

MEMO# 12853

November 14, 2000

NASD PROPOSED RULE CHANGE AMENDING SUPERMONTAGE PROPOSAL

[12853] November 14, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 58-00 RE: NASD PROPOSED RULE CHANGE AMENDING SUPERMONTAGE PROPOSAL The Securities and Exchange Commission has published for comment Amendment No. 8 to Nasdaq's proposed Order Display Facility ("SuperMontage").¹ The SEC's release is attached and the aspects of the proposal most relevant to the buy-side are summarized below. In addition, attached is a paper prepared by Nasdaq discussing the SuperMontage system functionality. A. Non-Directed Order Processing In response to concerns expressed by commenters regarding ECN quote access fees and to address comments that factors other than cost may be important to a market participant in making investment decisions, the NASD proposes to amend the Order Execution Algorithm for non-directed orders. Under the amended algorithm, the NASD proposes to give SuperMontage participants that enter non-directed orders three options on how their orders would interact with the quotes/orders in Nasdaq. 1. Strict Price/Time Priority The first option would have orders executed in strict price/time priority and would be the default algorithm for SuperMontage. Therefore, unless a market participant affirmatively selects one of the alternative algorithms, non-directed orders would be executed in strict price/time priority, in the following order: (1) against displayed quotes/orders of market makers, ECNs, and non-attributable agency interest of UTP Exchanges; (2) against reserve size of market makers and ECNs; and (3) against principal quotes of UTP Exchanges. 2. Price/Size/Time Priority The second option would enable a market participant to indicate that its orders be executed on a price/size/time basis. Under this option, non-directed orders at a particular price level would execute against displayed quotes and then reserve size based on the size of the displayed quote, and then time if there is a tie in size. Reserve size would be executed 1 Securities Exchange Act Release No. 43514 (November 3, 2000). 2 against based on the size of the related displayed quote, not the total amount held in reserve. Therefore, under this option, non-directed orders would be executed in the following order: (1) against displayed quotes/orders of market makers, ECNs, and non-attributable agency interest of UTP Exchanges in price/size/time priority between such interest; (2) against reserve size of market makers and ECNs, in price/size/time priority of such interest, with size priority based on the size of the related displayed quote/order; and (3) against principal quotes of UTP Exchanges, in price/size/time priority between such interest. 3. Price/Time Priority that Accounts for ECN Quote-Access Fees The third option would take into account an ECN's separate quote-access fee. Specifically, under this option, non-directed orders would be executed in the following order: (1) against displayed quotes/orders of market makers, ECNs that do not charge a separate quote-access fee, and non-attributable agency interest of UTP Exchanges, as well as quotes/orders of ECNs that charges a separate quote-access fee where the ECN indicates that the price improvement offered by the quote/order is equal to or exceeds the quote-

access fee, in time priority between such interest; (2) against displayed quotes/orders of ECNs that charge a separate quote-access fee to non-subscribers; (3) against reserve size of market makers and ECNs that do not charge a separate quote-access fee to non-subscribers, as well as reserve size of quotes/orders from ECNs that charge a separate quote-access fee to non-subscribers where the ECN entering such quote/order has indicated that the price improvement offered is equal to or exceeds the quote-access fee, in time priority between such interest; (4) against reserve size of ECNs that charge a separate quote-access fee to non-subscribers, in time priority between such interest; and (5) against principal quotes of UTP Exchanges, in time priority between such interest. The internalization feature of SuperMontage will be preserved in all three of the proposed algorithms. In particular, SuperMontage will internalize non-directed orders entered by a market maker or an ECN when they are also at the inside market by matching the non-directed order with the inside quote/order instead of sending it to the participant next in the queue.

B. Preferred Orders The amended proposal would create a new class of orders called "preferred orders." Preferred orders would be processed in the same queue as non-directed orders and would be considered liability orders. When a preferred order is next to be executed within the non-directed order queue, SuperMontage would execute against both the displayed quote/order and the reserve size of the preferred quoting market participant. Any unexecuted portion would be returned to the entering market participant. Two possible approaches to preferred orders are proposed: Alternative A, which would provide for preferred orders with no price restrictions and Alternative B, which would provide for preferred orders with price restrictions. Comments are specifically requested on whether Alternative A or Alternative B is the proper approach for preferred orders.

31. Alternative A - Preferred Orders with No Price Restrictions Under Alternative A, when a preferred order is next to be executed within the non-directed order queue, the preferred order would execute at the preferred quoting market participant's price, regardless of whether the quoting market participant is at the BBO. Therefore, under Alternative A, preferred orders could be executed at the BBO or outside the BBO.

2. Alternative B - Preferred Orders with Price Restrictions Under Alternative B, when a preferred order is next to be executed within the non-directed order queue, the preferred order would execute at the preferred quoting market participant's price only if the quoting market participant is at the BBO. If that quoting market participant is not at the BBO when the preferred order is next to be delivered or executed, the preferred order will be returned to the entering participant.

C. Preservation of Time Priority for Size Increases to Quotes/Orders In response to concerns expressed by commenters, the NASD proposes to modify SuperMontage to protect the time priority of a market participant that changes its displayed trading interest by increasing its displayed size. Specifically, under the proposal, quote entries would receive a time stamp which would 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 entries in reverse time priority.

D. Increased Dissemination of Quotation Information The NASD is proposing to create a new vendor data feed, "NQDS Prime," that would provide, on a real-time basis, all individual attributable quote/order information at the three best price levels displayed in the SuperMontage. The proposal states that NQDS Prime is intended to eliminate any purported informational advantage accruing to the SuperMontage system from the retention of this information. Comments on the proposed rule change are due to the SEC no later than 21 days from the date of publication of the proposed rule change in the Federal Register. Publication is expected the week of November 13. 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 no later than November 29. Ari Burstein Associate Counsel Attachments (in .pdf format)

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