**MEMO# 10945**

April 30, 1999

# NASD FILES PROPOSED RULE CHANGE RELATING TO THE ESTABLISHMENT OF AN AGENCY QUOTATION

1 Under the Manning Interpretation, a member violates NASD Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade, if the member accepts and holds an unexecuted limit order from its customer (or a customer of another member) in a Nasdaq security and continues to trade the security for its own account at prices that would satisfy the customer's limit order, without executing that limit order. 2 Nasdaq has filed a proposed rule change with the SEC to functionally integrate the SOES and SelectNet systems into a new system called the Nasdaq National Market Execution System (“NNMS”). See Memorandum to Equity Markets Advisory Committee, No. 12-99, dated April 29, 1999. 1 [10945] April 30, 1999 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 13-99 RE: NASD FILES PROPOSED RULE CHANGE RELATING TO THE ESTABLISHMENT OF AN AGENCY QUOTATION

_______________________________________________________________________________ The National Association of Securities Dealers, Inc. ("NASD"), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), has filed with the Securities and Exchange Commission ("SEC") a proposed rule change (attached) to allow market makers in Nasdaq National Market ("NNM") securities to display a second quotation - an agency quote - separate from their proprietary quotation for the purpose of displaying customer orders. The proposed rule change would permit market makers to display in the agency quote their own customers' orders and the orders of other broker/dealers. Market makers also could choose to reflect the order, in whole or in part, in the agency quote. A market maker would not be permitted, however, to display in the agency quote its own proprietary interest or the proprietary interest of another broker/dealer that also is a registered market maker in the security at issue. The proposed rule change provides an exception to this general prohibition which would allow a market maker to display in the agency quote a proprietary interest that represents a portion of a customer order that the market maker has contemporaneously filled from its inventory. Market makers therefore could use the agency quote to work an institutional-sized order by displaying the entire order, or portions of the order, in the quote. Under the proposed ruled change, the Manning Interpretation1 would continue to apply to both the market maker's proprietary and agency quotes. Therefore, a market maker would still be prohibited from trading ahead of customer orders, whether the order was reflected in the market maker's proprietary or agency quote. In addition, agency quotes would be available for auto-execution through SOES or a successor execution system.2 Nasdaq also would permit agency quotes to use a reserve size feature, so that a customer could have a portion of its order displayed in the quote, with the remainder of the order in reserve to be displayed in pieces after the displayed portion is executed.

2According to Nasdaq, the proposed rule change is intended, among other things, to respond to market makers’ concerns that the implementation of the Order Handling Rules (“OHR”) have caused market makers to "lose control" of their quotes. Under the OHR, market makers must change their proprietary quote to reflect certain customer limit orders and must make publicly available any superior prices that it privately quotes through an ECN. Nasdaq states that the agency quote will give market makers more flexibility in determining how they wish to handle customer orders and other agency business. Instead of having to display a customer limit order in their proprietary quote or in a qualifying ECN, market makers would be able to display the order in their agency quote. The agency quote proposal also is intended to address several other concerns relating to the representation of both proprietary and agency interest in the same quotation. For example, Nasdaq believes that the OHR frequently make it difficult for market makers to work institutional or block-sized orders. Under the OHR, if the market maker receives an order priced better than the order being worked, unless the market maker executes the smaller order or sends it to an ECN or another broker- dealer to be displayed, the market maker must display the customer limit order, which Nasdaq believes may impede the market maker's ability to execute the institutional order efficiently. In addition, Nasdaq believes that the inability of market makers to separate their retail and proprietary interest occasionally causes confusion to market participants because an institutional customer may erroneously believe that the price of a displayed customer limit order represents the starting point for negotiating the price the institution will receive or pay if it places a large order with the market maker. Comments on this proposal are due to the SEC no later than June 1, 1999. If you have any comments you would like the Institute to consider including in a comment letter, please provide them to Ari Burstein by phone at (202) 371-5408, by fax at (202) 326-5841, or by e-mail at aburstein@ici.org no later than May 14. Ari Burstein Assistant Counsel Attachment

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