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SEC ORDER APPROVING NASDAQ SUPERMONTAGE PROPOSAL

[13116] February 2, 2001 TO: SEC RULES MEMBERS No. 12-01 EQUITY MARKETS ADVISORY COMMITTEE No. 4-01 RE: SEC ORDER APPROVING NASDAQ SUPERMONTAGE PROPOSAL The Securities and Exchange Commission has issued an order approving Nasdaq's proposed Order Display Facility and Order Collector Facility as well as modifications to the Nasdaq trading platform (referred to as "SuperMontage").1 In addition, the SEC is soliciting comments on, and at the same time has granted accelerated approval to, Amendment No. 9 to the proposal.2 A copy of the Release is attached. SuperMontage was initially published for comment in December 1999.3 Since that time, in response to concerns expressed by commenters, the proposal was amended and published for comment three more times.4 The Institute filed several comment letters on SuperMontage.5 These letters expressed support for the objectives of SuperMontage, in particular, increasing the transparency of limit orders in the Nasdaq market and the ability of those orders to interact with one another. The letters, however, also expressed concerns regarding various aspects of the proposal. Those concerns, and Nasdaq's and the SEC's response to those concerns, are summarized in the following description of SuperMontage as adopted. 1 Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8019 (January 26, 2001) ("Release"). 2 Amendment No. 9 specifies how preferenced orders (discussed below) will be processed. The amendment also makes a technical correction to the definition of preferenced orders and represents that Nasdaq will not use OATS data to gain an unfair competitive advantage over other market participants. Comments on Amendment No. 9 are due to the SEC no later than February 16, 2001. 3 Securities Exchange Act Release No. 42166 (November 22, 1999), 64 FR 68125 (December 6, 1999). 4 Securities Exchange Act Release Nos. 42573 (March 23, 2000), 65 FR 16981 (March 30, 2000); 43133 (August 10, 2000), 65 FR 49842 (August 15, 2000); and 43514 (November 3, 2000), 65 FR 69084 (November 15, 2000). 5 See Letters from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 11, 2000, April 20, 2000, and December 5, 2000 (File No. SR- NASD-99-53). See also Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Arthur Levitt, Chairman, Securities and Exchange Commission, dated October 24, 2000. 2Background As noted above, SuperMontage will consist of a new Nasdaq Order Display Facility and Order Collector Facility. The Order Display Facility will display the best bid/best offer in Nasdaq and two price levels away from the best bid/best offer, in addition to the aggregate size at each price level of the "displayed" trading interest of market makers, ECNs, and UTP Exchanges. Nasdaq market makers and ECNs that are NASD members ("Nasdaq Quoting Market Participants") will be able to display their quotes/orders anonymously at these price levels in the Order Display Facility. The Order Display Facility

also will allow Nasdaq Quoting Market Participants to provide the Nasdaq system with multiple agency and principal quotes/orders at single, as well as multiple, price levels. Nasdaq Quoting Market Participants will be required to designate a quote/order as “attributable” or “non-attributable,” and will be able to indicate a reserve size for the quote/order.6 If an order is “attributable,” the price and size of the order will be displayed next to the Nasdaq Quoting Market Participant's market maker ID (“MMID”) in the Nasdaq Quotation Montage if this is the Quoting Market Participant's best-priced attributable order. Attributable orders or quotes would be displayed in the Nasdaq Order Display Facility as part of the aggregate trading interest when the price of the quote/order is within the best three price levels in Nasdaq. If a Nasdaq Quoting Market Participant designates a quote/order as “non-attributable,” it will be displayed in the Nasdaq Order Display Facility as part of the aggregate trading interest when the price of the quote/order is within the best three price levels. That order or quote would not, however, be displayed in the Nasdaq Quotation Montage next to the Quoting Market Participant's MMID. SuperMontage also will consist of an Order Collector Facility that will serve as a single point of order entry and single point of delivery of liability orders and executions.7 To access the best-priced quotes/orders, a market participant will be required to enter an order into the Order Collector Facility, which will deliver either an automatic execution or a liability order to the next Quoting Market Participant in the queue based on SuperMontage’s order execution algorithms. By creating the Order Collector Facility as the single point of order entry and the single point of delivery of executions and orders, Nasdaq believes that SuperMontage will fully integrate its two current trading systems, SelectNet and SOES, from the end user's perspective. Order Execution Algorithms SuperMontage will replace Nasdaq's current SOES and SelectNet services with two new processes: a directed order process and a non-directed order process. 6 The “reserve size” function allows a Nasdaq market maker or ECN to display publicly part of the full size of its order or interest with the remainder held in reserve on an undisplayed basis to be displayed in whole or in part as the displayed part is executed. 7 A “liability order” means an order to which an ECN, market maker, or UTP Exchange specialist owes a firm quote obligation under Securities Exchange Act Rule 11Ac1-1. 31. Directed Order Process The directed order process will be functionally similar to the current SelectNet service in that it will allow a Nasdaq participant to direct an order to a particular Nasdaq Quoting Market Participant or UTP Exchange. A directed order can be a liability order or a non-liability order. However, to avoid creating a risk of double liability, a Nasdaq Quoting Market Participant or UTP Exchange will not be required to receive directed liability orders through the Order Collector Facility. 2. Non-Directed Order Process A non-directed order is an order that the market participant does not route to a particular Nasdaq Quoting Market Participant or UTP Exchange, or a preferenced order (discussed below). Upon receipt of a non-directed order that is not a preferenced order, the Order Collector Facility will determine the next Nasdaq Quoting Market Participant or UTP Exchange in the queue due to receive an order based on one of three order execution algorithms and deliver either an execution or a liability order, depending on how the Nasdaq Quoting Market Participant or UTP Exchange participates in Nasdaq. As originally proposed, SuperMontage would have executed non-directed orders entered into the system in general price/time priority. Within a price level, however, the system would have executed non-directed orders first against the displayed quotes/orders of market makers and ECNs that participate in the automatic-execution functionality of the system (“Auto-Ex ECNs”), then 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 have executed against reserve size of market makers and Auto-Ex ECNs, and then reserve size of Order-Delivery ECNs. Finally, the system would have executed against the quotes of UTP exchanges. In response to concerns expressed by commenters on the original proposal, the NASD eliminated the distinction between automatic execution participants and order delivery participants and, instead, proposed to give ECNs that do not charge a separate quote access fee priority over ECNs that do. After receiving comments on this proposed change, the NASD amended the proposal to give market participants that enter non-directed orders a choice as to how their orders will be executed. In particular, orders in SuperMontage will be executed based on one of three order execution algorithms: price/time priority; price/time priority considering ECN access fees; or price/size/time priority. The price/time priority algorithm will be the default algorithm for non-directed orders.8 a. Price/Size/Time Priority The Institute and other commenters objected to the proposed price/size/time algorithm. The Release specifically notes the Institute's concerns that (1) granting size priority ahead of time priority would negate the incentive for price improvement, (2) the price/size/time algorithm would offer little, if any, benefit because, under the other two algorithms, 8 The SEC notes in the Release that although none of the three order execution algorithms maintains pure price/time priority, they afford price/time priority to a wider range of orders than is currently available in Nasdaq. 4participants would still have the ability to sweep through all orders at a given price level, and (3) participants could instead utilize the directed order process to send an order to a participant displaying greater size.9 The Release states that the SEC concluded that the algorithm based on price/size/time priority is consistent with the Exchange Act as it will assist market participants in quickly assessing liquidity in a dynamic trading environment, while rewarding liquidity providers, particularly in a decimals environment where liquidity may be spread over a greater number of trading increments. The SEC acknowledged concerns raised by commenters, including the Institute, that the choice of algorithms lessens the importance of time priority, and therefore may provide less incentive to aggressively enter better-priced quotes. The SEC, however, notes that the three algorithms afford greater price/time priority than currently exists in the Nasdaq market. In addition, the SEC states that because it does not believe that entering orders into SuperMontage should be mandated, requiring time priority within SuperMontage runs the risk of reducing a market participant's willingness to enter orders into SuperMontage, therefore undermining the effectiveness of the system. For this reason, the SEC believes that providing the choice of a price/size/time priority algorithm is a statutorily-permissible balance between encouraging liquidity, accommodating the preferences of market participants, and maintaining time priority. The SEC also states that while this algorithm may reduce the incentive to be the first with the better price, it may encourage a Nasdaq Quoting Market Participant to display greater size. b. ECN Fees The NASD proposed to give market makers and ECNs that do not charge a separate access fee priority over ECNs that do. The Release states that commenters were split on this issue with some believing it was appropriate to give the orders of ECNs that do not charge fees priority because the ECNs that charge fees provide an inferior execution price. Others, however, argued that ECNs frequently offer a better price than market makers at the BBO even after access fees have been deducted from the execution price. In response to commenters, the NASD amended SuperMontage to provide investors with the order execution algorithm choice that considers access fees. In addition, SuperMontage was amended to provide parity to ECNs that charge access fees when the price improvement on a particular quote/order at least equals the access fee under the price/time priority option that takes ECN fees into account. The Release notes the Institute's support for the NASD's elimination of the per se treatment of ECN access fees but also said that several commenters, including the Institute, nevertheless supported executions based on strict price/time priority. 9 The Institute supported the two algorithms that follow price/time priority because they would resolve the dispute over how to treat ECN access fees within SuperMontage while maintaining adherence to the principle of price/time priority. 5The SEC found that the price/time algorithm that takes ECN access fees into account is a reasonable attempt to allow market participants to access the quote of an entity that does not charge fees before directing their orders to an ECN that charges fees because the quote/order of an ECN that charges an access fee may actually result in an inferior execution price after the fee is added. In addition, the Release states that the NASD's decision to retain the algorithm that accounts for ECN access fees does not unfairly discriminate against ECNs, particularly because market participants may choose either of the two other algorithms that do not consider ECN fees. Preferencing and Amendment No. 9 Amendment No. 8 to the SuperMontage proposal introduced a new class of orders into SuperMontage called "preferenced orders," which will allow a market participant to designate a particular quoting market participant against which its order is to be executed or delivered. Preferenced orders will be processed in the same queue as non-directed orders and will be considered liability orders. When a preferenced order is next to be executed within the non- directed order queue, SuperMontage will execute against both the displayed quote/order and the reserve size of the preferenced quoting market participant. Any unexecuted portion will be returned to the entering market participant. Two possible approaches to preferenced orders were proposed in Amendment No. 8: Alternative A, which would provide for preferenced orders with no price restrictions and Alternative B, which would provide for preferenced orders only at the BBO. In response to commenters objections, including those of the Institute, that allowing market makers to preference orders away from the BBO would give them the ability to trade with each other and ignore better-priced quotes/orders offered by other participants, the NASD withdrew Alternative A in Amendment No. 9 and chose Alternative B as the approach by which preferenced orders will be processed. The Institute opposed the introduction of preferenced orders into SuperMontage because, among other things, allowing market participants to send preferenced orders inside the SuperMontage system would undermine the concept of price/time priority by allowing market participants to preference market participants that lack priority status, and thus damage the integrity of the Nasdaq market. In addition, the Institute stated that it is likely that such orders could be used as a mechanism to facilitate such practices as internalization and payment for order flow. In response to these concerns, the SEC noted, among other things, that preferenced orders are just one of the delivery options available to market participants and that market participants also may send directed orders, non-directed non-preferenced orders, and orders outside the SuperMontage (via private links). In addition, the SEC states that it is highly unlikely that orders subject to payment for order flow will be preferenced through SuperMontage rather than routed directly to market makers. Finally, the SEC states that while it recognizes that preferenced orders do not create as strong incentives to quote aggressively in SuperMontage as would strict price/time priority, there is substantial doubt whether these orders would be entered in SuperMontage at all without the preferencing feature. 6Internalization Under all three order execution algorithms, when a Nasdaq Quoting Market Participant is at the best bid/best offer, Nasdaq will provide for internal matching of that participant's orders against the participant's quotes/order before the order is sent into the Nasdaq system to execute against all non-directed orders. The Release notes that the Institute opposed SuperMontage's internalization function and specifically notes that the Institute believed that the internalization of orders could impede access to liquidity and price discovery for market participants, especially if a significant amount of a particular security's daily volume is internalized. In response to comments opposing internalization, the Release states that market makers currently internalize order flow without ever providing access to any other market participants and that it is unlikely that market makers will enter customer market orders into SuperMontage rather than simply internalizing them directly. Nevertheless, the internal matching function attempts to encourage market makers to enter these orders into SuperMontage where superior quotes would have some chance of interacting with them. The SEC therefore believes that the SuperMontage's internalization function is a reasonable attempt to encourage Nasdaq Quoting Market Participants to include their customer orders in a system that will provide greater transparency and accessibility to other participants, and could lead to a more transparent and seamless integration of internalizing market makers with the rest of the marketplace.10 Reserve Size As noted above, the reserve size function of SuperMontage allows a Nasdaq market maker or ECN to publicly display part of the full size of its order or interest, with the remainder held in reserve on an undisplayed basis to be displayed in whole or in part as the displayed part is executed. In response to a commenter's suggestion on the original proposal, in Amendment No. 4 to SuperMontage, the NASD added the "size/time priority" characteristic to the reserve size function to provide order execution priority for orders with the larger displayed size (after being refreshed out of reserve). The Release notes the Institute's concerns with this proposal, particularly that the size/time prioritization of reserve size would discourage market participants from displaying orders greater than 1,000 shares. In response to these concerns, the SEC states in the Release that two requirements should ensure that market participants continue to have an incentive to display their quotes/orders. First, market participants must display a minimum of 1,000 shares to use the reserve size feature. Second, all displayed quotations at the same price level in the SuperMontage generally will have priority up to their displayed size over all reserve size at the same price level. In addition, the SEC states that market forces and competition may encourage 10 The SEC reiterated, however, that its approval of this aspect of the proposal is based on the structure of the existing dealer market and the voluntary nature of the SuperMontage. In addition, the SEC states that while a broker does not necessarily violate its duty of best execution by internalizing its agency orders, the duty also is not necessarily satisfied by routing orders to a market center that merely guarantees an execution at the national BBO without taking into account the possibility of price improvement. 7Nasdaq Quoting Market Participants to display greater size if the price/size/time algorithm is widely used. The SEC therefore concluded that Nasdaq's use of the reserve size feature is reasonable and could result in increased depth and liquidity in Nasdaq. Preservation of Time Priority for Size Increases to Quotes/Orders As proposed, a market participant that changed its displayed trading interest by increasing its displayed size would lose its priority status in the SuperMontage order execution queue. In response to concerns expressed by commenters on this aspect of the proposal, including the Institute, the NASD modified SuperMontage to protect the time priority of these market participants. Specifically, under SuperMontage, quote entries will receive a time stamp which will be used in determining their ranking in the execution algorithm relative to other quotes/orders at that price level. If a market participant increases its displayed size, the system will maintain the original time stamp for the original quantity, protecting its time priority, and assign a separate timestamp for the increased portion. Decreases in size will be deducted from individually-stamped components in reverse time priority, i.e., the last entered size component will be exhausted first. Five-Second Interval Delay Between Price Levels As originally proposed, after displayed and reserve size is exhausted at a particular price level, there would be a five-second interval delay before SuperMontage would attempt to execute an order at a new price level. The Institute questioned this provision, specifically whether the proposed five-second delay would reduce volatility in the markets as intended. In response to these comments, Nasdaq amended SuperMontage to include a more limited interval delay parameter. In particular, the system limits the five-second interval delay to situations where an order is partially filled at one price level, and the remaining shares of the order will not be filled in full at the next two trading increments away. In these situations, there will be a five-second interval delay or pause before the order moved to the next increment away from the original increment. In addition, a market participant will be able to set a parameter on an individual order so that the order will trade through all displayed and reserve interest at the three price levels being displayed in the Order Display Facility 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 Order Display Facility (and into the third price level). If the Sweep Order is not executed in full at the third price level, the order will pause for five seconds between each subsequent price level. The Release notes that the Institute, in its comment letter on the amended proposal, supported the limited five-second interval delay between price levels and the proposed Sweep Order parameter, but also notes the Institute’s uncertainty over whether the NASD’s modifications to the process went far enough to address concerns about imposed trading delays. Despite these concerns, the SEC concluded that the two exceptions to the five-second interval delay between price levels provide a reasonable compromise between the need for fast executions and the need to provide market participants adequate time to manage their capital risk by monitoring and updating their quotes. In addition, the SEC expects that the NASD will monitor market performance in the SuperMontage as it relates to the five-second interval delay, particularly the potential for queuing, and consider modifying that time period, if necessary. 8Finally, the SEC believes that the delay could help stabilize the market during periods of volatility by allowing Nasdaq Quoting Market Participants and UTP Exchanges the opportunity to monitor and assess their quotes in a reasonable manner in response to changing market conditions. Issues Relating to Competition The Release notes that many commenters were concerned that SuperMontage would be anti-competitive either because, in their view, the SuperMontage will implement a monopolistic execution system that will compel participation by NASD regulated broker-dealers, and in turn stifle ECN innovation and diminish market competition, or that the automatic execution feature of the SuperMontage will force order flow into the SuperMontage. In addition, the Release notes that many commenters raised issues that relate to the multiple roles that the NASD has as an SRO and, through Nasdaq, as an exclusive processor of market information and as an operator of trading facilities. In response to these concerns, the NASD agreed to provide an alternative quotation and transaction reporting facility for NASD members, including ATSs, ECNs, and market makers, that will permit NASD members to comply with their obligations under SEC and NASD rules without participating in SuperMontage. The NASD represented that the facility will be available upon the implementation of SuperMontage. The SEC states it believes that this undertaking by NASD, in conjunction with other terms applicable to the NASD’s interaction with the SuperMontage, provides an appropriate balance of NASD’s role as regulator of the OTC market and its role as operator of an execution service in a competitive market. Implementation Date The Release states that Nasdaq intends to implement SuperMontage as soon as practicable after decimal pricing is fully implemented in Nasdaq. According to the Release, Nasdaq plans to phase-in Nasdaq securities similar to the way the SEC’s Order Handling Rules were introduced, i.e., initially implement the system for a limited number of securities (e.g., 100 stocks) representing a cross-section of Nasdaq-listed stocks and, on a regular basis thereafter, add 100 new stocks until the system is implemented for all Nasdaq-listed securities. Ari Burstein Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13116. ICI Members may retrieve this memo and its attachment from ICINet (http://members.ici.org). Attachment (in .pdf format)
