

**MEMO# 11787**

April 5, 2000

## **NASD PROPOSED RULE CHANGE AMENDING SUPER MONTAGE PROPOSAL**

1 Securities Exchange Act Release No. 42573 (March 23, 2000), 65 FR 16981 (March 30, 2000) ("Release"). 2 In its original proposal, Nasdaq proposed enhancing the Nasdaq quotation montage and Nasdaq's main trading platform - the Nasdaq National Market System ("NNMS"). In particular, Nasdaq proposed, among other things, to: (1) add a new display to the Nasdaq Workstation II called the Nasdaq Order Display Facility ("NODF"), which would show the best bid/best offer in Nasdaq and two price levels away, accompanied by the aggregate size at each price level of the "displayed" trading interest of market makers, ECNs, and UTP Exchanges; (2) allow market makers and ECNs to designate orders for "display" in Nasdaq on either an attributable or non-attributable basis; (3) establish the Order Collector Facility ("OCF") as part of the NNMS, which would allow Nasdaq market makers and ECNs to give the Nasdaq system multiple quotes/orders at a single as well as multiple price levels, which would be displayed in the Nasdaq Quotation Montage and the NODF, consistent with an order's parameters; and (4) establish the OCF as a single point of order entry and single point of delivery of liability orders and executions. 1 [11787] April 5, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 24-00 SEC RULES COMMITTEE No. 55-00 RE: NASD PROPOSED RULE CHANGE AMENDING SUPER MONTAGE PROPOSAL

The Securities and Exchange Commission ("SEC") has published for comment a proposed rule change filed by the National Association of Securities Dealers, Inc. ("NASD"), through its wholly-owned subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"),<sup>1</sup> amending certain aspects of its previous proposal to establish the Nasdaq Order Display Facility and to modify the Nasdaq trading platform.<sup>2</sup> In particular, in response to comments on the original proposal, Nasdaq is proposing to amend, among other things, (1) the five-second interval delay between price levels and (2) the order execution algorithm as it relates to ECNs, UTP Exchanges, and displayed size refreshed from reserve. Nasdaq also stated that it is working to address concerns regarding Nasdaq technology, competition, system roll-out, and any other relevant comments. Five-Second Interval Delay Between Price Levels As originally proposed, if all trading interest is exhausted at a particular price level, there would be a five-second interval delay before the system would attempt to execute an order at a new price level. The Release states that commenters believed the proposed five-second interval delay between price levels was too long and/or unnecessary for liquid stocks and could cause queuing of orders within the system. In response, Nasdaq is proposing that the system have a more limited interval delay parameter. 2 In particular, the system would limit the five-second interval delay to situations where an order is partially filled at one price level, and the remaining shares of the order would not be filled in full at the next two trading increments ("ticks") away. In these situations, there would be a five-second interval delay or pause before the order moved to the next increment away from the original

increment. A market participant also would be able to set a parameter on an individual order so that the order would trade through all interest (i.e., displayed and reserve interest) at the three price levels being displayed in the NODF at the time of entry, without pausing five seconds in between each displayed price ("Sweep Order"). However, a Sweep Order may only execute through a maximum of the two price levels displayed in the NODF (and into the third price level). If the Sweep Order were not executed in full at the third price level, the order would pause for five seconds between each subsequent price level. Nasdaq stated that it believes that these two approaches provide a balance between the need of institutional investors and market professionals for speed, while providing greater price continuity for individual investors.

**Processing of Non-Directed Orders** As originally proposed, the system would execute non-directed orders entered into the system in general price/time priority. Within a price level, however, the system would execute non-directed orders against displayed quotes/orders of market makers and ECNs that participate in the automatic-execution functionality of the system ("Auto-Ex ECNs"), within time priority of this class of market participants. The system then would execute against the displayed quotes/orders of ECNs that participate in order-delivery ("Order-Delivery ECNs"). After displayed size of Nasdaq market makers and ECNs was exhausted, the system would execute against reserve size of market makers and Auto-Ex ECNs, and then reserve size of Order-Delivery ECNs. Lastly, the system would execute against the quotes of UTP Exchanges. In light of concerns expressed by commenters, Nasdaq is proposing to change the order execution algorithm with respect to ECNs. In particular, Nasdaq believes that all ECNs (who are NASD members), market makers, and non-attributed UTP Exchange agency interest, at a given price level, should be executed against in strict time priority, unless an ECN charges a fee to non-subscribers for accessing its quote. ECNs that charge an access fee should be executed after non-attributed UTP Exchange agency interest, market makers, and ECNs who do not charge an access fee because such a fee represents an increase in trading costs and therefore an inferior price. Nasdaq believes that any other prioritization would be inconsistent with the statutory mandate of providing investors with best execution of their orders.

**Reserve Size** The Release states that one commenter suggested that when displayed size is completely exhausted, quotes/orders refreshed out of reserve size should be accessed in a slightly different manner than described in the original proposal. Specifically, the commenter suggested that after the displayed size of market participants quoting at the same price level is exhausted simultaneously and then displayed size is refreshed from reserve, the system should establish a quoting market participant's priority to receive non-directed orders based on the new size of the displayed quotes (instead of the market participant's time of original quote/order entry) with time priority governing as to any two market participants at the same size. Nasdaq is proposing to amend the filing to incorporate this approach into the order execution algorithm as it believes it is logical to reward Nasdaq Quoting Market Participants displaying greater size.

**Order Execution Algorithm** Based on the proposed changes to the system, Nasdaq is proposing to amend the order execution algorithm to execute non-directed orders entered into the system as follows: (1) displayed quotes of market makers, ECNs that do not charge a quote-access fee to non-subscribers, and non-attributable agency quotes of UTP Exchanges, in time priority between such participants; (2) displayed quotes of ECNs that charge a quote-access fee to non-subscribers, in time priority between such participants; (3) reserve size of market makers and ECNs that do not charge a quote-access fee to non-subscribers, in time priority between such participants; (4) reserve size of ECNs that charge a quote-access fee to non-subscribers, in time priority between such participants; and (5) principal quotes of UTP Exchanges, in time priority between such participants. Comments on the proposed rule change are due to the SEC no later than April 20, 2000. If you have any comments you would like the Institute to consider including in its comment letter,

please provide them to the undersigned by phone at (202) 371-5408, by fax at (202) 326-5839, or by e- mail at [aburstein@ici.org](mailto:aburstein@ici.org) no later than April 14. Ari Burstein Assistant Counsel Attachment

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