities underlying options admitted to trading on any exchange).

(25) The term *subject security* shall mean:

(i) With respect to an exchange:

(A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and

(B) Any other covered security for which such exchange has in effect an election, pursuant to paragraph (b)(5)(i) of this section, to collect, process, and

make available to quotation vendors, bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of an association:

(A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and

(B) Any other covered security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to paragraph (b)(5)(ii) of this section, to communicate to its association bids, offers and quotation sizes for the purpose of making such bids, offers and quotation sizes available to quotation vendors.

(b) *Dissemination requirements for exchanges and associations.* (1) Every exchange and association shall establish and maintain procedures and mechanisms for collecting bids, offers, quotation sizes and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association, processing such bids, offers and sizes, and making such bids, offers and sizes available to quotation vendors, as follows:

(i) Each exchange shall at all times such exchange is open for trading, collect, process and make available to quotation vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any exchange by any responsible broker or dealer, but shall not include:

(A) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication; and

(B) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange.

(ii) Each association shall, at all times that last sale information with respect to reported securities is reported pursuant to an effective transaction reporting plan, collect, process and make available to quotation vendors the best bid, best offer, and quotation sizes communicated otherwise than on an exchange by each member of such association acting in the capacity of an



OTC market maker for each subject security and the identity of that member (excluding any bid or offer executed immediately after communication), except during any period when over-the-counter trading in that security has been suspended.

(2) Each exchange shall, with respect to each published bid and published offer representing a bid or offer of a member for a subject security, establish and maintain procedures for ascertaining and disclosing to other members of that exchange, upon presentation of orders sought to be executed by them in reliance upon paragraph (c)(2) of this section, the identity of the responsible broker or dealer who made such bid or offer and the quotation size associated with it.

(3)(i) If, at any time an exchange is open for trading, such exchange determines, pursuant to rules approved by the Securities and Exchange Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that the level of trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting, processing, and making available to quotation vendors the data for a subject security required to be made available pursuant to paragraph (b)(1) of this section in a manner that accurately reflects the current state of the market on such exchange, such exchange shall immediately notify all specified persons of that determination. Upon such notification, responsible brokers or dealers that are members of that exchange shall be relieved of their obligation under paragraph (c)(2) of this section and such exchange shall be relieved of its obligations under paragraphs (b) (1) and (2) of this section for that security: *provided, however*, That such exchange will continue, to the maximum extent practicable under the circumstances, to collect, process, and make available to quotation vendors data for that security in accordance with paragraph (b)(1) of this section.

(ii) During any period an exchange, or any responsible broker or dealer that is a member of that exchange, is relieved of any obligation imposed by this section for any subject security by virtue of a notification made pursuant to paragraph (b)(3)(i) of this section, such exchange shall monitor the activity or conditions which formed the basis for such notification and shall immediately renotify all specified persons when that exchange is once again capable of collecting, processing, and making available to quotation vendors the data for that security required to be made available pursuant to paragraph (b)(1) of this section in a manner that accurately

reflects the current state of the market on such exchange. Upon such renotification, any exchange or responsible broker or dealer which had been relieved of any obligation imposed by this section as a consequence of the prior notification shall again be subject to such obligation.

(4) Nothing in this section shall preclude any exchange or association from making available to quotation vendors indications of interest or bids and offers for a subject security at any time such exchange or association is not required to do so pursuant to paragraph (b)(1) of this section.

(5)(i) Any exchange may make an election for purposes of paragraph (a)(25)(i)(B) of this section for any covered security, by collecting, processing, and making available bids, offers, quotation sizes, and aggregate quotation sizes in that security; except that for any covered security previously listed or admitted to unlisted trading privileges on only one exchange and not traded by any OTC market maker, such election shall be made by notifying all specified persons, and shall be effective at the opening of trading on the business day following notification.

(ii) Any member of an association acting in the capacity of an OTC market maker may make an election for purposes of paragraph (a)(25)(ii)(B) of this section for any covered security, by communicating to its association bids, offers, and quotation sizes in that security; except that for any other covered security listed or admitted to unlisted trading privileges on only one exchange and not traded by any other OTC market maker, such election shall be made by notifying its association and all specified persons, and shall be effective at the opening of trading on the business day following notification.

(iii) The election of an exchange or member of an association for any covered security pursuant to this paragraph (b)(5) shall cease to be in effect if such exchange or member ceases to make available or communicate bids, offers, and quotation sizes in such security.

(c) *Obligations of responsible brokers and dealers.* (1) Each responsible broker or dealer shall promptly communicate to its exchange or association, pursuant to the procedures established by that exchange or association, its best bids, best offers, and quotation sizes for any subject security.

(2) Subject to the provisions of paragraph (c)(3) of this section, each responsible broker or dealer shall be obligated to execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another

broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or published offer (exclusive of any commission, commission equivalent or differential customarily charged by such responsible broker or dealer in connection with execution of any such order) in any amount up to its published quotation size.

(3)(i) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (c)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation if:

(A) Prior to the presentation of an order for the purchase or sale of a subject security, a responsible broker or dealer has communicated to its exchange or association, pursuant to paragraph (c)(1) of this section, a revised quotation size; or

(B) At the time an order for the purchase or sale of a subject security is presented, a responsible broker or dealer is in the process of effecting a transaction in such subject security, and immediately after the completion of such transaction, it communicates to its exchange or association a revised quotation size, such responsible broker or dealer shall not be obligated by paragraph (c)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation size.

(ii) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (c)(2) of this section if:

(A) Before the order sought to be executed is presented, such responsible broker or dealer has communicated to its exchange or association pursuant to paragraph (c)(1) of this section, a revised bid or offer; or

(B) At the time the order sought to be executed is presented, such responsible broker or dealer is in the process of effecting a transaction in such subject security, and, immediately after the completion of such transaction, such responsible broker or dealer communicates to its exchange or association pursuant to paragraph (c)(1) of this section, a revised bid or offer; *provided, however*, That such responsible broker or dealer shall nonetheless be obligated to execute any such order in such subject security as provided in paragraph (c)(2) of this section at its revised bid or offer in any

amount up to its published quotation size or revised quotation size.

(4) Subject to the provisions of paragraph (b)(4) of this section:

(i) No exchange or OTC market maker may make available, disseminate or otherwise communicate to any quotation vendor, directly or indirectly, for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any covered security which is not a subject security with respect to such exchange or OTC market maker; and

(ii) No quotation vendor may disseminate or display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size from any exchange or OTC market maker for any covered security which is not a subject security with respect to such exchange or OTC market maker.

(5)(i) Entry of any priced order for a covered security by an exchange market maker or OTC market maker in that security into an electronic communications network that widely disseminates such order shall be deemed to be:

(A) A bid or offer under this section, to be communicated to the market maker's exchange or association pursuant to paragraph (c) of this section for at least the minimum quotation size that is required by the rules of the market maker's exchange or association if the priced order is for the account of a market maker, or the actual size of the order up to the minimum quotation size required if the priced order is for the account of a customer; and

(B) A communication of a bid or offer to a quotation vendor for display on a display device for purposes of paragraph (c)(4) of this section.

(ii) An exchange market maker or OTC market maker that has entered a priced order for a covered security into an electronic communications network that widely disseminates such order shall be deemed to be in compliance with paragraph (c)(5)(i)(A) of this section if the electronic communications network:

(A) Provides to an exchange or association (or an exclusive processor acting on behalf of one or more exchanges or associations) the prices and sizes of the orders at the highest buy price and the lowest sell price for such security entered in, and widely disseminated by, the electronic communications network by exchange market makers and OTC market makers for the covered security, and such prices and sizes are included in the quotation data made available by the exchange, association, or exclusive processor to

quotation vendors pursuant to this section; and

(B) Provides, to any broker or dealer, the ability to effect a transaction with a priced order widely disseminated by the electronic communications network entered therein by an exchange market maker or OTC market maker that is:

(1) Equivalent to the ability of any broker or dealer to effect a transaction with an exchange market maker or OTC market maker pursuant to the rules of the exchange or association to which the electronic communications network supplies such bids and offers; and

(2) At the price of the highest priced buy order or lowest priced sell order, or better, for the lesser of the cumulative size of such priced orders entered therein by exchange market makers or OTC market makers at such price, or the size of the execution sought by the broker or dealer, for the covered security.

(d) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

4. Section 240.11Ac1-4 is added to read as follows:

**§ 240.11Ac1-4 Display of customer limit orders.**

(a) *Definitions.* For purposes of this section:

(1) The term *association* shall mean any association of brokers and dealers registered pursuant to Section 15A of the Act (15 U.S.C. 78o-3).

(2) The terms *best bid* and *best offer* shall have the meaning provided in § 240.11Ac1-1(a)(3).

(3) The terms *bid* and *offer* shall have the meaning provided in § 240.11Ac1-1(a)(4).

(4) The term *block size* shall mean any order:

(i) Of at least 10,000 shares; or

(ii) For a quantity of stock having a market value of at least \$200,000.

(5) The term *covered security* shall mean any "reported security" and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)).

(6) The term *customer limit order* shall mean an order to buy or sell a covered security at a specified price that

is not for the account of either a broker or dealer; *provided, however*, That the term customer limit order shall include an order transmitted by a broker or dealer on behalf of a customer.

(7) The term *electronic communications network* shall have the meaning provided in § 240.11Ac1-1(a)(8).

(8) The term *exchange-traded security* shall have the meaning provided in § 240.11Ac1-1(a)(10).

(9) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(10) The term *reported security* shall have the meaning provided in § 240.11Ac1-1(a)(20).

(b) *Specialists and OTC market makers.* For all covered securities:

(1) Each member of an exchange that is registered by that exchange as a specialist, or is authorized by that exchange to perform functions substantially similar to that of a specialist, shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the specialist that is at a price that would improve the bid or offer of such specialist in such security; and

(ii) The full size of each customer limit order held by the specialist that:

(A) Is priced equal to the bid or offer of such specialist for such security;

(B) Is priced equal to the national best bid or offer; and

(C) Represents more than a *de minimis* change in relation to the size associated with the specialist's bid or offer.

(2) Each registered broker or dealer that acts as an OTC market maker shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the OTC market maker that is at a price that would improve the bid or offer of such OTC market maker in such security; and

(ii) The full size of each customer limit order held by the OTC market maker that:

(A) Is priced equal to the bid or offer of such OTC market maker for such security;

(B) Is priced equal to the national best bid or offer; and

(C) Represents more than a *de minimis* change in relation to the size associated with the OTC market maker's bid or offer.

(c) *Exceptions.* The requirements in paragraph (b) of this section shall not apply to any customer limit order:

(1) That is executed upon receipt of the order.

(2) That is placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed.

(3) That is an odd-lot order.

(4) That is a block size order, unless a customer placing such order requests that the order be displayed.

(5) That is delivered immediately upon receipt to an exchange or association-sponsored system, or an electronic communications network that complies with the requirements of § 240.11Ac1-1(c)(5)(ii) with respect to that order.

(6) That is delivered immediately upon receipt to another exchange member or OTC market maker that complies with the requirements of this section with respect to that order.

(7) That is an "all or none" order.

(d) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on

specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

Dated: September 6, 1996.

By the Commission.

Margaret H. McFarland,

*Deputy Secretary.*

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