

has addressed any concerns by adopting the existing criteria used in other index related products. In addition, the CBOE will highlight these different features in the circular to members.

D. Dissemination of Information

The Commission believes that the value of index-linked exchangeable notes that the Exchange proposes to disseminate will provide investors with timely and useful information concerning the value of the index-linked exchangeable notes based on current information regarding the value of the Underlying Index. The value of the Underlying Index will also be publicly disseminated. This information will be disseminated and updated every 15 seconds during regular CBOE trading hours of 8:30 a.m. to 3 p.m., Chicago time.

E. Surveillance

The Commission believes that the surveillance procedures developed by the CBOE for index-linked exchangeable notes should be adequate to address concerns associated with the listing and trading of such notes. In this regard, the CBOE has developed procedures to monitor activity in index-linked exchangeable notes to identify and deter improper trading activity.

The Commission also notes that concerns are raised when a broker-dealer is involved in the development and maintenance of an Underlying Index upon which a product, such as index-linked exchangeable notes is based, in that case, the broker-dealer and its affiliate should have procedures designed specifically to address the improper sharing of information. The Commission notes that the Exchange requires the implementation of procedures that are satisfactory to the Exchange to prevent the misuse of material, non-public information regarding changes to Underlying Stocks of an Underlying Index in a particular series of index-linked exchangeable notes. In addition, the Commission notes that if a broker-dealer is involved in developing or maintaining an Underlying Index, the Index must be calculated by a third party who is not a broker-dealer.²⁶ The Commission believes that such information barrier procedures will address the unauthorized transfer and misuse of material, non-public information.

F. Scope of the Commission's Order

The Commission is approving the Exchange's proposed listing and trading standards for the index-linked

exchangeable notes as discussed herein. Index-linked exchangeable notes addressed in this order can be listed pursuant to Rule 19b-4(e)²⁷ if they meet the standards discussed above in the CBOE rules. The Commission notes that with respect to any future rules adopted by the Exchange pursuant to Rule 19b-4(e),²⁸ the Exchange has indicated that in its Section 19(b)(2) filings to adopt such new rules, it will state and discuss whether or not it proposes to apply the new rule standards to index-linked exchangeable notes.

G. Accelerated Approval

The Commission finds good cause for approving the proposal and Amendments Nos. 1 and 2 thereto prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The proposal establishes listing and trading standards for a new product, index-linked exchangeable notes. Granting accelerated approval will allow the Exchange to immediately begin listing and trading series of index-linked exchangeable notes under these new standards. While the structure of the product is different from those previously reviewed by the Commission, the CBOE proposes to apply existing criteria used for other index related products. In addition, the Commission has approved the trading of identical products on the Amex²⁹ and the Phlx.³⁰ Accordingly, the Commission believes that there is good cause, consistent with Sections 6(b)(5) and 19(b) of the Act,³¹ to approve the proposal and Amendments Nos. 1 and 2 thereto on an accelerated basis.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,³² that the proposed rule change (SR-CBOE-2002-29) and Amendments Nos. 1 and 2 thereto are hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³³

Margaret H. McFarland,

Deputy Secretary.

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²⁷ 17 CFR 240.19b-4(e).

²⁸ 17 CFR 240.19b-4(e).

²⁹ See Securities Exchange Act Release No. 44621, *supra* note 3.

³⁰ See Securities Exchange Act Release No. 45082, *supra* note 3.

³¹ 15 U.S.C. 78f(b)(5) and 78s(b).

³² 15 U.S.C. 78s(b)(2).

³³ 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46369; File No. SR-NASD-2002-42]

Self-Regulatory Organizations; Order Granting Approval to a Proposed Rule Change and Amendments Nos. 1, 2, 3, 4, 5 and 6 Thereto by the National Association of Securities Dealers, Inc. Relating to the Integrated Processing of Odd-Lot Share Amounts in Nasdaq's SuperMontage System

August 16, 2002.

I. Introduction

On March 25, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend several NASD Rules governing the operation of Nasdaq's future Order Display and Collector Facility ("SuperMontage") to allow the system to accept, integrate, process, and otherwise facilitate the interaction of orders of less than one round-lot (100 shares) with all other SuperMontage quotes and orders. Nasdaq filed Amendment No. 1 to the proposed rule change on April 23, 2002.³ Nasdaq filed Amendment No. 2 to the proposed rule change on May 17, 2002.⁴ Nasdaq filed Amendment No. 3 to the proposed rule change on May 17, 2002.⁵ The proposed rule change, as amended by Amendments Nos. 1, 2, and 3, was published for comment in the **Federal Register** on May 28, 2002.⁶ The Commission received thirteen comment letters on the proposed rule change, as amended.⁷ Nasdaq filed Amendment

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ On April 23, 2002, the Exchange filed a Form 19b-4, which replaced the original filing in its entirety ("Amendment No. 1").

⁴ On May 17, 2002, the Exchange filed a Form 19b-4, which replaced the original filing and Amendment No. 1 in their entirety ("Amendment No. 2").

⁵ See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated May 17, 2002 ("Amendment No. 3").

⁶ See Securities Exchange Act Release No. 45968 (May 20, 2002), 67 FR 36946 ("Proposing Release").

⁷ See email to rule-comments@sec.gov, Commission, from Joshua Levine, dated May 30, 2002 ("Levine Letter"). See also letters to Jonathan G. Katz, Secretary, Commission, from Keith A. Gertsen, Managing Director, Head, Nasdaq Trading,

Continued

²⁶ See CBOE Rule 24.2(b)(12).

No. 4 to the proposed rule change on June 6, 2002.⁸ Nasdaq filed Amendment No. 5 to the proposed rule change on August 9, 2002.⁹ Nasdaq filed Amendment No. 6 to the proposed rule change on August 13, 2002.¹⁰ This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

As originally approved, SuperMontage included a separate mechanism for processing and executing odd-lot orders at the inside price.¹¹ Nasdaq now proposes to fully integrate the processing of odd, mixed, and round-lot orders in the SuperMontage Non-Directed Order

and Ken P. Dengler, Managing Director, Head, Nasdaq Sales Trading, Deutsche Bank Securities, Inc., dated June 14, 2002 ("Deutsche Bank Letter"); C. Thomas Richardson, Head, Nasdaq Trading, Salomon Smith Barney, dated June 14, 2002 ("Salomon Letter"); Michael A. Bird, Chairman, and John C. Giese, President and Chief Operating Officer, Securities Traders Association, dated June 17, 2002 ("STA Letter"); Bruce Turner, CIBC World Markets Corp. ("CIBC"), dated June 6, 2002 ("CIBC Turner Letter"); Scott W. Anderson, Associate Director, Region Americas Legal, USB Warburg LLC, dated June 17, 2002 ("USB Warburg Letter"); Howard Berstein, Vice President, Compliance Department, Robertson Stephens, Inc., dated June 17, 2002, ("Robertson Stephens Letter"); Robert Arancio on behalf of Mathew Johnson, Managing Director, Lehman Brothers Inc., dated June 18, 2002 ("Lehman Letter"); Elliot Levine, Assistant General Counsel and Executive Director, CIBC, dated June 18, 2002 ("CIBC Levine Letter"); John P. Hughes SR, V.P., Director, Nasdaq & Listed Trading, Janney Montgomery Scott LLC, dated June 12, 2002 ("Janney Letter"); Heidi H. Reynolds, Managing Director, Nasdaq Trading, Morgan Keegan & Company, Inc., dated June 14, 2002 ("Morgan Letter"); C.E. Wasson, SVP Director, Nasdaq Trading, Legg Mason, Inc., dated June 20, 2002 ("Legg Mason Letter"); and Gerald D. Putnam, Chairman and CEO, Archipelago Holdings, LLC, dated July 9, 2002 ("Arca Letter").

⁸ See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated June 6, 2002 ("Amendment No. 4"). In Amendment No. 4, Nasdaq made technical, non-substantive changes to the proposed rule text, which were reflected in the Proposing Release.

⁹ See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated August 9, 2002 ("Amendment No. 5"). In Amendment No. 5, Nasdaq made technical, non-substantive changes to the proposed rule text that are not subject to notice and comment.

¹⁰ See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated August 13, 2002 ("Amendment No. 6"). In Amendment No. 6, Nasdaq amended the text of NASD Rule 4710(b)(2)(A) to reflect recent amendments to the rule. See Securities Exchange Act Release No. 46320 (August 8, 2002) (File No. SR-NASD-2002-84). The Commission notes that this is a technical, non-substantive amendment and not subject to notice and comment.

¹¹ See Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001) ("SuperMontage Order").

Process.¹² As such, Nasdaq would not provide a separate process for odd-lot orders in SuperMontage, as originally approved, but instead would allow the entry and execution of orders in any whole share amount from 1 to 999,999 shares.

A. Entry and Display of Quotes/Orders

Under the proposal, all Nasdaq market participants including market makers, Electronic Communication Networks ("ECNs"), order entry firms, and Unlisted Trading Privilege ("UTP") Exchanges will be able to enter orders into SuperMontage in any whole-share amount from 1 to 999,999 shares. Odd-lot and mixed-lot orders would generally be treated the same as round-lot orders. For instance, odd-lot and mixed-lot orders, like round-lot orders, will receive a time stamp upon entry in the SuperMontage. Market makers and ECNs ("Nasdaq Quoting Market Participants") and UTP Exchanges will be able to enter odd-lot and mixed-lot orders as market orders or limit orders with any non-directed order designation type permitted by the NASD rules.¹³ Odd-lot and mixed-lot orders will be aggregated, decremented, and cancelled under the same terms and conditions as round-lot orders.¹⁴ Odd-lot and mixed-lot orders could be preferenced to other market participants in the same manner as round-lots.¹⁵ While orders originally entered into the SuperMontage as odd-lots would not be able to use reserve size, orders originally entered into the system as mixed-lots could use reserve size.¹⁶

Under the proposal, all displayed interest in the Nasdaq Order Display Facility ("NODF") would continue to be in round-lot increments. The NODF, which aggregates all quotes and orders (attributable and non-attributable) at each price level, and displays the five best prices with associated aggregate size on each side of the market, will reflect odd and mixed-lots in the manner described below. For display purposes, Nasdaq would aggregate the shares of the multiple quotes¹⁷ and

¹² The term "odd-lot" refers to an order that is less than 100 shares. The term "round-lot" refers to an order in 100 share increments. The term "mixed-lot" refers to an order that is comprised of round and odd lots.

¹³ See NASD Rule 4706(a)(1)(B).

¹⁴ See NASD Rule 4710(b).

¹⁵ See NASD Rule 4710(b)(1)(B)(iv).

¹⁶ See Securities Exchange Act Release No. 46320 (August 8, 2002), 67 FR 53033 (August 14, 2002) (File No. SR-NASD-2002-84).

¹⁷ The Commission notes that the Nasdaq system will continue to display and require the entry of quotes in round-lot increments. Telephone conversation between Thomas P. Moran, Associate General Counsel, Nasdaq, and Kelly Riley, Senior

orders entered by a Nasdaq Quoting Market Participant or UTP Exchange at a single price level and round that total share amount down to the nearest round-lot amount for display and dissemination.¹⁸ Likewise, if a party enters a mixed-lot order, the system would round down the mixed-lot order to the nearest round-lot increment for display in the NODF. Any odd-lot portion of a mixed-lot that is not displayed as a result of this rounding process would remain in the system eligible for execution, with the time-priority of its original entry. Orders originally entered as odd-lots that are not aggregated to any other quotes and orders, and quotes or orders that have been decremented to an odd-lot remainder would not be displayed.

Although the SuperMontage is similar in many respects to Nasdaq's current trading platform, because it is a new system, market participants will have to program their interfaces to enable them to utilize SuperMontage features. For market participants that update their technology to permit them to enter multiple quotes or orders, any insufficient amount of shares at a price level to display a round-lot share amount (*i.e.*, odd-lot remainder) after an execution against its quote/order would remain in the system eligible for execution, unless cancelled by the market participant. Because odd-lots will not be displayed in SuperMontage, the system would display that market participant's next best priced quote/order in a round-lot share amount on that same side of the market if the market participant has attributable and displayable trading interest of at least a single round-lot share amount in the system. If the market participant does not have another quote/order in SuperMontage on a particular side of the market, and the market participant fails to update its quote/order, a new quote/order would be generated using the "penalty quote refresh" process.¹⁹

Special Counsel, Division, Commission, on July 31, 2002.

¹⁸ For example, if a Nasdaq Quoting Market Participant enters three separate orders to buy 50 shares, 225 shares and 590 shares at the same price level, it would have displayed next to its market identifier on the bid side of the market an aggregate quote size of 800 shares (50 + 225 + 590 = 865, rounded down to 800 shares for display purposes).

¹⁹ Pursuant to NASD Rule 4710(b)(5) if all market maker bids and/or offers are exhausted so that there are no longer any quote or orders displayed on the bid or offer side of the market, and the market maker does not update its principal quote via Auto Quote Refresh ("AQR"), transmit a revised attributable quote/order to Nasdaq, or have another attributable quote or order in the system, the system, after 30 seconds, will refresh only the market maker's exhausted bid or offer quote to a normal unit of trading priced \$0.01 inferior to the

The odd-lot remainders of market participants using updated technology would remain in the system, undisplayed, until executed or cancelled, with its original time-stamp of entry.²⁰

In the Proposing Release, Nasdaq explained that during the initial SuperMontage roll-out it will also permit participants to access SuperMontage using their current technology ("Legacy Quotes"), but that the use of current technology limits a market participant's ability to use certain SuperMontage features. Most notably, if a participant uses its current technology, it will be unable to enter multiple quotes/orders in SuperMontage. According to Nasdaq, because of the inability of Legacy Quote users to enter multiple quotes/orders, it would also be technologically infeasible for these market participants to simultaneously support a quote/order and an odd-lot remainder in the system. Thus, the odd-lot remainders of Legacy Quote users would be purged from SuperMontage contemporaneous with a market participant's quote or order being refreshed to at least a round-lot amount. The quote of a market participant that uses Legacy Quote technology may be refreshed: (1) By the market participant, (2) using the AQR function to a price and size selected by the entering party,²¹ or (3) using the penalty quote refresh process.²²

lesser of either: (a) The last valid displayed inside bid/offer in the security before all such bids/offers were exhausted; or (b) the market maker's last displayed bid/offer before exhaustion. If the resulting bid/offer quote will create a locked or crossed market, SuperMontage will instead re-open the exhausted market maker's bid/offer quote at a price \$0.01 inferior to the unexhausted inside bid/offer in that security. If at any time this penalty quote refresh process will result in the creation of a bid/offer of less than \$0.01, the system will refresh that bid/offer to a price of \$0.01. See Securities Exchange Act Release No. 46141 (June 28, 2002), 67 FR 44906 (July 5, 2002) (approving File No. SR-NASD-2002-01).

²⁰ Market-makers cannot fulfill their quote display obligations through the presence of odd-lot remainders in the system. See NASD Rule 4613.

²¹ Nasdaq's AQR function will allow Legacy Quote market participants to have their displayed quote refreshed to a pre-determined price and size (round-lot share amount) immediately after its displayed and reserve size at a price level is reduced to less than 100 shares. Any odd-lot share amount present at the time a Legacy Quote market participant's quote is refreshed by AQR shall not be retained in SuperMontage for execution and the system would only recognize and potentially process the round-lot refreshed amount. Market participants using updated technology who have the ability to enter multiple quotes/orders cannot use the AQR function.

²² Between the time a Legacy Quote user's quote/order is decremented to less than a round-lot share amount and the Legacy Quote user's quote is refreshed pursuant to the penalty quote refresh process (or updated by the transmission of a revised

Nasdaq Quoting Market Participants and UTP Exchanges entering orders that are at least 100 shares would be able to use the SuperMontage reserve size function.²³ If a quote/order with a reserve size is decremented to an odd-lot remainder, the system would refresh the quote/order from reserve size by an amount designated by the market participant. Any odd-lot remainder available prior to the reserve size refresh would be retained by the system. Thus, the reserve size refresh amount and the odd-lot remainder would be aggregated and displayed.²⁴

B. Execution Process

Under the proposal, odd-lots and mixed-lots shall be executed on a share-by-share basis consistent with the SuperMontage order execution algorithms. Like round-lots, odd-lots and mixed-lots would be executed pursuant to the execution algorithm selected (price/time (default), price/time with fee consideration, and price/size/time) by the entering market participant.²⁵ Accordingly, SuperMontage would not execute an odd or a mixed-lot at an inferior price level until all better-priced share amounts that are in the system, including undisplayed odd-lots, are executed.

Under the proposal, undisplayed odd-lots with a better price than the Nasdaq best bid or offer ("BBO") would be executed pursuant to the SuperMontage rule for clearing locked and crossed markets.²⁶ A locked market occurs when a market participant's bid equals the lowest offer of another market participant. A crossed market occurs when a market participant's bid exceeds the lowest offer of another market participant. If a market participant submitted a quote that would lock or cross an undisplayed odd-lot, that

attributable quote) an odd-lot remainder would be eligible for execution in SuperMontage.

²³ Orders originally entered as odd-lots would not be able to use reserve size refresh. See *supra* note and accompanying text.

²⁴ For example, a market maker ("MMA") is displaying a 1000 share bid quote. MMA has 5000 shares in reserve and a 500 share refresh size. SuperMontage executes 925 shares against MMA's quote. Upon execution, since MMA's displayable interest is less than 100 shares, the system would refresh MMA's quote by the refresh amount—500 shares, but would also retain the 75 share odd-lot remainder in the system. The resulting 575 share total would remain in the system and available for execution but would be rounded down to 500 shares for display purposes.

²⁵ The three SuperMontage order execution algorithms will make an exception for non-directed, non-preferenced orders entered by a market maker or ECN when that market maker or ECN's quote/order is at the inside market. See NASD Rule 4710(b)(1)(B)(iv).

²⁶ See NASD Rule 4710(b)(3)(A).

market participant would receive a system warning. To complete the quote entry, the participant would have to override the system warning.²⁷ If a Nasdaq Quoting Market Participant or UTP Exchange used the system override for a quote that would lock or cross an undisplayed odd-lot, the SuperMontage would not display the quote, but instead would reformat the quote as a marketable limit order and enter it into the SuperMontage as a non-directed order for execution. The reformatted order would be routed to the undisplayed odd-lot order next in the queue that would be locked or crossed, and the order would be executed at the price of the undisplayed odd-lot. Once the odd-lot execution takes place, if the Nasdaq Quoting Market Participant or UTP Exchange's quote that would have locked or crossed the odd-lot has not been completely filled, the SuperMontage would reformat the order again and display it (consistent with the parameters of the quote) as a quote on behalf of the entering Nasdaq Quoting Market Participant or UTP Exchange. If the market participant did not override the system warning for a quote/order that would lock or cross an undisplayed odd-lot, the SuperMontage would reject the market participant's quote and return it to the entering party.

C. Trade Reporting

Under the proposal, Nasdaq would continue to disseminate transactions to the public tape, whether it is a round or mixed-lot execution, in round-lot increments. Thus, mixed-lot executions would be rounded down to the next lowest round-lot increment for the purpose of reporting transactions to the public tape. Odd-lot transactions would not be reported to the tape. However, odd-lots and mixed-lots would be included in Nasdaq's daily volume report.

III. Summary of Comments

The Commission received thirteen comment letters on the proposed rule change, all of which supported the proposal.²⁸ A majority of commenters noted that the proposal should enhance

²⁷ Prior to entry, a market participant could append an override instruction to the locking/crossing quote. The system would deliver an execution or a rejection based on the market participant's instructions.

²⁸ See *supra* note 7. One commenter, however, noted that it would only support approval of the proposed rule change on a pilot basis. This commenter believed that only after SuperMontage becomes operational can a better solution to the odd-lot process become apparent. In addition, the commenter suggested that Nasdaq study the proposed odd-lot process in the SuperMontage environment. See UBS Warburg Letter.

both liquidity and transparency.²⁹ Several commenters believed that the proposal could benefit individual investors by providing small orders with standing along with large orders on the book.³⁰ Several commenters also believed that the proposed changes would continue to address the gaming issues that the originally approved odd-lot process intended to minimize.³¹ Some commenters noted that the proposal would remove the possibility that existed in the previously approved odd-lot process that a market maker might have to execute more shares than it was willing to trade.³² Finally, a few commenters believed that the proposal would prevent market participants from hiding significant numbers of shares from their quote and the tape by entering multiple odd-lots.³³

One commenter, while supporting approval of the proposal, suggested modifications.³⁴ First, the commenter suggested that SuperMontage permit participants to enter multiple quotes/orders with odd-lot and mixed-lot sizes. Second, the commenter suggested that Nasdaq extend its trade reporting rules to cover odd-lot transactions. Finally, the commenter suggested that Nasdaq introduce the actual shares concept to their data feeds (*i.e.*, disseminate the actual size of quotes and orders).

In response to these suggestions, Nasdaq submitted a letter to the Commission.³⁵ Nasdaq stated that the requirement that initial entry of quotes be in round-lot amounts is based on the concept that a party should not be allowed to initially enter a quotation that is not displayable. With regard to trade reporting and Nasdaq data feeds, Nasdaq stated that expanding the actual shares concept to the dissemination of quotes and orders would raise issues that impact numerous market participants, including data vendors, other markets, the internal systems of broker-dealers, regulators, and public investors.

Finally, one commenter, while supporting Nasdaq's goal of integrating

odd-lot orders in the execution process, raised concerns about the technical design of the proposal.³⁶ Specifically, the commenter expressed concern regarding undisplayed odd-lots orders that have a better price than the displayed BBO. The commenter explained that order-delivery ECNs would have three options when an undisplayed odd-lot order was locked or crossed: (1) Override the lock/cross warning message and receive an automatic execution, (2) accept the lock/cross warning message, have the system reject and return the quotation, and not display it in SuperMontage, or (3) convert the quotation to an order and re-submit it to SuperMontage. The commenter believed that these three options were respectively problematic because: (1) ECNs would be exposed to dual liability, (2) compliance with the Quote Rule³⁷ would be frustrated, and (3) delays in the entry of trading interest in the system would result.

In response, Nasdaq submitted a letter to the Commission.³⁸ Specifically, Nasdaq disagrees with the commenter's suggestion that Nasdaq's refusal to display a quotation of an ECN that locks or crosses the market is contrary to its requirements under the Quote Rule. According to Nasdaq, this issue was previously resolved by the Commission both in the context of the Order Handling Rules and the SuperMontage Order. Further, Nasdaq believes that SuperMontage ensures that ECNs are able to make reasonable efforts to trade before entering quotes that would lock or cross the market. Accordingly, Nasdaq believes that ECNs do have the ability to display their trading interest in SuperMontage by converting any locking or crossing quotation into an order or overriding the warning message, which enables ECNs to meet their obligations to display customer orders and also satisfies Nasdaq requirements under the Quote Rule.

IV. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.³⁹ The Commission finds that the proposed

rule change, as amended, is consistent with Section 15A of the Act.⁴⁰ Specifically, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act because it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals 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.⁴¹

With this filing Nasdaq proposes to fully integrate the entry, execution, and processing of odd and mixed-lot orders into SuperMontage. Integrating odd-lot orders into SuperMontage should provide investors with small-sized orders with many system protections that they do not currently enjoy. For example, odd-lot orders and odd-lot portions of mixed-lot orders will participate in the Non-Directed Order Process in virtually the same manner as larger sized round-lot quotes and orders. Under the proposal, odd-lot and mixed-lot orders will achieve price and time priority on the same basis as round-lot orders. Whether the order is an odd, mixed, or round-lot, SuperMontage gives execution priority to the best price in the system (as determined by the order execution algorithm selected by the entering party).⁴² Specifically, odd and mixed-lot orders will receive a time stamp upon entry into SuperMontage, which will be effective until the order is fully executed or cancelled. The Commission believes that integrating odd, mixed, and round-lot orders into SuperMontage should provide investors of such orders with better executions and should enhance the integrity of the market.

The Commission believes that the proposal may increase liquidity and transparency in SuperMontage.⁴³ The integration of odd and mixed-lot orders could increase liquidity since odd-lots and the odd-lot portion of mixed-lot orders will be able to fully interact with the round-lot market. The accessibility and eligibility for execution of odd-lots and the odd-lot portion of mixed-lots should add depth to the market, which also could increase liquidity. Although

²⁹ See Deutsche Bank Letter, Salomon Letter, STA Letter, CIBC Turner Letter, Lehman Letter, CIBC Levine Letter, Janney Letter, and Morgan Letter.

³⁰ See Deutsche Bank Letter, STA Letter, CIBC Turner Letter, Lehman Letter, CIBC Levine Letter, Janney Letter, and Morgan Letter.

³¹ See CIBC Turner Letter, CIBC Levine Letter, Janney Letter, and Legg Mason Letter.

³² See Deutsche Bank Letter, Salomon Letter, STA Letter, Robertson Stephens Letter, and Lehman Letter.

³³ See Deutsche Bank Letter, CIBC Turner Letter, CIBC Levine Letter, and Morgan Letter.

³⁴ See Levine Letter.

³⁵ See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine England, Assistant Director, Division, Commission, dated July 2, 2002.

³⁶ See Arca Letter.

³⁷ Exchange Act Rule 11Ac1-1, 17 CFR 240.11Ac1-1.

³⁸ See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine England, Assistant Director, Division, Commission, dated July 26, 2002.

³⁹ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁴⁰ 15 U.S.C. 78o-3.

⁴¹ 15 U.S.C. 78o-3(b)(6).

⁴² See NASD Rule 4710.

⁴³ The Commission notes that a majority of commenters believed that the proposal would enhance liquidity and transparency. See *supra* note 29 and accompanying text.

SuperMontage will continue to only display quotes and orders in round-lot increments, the system will aggregate all shares (orders and quotes) entered by a Nasdaq Quoting Market Participant or UTP Exchange, at a single price level and then round that total share amount down to the nearest round-lot amount for display and dissemination. While the actual size of a Nasdaq Quoting Market Participant's trading interest may not be fully displayed, adding odd-lot amounts to the disseminated size of Nasdaq Quoting Market Participants should portray a more accurate representation of trading interest. Thus, the proposal should enhance transparency.

The Commission believes that small retail investors who may find it difficult to participate in the market in full round-lot increments, will be able to have their smaller-sized orders interact with the orders of institutional investors and highly-capitalized individuals. As noted by a commenter, odd-lot orders are employed typically by small investors who cannot afford to transact in full round-lot quantities.⁴⁴ Further, the Commission believes that the proposed rule change should give market participants greater flexibility in handling small retail customer orders as market participants will be able to enter odd-lots and mixed-lots in SuperMontage with system protections similar to round-lots.

As previously noted, Nasdaq will continue to only display quotes and orders in round-lot increments.⁴⁵ One commenter did express a concern about the presence of undisplayed odd-lot orders that have a better price than the displayed BBO.⁴⁶ The commenter explained that order delivery ECNs would have three options when their quote locked or crossed an undisplayed odd-lot order: (1) Override the lock/cross warning message and receive an automatic execution, (2) accept the lock/cross warning message, have the system reject and return the quotation, and not display the order in SuperMontage, or (3) convert the quotation to an order and re-submit it to SuperMontage. The commenter believed that these three options were respectively problematic because: (1) ECNs would be exposed to dual liability, (2) compliance with the Quote Rule⁴⁷ would be frustrated, and (3) delays in the entry of trading interest

in the system would result. While the Commission appreciates the commenter's concerns, the Commission believes that Nasdaq and traditional exchanges must have the flexibility to rethink their structures to permit appropriate responses to the rapidly changing marketplace. Congress instructed the Commission to seek to "enhance competition and to allow economic forces, interacting with a fair regulatory field, to arrive at appropriate variation in practices and services."⁴⁸ The Commission finds that the proposal to fully integrate the entry, execution, and processing of odd and mixed-lot orders in SuperMontage is consistent with these goals in that it is reasonably designed to promote price discovery, best execution, liquidity, and market innovation, while continuing to preserve competition among market centers. The Commission emphasizes that participation in SuperMontage as originally designed, and as subsequently amended, is voluntary.

As the commenter noted, ECNs that do not wish to be exposed to dual liability could accept the lock/cross warning message and then re-route the order to SuperMontage. While this solution may be less than optimal, the commenter indicated that it is a viable option. Further, the Commission notes that the original approval of the SuperMontage was conditioned on the NASD offering a quote and trade reporting alternative that satisfies the Order Handling Rules, Regulation ATS, and other regulatory requirements for ATSS, ECNs, and market makers prior to or at the same time as the implementation of SuperMontage.⁴⁹ Thus, prior to the implementation of the SuperMontage, market participants will be able to fulfill their obligations under the Order Handling Rules if they choose not to participate in the SuperMontage for any reason.

Notwithstanding the flexibility warranted in a market center's determination of its market structure, the Commission expects that Nasdaq will carefully monitor quote and execution quality under the proposal. In addition, the Commission expects Nasdaq to monitor the impact and surveil the entry and execution of odd-lot orders in SuperMontage. If the

integration of odd-lot orders has a deleterious effect on quoting and execution in the Nasdaq market, the Commission expects that Nasdaq will submit an appropriate response, in the form of a proposed rule change, to restore and enhance quote and execution quality.

Finally, the Commission finds that with regard to trade reporting this proposal raises no new regulatory issues and that Nasdaq will continue to meet its trade reporting obligations under the Act.

V. Conclusion

For the foregoing reasons, the Commission finds that the proposal, as amended, is consistent with the requirements of the Act and rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁵⁰ that the proposed rule change (SR-NASD-2002-42), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁵¹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46373; File No. SR-NASD-2002-101]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. To Increase Fees for the Mutual Fund Quotation Service and To Adopt a New Fee To Process a Request To Amend the Name and/or Symbol of a Fund

August 16, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 30, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association") through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq filed

⁴⁴ See S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975) at p. 8 ("Senate Report").

⁴⁹ On July 24, 2002, the Commission approved an NASD proposal to establish an alternate display facility on a pilot basis. See Securities Exchange Act Release No. 46249, 67 FR 49822 (July 31, 2002) (File No. SR-NASD-2002-97). However, the Order expressly notes that the Commission has not determined that the preconditions of SuperMontage have been met.

⁵⁰ 15 U.S.C. 78s(b)(2).

⁵¹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

⁴⁴ See Levine Letter. See also CIBC Levine Letter.

⁴⁵ The Commission notes that the Customer Limit Order Display Rule exempts odd-lot orders from the display requirement. See Exchange Act Rule 11Ac1-4(c)(3), 17 CFR 240.11Ac1-4(c)(3).

⁴⁶ See Arca Letter.

⁴⁷ Exchange Act Rule 11Ac1-1, 17 CFR 240.11Ac1-1.