

MEMO# 12497

August 17, 2000

NASD PROPOSED RULE CHANGE AMENDING SUPERMONTAGE PROPOSAL

[12497] August 17, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 45-00 SEC RULES COMMITTEE No. 107-00 RE: NASD PROPOSED RULE CHANGE AMENDING SUPERMONTAGE PROPOSAL The Securities and Exchange Commission has published for comment a proposed rule change filed by the NASD¹ (a copy of which is attached) amending certain aspects of its proposal to establish the Nasdaq Order Display Facility ("SuperMontage") and to modify the Nasdaq trading platform. In particular, Nasdaq has filed Amendments Nos. 5, 6, and 7 in response to comments submitted to the SEC on the original proposal. The most significant aspects of the amendments are summarized below.

ECN Access Fees Earlier proposed amendments to the SuperMontage proposal provide that orders of market makers, ECNs that do not charge a separate access fee, and agency orders of UTP Exchanges would be executed in strict price/time priority before orders of ECNs that charge a separate access fee. The orders of these ECNs would be executed against only after the trading interest of the aforementioned SuperMontage participants at a given price level is exhausted. This prioritization plan was proposed by Nasdaq because Nasdaq believes that an access fee represents an increase in trading costs and therefore an inferior price. One commenter, however, stated that this prioritization plan was contrary to best execution practices because ECNs may sometimes offer a price better than a market maker at the best bid and offer even after access fees have been fully deducted from the execution price. This may occur because ECNs permit subscribers to trade in finer increments than recognized by Nasdaq's quotation system and these finer-priced orders are rounded to the nearest quotation increment when they are displayed in Nasdaq. The Release states that Nasdaq disagrees with these assertions and believes that the implementation of decimal pricing will, in any case, reduce the extent to which rounding will be significant as the quotation increments in a decimal environment will most likely be fine enough to match the trading increment. The Release also states that Nasdaq understands that in a decimals environment, ECNs may change the manner in which they charge access fees and may develop the capability to reflect these fees in their published quotes. Once this occurs, the Release states that non-directed orders of ECNs that charge a separate access fee would be given the same priority as those of other market participants. The Release also states, however, that ECNs claim that including their access fee in the quote will not completely resolve their concerns because: (1) ECN orders may be priced in increments less than a penny; and (2) ECNs do not charge the same fee to all subscribers, but charge a sliding fee based on a subscriber's volume. Nasdaq stated that they have already addressed these concerns and continue to find the ECNs arguments unpersuasive. Nevertheless, Nasdaq stated that it is amending the proposal to offer a 1 Securities Exchange Act Release No. 43133 (August 10, 2000), 65 FR 49842 (August 15, 2000)

("Release"). 2second alternative to ECNs. Specifically, ECNs that charge a separate access fee will have the ability to indicate on an order-by-order basis whether the price improvement offered by the order exceeds the access fee charged. If the price improvement exceeds the access fee, Nasdaq will rank that order for execution purposes with same-priced orders of other market participants. Finally, the Release states that Nasdaq understands that when decimal pricing is implemented in the Nasdaq market, ECNs may wish to reflect orders in Nasdaq that are at an increment finer than one penny. This could occur, for example, if an ECN charges a separate access fee that is less than one penny and that separate access fee is included in the quoted price. Nasdaq stated that in the event that priced quotations shrink to this level, it is committed to re-examining the order execution algorithm to determine whether it is prudent and feasible to rank orders based on quotation increments of less than one penny.

UTP Exchange Participation In an earlier amendment to the SuperMontage, Nasdaq proposed to provide automatic execution against Nasdaq market participants for non-directed orders emanating from the floor of the Chicago Stock Exchange, as long as the Chicago Stock Exchange reciprocates by agreeing to provide automatic execution for orders sent to the exchange by Nasdaq market participants. Nasdaq states that this view is consistent with its position that it is willing to provide automatic execution against its market if a UTP Exchange is willing to provide automatic execution against its specialists' quotes. The Release states that SEC staff noted that the proposed rules do not address a situation where a UTP Exchange may not wish to participate in automatic execution, but instead may wish only to take order delivery against its quotes ("Order-Delivery UTP Exchange"). In response to these concerns, Nasdaq has amended the proposed rules to address this type of situation. In particular, under the proposed rules, if an Order-Delivery UTP Exchange is next in line to receive a non-directed liability order, Nasdaq will deliver the order to the UTP Exchange up to the size of the UTP Exchange's quote. The system then will decrement the Order-Delivery UTP Exchange's quote by an amount equal to the size of the delivered order.

Implementation Date The Release states that Nasdaq intends to implement the SuperMontage system as soon as practicable after decimal pricing is fully implemented in the Nasdaq market. Nasdaq also committed to providing sufficient lead time for all market participants to have the opportunity to adequately prepare and test their internal systems for the SuperMontage functionality before implementing the new system.

Other Significant Amendments The amendments address several other concerns and suggestions raised by commenters on the original proposal. For example, the amendments reiterate that participation in the SuperMontage is voluntary, that the system will be rolled out in phases similar to the manner in which Nasdaq implemented the Order Handling Rules where a limited number of stocks which represent a cross section of Nasdaq stocks are phased in, and clarify how the sweep order² and request to cancel function in the SuperMontage will work for market makers and ECNs that accept automatic executions. 2 Under the SuperMontage sweep order function, a market participant can set a parameter on an individual order so that the order will execute against all trading interest at the three price levels being displayed in the SuperMontage at the time of entry without pausing five seconds in between each displayed price. If the sweep order, however, is not executed in full at the third price level, the order would pause for five seconds between each subsequent price level. 3The amendments also respond to suggestions from commenters that Nasdaq develop a hybrid order routing and execution assignment system instead of the automatic execution system contemplated by the SuperMontage and provide assurances that the construction of the SuperMontage does not divert resources from the efforts to implement decimalization in the Nasdaq market. Comments on the proposed rule change are due to the SEC no later than August 30, 2000. If you have any comments you would like the Institute to consider including in a possible 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 no later than August 25. Ari Burstein Assistant Counsel Attachment Attachment (in .pdf format)

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