should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to the File No. SR-Amex–96–35 and should be submitted by February 6, 1997.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[33] that the proposed rule change (SR-Amex–96–35), as amended, is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[34]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–1034 Filed 1–15–97; 8:45 am]

BILLING CODE 8010–01–M

[33] 15 U.S.C. 78s(b)(2).

[34] 17 CFR 200.30–3(a)(12).

[Release No. 34–38156; File No. SR–NASD–96–43]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Partial Approval and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to Proposed Rule Change Relating to Implementation of the Commission's Order Handling Rules

January 10, 1997.

On November 18, 1996, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1], and Rule 19b–4 thereunder.[2] On January 9, 1997, the NASD submitted a letter amending the proposed rule change.[3] The proposed rule change adopts a new rule, and amends existing NASD rules and The Nasdaq Stock Market's (''Nasdaq'') Small Order Execution System (''SOES'') and SelectNet Service to enable the NASD to implement on a timely basis the Commission's new limit order display rule, Rule 11Ac1–4 under the Act[4] (''Display Rule'') and amendments to Rule 11Ac1–1 under the Act[5] (''Quote Rule'').

Notice of the proposed rule change, together with the substance of the proposal as initially filed, was provided by issuance of a Commission release (Securities Exchange Act Release No. 38008, Dec. 2, 1996) and by publication in the Federal Register (61 FR 64550, Dec. 5, 1996). The Commission received over 350 comment letters on the proposal.

I. Introduction and Background

A. The Commission's Order Handling Rules

On August 28, 1996, the Commission adopted the Display Rule, which requires the display of customer limit orders priced better than a market maker or specialist's quote, and adopted amendments to the Quote Rule to enhance the quality of published quotations for securities, and competition and pricing efficiency in U.S. securities markets.[6] These rules (collectively, ''Order Handling Rules'') were designed to address growing concerns about the handling of customer orders for securities.

Specifically, the Display Rule[7] requires the display of a customer limit order priced better than a specialist's or over-the-counter (''OTC'') market maker's quote or that adds to the size associated with such quote if that quote is at the national best bid or offer (''NBBO''). An OTC market maker who receives a customer limit order meeting these parameters must immediately: (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 to an exchange-or association-sponsored system that complies with the requirements of the rule; (4) send the limit order to another market maker or specialist who complies with the requirements of the rule; or (5) deliver a limit order to an electronic communications network (''ECN'') that meets certain requirements regarding the display of limit orders, as an alternative to representing the limit order in its quote.[8]

One amendment to the Quote Rule[9] requires an OTC market maker to make publicly available any superior prices that a market maker privately quotes through ECNs (''ECN Amendment''). A market maker may comply with this amendment by changing its quote to display any such superior prices privately quoted. Alternatively, a market maker can deliver better priced orders to an ECN without changing its public quote if that ECN: (i) ensures that the best prices market makers and specialists have entered therein are communicated to the public quotation system; and (ii) provides brokers and dealers equivalent 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 (''ECN Display Alternative'').

The ECN amendment becomes effective on January 20, 1997 for exchange traded securities and 50 of the 1000 most actively traded OTC securities. These 50 securities have been identified by Nasdaq.[10] The phase-in date for the next 100 securities is scheduled for February 7, 1997. On February 28, 1997, the additional 850 of the 1000 most actively traded securities will be phased in. Finally, on March 28, 1997, the ECN amendment will apply to all remaining OTC securities.

The Limit Order Display Rule also becomes effective on January 20, 1997 for all exchange traded securities and 50 OTC securities identified by Nasdaq. Other Nasdaq securities will become

[1] 15 U.S.C. § 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Letter from Robert E. Aber, NASD to Robert L.D. Colby, Commission, dated January 9, 1997. The amendment would (1) establish a three month pilot for reduction of the market maker minimum quotation size in the fifty Nasdaq securities subject to the first phase-in of the Order Handling Rules; (2) state that a market maker's obligation to maintain its displayed quotation size at or above the applicable minimum quotation size does not apply when the market maker's quote size has been decremented by the execution of SOES orders, until that quotation size is decremented to zero; (3) make the decrementing provision optional for market makers whose quotation in a particular security is equal to or greater than the SOES tier size for that security; and (4) permit market makers to enter riskless principal orders, in addition to agency orders, into the Small Order Execution System.

[4] 17 CFR 240.11Ac1–4.

[5] 17 CFR 240.11Ac1–1.

[6] *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (''Adopting Release''). *See also* Securities Exchange Act Release Nos. 38110 (January 2, 1997), 62 FR 1279 (January 9, 1997) (order revising the effective date of the Order Execution Rules to January 13, 1997); and 38139 (January 8, 1997) (order revising the effective date of the Order Execution Rules until January 20, 1997).

[7] 17 CFR 240.11Ac1–4.

[8] The Display Rule does not apply to limit orders placed by customers requesting that they not be displayed, limit orders for odd-lots, and limit orders that are all-or-none orders. The rules do not require the display of limit orders of block size (10,000 shares or $200,000) unless the customer requests that the order be displayed.

[9] 17 CFR 240.11Ac1–1.

[10] *See* Letter from S. William Broka, Senior Vice President, Trading & Market Service, Nasdaq Stock Market, Inc., dated December 23, 1996.

subject to the rule on a phased-in basis, with all Nasdaq securities phased in by August 28, 1997.

B. Changes Required to NASD Rules and Systems

The Adopting Release recognized that the Order Handling Rules would require the NASD, as well as national securities exchanges (''exchanges''), to change certain systems and rules to facilitate compliance with the Order Handling Rules by January 20, 1997.[11] For example, the NASD's SOES system currently accepts limit orders. If a limit order is not immediately executable, or non-marketable, (*i.e.*, a limit order to buy priced below the offer price, or a limit order to sell priced above the bid price), it is placed in the SOES limit order file and subsequently executed if the best bid for a buy, or offer for a sell order becomes equal to the limit price. Limit orders placed into SOES are never publicly disseminated, included in the calculation of the best bid or offer, or matched against incoming market orders. Thus, an OTC market maker that places a customer limit order into the SOES limit order facility would not comply with the Display Rule.

In addition, NASD Rule 4613 currently requires Nasdaq market makers to display continuous two-sided quotations in Nasdaq National Market (''NNM'') securities (approximately the top 4000 Nasdaq securities) in sizes of 1,000, 500 or 200 shares, depending upon the price and trading volume of the security. However, the Display Rule may require a market maker to display in its quote a customer limit order that is smaller than the mandatory quotation size imposed by NASD Rule 4613. This creates the possibility that a market maker could be required to publish a quote at a price and size that it is otherwise unwilling to trade at for its own account. The changes to the NASD's systems and rules approved today are intended to facilitate compliance with the Order Handling Rules and are intended to more closely tailor a market maker's obligations to the structure of the Nasdaq market anticipated to result from implementation of the Order Handling Rules.

[11] *See supra* note 6.

II. Proposed Rule Changes To Implement the Display Rule

A. Minimum Quotation Size Requirements

1. Quote Size When Displaying Customer Limit Orders

To facilitate the display of customer limit orders in accordance with the Display Rule, the NASD proposes to amend NASD Rules 4613 and 6330 to provide that Nasdaq market makers and CQS market makers may display a quotation size for one normal unit of trading (*i.e.*, 100 shares) or a larger multiple thereof to reflect the actual size of a customer limit order.[12] Thus, if a market maker is bidding 20 for 1000 shares and offering 1000 shares at 20¼ (20 bid—20¼ offered, 1000×1000), and the market maker receives a customer limit order to buy 100 shares at 20⅛, the market maker would be permitted to update its quote to 20⅛–20¼, 100×1000. Market makers would not be responsible for executing any additional shares above the size of the limit order. The NASD believes that this rule change will promote market maker acceptance of limit orders priced inside quoted markets, thereby furthering the investor protection and market transparency objectives of the Order Handling Rules. Moreover, without these rule changes, in instances where a customer limit order is smaller than the applicable minimum quotation size requirement and a market maker's quote is inferior to the limit order price, market makers would be obligated to execute trades at prices superior to their proprietary quotations. The NASD and Nasdaq maintain that subjecting market makers to such an order execution requirement would be unfair and create a disincentive for firms to function as market makers.[13]

[12] As noted above, NASD Rule 4613 currently requires each market maker in a Nasdaq issue to enter and maintain two-sided quotations with a minimum size equal to or greater than the applicable SOES tier size for the security (*e.g.*, 1,000, 500, or 200 shares for NNM issues and 500 or 100 shares for Nasdaq SmallCap Market issues). NASD Rule 6330 requires registered market makers in exchange-listed securities to display a minimum quotation size of 200 or 500 shares in each reported security (as established and published from time to time by the Association) depending on trading characteristics of the security.

[13] The Commission stated in the Adopting Release:

> 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.

Adopting Release, *supra* note, 61 FR at 48301 n.144.

2. Quote Size When Displaying Proprietary Market Maker Quotes

The NASD stated in its filing that market makers should not be subject to minimum quote size requirements greater than a normal unit of trading in an environment in which Nasdaq market makers will compete with customers to affect quotation prices. The NASD also stated that the new order-driven nature of Nasdaq brought about by the Display Rule will obviate the regulatory justification for minimum quote size requirements because investors will have the capability to display their own orders in the marketplace. The NASD stated that the inclusion of limit orders and ECN orders in Nasdaq quotations should also ensure that market liquidity and price continuity will not be harmed by the elimination of minimum quotation size requirements. Therefore, it proposed to amend NASD Rule 4613 to require market makers to quote in minimum trading increments of 100 shares.

On January 9, 1997 the NASD filed an amendment to its filing that proposes allowing market makers to quote in minimum sizes of 100 shares for a three-month pilot program in the 50 Nasdaq stocks subject to the first phase-in under the Order Handling Rules. The remaining securities would still be subject to the existing minimum quotation display requirements for proprietary quotes.

B. Operation of SOES

1. Current Operation of SOES

NASD Rule 4611(f) requires each market maker in an NNM security to register as a SOES market maker in that security. SOES is voluntary for market makers in Nasdaq SmallCap securities. The maximum SOES order size for a NNM security is either 1,000, 500, or 200 shares, depending on the price and volume of the security; the maximum order size for a Nasdaq SmallCap Market security is 500 shares.[14] SOES automatically executes unpreferenced

[14] A 1,000 share maximum order size applies to NNM securities with an average daily non-block volume of 3,000 shares or more per day, a bid price not exceeding $100 and with three or more market makers. A 500 share maximum order size applies to NNM securities with an average daily non-block volume of 1,000 shares or more per day, a bid price not exceeding $150 and with two or more market makers. A 200 share maximum order size applies to NNM securities with an average daily non-block volume of less than 1,000 shares per day, a bid price not exceeding $250 and with two or more market makers. *See* NASD Notice to Members 88–43 (June 22, 1988).

orders in rotation against those market makers who are at the best quoted bid or offer on Nasdaq at the time the order is entered. With the agreement of the market maker, SOES orders also may be routed or ''preferenced'' to a particular market maker for execution at the inside market, regardless of what price the preferenced market maker is quoting. A SOES market maker is obligated to execute SOES orders up to the minimum SOES exposure limit for that stock or such greater exposure limit established by the market maker. The minimum exposure limit for a particular stock is two times the applicable maximum SOES order size (*e.g.*, 2,000 shares for stocks in the 1,000 share tier size). If a market maker's exposure limit is exhausted, it is temporarily suspended from SOES, placed in a ''closed quote state,'' and permitted a five-minute period to restore its exposure limit. If a market maker does not restore its exposure limit within five minutes, it is automatically withdrawn from the stock and cannot re-enter quotes in the issue for at least twenty business days.

Thus, SOES is currently designed to execute orders against market makers based on the tier size for a particular stock, without regard to the quotation size displayed by a market maker. Because the minimum quotation sizes for market makers are presently aligned with the maximum SOES order sizes, it would not be possible to enter into SOES an order greater in size than the market maker's quote.

2. Changes to SOES in Response to the Order Handling Rules

Because market maker quotes will at times reflect customer limit orders under the Display Rule, the NASD proposed to modify SOES to execute market orders only against market makers' displayed quotation sizes.

a. *Decrementation of displayed quotation sizes after SOES executions.* To avoid instances where a market maker could automatically receive multiple SOES executions because it displayed a customer's limit order at a price superior to the market maker's proprietary quote or increased its quote size because of the limit order, the NASD has proposed to modify SOES to decrement [15] a market maker's displayed quote size upon the execution of unpreferenced SOES orders. For example, if a market maker's quote in security ABCD is 20–20¼ (1000 × 1000), and it receives a customer limit order to buy 500 shares at 20⅛, it would update its quote to 20⅛–20¼ (500 × 1000). [16] Thereafter, if the market maker received a SOES execution at 20⅛ for 500 shares, the size of its bid would be depleted to zero and the market maker would have to re-enter a new quotation within five minutes, or withdraw from the stock for 20 days. [17] The NASD states that this change is intended to encourage market makers to accept and display customer limit orders because they will not be subject to mandatory SOES executions larger than the size of the limit orders they display or at prices at which the market maker is not willing to trade for its proprietary account. [18]

The NASD filed a letter amending the proposal to make decrementing optional for market makers whose quotation in a particular security is equal to or greater than the SOES tier size for that security. Thus, market makers who are willing to commit greater capital will have the option of accepting repeated orders at their quoted price and size on a stock-by-stock basis.

In the NASD's proposal for a pilot program for the quotation requirement, the non-pilot stocks would still be subject to the decrementing proposal. Thus, market makers would be required to publish a quote in non-pilot stocks in the required quote size, but this quote could be decremented. Once the quote was decremented to zero, or the market maker chose to manually change the price or size of the proprietary quote, the market maker would be required to enter at least the minimum quote size.

b. *Split order execution.* The NASD proposal would limit a market maker's SOES exposure to its displayed quotation size, even if less than the SOES maximum order size. In addition, SOES would be modified to decrement market makers' displayed quotation sizes in response to unpreferenced SOES executions. To ensure that a SOES order can be executed in full in an environment in which SOES maximum order sizes may be greater than a market maker's displayed quote, the NASD has proposed changes to SOES that would allow one order to be executed against multiple market makers. In addition, the NASD has proposed to change SOES to reject ''all-or-none'' orders. [19]

For example, if the inside market for ABCD is 20–20¼ and two market makers are each at the inside bid for 500 shares, a SOES market order to sell 1,000 shares of ABCD would be executed at 20, with both market makers buying 500 shares. In addition, because all market maker quotations at the inside could be depleted by the execution of a SOES order, SOES is being modified to permit market orders to be filled at multiple price levels. For example, if the inside market for ABCD is 20–20¼ and Market Makers A and B are each at the inside bid for 100 shares, with Market Maker C bidding at 19⅞ for 800 shares, a SOES market order to sell 1,000 shares of ABCD would be executed against all three market makers. Market Makers A and B would each buy 100 shares at 20 and Market Maker C would buy 800 shares at 19⅞''. Finally, a marketable limit order entered into SOES that exceeds the size of market maker quotes at the limit price receives a partial fill. The unfilled portion of the order is returned to the entering firm.

c. *Displayed quotation sizes will constitute exposure limits.* Under the proposal, decrementing market maker quotes after unpreferenced SOES executions will cause each market maker's displayed quotation size to become its exposure limit. SOES will cease executing orders against a market maker once its quote size has gone to zero. Therefore, the NASD has proposed to amend the SOES rules to replace references to exposure limits with references to a market maker's displayed size.

d. *Prohibition against the entry of non-marketable limit orders into SOES.* SOES currently accepts both market orders and limit orders. If a limit order is not immediately executable, or non-marketable, (*i.e.*, a limit order to buy priced below the offer price, or a limit order to sell priced above the bid price) it is placed in the SOES limit order file and subsequently executed if the limit price becomes equal to the best bid or offer. Limit orders placed into SOES are never publicly disseminated, included in the calculation of the best bid or offer, or matched against incoming market orders. The NASD maintains that the processing of such orders conflicts with the requirements of the Display Rule and with the duty of best execution as articulated in the Adopting

[15] The term ''decrement'' is used here to mean to automatically reduce the quote by the number of shares executed against it.

[16] The market maker could elect to quote a size of 1500 × 1000 if it wished to also represent its own proprietary trading interest at the price established by the customer limit order.

[17] If the market maker is using the auto-refresh feature, described below, the update would be automatic.

[18] The NASD and Nasdaq also propose that displayed quotations not be decremented after the execution of an odd-lot order (*i.e.*, an order for less than 100 shares) and that the execution of a mixed lot order (*i.e.*, an order for greater than 100 shares but in an increment other than 100 shares) will only decrement a market maker's quotation by the number of shares represented by the number of round lots contained in the mixed lot order.

[19] An ''all or none'' order is a buy or sell order marked to provide that no partial transaction is to be executed.

Release.[20] Therefore, the NASD has proposed that SOES no longer accept non-marketable limit orders.

e. *Modifications to the SOES automated quotation update feature.* Currently, the ''auto-refresh'' feature of SOES updates both sides of a market maker's quotation in parallel by a pre-determined amount after a SOES execution. The NASD has proposed that, with regard to the fifty stocks that would be included in the pilot, the Nasdaq Stock Market would re-establish the market maker's quote, when it is exhausted, for one normal unit of trading. For those securities not subject to the pilot, the market maker's quote would be refreshed for the SOES tier size. For both pilot stocks and all other securities the auto-refresh feature would be modified to only update the side of a market maker's quote that has been decremented.[21]

In its amendment, the NASD proposes to refresh all stocks for the SOES tier size, because most stocks would remain subject to initial quotation requirements at this size. The NASD would refresh stocks subject to the pilot at the SOES tier size, because of difficulties programming its system to provide different refresh sizes for particular stocks.

f. *Allowing SOES market makers to enter agency orders into SOES.* A SOES market maker currently is prohibited from entering agency orders into SOES unless a locked or crossed market exists. This rule was intended to prevent market makers from engaging in ''fair weather'' market making by executing unwanted orders against other market makers through SOES. However, a market maker's disseminated quote may now reflect a customer limit order displayed in accordance with the Display Rule. The NASD has proposed to amend NASD Rule 4730 to permit a SOES market maker to enter agency orders into SOES to ensure that a customer's order has access to a better-priced customer limit order displayed in a market maker's quote regardless of whether the customer's broker dealer is a SOES market maker. Pursuant to the amendment, market makers would be able to enter riskless principal orders into SOES if these orders reflect customer agency orders.[22]

g. *Processing of marketable limit orders.* SOES currently is designed to execute marketable limit orders ahead of market orders queued in SOES. Although a marketable limit order is functionally equivalent to a market order when the limit price is equal or superior to the inside market,[23] SOES currently provides preferential treatment to marketable limit orders. To eliminate the disparate treatment of substantively identical orders, the NASD proposed to amend SOES to execute market and marketable limit orders on a time priority basis.

h. *Market maker withdrawal from Nasdaq SmallCap Market securities.* Because SOES is voluntary for Nasdaq SmallCap Market securities, when a market maker's exposure limit is exhausted in one of these securities, the NASD does not deem the market maker to have voluntarily withdrawn from the stock, because the market maker can continue to quote the issue without participating in SOES. If market maker quotations are decremented after SOES executions, however, it will now be possible for a market maker in a SmallCap security to go into a ''closed quote'' state because its quotation size has been depleted. Accordingly, the NASD proposal would amend NASD Rule 4730(b) to specify that a market maker in a SmallCap security shall be deemed to have voluntarily withdrawn from a stock if its quote size remains at zero at the close of the trading day, thereby precluding the market maker from being a market maker in the issue for twenty business days.

C. Proposed Rule Changes to Implement the ECN Amendment

The NASD also proposed to amend certain rules and characteristics of the SOES and SelectNet systems to facilitate the development of a means for ECNs to comply with the requirements of the ECN Display Alternative. As noted above, the ECN Display Alternative relieves an exchange specialist or OTC market maker of the requirement to publicly quote any superior prices that it privately displays through an ECN if that ECN: (1) Ensures that the best priced orders entered by market makers and specialists into the ECN are communicated to an exchange or Nasdaq for public dissemination; and (2) provides brokers and dealers access to orders entered by exchange specialists and OTC market makers into the ECN, so that brokers and dealers who do not subscribe to that ECN can trade with those orders. This access must be equivalent to the access that would have been available had the market makers or specialists reflected these superior prices in their public quotes.[24]

The NASD has proposed to implement, on an interim basis, a linkage to facilitate the operation of the ECN Display Alternative[25] based on existing Nasdaq system platforms, SOES and SelectNet (''SelectNet Linkage''). The methodology for establishing the SelectNet Linkage and the rule changes proposed by the NASD are described below.

1. Overview of the Operation of the SelectNet Linkage

The SelectNet Linkage is intended to provide a means for an ECN to disseminate publicly the price and full size of the orders entered by specialists and OTC market makers to the NASD and to provide access to other broker-dealers to trade at those prices, equivalent to that provided in the market where the prices are disseminated. The SelectNet Linkage would disseminate ECN prices and sizes by utilizing the methodology currently used for displaying Unlisted Trading Privileges (''UTP'') exchange quotes,[26] and would provide access to ECN prices in the same manner that broker-dealers currently may preference orders through SelectNet.

The SelectNet Linkage would allow an ECN to enter its best-priced orders into Nasdaq for display on the Nasdaq Workstation. To effect transactions against these displayed prices, an NASD member that subscribes to the Nasdaq Workstation II service would be permitted to access the ECN prices by directing orders through SelectNet to the ECN. New NASD Rule 4623 would

[20] See Adopting Release, *supra* note , 61 FR at 48324.

[21] The NASD has also proposed to amend the auto-refresh feature to allow a market maker to maintain its quote at the inside market. With this auto-refresh feature, those market makers seeking to buy or sell more stock than its displayed quotation could auto-refresh at its same quotation price if the market maker entered a quotation size equal to or greater than the maximum SOES order size.

[22] *See* supra note 3.

[23] That is, a limit order to buy priced at or above the offer and a limit order to sell priced at or below the bid.

[24] *See* Adopting Release, *supra* note 6.

[25] The NASD stated in the filing that they continue to examine other means to develop a longer-term mechanism that would provide a permanent means to establish an ECN Display Alternative that meets every aspect of the Commission's rule. The NASD stated that it would propose a permanent approach separately from the instant filing.

[26] Pursuant to the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information For Exchange Listed Nasdaq/National Market System Securities Traded On Exchanges On An Unlisted Trading Privileges Basis (''Nasdaq/NMS/UTP Plan''), Nasdaq acts as the facilities manager for itself and the UTP Exchanges in collecting, consolidating and disseminating quotes from Nasdaq market makers and UTP exchange specialists that trade Nasdaq securities pursuant to Section 12(f) of the Act. The prices quoted by UTP exchange specialists appear on the Nasdaq montage with those quoted by Nasdaq market makers. Currently, UTP exchange specialists are not subject to SOES executions.

provide for display of and access to ECN prices and sizes and would articulate the standards for ECN participation in the SelectNet Linkage.

Proposed NASD Rule 4623 provides that an ECN that wishes to use the SelectNet Linkage, or any future system Nasdaq develops to facilitate compliance with the ECN Display Alternative, must: (1) Demonstrate to the NASD that it meets the ECN definition found in the Quote Rule; (2) be registered as an NASD member; (3) enter into and comply with the terms of a Nasdaq Workstation Subscriber Agreement; (4) agree to provide for Nasdaq's dissemination in the quotation data stream that it makes available to quotation vendors, the prices and sizes of Nasdaq market maker orders [27] at the highest buy price and the lowest sell price for each Nasdaq security entered in and widely disseminated by the ECN; and (5) provide an automated execution of priced orders displayed through the linkage or, if the price is no longer available, an automated rejection of any order routed to the ECN through the Nasdaq-provided display alternative.

a. *Display of ECN prices.* For quotation display purposes, ECNs would deliver prices to Nasdaq reflecting customer orders in their systems, and Nasdaq would display and disseminate rounded prices.[28] Nasdaq would furnish ECNs with market maker identifiers (''MMIDs''). While ECNs would be assigned MMIDs, ECNs would not be registered as market makers. With the exception of certain rules such as the NASD's firm quote rule, the two-sided quote requirement,[29] and the locked and crossed markets rule discussed below, ECNs would not be subject to standard market maker requirements in the NASD's Rules. Nasdaq would include the ECN prices and sizes in the Nasdaq Workstation II quote montage with the ECN MMID and incorporate the ECN price in the Nasdaq best price calculation. When the ECN is at the best bid or offer in the market, its price would be included in the NBBO.

For example:

NBBO 20⅛–20¼, 1000 x 1000
ABCD 19⅞–20¼, 1000 x 1000
EFGH 20–20½, 1000 x 1000
ECNA 20⅛–20¼, 1000 x 1000 (an ECN)

Following current practices for UTP exchanges, Nasdaq would not include the ECN as a SOES market maker. Consequently, an ECN participating in the SelectNet Linkage would not be subject to SOES executions. The NASD stated in its filing that it would not subject ECNs to SOES executions because the ECN would be exposed to the risk of double executions and the consequent need to take a principal position, which is inconsistent with the ECN's role of acting solely as agent on behalf of its customers. The NASD stated that the risk of double executions arises because, with electronic order entry capabilities, once an order is displayed in multiple execution systems, such as SOES and an ECN's own system, the same order can be accessed nearly simultaneously by different counterparties.

b. *Access to ECN prices.* NASD members would be able to reach ECN prices displayed in Nasdaq by directing orders through SelectNet, up to the size displayed in the ECN quote. The ECN would have the ability to accept orders at the displayed price, or accept orders at an improved price if its actual price is at an increment better than that displayed.[30] The ECN would review its own file to determine whether the priced order displayed in Nasdaq has already been executed in the ECN's own system. The ECN could reject the order if the order residing in its own system already has been executed by the time the SelectNet order is delivered to the ECN. An ECN cannot decline an order delivered through the SelectNet Linkage because it may find a better order elsewhere. The Commission understands that ECNs that wish to utilize the SelectNet Linkage will be required to provide virtually immediate responses to members entering orders seeking to access publicly displayed ECN orders.[31] The Nasdaq Workstation Subscriber Agreement would require prompt and non-discriminatory execution of linkage orders by the ECN.

In addition, as NASD members and subscribers to the Nasdaq Workstation II service, ECNs would be subject to contractual obligations to demonstrate that their systems are properly designed to operate in high volume trading environments and that they have adequate security and other operational procedures in place to maintain the integrity of Nasdaq systems. ECNs that are not willing or are unable to comply with such system requirements would not be permitted to establish a SelectNet Linkage for ECN Display Alternative purposes.

2. Other Rule Changes Necessitated By Development of the SelectNet Linkage

a. *SelectNet changes.* i. *Current operation of SelectNet.* SelectNet is an automated order routing and execution system that allows a member to direct buy or sell orders in Nasdaq securities to a single market maker (preferenced orders) or broadcast orders to all market makers in the security. Upon receiving a SelectNet order, a member can accept the order, decline it (if consistent with its firm quote obligations), or send a counter-offer to the originating member.

ii. *Elimination of SelectNet Broadcast feature.* The NASD has proposed to eliminate the SelectNet Broadcast feature and allow only the entry of a SelectNet order directed to a specific market maker or ECN. The NASD offered several reasons for eliminating the Broadcast feature in its rule filing. The NASD noted that with the Broadcast feature, SelectNet falls within

[27] The ECN Amendment does not require an ECN to provide non-market maker interest in the data that would be provided under the ECN Display Alternative. Nasdaq has been informed, however, by several ECNs that have non-NASD member participants, *e.g.*, institutional investors, that these ECNs will deliver to Nasdaq the best prices for each security for which they permit orders to be entered, whether those best prices are from a market maker subject to the rule or an entity not subject to the rule. If the ECN so chooses, it may send priced orders to Nasdaq from other entities that are not Nasdaq market makers or exchange specialists. Nasdaq will display such prices as it does other ECN-provided prices.

[28] ECNs often display priced orders that are quoted in finer increments (*e.g.*, 1⁄16, 1⁄32, 1⁄64) than the minimum variation for Nasdaq (currently ⅛ for stocks over $10). Under the ECN Amendment, Nasdaq would not be required to display the actual price of the finer-incremented order; instead, it would round the order to the nearest standard quote increment (rounding down for increments on the better-priced bids and up for better-priced offers). The Commission in the Adopting Release stated that Nasdaq should develop a capability in its quote dissemination system to flag or specially denote that an ECN priced order is rounded, but noted that this capability does not currently exist. Nasdaq has stated that it is developing a rounding indicator. *See* Letter from Alfred R. Berkeley, President, NASD to Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated November 18, 1996, and letter from Richard R. Lindsey to Alfred R. Berkeley, dated November 22, 1996 (regarding display of rounded prices in public quotes).

[29] The requirement for ECNs to display two-sided quotes is a temporary requirement, contingent on Nasdaq's development of a capability that permits ECNs to display a one-sided quote. Nasdaq recognizes that ECNs often have orders only on one side of the market. Currently, however, because Nasdaq's quote display system was built to display market maker quotations and market makers are required by rule to furnish both a bid and offer, Nasdaq's system would be unable to recognize an ECN price unless that price were also entered with a corresponding bid or offer. Accordingly, until such time as Nasdaq builds a one-sided ECN priced order display capability, ECNs must enter two-sided ''quotations.'' The NASD and Nasdaq believe that the one-sided ECN order entry capability should be available sometime in the first quarter of 1997.

[30] *See* discussion below regarding the execution of SelectNet orders at rounded ECN prices when such orders are priced at increments finer than those permitted to be displayed in the consolidated quote system.

[31] An ECN is expected to respond on an automated basis to orders delivered through the SelectNet Linkage much more rapidly than a market maker that receives an order delivered through SelectNet.

the definition of an ECN[32] because it is an ''electronic system that widely disseminates to third parties orders entered therein by an exchange specialist or OTC market maker, and permits such orders to be executed against in whole or in part.'' The NASD stated that it would be unable to make the systems changes necessary to permit a market maker to rely upon the ECN Display Alternative if it entered a priced order into SelectNet. Consequently, market makers that entered priced orders into SelectNet Broadcast would be required to change their quotes in the Nasdaq Workstation display. The NASD also stated that the SelectNet Broadcast feature is a very significant drain on Nasdaq network capacity resources, and in the face of potentially heavy additional system usage pursuant to the Order Handling Rules, network resources are more appropriately devoted to establishing the ECN linkage for directed orders.

iii. *Acceptance of orders at improved prices.* The NASD has also proposed a modification to SelectNet to permit an ECN or market maker receiving an order through SelectNet at a specific price to execute that order at a price reflecting price improvement without having to go through the currently designed counter-offer mechanism. Currently, when a market maker receives a SelectNet order, it can accept at the price sent by the order entry firm; or it can counter with a different price or size. As soon as the market maker puts in a different price, however, the current system treats the new price as a counter-offer message. Because ECNs are likely to hold orders at increments that cannot currently be shown in Nasdaq, when an ECN attempts to accept an order at a better price, *e.g.*, 1⁄16th better, the extant SelectNet system would treat the new price as a counter-offer. Accordingly, to comply with the ECN Amendment requirement that orders be executed at their actual prices, Nasdaq will change SelectNet to prevent the counter-offer mechanism from operating in such a situation and will deliver to the order entry firm and the ECN an execution report at the improved price.

b. *SOES rule change.* The NASD also has proposed an amendment to NASD Rule 4730 to modify the SOES system to reject orders entered when an ECN or UTP Exchange alone sets the price of the NBBO. Although UTP exchanges and ECNs can establish the best price in Nasdaq, they are not required to participate in SOES as market makers and therefore are not accessible through SOES. Proposed Rule 4730(b)(10) provides that if there are no SOES market makers at the best bid or offer that is being disseminated by Nasdaq, orders entered into SOES will be returned to the order entry firm to permit the order entry firm to direct the order to the entity establishing the best price.

Because the ECN quote is incorporated in Nasdaq's inside price but is not accessible through SOES under this approach, and SOES is programmed to execute at the best price displayed, SOES, as currently designed and operating, would execute orders against the next available Nasdaq market maker at the inside price established by an ECN whether that Nasdaq market maker is at the better ECN price or at an inferior price. The NASD expressed concern that a person could ''game'' SOES by entering an order into an ECN that drives the Nasdaq inside quote and obtain multiple SOES automated executions at that price against Nasdaq market makers even though they are not quoting the ECN price.

Therefore, the NASD has proposed to modify SOES to return unexecuted SOES orders to the entering member when the inside quote consists of a SOES-inaccessible price. Order entry firms that enter orders into SOES during the period when there is no SOES market maker at the inside market will be informed that the order has been rejected and may choose to route that order into SelectNet to access the ECN order driving the inside market or take other measures, such as routing the order to a market maker that guarantees the best price.[33] The NASD stated that it believes that order entry firms could avoid submitting orders to SOES during times that a SOES-inaccessible price drives the inside by developing automated means to determine when an ECN or UTP exchange is alone at the inside and delivering orders at such times to an ECN through the SelectNet directed order capability.[34]

c. *Locked and crossed markets rule amendments.* The NASD has proposed amendments to its locked and crossed markets rule, Rule 4613(e), to state that the locked and crossed markets rule applies to any NASD member, when that member enters into an ECN a priced order that is displayed in Nasdaq. The proposed amendment also states that the locked and crossed markets rule would apply to ECNs when the ECN, as an NASD member acting as agent, represents an institutional order or other non-NASD member order the price of which would lock or cross the best bid or offer in Nasdaq. Therefore, under the proposed locked and crossed markets rule, NASD members using ECNs, and ECNs themselves for non-member orders, must comply with Nasdaq's rule that before a market is locked or crossed, the locking or crossing party must first make reasonable efforts to execute the quote that would be locked.

The NASD believes that locked or crossed markets can cause investor confusion because investors will not know the true price of the security at the time when a locked or crossed quote is publicly displayed. The NASD also notes that broker-dealers operating internal order execution systems may be foreclosed from operating those systems when the market for a particular security is locked or crossed.

The NASD and Nasdaq believe that an ECN should be prohibited from entering an institutional order into Nasdaq until the ECN has made a reasonable effort to reach the entity on the other side of the market whose quote would be locked or crossed. It should be noted that if an ECN locks or crosses the market, is alone at that price, and a SOES order is entered against the ECN price that is causing the lock or cross, SOES will be programmed to reject such orders, rather than executing them against a Nasdaq market maker at a different price level.

3. Modifications to Autoquote Policy

Currently, the NASD's Autoquote Policy—which prohibits computer generated quotes—does not allow a market maker to autoquote to display a customer limit order. Although the NASD has previously interpreted the policy to permit a customer limit order to be displayed on an automated basis, because of the requirements of the Display Rule and the benefits to investors and the marketplace to be derived from the Display Rule, the NASD has proposed an amendment to the Autoquote Policy to clarify that it is permissible to autoquote to display a customer limit order.

Another amendment to the Autoquote Policy proposed by the NASD clarifies that ECNs may autoquote to maintain a continuous two-sided quote for as long as Nasdaq requires ECNs to enter two-sided quotes because of existing systems limitations. Once Nasdaq develops a

[32] SEC Rule 11Ac1–1(a)(8).

[33] The NASD and Nasdaq have committed to continue to develop a longer-term approach to the ECN Display Alternative that would better integrate various electronic systems.

[34] The NASD considered the alternative of modifying SOES to ignore the ECN or UTP quote and execute SOES orders at the Nasdaq market maker's inferior price. The NASD expressed concern that this approach would raise best execution concerns because the customer's order entered in SOES would be executed at a price inferior to the best price displayed in Nasdaq's inside market.

system capability that permits ECNs to display a one-sided quote, this exception would lapse.

III. Comments

The Commission received 366 comment letters.[35] A separate summary of comments has been prepared and is available in the public file. The specific issues addressed by commenters will be discussed in the appropriate sections of this order.[36]

IV. Discussion

The standard by which the Commission must evaluate proposed rule changes is set forth in Section 19(b) of the Act. The Commission must approve a proposed NASD rule change if it finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that govern the NASD.[37] In evaluating a given proposal, the Commission examines the record before it and all relevant factors and necessary information.[38] After carefully considering all of the comments, and based on the Commission's experience and knowledge of current market practices and conditions, the Commission believes the NASD's proposed rule changes are consistent with the Act. As noted earlier, the Commission is not acting at this time on the NASD's proposed change to the SelectNet broadcast feature.

Section 15A of the Act, which incorporates by reference Section 11A of the Act, establishes specific standards for NASD rules against which the Commission must measure the NASD proposal.[39] As discussed below, the Commission has evaluated the NASD's proposed changes in light of the standards and objectives set forth in Sections 15A and 11A of the Act.

In enacting the 1975 Amendments and establishing the objective of achieving a national market system, Congress focused closely on the concept of best execution. To this end, Section 11A provides, among other things, that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure economically efficient execution of securities transactions; fair competition among market participants; the availability to brokers, dealers and investors of information with respect to quotations in securities; and the practicality of brokers executing orders in the best market.[40]

Further, as discussed in the Adopting Release for the Order Handling Rules, the 1975 Amendments contain an explicit statutory mandate for the establishment of a national market system. Congress considered mandating certain minimum 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.[41] In accordance with this mandate, the Commission adopted the Order Handling Rules last year.

The Commission believes that the rule changes proposed by the NASD are consistent with the NASD's obligations under the Order Handling Rules and 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 the practicability of brokers executing investors' orders in the best market.[42] The Commission expects that the NASD's rule changes will enhance transparency and facilitate best execution of customer orders, thereby contributing to the achievement of the full potential of the national market system. Further, the NASD's rule changes will bring its systems in compliance with the Order Handling Rules and ensure that its members will be able to meet their obligations under the Order Handling Rules.

The Commission also believes that the proposal advances the objectives of Section 11A of the Act.[43] The Commission believes that in furthering the objectives of the Order Handling Rules, the proposed changes submitted by the NASD are designed to remove impediments to the operation of a free and open market and a national market system, enhance the protection of investors and the public interest, and produce fair and informative quotations, consistent with Sections 15A(b)(6)[44] and 15A(b)(11)[45] of the Act. In addition, the Commission believes that the benefits of the proposal in terms of making the systems and regulatory changes necessary to provide for the enhanced opportunities for price improvement and greater transparency of customer limit orders under the Commission's Order Handling Rules outweigh any potential burden on competition or costs to customers or broker-dealers affected adversely by the proposal. Thus, the Commission believes that the proposal is consistent with Section 15A(b)(9) of the Act in that it does not impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.[46]

[35] The Commission received comment letters from numerous broker-dealer firms, some of which are market makers, and others that are order entry firms. The Commission received comment letters from a large number of individuals who could be identified as SOES traders. The Commission also received comment letters from one self-described entrepreneur, several individual investors and academic commenters. In addition, comment letters were received from several professional associations. The Commission also received comment letters from a member of Congress, Instinet, the American Stock Exchange (''Amex'') and the Chicago Board Options Exchange (''CBOE'').

[36] Several commenters asked that the Commission extend the comment period to allow additional comment. *See* letter from the Honorable Ralph Hall to Arthur Levitt, Chairman, SEC, dated January 8, 1997. The Commission provided the full comment period required under the statute and received over 350 comments. The Commission also has considered numerous comments received after the close of the comment period. In view of the importance of considering the NASD's proposals before the effective date of the Order Handling Rules, however, a longer comment period was not practicable.

[37] 15 U.S.C. §78s(b). The Commission's statutory role is limited to evaluating the rules as proposed against the statutory standards, and does not require the SRO to prove its proposal is the least burdensome solution to a problem.

[38] In the Securities Acts Amendments of 1975 (''1975 Amendments''), Congress directed the Commission to use its authority under the Act, including its authority to approve SRO rule changes, to foster the establishment of a national market system and promote the goals of economically efficient securities transactions, fair competition, and best execution. Congress granted the Commission ''broad, discretionary powers'' and ''maximum flexibility'' to develop a national market system and to carry out these objectives. Furthermore, Congress gave the Commission ''the power to classify markets, firms, and securities in any manner it deems necessary or appropriate in the public interest or for the protection of investors and to facilitate the development of subsystems within the national market system.'' S.Rep. No. 75, 94th Cong., 1st. Sess., at 7 (1975).

[39] See 15 U.S.C. §§ 78k–1 and 78*o*–3.

[40] 15 U.S.C. § 78k–1(a)(1).

[41] S. Rep. No. 75, 94th Cong., 1st Sess. 8–9 (1975) (''Senate Report'').

[42] Exchange Act Section 11A(a)(1)(C)(iii) & (iv), 15 U.S.C. § 78k–1(a)(1)(C)(iii) & (iv).

[43] *See* 15 U.S.C. § 78k–1.

[44] Section 15A(b)(6) authorizes the NASD to adopt rules designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Furthermore, the rules of the NASD must not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

[45] Section 15A(b)(11) authorizes the NASD to adopt rules relating to quotations. Such rules must be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

[46] S.Rep. at 13–14. In weighing the competitive effects of an SRO rule filing, the Commission must

Continued

The Commission has determined at this time to approve the NASD's proposed rule change.[47] The Commission believes that the rules being approved today are consistent with the Act, in particular, with Sections 11A(a),[48] 15A(b)(6),[49] 15A(b)(9)[50] and 15A(b)(11)[51] of the Act and Rules 11Ac1–1 and 11Ac1–4 thereunder.

Various commenters supported the proposed rule change, including market makers, broker-dealers and associations representing broker-dealers. Most of these commenters believed that the proposed rule change would facilitate the implementation of the Order Handling Rules. Many commenters opposed to the proposed rule change cited a concern for decreased liquidity and increased volatility as a potential result of approving the proposed rule change. Still other commenters, including broker-dealers, individual investors and day traders, supported various aspects of the proposed rule change while opposing others. The Commission has determined, for the reasons discussed below, to partially approve the proposal, and to approve Amendment No. 1 on an accelerated basis.

Most of the favorable comments, as discussed below, supported the NASD's efforts to implement the Order Handling Rules by providing mechanisms for the display of customer limit orders and orders placed in ECNs by market makers within the time frame set forth by the Commission in the Adopting Release. In light of all the comment letters received, the Commission believes that the proposal represents a workable first step in the implementation of the Order Handling Rules. In adopting the Order Handling Rules, the Commission firmly believed that they would increase investor protection by ensuring that customer limit orders were immediately displayed in the markets, thus narrowing the quote and increasing quote competition and customer interaction, and by providing investors information about and access to superior prices that specialists and market makers displayed in ECNs. To provide these benefits to the public as soon as possible, the Commission set an accelerated implementation period that was brief in view of the magnitude of the changes necessary to prepare for the Order Handling Rules.

In responding to the established deadlines with the necessary changes to its systems and rules, the NASD was subject to several significant constraints. First, the NASD sought to create a linkage with ECNs by modifying its existing systems because the schedule for implementation of the rules precluded developing new systems or making extensive revisions to its existing systems. Second, the redesign of the NASD's SOES and SelectNet systems (''Legacy systems''), which the NASD has proposed to replace with a newer NAqcess system, was limited by these existing Legacy systems' age and inflexibility. Third, the Nasdaq system has experienced rapid growth in trading and message volume, and has struggled to maintain sufficient capacity for this growth. The significant quote changes resulting from the Order Handling Rules are expected to place serious additional demands on Nasdaq system capacity. Because of these significant constraints and the need to comply with the Order Handling Rules' effective dates, the NASD made a number of compromises in adapting its systems and rules to the Order Handling Rule requirements. These compromises underlie many of the issues raised by commenters regarding the amendments. In a number of instances, the NASD intends to revise its systems after the rules go into effect, which will reduce some of the concerns raised by the commenters.

A. Changes to Minimum Quote Size Requirements

1. Comments

Commenters favoring this aspect of the proposal include market makers, professional associations, institutions and Instinet. These commenters generally agreed with the NASD that the Order Handling Rules will transform Nasdaq into more of an order-driven market, and that market makers should no longer be required to quote more than 100 shares because investor orders will be displayed to the market and included in Nasdaq quotations. These commenters did not believe that liquidity would be adversely affected by the amendment.

These commenters believe that the amendment will motivate market makers to display a size commensurate with their interest whether as principal or agent. They note that this will enhance price discovery, as market makers will not be forced to a quotation size that is not reflective of their actual trading interest, nor will market makers be restricted in their ability to commit capital without also having an opportunity to negotiate an appropriate clearing price.[52] Making the quotation requirement the lowest unit of trading, rather than an artificial minimum decreed by regulation, also conforms to the practices of other markets (*e.g.*, the NYSE and Amex).[53] Finally, these commenters believe that the competitive environment that will result from allowing market makers to quote in sizes equal to their own freely determined trading interest will enhance pricing efficiency.[54]

---

balance any perceived anti-competitive effects against other statutory objectives. The statute does not require the NASD to achieve its objective by selecting the least anti-competitive alternative. *See infra* notes 86–87 and accompanying text.

[47] The Commission is not approving, however, the exception of the proposed elimination of the SelectNet broadcast feature, which the Commission is still considering. Furthermore, the Commission is approving the elimination of the minimum quotation requirement only for the NASD's pilot program for 50 stocks for a three-month period.

[48] Section 11A(a)(1)(C) provides that it is in the public interest among other things, to assure the economically efficient execution of securities transactions and the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities.

[49] Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and in general to protect investors and the public interest.

[50] Section 15A(b)(9) requires that rules of an Association not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

[51] Section 15A(b)(11) requires the NASD, among other things, to formulate rules designed to produce fair and informative quotations.

[52] Letter from Peter W. Jenkins, Chairman, and Holly A. Stark, Vice Chairman, Security Traders Association Institutional Committee, to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''STAIC Letter''); letter from William H. Sulya, Vice President-Manager & Director, Nasdaq/OTC Department, A.G. Edwards & Sons, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 23, 1996 (''A.G. Edwards Letter''); letter from Taymond V. Wilmarth, Vice President and Manager, Equity Trading, Stephens Inc., to Jonathan G. Katz, Secretary, SEC, dated December 23, 1996 (''Stephens Letter''); letter from Antonio Cecin, Managing Director, Equity Trading, Piper Jaffray Inc., to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''Piper Jaffray Letter''); letter from Paul Schott Stevens, Senior Vice President and General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated December 26, 1996 (''ICI Letter''); letter from Robert J. McCann, Managing Director, Co-Head, Global Equity Markets, Merrill Lynch, to Jonathan G. Katz, Secretary, SEC, dated January 7, 1997 (''Merrill Lynch Letter'').

[53] Letter from Dennis Marino, Chairman, and John N. Tognino, President, Security Traders Association, to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''STA Letter''); letter from Dennis Marino, President and Chief Executive Officer, Sherwood Securities Corp., to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''Sherwood Securities Letter''); letter from Bart Green, Manager, OTC Trading, and Phil Schwab, Principal, Edward Jones, to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''Edward Jones Letter''); Merrill Lynch Letter.

[54] Letter from Robert Padala, President, The Security Traders Association of New York, Inc., to

One supporting commenter noted that liquidity will not be reduced because many firms provide automated execution at the quote for small and medium sized customer orders and to other dealers in the market through systems other than SOES.[55] This commenter believes many dealers will continue this practice for competitive reasons.

Commenters opposing the proposal include several order entry firms, some academics, certain individual investors, the Amex and the CBOE. Most of these commenters argued that the proposal would adversely impact liquidity and create volatility. Several commenters were concerned that with the 100-share minimum quotation size all SOES market makers' quotations would easily be exhausted and result in a closed quote state.[56] The NASD rule, in the view of some, would reduce the value of displayed market maker quotes, provide no incentive to quote larger sizes and undermine the Quote Rule.[57] A few order entry firms asserted that the proposal effectively reduces market maker risk by 90%.[58] A number of commenters said that reducing the minimum quote size would effectively eliminate investors' ability to execute orders against market makers' quotes through SOES during volatile trading conditions in individual stocks or market-wide, under the theory that there would be no trading interest in the market from customers or market makers during such times. These commenters argue that this was the very reason that SOES was made mandatory after the 1987 Market Break.[59] One commenter representing a group of SOES users argued that the display of a limit order does not obviate the need for market maker quotes and that the Commission, in the Adopting Release, seemed to suggest that a need for market maker quotes would continue. This commenter argued that the NASD's proposal is thus inconsistent with the Adopting Release.[60]

Amex and CBOE expressed concern over the rule's impact on options market makers' ability to trade at the quote.[61] Several commenters believed the requirement will hurt small order entry firms without order routing arrangements.[62]

Many commenters, while opposed to the change in the minimum quote size requirement for the market maker's proprietary quote, were not opposed to the change in the minimum quote size for market makers displaying a customer limit order.[63]

Finally, a number of commenters opposed to the rule suggested an alternative under which a market maker would separately display both its own proprietary quote and any customer limit orders it holds.[64] They suggested that this could be accomplished either through separate quotes with separate market maker identifiers or as a separate field in the Nasdaq display.

2. Commission Analysis

The Commission has determined to approve the amendment to reduce quotation size requirements for market makers displaying customer limit orders. The Commission believes there are substantial reasons, as explained below, to expect that reducing market makers' proprietary quotation size requirements in light of the shift to a more order-driver market would be beneficial to investors. To gain practical experience with the proposal, the Commission has determined to approve, on a three-month pilot basis, the amendment reducing quotation size requirements for market makers displaying proprietary quotes for the 50 securities first subject to the Limit Order Display Rule.[65] During this pilot program, the Commission, the NASD

Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''STANY Letter''); letter from Alan B. Levenson, Esq. and Robert H. Rosenblum, Esq., Fulbright & Jaworski L.L.P., on behalf of Herzog, Hein, and Geduld, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 26, 1996 (''Herzog, Heine, Geduld Letter''); letter from the Denver Security Traders Association, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''DSTA Letter''); letter from George K. Jennison, Managing Director, Nasdaq Trading, Wheat First Butch Singer, to Jonathan G. Katz, Secretary, SEC, dated December 31, 1996 (''Wheat First Letter''); Merrill Lynch Letter.

55 Wheat First Letter.

56 *See* Letters from Scott Dishner, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Dishner Letter''); Patrick G. Dolan, to Jonathan G. Katz, Secretary, SEC, dated December 30, 1996 (''Dolan Letter''); Joseph Pellechia, to Jonathan G. Katz, Secretary, SEC, dated December 23, 1996 (''Pellechia Letter''); Ishtaj Rahman, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Rahman Letter''); Joel Rebhun, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1996 (''J. Rebhun Letter''); letter from Timothy Whelan, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''Whelan Letter'').

57 Letter from Bruce L. Miller, to Jonathan G. Katz, Secretary, SEC, dated December 23, 1996 (''B. Miller Letter''); letter from David K. Whitcomb, Professor of Finance, Graduate School of Management, Rutgers University, to Dr. Richard Lindsey, Director, Division of Market Regulation, SEC, dated November 21, 1996 (''Whitcomb Letter (11/21/96)''); letter from Ilian Petrov, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Petrov Letter''); letter from Sayan Bhattacharya, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Bhattacharya Letter''); letter from John Geisler, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Geisler Letter''); letter from William Turner, President, Turner Vision, to Jonathan G. Katz, Secretary, SEC, dated December 26, 1996 (''Turner Vision Letter''); letter from Paul Schultz, Associate Professor of Finance, College of Business, The Ohio State University, to Richard Lindsey, Director, Division of Market Regulation, SEC, dated December 13, 1996 (''Paul Schultz Letter''); letter from Winston Meyer, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Meyer Letter'').

58 Letter from Linda Lerner, General Counsel, All-Tech Investment Group, Inc., to Jonathan G. Katz, Secretary, SEC, dated November 22, 1996 (''All-Tech Letter (11/22/96)''); letter from Marina Kaneti, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1996 (''Kaneti Letter''); letter from Michael O'Reilly, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''O'Reilly Letter''); letter from Tolga Erman, to Jonathan G. Katz, Secretary, SEC, undated (''Erman Letter''); letter from David Sciortino, to Jonathan G. Katz, Secretary, SEC, December 19, 1996 (''Sciortino Letter''); letter from Frederick N. Balbi, President, FNB Managment [sic] Inc., to Jonathan G. Katz, Secretary, SEC, undated (''FNB Letter'').

59 *See e.g.*, letter from Jason Goldstein, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Jason Goldstein Letter''); letter from Rob Lindauer, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1996 (''Lindauer Letter''); letter from Bryan Hollander, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Hollander Letter''); letter from James R. Gibbs, Jr., to Jonathan G. Katz, Secretary, SEC, dated December 15, 1996 (''Gibbs Letter''); letter from Alexander Goor, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''Goor Letter'').

60 J. Lee Letter.

61 The Amex also asked the Commission to clarify that the Limit Order Protection Interpretation of the NASD (Manning II) still requires market makers to fill customer limit orders at the quote prior to or at the same time as trading for its dealer account. The Commission notes that the present proposal has no effect on the outstanding Limit Order Protection Interpretation of the NASD. Letter from James F. Duffy, Executive Vice President and General Counsel, American Stock Exchange, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 26, 1996 (''Amex Letter'').

62 Letter from Raymond L. Hope, Jr., to Jonathan G. Katz, Secretary, SEC, dated December 21, 1996 (''Hope Letter''); Turner Vision Letter; letter from David K. Whitcomb, Professor of Finance, Graduate School of Management, Rutgers University, to Richard Lindsey, Director, Division of Market Regulation, SEC, dated January 7, 1997 (''Whitcomb Letter (1/7/97)''). *See also* letter from Yusif Simaan, Associate Professor of Finance, Fordham University, to Richard Lindsey, Director, Division of Market Regulation, SEC, dated December 9, 1996 (''Simaan Letter''); letter from John M. Lang, President, I.Q. Management, Inc., to Jonathan G. Katz, dated December 19, 1996 (''I.Q. Letter'').

63 Letter from Elizabeth Erwin, President, Momentum Securities, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 23, 1996 (''Momentum Letter''); letter from James H. Lee *et al.*, to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''J. Lee Letter''); letter from Dongsoo Lee, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Dongsoo Lee Letter'').

64 Whitcomb Letter (11/21/96); letter from Michael F. Frey, President, A.J. Michaels & Co., Ltd., to Jonathan G. Katz, Secretary, SEC, dated November 20, 1996 (''A.J. Michaels Letter''); letter from Dennis Grossman, President, Grossman & Co., to Jonathan G. Katz, Secretary, SEC, dated December 21, 1996 (''Grossman Letter''); letter from Wesley Jordan, to Jonathan G. Katz, Secretary, SEC, undated (''W. Jordan Letter''); letter from David T.K. Lu, to Jonathan G. Katz, Secretary, SEC, undated (''Lu Letter'').

65 These securities, selected by Nasdaq from the 500 most actively traded securities, range in median daily dollar volume from first to 478th, cover a range of industry sectors, and have an average spread ranging from ⅛ to over one dollar.

and Nasdaq will evaluate the effect of reduced quotation sizes on the market for these securities. As discussed below, factors to be considered in this evaluation include, among others, the impact of reduced quotation sizes on liquidity, volatility and quotation spreads. The Commission believes that the quote size amendment is consistent with the Sections 11A and 15 of the Act both for proprietary and limit order quotes because, in the context of the implementation of the Order Handling Rules, it is designed to encourage fair competition and improved quotation prices, thus improving the quality of executions for investors.

The Commission believes that when an OTC market maker displays a customer limit order, it is appropriate to relieve the market maker of the obligation to quote a minimum size at the limit price. As noted by the NASD and many commenters, if the limit order is smaller than the minimum required quotation size, the quotation requirement would expose the market maker to a principal execution at a price established by the limit order, not by its own proprietary trading interest. In adopting the Limit Order Display Rule, the Commission did not intend to increase market makers' principal exposure and indeed expressly noted that the SROs should consider amending their rules as necessary to allow market makers displaying customer limit orders to quote in smaller size increments.[66]

The Commission is also approving, on a limited basis, the NASD's reduction of minimum quotation sizes for proprietary market maker quotes. The Commission recognizes the concerns of many of the opposing commenters regarding the provision's potential impact on liquidity and volatility. The Commission, based on its experience with the markets and discussions with market participants, believes that decreasing the required quote size will not result in a reduction in liquidity that will hurt investors. As discussed in its release adopting the Order Handling Rules, the Commission expects the public display of market makers' ECN orders and customer orders to add significant depth and stability to the market in OTC stocks. Indeed, the display of customer limit orders provides an unprecedented opportunity in the Nasdaq market for customer interest to interact without the intervention of a dealer. In this regard, the Commission also anticipates that many market makers will choose to display larger quotes as a competitive matter. For these reasons, the Commission also does not believe that the amendments will result in smaller quotes that will prevent investors from obtaining executions in market crises. The Commission also notes that brokers often use other means, such as directing orders to market makers through SelectNet, routing orders on a pre-agreed basis through the NASD's ACES systems, or using private order routing systems, to obtain automated executions for retail investors at sizes larger than market makers' published quotations.

The Commission recognizes that with the shift to a more order driven market, the role of market makers in providing liquidity changes substantially. Currently, Nasdaq market makers are the principal source of liquidity for investors seeking immediacy (*i.e.*, seeking to buy or sell at the best currently available market price). In contrast, on exchanges, where the specialist market maker typically displays most customer orders, those orders provide the principal source of liquidity. With the display of ECN orders and retail and institutional customer limit orders in the Nasdaq market, Nasdaq market makers may frequently find themselves in a similar situation, with customer orders providing the primary source of liquidity and market makers providing liquidity during temporary imbalances in supply and demand.

The Commission believes that it is appropriate to consider whether, in a market displaying customer orders in competition with market maker quotes, there is justification for requiring market makers to quote at a mandatory size. Neither the Act nor the Commission's rules require a quote size larger than 100 shares. Historically, because customer trading interest was not displayed in the Nasdaq market, the NASD determined that it was appropriate that market makers display at least a minimum size in their quotes that would be representative of their trading interest in that security. In contrast, the exchanges have not imposed such a requirement on their own order-driven markets, where specialist market makers are permitted to quote sizes as small as one round lot (100 shares) when they are not representing customer orders. The Commission recognizes, of course, that exchange specialists, in consideration for their central role in a particular security on the exchange, are subject to various trading requirements which are intended to ensure the maintenance of stable and liquid markets.[67] However, a substantial factor contributing to market depth on the exchanges is the peer allocation review process on many of the exchanges, under which specialists are rated on their performance in maintaining stable and liquid markets, and risk forfeiting their stock allocations should their performance lag. The Commission notes that on Nasdaq, not only will customer orders provide liquidity, but multiple market makers compete in various securities. Consequently, even though market makers do not risk losing a stock allocation to another market maker by regulation, they nevertheless risk losing business in the stock to another market maker, an ECN, or a customer order if they are not quoting competitive prices and significant size at those prices. In other words, given a choice between two market makers quoting different sizes at the same price, all else equal, a customer would be more likely to approach the market maker quoting the larger size.[68] Accordingly, at this time the Commission believes that there may be substantial reason to expect that various competitive pressures would encourage market makers to maintain deep markets.

The economic impact on the market of reducing the minimum market maker quote size from 1000 shares to 100 shares raises several issues. The Commission recognizes that the 1000-share quote minimum applicable to many Nasdaq stocks has been viewed as a means of providing liquidity to orders seeking the quoted price. However, the Commission preliminarily believes that a number of factors may well prevent a significant loss of liquidity in moving to 100-share quote minimums.

First, the presence of limit orders mitigates the loss of displayed trading interest by market makers. The Commission believes that the increased representation of customer limit orders is likely to add depth to the markets. As customer limit orders that are priced better than existing market maker quotes are displayed in the public quote, greater flexibility in market maker quotation size may increase trading

[66] Adopting Release, *supra* note 6, at n. 144.

[67] For example, New York Stock Exchange Rule 104.10 requires a specialist to maintain, as far as reasonably practicable, a fair and orderly market, as measured by price continuity and depth, and minimization of the effects of any temporary disparity between supply and demand. *See* Division of Market Regulation, SEC, The October 1987 Market Break Report, (February 1988) p.4–2.

[68] While, as pointed out by commenters, a significant share of retail order flow in the Nasdaq market is internalized or otherwise subject to predetermined order routing arrangements, the Commission nevertheless believes that market maker quotes should serve an important function in attracting trading interest, especially in an order driven environment where there is less incentive and flexibility for market makers to avoid displaying actual trading interest.

interest from market professionals at the inside quotation, thereby adding to market depth. As noted by one commenter, revising minimum quote size will increase the information content of market maker quotes by facilitating different quote sizes from dealers who have a substantial interest in the stock at a particular time and those who do not.[69] This same commenter notes, and the Commission agrees, that for the most liquid Nasdaq securities, ''the ability to interact with live bids and offers that represent real orders, where size is revealed at all price levels (depth of book) is the most fair for all market participants.'' [70]

Second, the 1000 share minimum quote size represents a barrier to entry for market making. Lowering this barrier to entry could attract more market makers, thereby increasing liquidity and competition across the market. Similarly, with large minimum quotes, smaller firms cannot effectively compete on a price basis for stocks with a high per-share price. For example, if security ABCD is trading at $85 per share, the market maker would be exposed at its quote for executions at a minimum of $85,000 when subject to a minimum quote size of 1000. If the minimum quote size is only 100 shares, the market maker's minimum capital exposure at its quote would be reduced to $8500. The Commission believes that a lower minimum quotation size will likely attract smaller firms into the market, increasing both price competition and liquidity.

Moreover, a significant motivation for the Commission's approval, on a limited basis, of the reduction of minimum quotation sizes for market maker quotes is the belief that greater quotation flexibility is likely to lead to narrowing of the spread. Reducing the quotation size requirement reduces the risk that market makers must take, and should encourage them to quote more aggressive prices.[71] Thus, the Commission believes even if there were a decline in quoted depth in certain securities, many investors in those securities may well receive better executions with narrower spreads.

Even if the spread is not narrowed, reducing the required quotation size could encourage continued and even increased market maker participation at the inside market other prices to the extent that the minimum quotation size requirement poses a barrier to entry. Thus, this change could help maintain or increase liquidity in the stock. This could be particularly significant if the display of customer limit orders reduces the profitability of market making in OTC securities, a possibility predicted by the Commission in the Adopting Release.[72] The reduction in risk resulting from reducing the required quotation size and the concomitant reduced exposure to automated executions should help preserve market maker participation that might otherwise be eroded by the display of limit orders and a larger market maker quote size. As noted below, the Commission has requested that the NASD study include information on the spreads and number of market makers of the 50 stocks that are the subject of the pilot program.[73]

Although the Commission preliminarily believes that the proposal will not adversely affect market quality and liquidity, the Commission believes that it is appropriate to take steps to further assess the effect on the markets. Therefore, the Commission is approving a lowering of the minimum quote size in a limited number of securities at this time to assess this provision's impact on a select group of Nasdaq securities. Thus, the Commission has determined that it is appropriate to allow the NASD to implement its proposed rule change reducing minimum quotation sizes for market makers' proprietary orders for the 50 stocks included in the first phase of the Limit Order Display Rule for a three-month period.[74] The Commission believes that these securities, all of which are among the 500 most actively traded Nasdaq securities, provide the most appropriate basis on which to assess the potential for any negative impact suggested by opposing commenters. The three-month pilot will give the Commission, the NASD and Nasdaq time to assess the impact of the change on the market, before considering the rule change on a broader or permanent basis. The Commission is approving this pilot program to begin at the same time as the first phase of the Order Handling Rules because the Commission believes that it is important for the markets and the Commission, in its oversight role over these markets, to be able to evaluate the combined impact of the NASD's proposed changes to Nasdaq and the Order Handling Rules in a limited group of securities.

The Commission requests that the NASD and Nasdaq conduct a study during this pilot to gauge the effect of the reduction in minimum quote size on the market for these 50 stocks. The Commission notes that these 50 stocks were chosen to provide a broad cross section of the most liquid Nasdaq securities. The number of market makers in these stocks presently ranges from a low of three to a high of 49. The inside spread ranges from ⅛ to $1 and the price ranges from approximately $9 to $141 with an average price of $44.50. The current 1000 share minimum for these stocks therefore represents, on average, approximately $44,000 per trade, a substantial amount in the retail context.

Specifically, the NASD study should include an analysis of: (1) The number of market makers in each of the 50 securities, and any change in the number over time; (2) the average aggregate dealer and inside spread by stock over time; (3) the average spread for each market maker by stock; (4) the average depth by market maker (including limit orders), and any change in the depth over time; (5) the fraction of volume executed by a market maker who is at the inside quote by stock; and (6) a measure of volume required to move the price of each security one increment (to determine the overall liquidity and volatility in the market for each stock). The Commission expects that these factors be contrasted over the time period immediately preceding the pilot and after the beginning of the pilot. Further, the Commission notes that beginning three weeks after the commencement of the pilot on 50 stocks, market makers will be required to display customer limit orders in 100 additional stocks pursuant to Rule 11Ac1–4. These 100 stocks will not be part of the pilot that the Commission is approving today, and therefore provide an opportunity for direct comparison with the stocks in the pilot. Thus, the Commission requests that the NASD and Nasdaq include in the study a matched pairs analysis of the 50 stocks in the pilot with 50 stocks in the second phase-in. This analysis should

---

[69] STAIC Letter.

[70] STAIC Letter.

[71] *See* All-Tech Letter (11/22/96); Kaneti Letter; Petrov Letter. *See supra* note 58. Even opponents of change recognize that reducing the mandatory size for quotations reduces market maker risk.

[72] Adopting Release, *supra* note 6.

[73] The Commission is aware of several articles associating smaller quote sizes with narrower spreads. *See* Bacidore, *The Impact of Decimalization on Market Quality: An Empirical Investigation of the Toronto Stock Exchange* (Revised: July 1996); Harris, *Minimum Price Variations, Discrete Bid-Ask Spreads, and Quotation Sizes*, Review of Financial Studies 7 (1994); Copeland, T. and Galai D., *Information Effects of the Bid-Ask Spread*, 38 Journal of Finance (1983). Although cognizant of distinctions in the relevant markets involved in these studies that make comparisons with the Nasdaq market nondefinitive, the Commission believes that these studies provide additional support for the proposed pilot program.

[74] The Commission notes that at the conclusion of the three-month pilot, the market makers must quote the previously required size unless the Commission approves the change on an extended or permanent basis.

encompass the six factors enumerated above. The Commission will consider the results of the study in determining whether to extend or expand the pilot.

Some commenters suggested that the Commission establish a system of dual quotes so that market makers could separately display limit orders and proprietary trading interest.[75] The Act does not require an exchange or association to separately display these two types of trading interest. These changes also could require extensive systems changes on the part of Nasdaq, and could absorb substantial additional Nasdaq systems capacity at a time when Nasdaq capacity may potentially be under strain. The Commission also does not believe that the NASD is statutorily required to move toward a central limit order book or ''black box'' system, as favored by some commenters.[76] It should be noted that the Commission was recently urged to adopt such approaches as alternatives to its Order Handling proposals. The Commission determined that at present it is in the best interest of investors, and consistent with the Act, to require the display of customer limit orders through the quotations communicated by market makers to the consolidated quotation stream, directly or through market or ECN systems.[77]

B. Changes to SOES in Response to the Order Handling Rules

Many commenters addressed the NASD's proposed changes to SOES in response to the Order Handling Rules. Specific areas of concern are discussed below.

1. Decrementation of Displayed Quotation Sizes After SOES Executions

a. *Comments.* As noted above, the rule change provides that a market maker's displayed size will be decremented after each unpreferenced SOES execution. Market makers generally, and the DSTA and STA, expressed support for the amendment. Several other market makers, while supportive of the provision, argued that a market maker should have the option to set a higher exposure limit than just its displayed quote size.[78] One market maker and the SIA argued that there is no reason to distinguish between preferenced and unpreferenced orders in decrementing the quote, and that a market maker's quote should be decremented upon execution of preferenced orders as well as non-preferenced orders.[79]

Academics, order entry firms and SOES traders opposed the amendment to make the displayed quotation size a firm's exposure limit. Several commenters argued that the proposed reduction of minimum quotation sizes to 100 shares, together with the proposal to establish a market maker's displayed quotation size as its exposure limit, would effectively eliminate SOES.[80] One order entry firm expressed concern that it is not clear what maximum order size limits order entry firms will be held to in the future. In addition, several SOES traders suggested that if this amendment is adopted, the NASD interpretation limiting order entry firms to one 1000-share trade per security every five minutes (''five minute rule'') should be eliminated.[81]

Several SOES traders argued that in light of the decrementing provision, the 15-second quote update period following an execution is too long and should be reduced or eliminated.[82] In addition, some of these commenters argued that the five minutes during which a market maker goes into a ''closed quote'' status following decrementation to zero is too long.[83]

b. *Commission analysis.* The NASD has proposed to replace its current mandatory quote size and SOES exposure limits with voluntary quote size, decremented as executions occur against this quote size. As a result, the maximum exposure at the quote will be reduced from twice the SOES tier size to the displayed quote size. The NASD redesigned the SOES exposure limits to reflect the introduction of customer limit orders required by the Order Handling Rules. Decrementing the quote will ensure that quotes reflecting limit orders are withdrawn once the limit order is fully executed, consistent with display of customer limit orders. The NASD applied decrementing to market maker proprietary quotes as well as customer limit orders in part because of the inability of the system to differentiate between market maker limit order and proprietary quotes. In addition, the NASD believes that reducing the quotation to reflect SOES executions more accurately reflects the nature of the market maker quote when limit orders are required to be displayed.

The Commission believes that allowing both proprietary and customer quote sizes to be reduced to reflect executions may encourage more competitive market maker quotes because, as discussed previously, market makers can control more precisely the extent of their exposure in SOES at the quoted price. This in turn may improve customer execution prices and increase investor participation in the market. In addition, market makers may be encouraged to continue or increase their market making role, mitigating the competitive pressure resulting from the display of ECN prices and customer limit orders.

In addition, the Commission believes that the display of customer limit orders should result in an increase in the displayed quotation size, offsetting at least in part the reduced exposure limits for market maker quotes. The Commission believes that these potential benefits from quotes more representative of market makers' actual trading interest and the display of limit orders offsets the potential for reduced execution size against the quote in

[75] *See supra* note 64.

[76] Whitcomb Letter (11/21/96); All-Tech Letter (11/22/96).

[77] Adopting Release, *supra* note 6. The Commission also does not believe that the liquidity available to options market makers, like other investors, will be reduced by the Amendments. Nor do the amendments approved today alter the access of options market makers to Nasdaq systems such as SOES or SelectNet.

[78] Letter from Edward J. Johnsen, Vice President and Counsel, Morgan Stanley & Co. Incorporated, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Morgan Stanley Letter''); Stephens Letter; Piper Jaffray Letter

[79] Letter from Bernard L. Madoff, Chairman, Trading Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC dated December 26, 1996 (''SIA Letter''); letter from Lon Gorman, Chief Executive Office, and Leonard Mayer, President, Mayer & Schweitzer, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 27, 1996 (''Mayer & Schweitzer Letter'').

[80] All-Tech Letter (11/22/96); Whitcomb Letter (11/21/96); Simaan Letter; Momentum Letter; letter from Mark K. Sydenstricker, Vice President and Chief Financial Officer, The Exchange House, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Exchange House Letter'').

[81] *See* e.g., letter from Adam Raichel, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Raichel Letter''); letter from Michael Gleeson, to Jonathan G. Katz, SEC, dated December 19, 1996 (''Gleeson Letter''); letter from Paul R. Rudd, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''P. Rudd Letter''); letter from Chris Boran, to Jonathan G. Katz, Secretary, SEC, undated (''Boran Letter''); letter from Arthur E. Herrmann, to Jonathan G. Katz, Secretary, SEC, dated December 10, 1996 (''Herrmann Letter''); letter from Feral Talib, to Jonathan G. Katz, SEC, undated (''Talib Letter'').

[82] Letter from Gil Shapiro, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1996 (''Shapiro Letter''); letter from Joshua Pohl, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Pohl Letter''); Joseph Walsh, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1996 (''Walsh Letter''); Raichel Letter; letter from Nancy Tom, to Jonathan G. Katz, Secretary, SEC, dated December 24, 1996 (''Tom Letter''); letter from Charles Rhyee, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Rhyee Letter''); Whelan Letter.

[83] Letter from Matthew Kansler, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Kansler Letter''); letter from John Parente, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Parente Letter''); letter from Alexis Theofilactidis, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Theofilactidis Letter''); letter from Marcie D. Rebhun, to Jonathan G. Katz, Secretary, SEC, dated December 15, 1996 (''M. Rebhun Letter'').

SOES. Therefore, the Commission believes that the decrementing of quote size is consistent with the Act, in particular 11A.

In response to commenters who recommended that market makers have an option of setting a higher exposure limit, the NASD has amended the proposal to make the decrementing provision optional for quotes displaying size equal to or more than the SOES tier size for the security.[84] The Commission agrees that this modification is consistent with the Act. The Commission believes that allowing market makers that quote in substantial size to opt out of decrementing will encourage the display of greater quote size and allow market makers to maintain quotes that add depth to the markets.

The Commission notes that the NASD did not propose in the current filing any amendments to the 15-second period following an execution during which a marker maker may update its quote, or the five-minute ''closed quote'' provision. These provisions thus are not under review at this time. Similarly, amendment of the five minute rule is not part of the current proposal, and thus not under review at this time.[85] However, the Commission believes that these time periods are not inappropriately long in the context of the instant SOES revisions. The Commission also believes that dropping a market maker with a zero quote to the bottom of the display screen helps reduce confusion and makes clear which market makers are ''in the market.''

Finally, the Commission believes that it is consistent with the Act to modify the quotation requirements for unpreferenced orders only. The Commission recognizes that many firms have arrangements with correspondents by which they agree to execute order flow at the prevailing quote. These preferencing arrangements are wholly voluntary, and can be subject to conditions if so desired by the market maker. The Commission has considered such arrangements in the past,[86] and has not found them to be violative of the investor protection goals of the statute. For firms executing high volumes of trades pursuant to such arrangements, mandatory decrementing pursuant to such activity would require the market maker to repeatedly update its quote in response to orders executed at its quote. The Commission does not believe this outcome is compelled by the statute. In any event, the NASD's current proposal does not include an optional decrementing provision for preferenced order flow, and thus this issue is not currently before the Commission.

2. Split Order Execution

a. *Comments.*Order entry firms and SOES traders argued against allowing SOES executions at split prices. These commenters stated that order entry firms and their customers would experience added expense and delay because their orders could be subject to multiple executions against multiple parties.[87] Several commenters stated that a SOES order of 1000 shares could be split up into as many as 10 trades and executed against 10 separate market makers at a price inferior to the best displayed quote at the time the order was sent.[88] Several commenters also objected to the elimination of ''all or none'' orders from SOES.[89]

b. *Commission analysis.* The Commission is approving the proposed amendment because it is a necessary adjunct to eliminating required quote sizes for market makers, and allowing display of customer limit orders of less than the SOES order size. As discussed previously, the Commission does not believe that in a market displaying limit orders the Act compels a market maker to trade at a size greater than the minimum trading unit, thus assuming greater risk than it would otherwise. Although split order executions can result in somewhat greater execution costs for an order entry firm, these split executions accurately reflect trading interest in the market at that time. In addition, the amendment is necessary to ensure the smooth functioning of SOES in an environment where market makers must regularly update their quotes to reflect customer limit orders and assess their own desire to assume market risk. Finally, if a customer wants to assure that it does not receive split executions, it may enter orders at the size of the best displayed quotes, or request that its order not be executed through SOES.

The NASD has proposed to prohibit entry of all-or-none orders in SOES because it believes that most users of all-or-none market orders do not expect execution of all-or-none orders at multiple prices. The amendment to the SOES system to allow split executions, combined with the proposed elimination of minimum quote size, could result in SOES orders being executed at more than one price. In addition, revising the SOES system to provide all-or-none executions in the context of the modified SOES system would require substantial Nasdaq resources. The Commission believes that the NASD's decision to not provide for all-or-none orders in the revised SOES system reduces the possibility of investor confusion regarding the execution prices that could result and, thus, is consistent with the directive in Section 15A(b)(6) that the NASD's rules be designed to facilitate the maintenance of fair and orderly markets.

3. Prohibition Against the Entry of Non-Marketable Limit Orders into SOES

a. *Comments.*Several market makers expressed support for prohibiting entry of non-marketable limit orders into SOES while several order entry firms and a SOES trader argued against it. These latter commenters generally argued that the NASD should not prohibit the entry of non-marketable limit orders into SOES and therefore should not eliminate the SOES limit order file.[90] One commenter said that the concept is not adequately described.[91]

b. *Commission analysis.* The Commission believes the prohibition is consistent with the Act because, as noted by the NASD, limit orders held in

[84] *See supra* note 3.

[85] The Commission notes that the NASD has proposed substantial revisions to small order execution in its NAqcess proposal.

[86] *See* Securities Exchange Act Release No. 29810 (October 10, 1991), 56 FR 52098 (October 17, 1991) (order approving SR-NASD–91–18 and SR-NASD–91–26, amendments to SOES).

[87] Letter from Kelly Jordan, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''K. Jordan Letter''); letter from Michael P. Doyle, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''Doyle Letter''); letter from Brian Schartz, to Jonathan G. Katz, Secretary, SEC, undated (''Schartz Letter''); letter from Drew Sohn, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1996 (''Sohn Letter''); Bhattacharya Letter, All-Tech Letter (11/22/96); letter from Paul Nadan, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''P. Nadan Letter''); letter from Steve Dworkin, to Jonathan G. Katz, Secretary, SEC, undated (''Dworkin Letter''); Petrov Letter, W. Jordan Letter; letter from Nicola Victory, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Victory Letter''); letter from Cornel Catrina, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Catrina Letter'').

[88] Whitcomb Letter (11/21/96); Simaan Letter.

[89] Letter from Ed Chui, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Chui Letter''); letter from Tracy Clarke, to Jonathan G. Katz, Secretary, SEC, undated (''Clarke Letter''); letter from Robert Beers and Stephen Wilk, to Jonathan G. Katz, Secretary, SEC, dated December 26, 1996 (''Beers & Wilk Letter''); letter from Michael T. Studer, President, Castle Securities Corp., to Secretary, SEC, dated December 24, 1996 (''Castle Letter''); letter from Russell A. Grigsby, President, Cornerstone Securities Corporation, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Cornerstone Letter''); FNB Letter.

[90] Letter from Warren E. Spehar and Michael J. Schunk, Managing Partners, First Westchester Securities, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''First Westchester Letter''); letter from Seth Hurwitz, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''Hurwitz Letter''); FNB Letter.

[91] Grossman Letter.

the SOES limit order file are not displayed in the public quote, thus making the file inconsistent with the Limit Order Display Rule. Further, because of its inherent limitations, the limit order file also was infrequently used, undermining its potential usefulness. Thus, the Commission agrees that it is appropriate to eliminate the file to assure compliance with the Order Handling Rules.[92]

4. Modifications to the SOES Automated Quotation Update Feature

a. *Comments.* Several market makers supported the proposal to allow auto-refreshing of the market maker's quote.[93] One market maker commented that automation facilitates the efficient operation of the multiple market making system and fosters efficiency and liquidity. Without this modification, according to this commenter, market making would become prohibitively expensive for many firms.[94] Another market maker argued that if a market maker could have one side of its quote refreshed at an inferior price without also adjusting the other side of its quote, then the NASD also should modify Rule 4613(d), the NASD excess spread parameters rule.[95] Several commenters were concerned about the NASD's proposal to refresh market maker quotes for 100 shares instead of tier size.[96]

b. *Commission analysis.* The Commission is approving the modification because it believes an automatic quote update feature, which is currently available in SOES, is consistent with the Act. As originally proposed, the auto-refresh capability will update the quote for only the required minimum quote size. In the NASD's amendment establishing the pilot, however, for programming reasons the NASD proposed to auto-refresh the quotation up to the SOES order size for all securities, including the 50 pilot stocks. The market maker would be allowed to reduce the size in these 50 pilot stocks if it wished to quote at a smaller size. The Commission believes that auto-refresh will be a helpful tool for market making in this new environment, and is consistent with the Act.

5. Allowing SOES Market Makers to Enter Agency Orders into SOES

a. *Comments.* Several market makers expressed support for the proposal to allow SOES market makers to enter customer orders into SOES.[97] The SIA and several market makers argued that market makers should be allowed to enter riskless principal orders into SOES as well as agency orders, as these orders are the economic equivalent of agency orders.[98] Several market makers argued that market makers should also be permitted to enter proprietary orders into SOES.[99]

Several SOES traders opposed the proposal.[100] One SOES trader suggested that verification procedures were needed to assure that orders entered by market makers were legitimate agency orders.[101]

b. *Commission analysis.* In the Adopting Release for the Order Handling Rules, the Commission suggested that the NASD consider revising SOES to allow market makers to enter customer orders into SOES in particular to execute against displayed customer limit orders.[102] The Commission was concerned that firms operating internal automated execution systems could execute substantial customer orders based on individual limit orders establishing a best bid or offer price. The Commission suggested that while under best execution principles the firm would be expected to match the displayed quote up to its size, the firm should be provided a mechanism to instead execute the customer limit order directly against the superior displayed quote. The NASD proposal is consistent with this suggestion. The NASD has not permitted market makers to enter orders into SOES for their own account, because to date the NASD has concluded that automated execution by one market maker against another would expose market makers to excessive risk and thus would discourage market making. Therefore, the proposal is limited to market maker riskless principal orders reflecting agency orders held by the market maker. The NASD intends to monitor for compliance with this condition as part of its regular examination program for market makers.

The Commission believes it is consistent with the Act to eliminate differentiating between agency orders entered in SOES by market makers or order entry forms. Accordingly, the Commission is approving the amendment. Furthermore, the Commission notes that riskless principal orders entered by market makers on behalf of customer orders will be accorded like treatment under the rule. The Commission agrees with the NASD that the amendment will help to ensure that all customer orders receive the benefit of interaction with other interest in the market and enhanced price improvement opportunities.

6. Processing of Marketable Limit Orders

a. *Comments.* Only one commenter addressed the issue of eliminating the priority accorded marketable limit orders over market orders in SOES, expressing support for the proposal.[103]

b. *Commission analysis* The Commission believes the amendment is consistent with the Act, and therefore approves this modification. This amendment will eliminate an unwarranted advantage to investors placing marketable limit orders over those placing market orders. This result recognizes the functional equivalency of these two types of orders.

7. Market Maker Withdrawal from Nasdaq SmallCap Market Securities

a. *Comments.* Only one commenter addressed this issue; this market maker believed the provision should be modified such that a market maker would be deemed to have voluntarily withdrawn from the market if its quote remained at zero at the opening of the following trading day.[104]

b. *Commission analysis.* The Commission believes this amendment is consistent with the Act, and therefore

[92] The Commission notes that the NASD's NAqcess proposal, which would create a publicly displayed limit order book, is still under consideration. *See* Securities Exchange Act Release No. 37302 (June 11, 1996), 61 FR 31574 (June 20, 1996).

[93] DSTA Letter; Edward Jones Letter; Herzog, Heine, Geduld Letter.

[94] Edward Jones Letter.

[95] Morgan Stanley Letter.

[96] Castle Letter; Gleeson Letter; letter from Wayne Hong, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Hong Letter''); letter from James B. Carpenter, to Jonathan G. Katz, Secretary, SEC, undated (''Carpenter Letter''); letter from Tai Truong, to Jonathan G. Katz, Secretary, SEC, dated December 15, 1996 (''Truong Letter''); letter from Daniel Balber, to Jonathan G. Katz, Secretary, SEC, undated (''Balber Letter''); letter from John Cassimatis, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''Cassimatis Letter'').

[97] *See e.g.*, Herzog, Heine, Geduld Letter; Edward Jones Letter.

[98] SIA Letter; letter from Peter C. Cohan, Managing Director, Pershing to Jonathan G. Katz, Secretary, SEC, dated January 2, 1997 (''Pershing Letter''); Mayer & Schweitzer Letter.

[99] Letter from Dan B. Franks, Senior Vice President, Equity Trading, Scott & Stringfellow, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 23, 1996 (''Scott & Stringfellow Letter''); letter from Leslie Seff, Fidelity Capital Markets, to Jonathan G. Katz, dated December 23, 1996 (''Fidelity Capital Letter'').

[100] Gleeson Letter; letter from Stephen Kovacs, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Kovacs Letter''); Grossman Letter.

[101] Letter from Hendrickson, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''Hendrickson Letter'').

[102] Adopting Release, *supra* note .

[103] Herzog, Heine, Geduld Letter.

[104] Herzog, Heine, Geduld Letter.

approves this modification. The Commission does not believe that requiring a market maker to reenter a quote in a SmallCap security by the close of trading for the day presents a significant hardship to market makers in a security. Furthermore, establishing an outer time frame by which a market maker must reenter its quote makes it clear to the market which market makers in a security are willing to continue market making in the security.

C. Implementing the SelectNet Linkage

As noted above, the NASD proposed to change certain rules and aspects of the SOES and SelectNet systems to implement the SelectNet Linkage, which is intended to facilitate the operation of the ECN Display Alternative based on existing Nasdaq system platforms, SOES and SelectNet. The nature of this linkage was constrained by the needs of the ECNs and the limitations on the Nasdaq computer systems discussed previously.

1. Display of ECN Prices

a. *Comments.* Several market makers and the SIA supported the proposal for the display of ECN prices and characterized it as a ''reasonable interim approach.'' [105] Those favoring the proposal praised the consolidated market maker/ECN quote as increasing market transparency.

Comments criticizing the proposal were submitted by Instinet, individual investors, academics, order entry firms and SOES traders. The majority of critical comments concerned the rounding indicator. Many commenters objected to the determination of the NASD not to disseminate the actual prices displayed by ECNs if those prices are in increments finer than the NASD's minimum quotation increments.[106] Some commenters argued that the failure to display the actual price or an indicator that a price was rounded would make it impossible for brokers to find the best price for retail customers.[107] These commenters requested either that rounding not be approved without the indicator, or encouraged the NASD and Nasdaq to implement the rounding indicator as soon as possible, and move to finer increments or decimal pricing as soon as feasible.[108] One commenter, noting that ECNs with rounded prices will not have display priority over market makers at an inferior, displayed price, but instead will be treated as if their rounded price were their actual price and entered according to time priority, questioned whether any technological reason existed for this approach.[109] One order entry firm suggested that rounding without an indicator permits an ECN to ''hide its market'' which is inconsistent with the Order Handling Rules.[110] This firm also suggested that once the rounding indicator is available, market makers should be allowed to quote with the indicator. Finally, several order entry firms suggested that rounding permits the market maker to trade at the superior price with the ECN, give its customer a fill at the posted quote, and keep the ''hidden'' fraction.[111]

b. *Commission analysis.* While recognizing and sharing concern about the lack of a rounding indicator, the Commission believes that this amendment represents a significant step forward in the public display of prices entered into ECNs. For the first time, a consolidated montage displaying both quotes of market makers and ECN prices will enable investors and market professionals alike to view in one place all the trading interest in a particular security in the market. In addition to providing improved transparency, the proposed Nasdaq linkage will enable investors to access prices that previously were available only to subscribers to an ECN. Thus, investors will have access to better prices and the goal of best execution for all customers will be advanced.

The Commission has determined the NASD's proposal to develop the SelectNet linkage is consistent with Act and, thus, is approving the proposal. The Commission believes the SelectNet linkage furthers the Section 11A objective of achieving more efficient and effective market operations, fair competition among brokers and dealers, and the economically efficient execution of investor orders in the best market. Specifically, the development of the SelectNet linkage will facilitate the display of customer limit orders, thereby advancing the national market system goal of the public availability of quotation information, as well as fair competition, market efficiency, and best execution. The enhanced transparency of these orders also 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.

In adopting the Order Handling Rules, the Commission recognized that ECNs may display orders in increments smaller than the minimum quotation increments used in the public trading markets. The Order Handling Rules sought to publicize the ECN prices in the existing public quotation systems, but in doing so did not require the SROs to alter their existing trading increment. Rather, the Commission allowed market makers' and specialists' quotes in ECNs at finer increments to be displayed in the SROs markets at prices rounded to the SROs' quotation increment, with a rounding indicator.[112] The NASD and other SROs have indicated that, as a technical matter, display of a rounding indicator is not possible by the implementation date of the rules.

Many commenters stated that the lack of a rounding indicator will make it difficult to determine if an improved price is available from an ECN. The NASD and Nasdaq have acknowledged this difficulty and have committed to resolving this problem by implementing a rounding indicator as soon as possible. The Commission believes the NASD and Nasdaq are acting in good faith and have granted the SROs no-action relief concerning the lack of a rounding indicator until July 31, 1997.[113] The Commission believes that there is much to be gained by going forward with the SelectNet linkage without the indicator, pending Nasdaq's development of an appropriate format for such a notation. The Commission notes that, consistent with the Order Handling Rules, when an order is sent through SelectNet to an ECN and a market maker or specialist has entered an order at a better price, which is rounded for display in Nasdaq, the order sent through SelectNet will receive the better price available in the ECN. Moreover, broker-dealers will be able to enter orders through the SelectNet linkage priced at finer increments than the rounded quotes. Broker-dealers and their customer can use such orders to define the prices at which they are willing to trade.

2. Access to ECN Prices

a. *Comments.*

Some commenters criticized the lack of an electronic linkage between the ECNs and SOES, and argued that it should be possible for SOES orders to be

[105] Herzog, Heine, Geduld Letter; Mayer & Schweitzer Letter; SIA Letter; Pershing Letter.

[106] A.J. Michaels Letter; All-Tech (12/23/96); Grossman Letter; Hope Letter; I.Q. Letter; Hurwitz Letter; Simaan Letter; Whitcomb Letter (11/21/96).

[107] All-Tech Letter (12/23/96), Whitcomb Letter (11/21/96); Simaan Letter; letter from Seth Modlin, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Modlin Letter'').

[108] A.J. Michaels Letter; All-Tech Letter (12/23/96); Simaan Letter; Whitcomb Letter (11/21/96). *See also* Hope Letter; I.Q. Letter; Hurwitz Letter.

[109] Whitcomb Letter (12/10/96). *See also* Instinet Letter.

[110] All-Tech Letter (12/23/96).

[111] A.J. Michaels Letter; First Westchester Letter.

[112] Adopting Release, *supra* note .

[113] *See supra* note .

electronically routed to an ECN.[114] Several commenters noted that the lack of the linkage could eliminate the market maker's risk of exposure to executions at the ECN price.[115] Furthermore, commenters argued that without automated execution through the linkage, ECNs would be able to favor their own customers in executions.[116] Other commenters expressed concern that because a SOES/SelectNet linkage was not required, the execution of small orders entered into SOES, but rejected on the basis of a superior ECN quote, will be delayed while they are manually rerouted to SelectNet.[117] In contrast, Instinet argued that the proposal's requirement that ECNs automate SelectNet response functions is costly and excessively burdensome. Instinet further maintained that ECNs should be given flexibility to evaluate the credit worthiness of non-ECN subscribers.

b. *Commission analysis.* As discussed above, some commenters criticized the lack of an automated execution between SOES and the ECNs. The Commission, in the Adopting Release, stated that ECNs must provide broker-dealers who use SOES with equivalent automated access to the best priced market maker orders in the ECN for NNM and SmallCap securities.[118] This could be accomplished either through an electronic linkage to SOES or by other means agreed upon with the NASD.[119] The Commission recognizes that the SelectNet Linkage does not include an electronic linkage to SOES. The SelectNet linkage was developed to accommodate the ECNs, at least on an interim basis, to receive an order rather than an automated execution such as provided by SOES. The ECNs by definition provide automated executions of orders internally. Linking to an external automated execution system would create the risk of two simultaneous executions against the same order, thereby forcing the ECN operator to trade as principal without an order on the other side. Because the Commission expressed strong support for an effective ECN display alternative as an element of the Order Handling Rules,[120] the NASD determined to create the SelectNet linkage as an interim measure to implement the ECN display alternative by the implementation date of the rules. Because of the age and inflexibility of the SOES and SelectNet systems, the NASD was unable to link its SOES system to the SelectNet system by the effective date of the rules, in order to allow SOES orders to be routed to the ECN via SelectNet when the ECN displayed a superior price. The NASD has indicated that the existing linkage is in its view an interim measure, and that it intends to link these functions in the future. The NASD also intends to include in its proposed ECN addendum to the Nasdaq Workstation subscriber agreement requirements that the ECN respond promptly to a SelectNet linkage order.

In response to Instinet's comment opposing the requirement of automated responses from ECNs, the Commission believes that this requirement is necessary to assure the smooth functioning of the SelectNet linkage. The Commission believes that, because the SelectNet linkage does not provide automated executions, any significant delay in response to a SelectNet order from the ECN will unreasonably prolong execution time for the customer. However, the Commission believes that the NASD requirements for ECNs will result in execution response times of a matter of seconds, so that use of the linkage will be virtually immediate.

The Commission takes very seriously the concern expressed that ECNs could potentially favor their own customers. The Commission is satisfied, however, that adequate safeguards are in place to prevent ECNs from discriminating between customers in a manner inconsistent with the Order Handling Rules. First, ECNs will be required to execute an ECN addendum to the Nasdaq Workstation subscriber agreement providing that they cannot prefer their own customers in executions or discriminate against linkage orders. Second, the subscriber agreement requires prompt responses to linkage orders. Finally, the Quote Rule only excepts a broker-dealer from honoring its quote if it is effecting a transaction or is in the process of updating its quote. If an ECN cannot demonstrate that one of these exceptions applies, it will be liable for a violation of its Quote Rule obligations as well as the NASD ECN subscriber agreement.

In response to Instinet's concern about the need for time to examine the credit worthiness of customers, the Commission notes that a key condition of performing as a display alternative under the Order Handling Rules is that the ECN provide access to its prices to broker-dealers equivalent to that provided by market makers and specialists. Market makers and specialists must be firm at their quotes for orders from at a minimum all brokers and dealers. The ECN must satisfy the same standard. The Commission staff has interpreted the Quote Rule to allow a narrow exception so that the market maker may take into account the substantial likelihood that a counterparty may not perform in determining whether to trade with the counterparty at its quote.[121] The SelectNet linkage and the NASD ECN addendum would not preclude an ECN from declining an order from a counterparty if it had a substantial basis for believing the counterparty would not perform; indeed, an ECN could program its system to reject linkage orders from particular counterparties if the ECN can satisfy this narrow exception from the Quote Rule. Rejection of linkage orders for generalized credit concerns would not constitute providing equivalent access as required to qualify as an ECN display alternative.

3. Implementation of the ECN Linkage

a. *Comments.* Instinet argued that the Workstation Subscriber Agreement required by the rule should not contain substantive conditions not imposed on other users Nasdaq workstation users. Instinet also objected to the characterization of the linkage by the NASD and Nasdaq as ''interim,'' and expressed its opposition to further modifications that may make the linkage resemble a consolidated limit order file. Instinet requested that the SEC monitor negotiations regarding further modification between the ECNs and the NASD.

b. *Commission analysis.* In its November interpretive letter,[122] the Commission staff recognized that the SROs should have the ability to establish reasonable conditions on ECNs linking with the SRO pursuant to the ECN display alternative. The Commission believes that the NASD's Workstation Subscriber Agreement addendum is an appropriate vehicle for establishing reasonable conditions for ECNs linking with Nasdaq. Regarding

[114] Morgan Stanley Letter; Instinet Letter; Exchange House Letter; Grossman Letter; Lu Letter.

[115] *See e.g.*, Grossman Letter; Hurwitz Letter.

[116] *See e.g.*, Cornerstone Letter; All-Tech Letter (12/23/96).

[117] All-Tech Letter (11/22/96); Pompeo Letter; Beers & Wilk Letter; Edward Jones Letter.

[118] Adopting Release, *supra* note . The Commission also discussed the provision of telephonic access to ECN prices.

[119] *Id.*

[120] Adopting Release, *supra* note .

[121] The Commission staff interpreted the Quote Rule as permitting a market maker from refraining from trading at its displayed quote if it had a substantial basis for believing that the counterparty to the transaction will not be able to honor the trade. Letter from Richard Lindsey, Director, Division of Market Regulation, SEC, to Richard Grasso, Chairman and CEO, NYSE, dated November 22, 1996, p. 17.

[122] *See* letter from Richard R. Lindsey, Director, Division of Market Regulation, SEC, to Richard Grasso, Chairman and CEO, NYSE, dated November 22, 1996.

Instinet's concerns about the NASD's further modifications to the interim approach, the Commission believes it is premature to consider the nature of potential revisions at this time. The Commission believes that it is important to enhance the SelectNet linkage to connect the market order executions systems with the ECN linkages; however, the design of these future enhancements has not been determined and is not before the Commission in the present filing. Any future changes would be filed by the NASD and Nasdaq as a rule filing with the Commission and published for comment. The Commission will fully consider the issues presented by, and comments on, such a filing at that time. The Commission intends to monitor future negotiations between the ECNs and the NASD regarding the design of this linkage.

4. Eliminating SelectNet Broadcast Feature

a. *Comments.* Several market makers, the STA and the DSTA favor the elimination of the SelectNet broadcast feature. [123] Several commenters expressed support for the elimination of the counter-offer function.[124]

Many commenters, including academics, order entry firms and SOES traders, objected to eliminating the SelectNet broadcast feature. [125] Several commenters argued that eliminating the SelectNet broadcast feature effectively eliminated the ability of SelectNet to function as an electronic stock market.[126] These commenters argued that the proposal turns SelectNet into ''nothing more than a message routing system.'' [127]

It was argued that eliminating the SelectNet broadcast feature, together with eliminating the SOES limit order file, meant that public orders could be entered into the market only if a market maker or ECN chose to accept that order in its sole discretion. [128] Another order entry firm echoed this comment and stated that order entry firms will now have no means of displaying orders between the spread. [129] Several order entry firms stated that the elimination of the broadcast function forces order entry firms to subscribe to an ECN. [130]

b. *Commission analysis.* The Commission is not taking action on the SelectNet broadcast feature at this time, pursuant to an NASD consent to an extension of time for consideration of this portion of its proposal. The NASD said that a major basis for its proposal to eliminate the SelectNet broadcast feature was concern that the Nasdaq system had inadequate capacity to continue all current functions once the Order Handling Rules went into effect. The NASD indicated that the SelectNet broadcast feature uses substantial systems capacity. The Commission intends to monitor the impact on Nasdaq systems capacity and quote traffic of the phase-in of the Order Handling Rules before reaching a determination regarding elimination of the SelectNet broadcast feature.

5. Rejection of SOES Orders When ECN or UTP Exchange Is at the Inside Quote

a. *Comments.* Market makers generally were in favor of the proposal to reject SOES orders when no Nasdaq market maker was quoting at the inside quote. They believe it is appropriate for the order to be returned to the entering firm when an exchange or ECN is driving the inside. Order entry firms and SOES traders generally opposed the proposal. One order entry firm argued that it would be possible for an order to be sent to an ECN through the SelectNet Linkage, rejected by the ECN, returned to the broker who then enters the order into SOES, which then rejects the order because in the interim, an ECN established a better price.[131] Another stated that the proposal would render SOES unusable for most large issues for many periods if market makers use the display alternative.[132] Several commenters believed this aspect of the proposal creates a risk that some market makers would improperly use ECNs to avoid being subject to SOES executions. [133] Another order entry firm claimed that the proposal undermines competition and legitimizes collusive behavior.[134] One order entry firm argued that the rule change moves the market from an environment where a customer cannot hope to obtain best execution to an environment where the customer must obtain best execution or no execution at all.[135] This commenter stated that the customer preferring speed and certainty of execution over price improvement is disadvantaged.

b. *Commission analysis.* The Commission is approving the amendment to effect this change as consistent with the Act and the rules thereunder, particularly the Order Handling Rules. As discussed below, the NASD was unable to link the SOES system with the SelectNet linkage by the implementation date for the Order Handling Rules. Therefore, when an ECN or a UTP exchange is alone at the best quote, the SOES system must either reject orders, execute them against Nasdaq market makers at the ECN or UTP exchange quote, or execute them at the Nasdaq market makers' best quote even though that quote is inferior to the NBBO. The Commission agrees with the NASD's analysis that to hold the market maker to a SOES execution at a price that is being driven by the ECN or exchange would be competitively unfair, and to execute SOES orders at the market maker's own quote would result in customer executions at a price that is inferior to the NBBO, generally violating best execution duties of broker-dealers entering the orders.

The Commission recognizes that the shutdown of SOES when better ECN or UTP exchange quotes are displayed in the NBBO will reduce the ability to execute customer orders immediately on an automated basis. At the same time, it will contribute to competitive quotations by encouraging customer orders to be routed to the ECN or UTP exchange displaying the best quote. Market makers that want to attract SOES order flow in these securities will be encouraged to publish a Nasdaq quote equal to or better than that displayed by the ECN or UTP exchange. This competition could improve market quotation quality and produce better prices for investors.

The proposed amendment is intended to address a problem arising from the

[123] A.G. Edwards Letter; letters from Daryl Andersen (Nasdaq Equity Trading), Joseph G. Geelan (Vice President, Institutional Trading), Jeff Peterson (Vice President, Senior Trader), Daniel L. Henn (Vice President, Nasdaq Equity Trading), Dede Yurecko (Vice President, Senior Trader), Art Kearney (Executive Vice President, Director of Capital Markets), Beth McCann (Vice President, Institutional Trading), John G. Kinnard & Co., to Secretary, SEC, dated December 24, 1996 (''Kinnard Letters''); DSTA Letter, Edward Jones Letter; Mayer & Schweitzer Letter; STA Letter; STAIC Letter; STANY Letter.

[124] Edward Jones Letter.

[125] *See e.g.,* All-Tech Letter (12/23/96); Boran Letter; Frame Letter; Grossman Letter; letter from Gerard Hunter, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''G. Hunter Letter''); FNB Letter, W. Jordan; Cornerstone Letter.

[126] Whitcomb Letter (11/21/96); Simaan Letter.

[127] Simaan Letter, Whitcomb Letter (11/21/96); letter from Jerry Putnum, Terra Nova Trading, LLC, to Jonathan G. Katz, Secretary, SEC, dated December 9, 1996 (''Terra Nova Letter'').

[128] *See e.g.* First Westchester Letter; Cornerstone Letter.

[129] Cornerstone Letter.

[130] First Westchester Letter; Grossman Letter.

[131] All-Tech Letter (11/22/96). *See also* Beers & Wilk Letter; letter from Geoffrey Dubey, to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (''Dubey Letter''); Edward Jones Letter, Lu Letter; letter from Michael McLoughlin, to Jonathan G. Katz, Secretary, SEC, dated December 16, 1996 (''McLoughlin Letter''); letter from Dario Pompeo, to Jonathan G. Katz, Secretary, SEC, dated December 18, 1996 (''Pompeo Letter'') (discussing the delay involved with this aspect of the proposal).

[132] Exchange House Letter.

[133] Cornerstone Letter; Morgan Stanley Letter.

[134] First Westchester Letter.

[135] All-Tech Letter (11/22/96).

lack of an interconnectivity between the SOES system and the SelectNet linkage. As discussed previously, the NASD was unable to complete the programming for the SelectNet linkage and the necessary changes to the SOES rules, and also link the separate SelectNet and SOES systems, both of which are aging Legacy systems. As discussed previously, the NASD has indicated that it plans to develop a revised system that will connect its market order execution system with its linkage to ECNs. When this system is developed, it should be possible to route market orders directly to the best market maker or ECN quote prevailing at that time.

In the meantime, the Commission believes that order entry firms should be able to reprogram their systems to scan the quote line and direct their order either into SOES or the SelectNet link, depending on where the best quote is at the time of the order's entry. In this manner, order entry firms can improve the efficiency of order routing and reduce the number of rejections received in the SOES system. The Commission notes that many SOES users are already frequent SelectNet users for orders not eligible for SOES.

The Commission also notes that during the initial stages of implementation of the Order Handling Rules when the rounding indicator is not available, SOES orders will be rejected only when ECN prices are a full quotation increment better than the best bid or offer. When a price is displayed in an ECN at a superior price at a smaller increment, such as 20 1/16, and rounded to a price reflecting a standard trading increment, such as 20 1/8, SOES executions will not stop if the best market maker quote is also at 20 1/8. This should substantially reduce the number of SOES rejections resulting from superior ECN prices, because ECN prices often are superior to Nasdaq by only a smaller quotation increment.

The Commission acknowledges that this provision creates a risk that market makers could enter orders into ECNs to avoid being subject to SOES executions. The Commission preliminarily believes that such activity would raise concerns under a broker-dealer's obligation to observe SRO just and equitable principles of trade.[136] The Commission encourages the NASD to monitor such activity carefully and to consider disciplinary action where warranted.

6. Summary and Effect on SOES Users

A number of commenters argued that the NASD was using the proposed changes as a whole to limit the ability of customers of order entry firms to trade efficiently through SOES. In particular, these commenters argue that the reduction in market makers' minimum quote size to 100 shares, the potential that SOES orders would receive split executions, the inability to enter all-or-none orders, and the inability to enter SOES orders when one or more ECNs are alone at the inside quote would limit their ability to execute orders rapidly and at low cost over SOES.

As discussed above, the Commission has reviewed each of these proposed revisions individually and has determined each of them to be consistent with the purposes of the Act. Furthermore, the Commission does not believe that these revisions, taken together, necessarily adversely affect the ability of customers of order entry firms to trade through SOES. As noted above, far from commenters' predictions of a market of uniform 100-share quotes, the Commission believes that the display of ECN orders and customer limit orders in the market should increase liquidity and narrow spreads in Nasdaq securities. In such an environment, customers entering orders through SOES would be expected to benefit from the better prices in the market. To the extent a SOES order would be subject to multiple executions, any improved prices could in fact offset the increased transactions costs attributable to split executions. Finally, as discussed above, the Commission believes that order entry firms should be able to program their systems to reroute SOES orders through SelectNet when SOES is disabled because one or more ECNs are alone at the inside price.

Therefore, while it is true that the NASD's proposed revisions will require changes in how orders are executed through SOES, the Commission does not believe that the revisions, individually or in the aggregate, impose unfair competitive burdens on SOES order entry firms or their customers, nor do they unfairly discriminate against investors who actively trade on the SOES system or the broker-dealers which service these investors.

After considering the comments, the Commission believes that at this time the NASD's proposed amendment is necessary to promptly effectuate the Order Handling Rules given the abbreviated time frames and the limitations on the NASD's system. The Commission also believes that the ultimate benefits of the availability to the customer of superior quotes resulting from display of ECN prices outweigh the inefficiencies resulting from rejections of SOES orders when ECNs are at better prices.

7. Locked and Crossed Markets Rule Amendments

a. *Comments.* Several market makers, the STA and the STANY commented in favor of applying the locked and crossed markets rule to market makers and other NASD members entering orders into ECNs, and to ECNs that are displaying orders in Nasdaq for non-NASD members.[137] The STANY supports the application of the locked and crossed markets rule to ECNs, because of the market confusion and inefficiency that results from locked and crossed quotes in Nasdaq. A few commenters offered suggestions to modify the rule,[138] including a requirement that a locking or crossing market maker should be required to notify the NASD, which notifies the potentially locked or crossed market maker, before entering the quote.[139] Another market maker supported the amendment as a first step, and suggested that the NASD should have authority to halt trading in locked and crossed markets, as do the exchanges.[140]

Instinet argued that an ECN does not trade as principal and does not have the ability to make ''reasonable efforts'' to avoid a locked or crossed market. Two commenters questioned the meaning of the exception for ''extraordinary circumstances.''[141] Another order entry firm stated that the rule is unclear.[142]

Amex and CBOE argued that applying the locked and crossed markets rule, Rule 4613(e), to ECNs, would inhibit the ability of options specialists and market makers to hedge in an ECN. Amex stated that it is impractical to require an options market maker to first ''clear the Street'' of all Nasdaq market maker quotes that it might cross when entering a hedging order into an ECN. It argued that the effects of the proposed application of the locked and crossed markets rule to ECNs and their users during volatile markets are uncertain and may cause a disruption in the ECN trading of Nasdaq stocks and may further disrupt trading in their options.

b. *Commission analysis.* The NASD has proposed the amendment to the locked and crossed markets rule to

[136] NASD Rule 2110.

[137] DSTA Letter; Herzog, Heine, Geduld Letter; letter from David Kuang, to Jonathan G. Katz, Secretary, SEC, dated December 19, 1996 (''Kuang Letter''); Mayer & Schweitzer Letter; STA Letter; STANY Letter.

[138] STA Letter; Herzog, Heine, Geduld Letter; Morgan Stanley Letter.

[139] Morgan Stanley Letter.

[140] Herzog, Heine, Geduld Letter.

[141] Amex Letter; Cornerstone Letter.

[142] Grossman Letter.

reduce the potential for a very significant and disruptive incidence of locked and crossed markets arising from ECN prices. The NASD argues that locked and crossed quotes interfere with the operation of the Nasdaq market by obscuring the true bid and offer prices at the time, and also may impact the use of firm, automated order execution systems. The NASD thus believes that NASD members, including ECNs, should attempt to trade with a market maker quote before locking or crossing that quote. The Commission believes that it is consistent with the purposes of the Act to maintain Nasdaq quotations that are informative and reliable. The Commission further believes that the NASD's proposal is reasonably designed to maintain the integrity of Nasdaq quotes by reducing the incidence of locking and crossing quotations displayed in Nasdaq by ECNs. The Commission urges the NASD to consider other means of reducing the incidence of locked and crossed quotes such as efficient means of executing against market maker quotes before entering a locking or crossing order.

The Commission notes that the term ''extraordinary circumstance'' is existing language in the locked and crossed markets rule. It would encourage any market participants unclear about the meaning of this language to seek interpretive guidance from the NASD.

8. Modifications to Autoquote Policy

a. *Comments.* Several commenters expressed support for the modification to the autoquote policy to permit computer generated display of limit orders, responses to executions and ECN prices. [143] One order entry firm argued that autoquoting should not be available in response to a partial fill.[144] One academic argued that the temporary requirement permitting ECNs to autoquote to post two-sided quotes (until technical modifications can permit one-sided quotes) forces ECNs to post ''phantom'' quotes, further debasing the meaning of quotes in the Nasdaq market.[145]

b. *Commission analysis.* The Commission has determined that the NASD's proposal is consistent with the Act and, therefore, is approving the amendment. The proposed amendments are narrow exceptions to the autoquote policy designed to help effectuate the Order Handling Rules. In the Adopting Release, the Commission urged the NASD to reconsider its general ban on computer generated quotes to allow members to use computer generated quotes that add value to the market.[146] The Commission understands that the NASD continues to consider this policy generally, while proposing these specific modifications to facilitate the Order Handling Rules.

The Commission also notes that the NASD's method of adapting its existing quotation system to accept quotes from ECNs, by permitting ECNs to autoquote to maintain two-sided quotes is only a temporary solution until the NASD can modify its system to accept one-sided quotes from ECNs.

V. Amendment No. 1

The Commission finds good cause for approving Amendment No. 1 prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Commission approval of the request made in Amendment No. 1 to grant temporary approval, on a three-month pilot basis, to the minimum quotation size requirements will allow market participants and the Commission to assess the effects of these changes. In addition, the Order Handling Rules will become effective on January 20, 1997. To facilitate the implementation of these rules, the NASD must make changes to its current rules that will affect manner of operation of its systems. The Commission believes that industry participants must be provided sufficient time to acclimate to these changes. Therefore, the Commission believes that granting accelerated approval to Amendment No. 1 is appropriate and consistent with Section 15A and Section 19(b)(2) of the Act.[147]

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1 to the proposed rule change. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to Amendment No. 1 that are filed with the Commission, and all written communications relating to Amendment No. 1 between the Commission and any persons, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. §552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD–96–43 and should be submitted by February 6, 1997.

VI. Conclusion

For all of the aforementioned reasons, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association. Specifically, the Commission believes the proposed rule change is consistent with Section 15A(b)(6) of the Act [148] because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.[149] In addition, the Commission believes the proposed rule change is consistent with Section 15A(b)(9) [150] and Section 15A(b)(11) [151] of the Act because it does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act and because it is designed to produce fair and informative quotations.

It is Therefore Ordered, pursuant to Section 19(b)(2) of the Act,[152] that the proposed rule change (SR-NASD–96–43) is partially approved, including Amendment No. 1 on an accelerated basis. The Commission is not approving at this time the NASD's elimination of the SelectNet broadcast feature and the elimination of minimum market maker quotation size for securities other than those covered by Amendment No. 1. The pilot program established by Amendment No. 1 expires on April 18, 1997.

By the Commission.

Dated: January 10, 1997.

Margaret H. McFarland

Deputy Secretary.

[FR Doc. 97–1107 Filed 1–13–97; 1:58 pm]

BILLING CODE 8010–01–P

[143] Herzog, Heine, Geduld Letter; Kuang Letter.

[144] All-Tech Letter (12/23/96).

[145] Whitcomb Letter (11/21/96).

[146] Adopting Release, supra note.

[147] 15 U.S.C. §§78*o*–3, 78s(b)(2).

[148] 15 U.S.C. §78*o*–3(b)(6).

[149] In making this finding, the Commission notes that the proposal should promote efficiency and competition in the securities markets. 15 U.S.C. §78c(f).

[150] 15 U.S.C. §78*o*–3(b)(9).

[151] 15 U.S.C. §78*o*–3(b)(11).

[152] 15 U.S.C. §78s(b)(2).