

thereunder applicable to a national securities exchange.<sup>19</sup> In particular, the Commission finds the proposal is consistent with Section 6(b)(5) of the Act.<sup>20</sup>

Under Section 6(b)(5) of the Act,<sup>21</sup> a registered national securities exchange must have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission finds that ISE's proposed amendments to ISE Rule 717(d) and (e) reducing the exposure time (*i.e.*, the amount of time EAMs are required to expose agency orders on the Exchange before executing them as principal or against a solicited order) from two minutes to 30 seconds are consistent with Section 6(b)(5) of the Act.<sup>22</sup> The Commission recognizes that, on floor-based exchanges, there are no rules that govern the extent to which a given trading crowd has an opportunity to interact with a proposed crossing of orders. Because the ISE operates a unique electronic options market, it must define an order exposure time period. The Commission finds that a 30 second exposure period is a reasonable time frame for participants in ISE's market to assess market conditions and their own trading interest, and to allow a reasonable opportunity for price improvement from interested participants. The Commission finds that a 30 second exposure period strikes a reasonable balance between maintaining liquidity and efficiency in the ISE market and preventing impediments to a free and open market, while providing the appropriate safeguards for investors and the public.

In determining that a 30-second exposure period is reasonable, the Commission has considered carefully the commenters' concern that market makers might be able to subvert the 30 second exposure period by posting bids or offers for a very short period of time, and arranging to receive agency orders simultaneously when they are executable against the market maker as

principal, or against other agency orders held by the market maker.<sup>23</sup> In such a scenario, EAMs allegedly would pre-screen order flow, and hold orders until they can be internalized, denying the order any exposure in the market and the opportunity for price improvement. The Commission is not persuaded by this argument. The ISE allows for only one exception to the 30 second exposure period, in the scenario where an EAM has previously disseminated proprietary trading interest on the ISE for at least 30 seconds prior to receipt of a customer order. Under this limited exception, a firm will have placed itself "at risk" to the public by having disseminated trading interest available to all customer orders at a stated price. ISE Rule 717(d) states that a member must have been bidding or offering on the Exchange for *at least* 30 seconds prior to receiving an agency order that is executable against such bid or offer. The Commission finds that an EAM's execution of its own customer order under this particular scenario would not deprive the public of the opportunity to trade at the same price.

The Commission also has considered carefully the commenters' concerns about the potential for internalization of order flow where there is a 30 second exposure period, and finds that the proposal provides sufficient safeguards against such activity. The ISE's system is designed to ensure that, once customer orders are entered into the system, any limit orders that do not improve upon the ISE best bid or offer automatically are placed into the ISE's electronic limit order book last in time priority behind any existing customer orders at the same price. Therefore, an EAM has no guarantee that it will be able to trade against its agency orders. Because ISE's system automatically provides reasonable safeguards to prevent EAMs from executing against their own customer orders, the Commission finds that a 30 second exposure period does not pose an unreasonable risk of increasing the internalization of order flow. For these reasons, the Commission finds that ISE's proposal is consistent with Section 6(b)(5) of the Act.<sup>24</sup>

## V. Conclusion

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act,<sup>25</sup> that the

proposed rule change (SR-ISE-00-04), as amended, is approved.

**Margaret H. McFarland.**

*Deputy Secretary.*

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>26</sup>

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42847; File No. SR-NASD-00-30]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Include UTP Exchanges in the Nasdaq National Market Execution Service

May 26, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 25, 2000, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed a proposed rule change with the Securities and Exchange Commission ("SEC" or "Commission"). The proposed rule change is described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule changes from interested persons.

### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq is proposing to provide for the inclusion of national securities exchanges trading Nasdaq-listed securities pursuant to grants of unlisted trading privileges ("UTP") in the automatic-execution functionality of the Nasdaq National Market Execution System ("NNMS"). Below is the text of the proposed rule change. Proposed deletions are in brackets and proposed addition are in *italics*.

4720. SelectNet Serve

(a)-(b) No Change

(c) Prohibition Regarding the Entry of Certain Preferred Orders to Nasdaq National Market Execution System Market Makers

(i) No member [may] *shall* direct a SelectNet preferred order to a Nasdaq

<sup>19</sup> In approving this rule, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>20</sup> 15 U.S.C. 78f(b)(5).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> See SA&B Letter at 8.

<sup>24</sup> 15 U.S.C. 78f(b)(5).

<sup>25</sup> 15 U.S.C. 78s(b)(2).

<sup>26</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

National Market Execution System ("NNMS") market maker including that market maker's Agency Quote (as defined in NASD Rule 4613), a Full Participant ECN (as defined in NASD Rule 4701), or a UTP Exchange that participates in the automatic execution functionality of the NNMS, unless that order is designated as:

A[(i)] an "All-or-None" order ("AON") and is at least one normal unit of trading (i.e. 100 shares) in excess of the displayed quote to which the preferred order is directed; or

B[(ii)] a "Minimum Acceptable Quantity" order ("MAQ"), with a MAQ value of at least one normal unit of trading in excess of the displayed quote to which the preferred order is directed.

(ii) The prohibition of this paragraph shall not apply to:

(A) preferred order sent by a UTP Specialist that does not participate in the automatic execution functionality of the NNMS, to an NNMS market maker; or

(B) [to] preferred order sent by an NNMS market maker to a UTP Specialist that does not participate in the automatic execution functionality of the NNMS.

(iii) For purposes of this rule a "UTP Specialist" shall mean a broker/dealer registered as a specialist in Nasdaq securities pursuant to the rules of an exchange that is a signatory to the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination Of Quotation and Transaction Information For Exchange-Listed Nasdaq/National Market System Securities Traded On Exchanges On An Unlisted Trading Privilege Basis ("Nasdaq/NMS/UTP Plan").

\* \* \* \* \*

## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

Nasdaq is proposing to amend the NASD rules governing the NNMS, to enable UTP Exchanges to participate in the automatic execution functionality of the NNMS. Nasdaq represents that currently, the Chicago Stock Exchange ("MWSE") is the only exchange that trades Nasdaq-listed securities pursuant to the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination Of Quotation and Transaction Information For Exchange-Listed Nasdaq/National Market System Securities Traded On Exchanges On An Unlisted Trading Privilege Basis ("Nasdaq UTP Plan").

On January 14, 2000, the Commission approved the new NNMS trading platform, which is to be implemented in July 2000.<sup>3</sup> As approved, the NNMS will be an automatic execution system that will serve as the primary trading platform for Nasdaq National Market securities. Under the NNMS rules, participation in the NNMS will be mandatory for Nasdaq market makers, and those market makers will be required to participate in the automatic execution functionality of the system.

ECNs will have two options for participating in NNMS. Specifically, ECNs can choose to be Order-Entry ECNs or Full-Participant ECNs. Order-Entry ECNs will participate in Nasdaq in substantially the same manner as ECNs do today. That is, market participants will be able to access Order Entry ECN quotes via the SelectNet linkage and to send preferred SelectNet messages of any size (up to 999,999 shares) to such ECNs. The oversized order requirement for a preferred SelectNet order would not apply to Order Entry ECNs. Order Entry ECNs that want to access other market maker quotes will need to request order-entry capability in NNMS. That is, they will enter orders into NNMS for automatic execution against quotes of market makers and Full Participant ECNs (i.e., those ECNs that choose to accept automatic execution against their quotes). Order Entry ECNs can also send preferred SelectNet orders to NNMS Market Makers subject to the over-sized order restriction described below.

Full-Participant ECNs will agree to provide automatic execution against their quotes for orders entered into NNMS, similar to market makers. Like

Order Entry ECNs, Full-Participant ECNs will use NNMS to obtain automatic execution of orders they send to NNMS Market Makers or other Full-Participant ECNs. Full-Participant ECNs will use SelectNet to deliver liability orders to Order Entry ECNs.

To avoid dual liability, market makers and Full Participant ECNs are only eligible to receive preferenced/directed orders through SelectNet that are either: (1) an "All-or-None" orders ("AON") and at least one normal unit of trading (i.e., 100 shares) in excess of the displayed quote to which the preferred order is directed; or a "Minimum Acceptable Quantity" order ("MAQ"), with a MAQ value of at least one normal unit of trading in excess of the displayed quote to which the preferred order is directed ("Over-Sized Order Requirement"). It is the NASD's view that orders that meet the Over-Sized Order Requirement are not liability orders under the NASD's and Commission's firm quote rule. Thus, the main purpose of the Oversized-Order Requirement is to limit dual liability for market participants that are required to (i.e., market makers), or chose to (i.e., Full Participant ECNs), take automatic execution against their quotes through the NNMS.<sup>4</sup> The underlying premise of the NNMS rule change is to establish (in most cases) only one point of (or system for) delivery of a liability order against the quote of a market maker, ECN, or UTP Exchange.

As originally proposed and approved, UTP Exchanges will only receive orders through Nasdaq's SelectNet system. This is because UTP Exchanges have traditionally received orders against their quotes through the order-delivery functionality of SelectNet. Because SelectNet is an order-delivery system—as opposed to an automatic-execution system like the NNMS—UTP Exchanges that receive SelectNet orders must manually respond to the order to complete a trade.

Under the approved NNMS rules (and similar to how SOES currently operates), when UTP Exchanges and/or Order Entry ECNs are alone at the best bid/best offer, the NNMS will stop processing orders that are in the NNMS system and will hold those orders in queue for 90 seconds. During this 90 seconds, the system essentially pauses to see if a market maker or Full Participant ECN will join the inside or the UTP Exchange or Order Entry ECN

<sup>4</sup> Such dual liability could occur if a market maker or ECN receives an order through SelectNet to which it owes an obligation under the NASD's and Commission's firm quote rule, and immediately thereafter receives an execution through the NNMS against the same quote.

<sup>3</sup> See Securities Exchange Act Release No. 42344 (Jan 14, 2000), 65 FR 3987 (January 25, 2000).

will drop away from the inside, thereby establishing a new inside market.<sup>5</sup> If after 90 seconds a market maker or Full Participant ECN does not join the inside, the NNMS will return the orders that are in queue and the system will shut down. If during the 90 seconds a market maker joins the inside or establishes a new (better priced) inside, the system resumes automatic-execution processing of orders.

After the Commission approved the NNMS, the MWSE and Nasdaq began discussing the possibility of the MWSE participating in the automatic-execution functionality of the NNMS. Both Nasdaq staff and the MWSE recognized that there could be delays in processing orders if the MWSE is alone at the inside and does not respond, within 90 seconds, to orders delivered to its quote.<sup>6</sup> This could occur if the MWSE is experiencing system problems, is slow to process an order, or if there are delays in Nasdaq systems.<sup>7</sup> Commission staff also raised this concern. In light of the above, Nasdaq is proposing a rule change to permit the MWSE to participate in the automatic-execution functionality of the NNMS.

In the NNMS, the quotes of market makers, Full Participants ECNs, and UTP Exchanges are accessed in general price/time priority. We note that this is unlike the exchange environment where markets are required to sweep the floor before accessing the quotes of a competing exchange. We also recognize that the approach in this filing differs from our proposal in SR-NASD-99-53, regarding the Nasdaq Order Display Facility, where the system would

execute against the propriety quotes of UTP Exchanges behind the quotes and orders of Nasdaq market makers, ECNs, and agency interest of UTP Exchange specialists. While we believe that the approach in SR-NASD-99-53 is more appropriate given the precedent established in the listed environment regarding order routing, we are proposing a strict price/time approach in this filing as a short-term solution to the potentially significant and crippling problems outlined above.<sup>8</sup>

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with Section 15A(b)(6)<sup>9</sup> of the Act in that the proposed rule change is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in the regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The rule change will eliminate the potential for order queuing or for this system to stop processing orders, when UTP Exchanges are alone at the inside. Thus, the rule change is designed to remove impediments to and perfect the mechanism of a free and open market and a national market system, and to protect investors and the public interest.

### *B. Self-Regulatory Organization's Statement on Burden on Competition*

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

<sup>8</sup> The rules clarify that if a UTP Exchange participates in the automatic-execution functionality of the NNMS, orders preferred to the UTP Exchange's quotes must meet the Oversized Order Requirement. This is to limit the potential for dual liability (described above) for UTP Exchanges. In addition, Nasdaq is proposing non-substantive rule changes to correct drafting errors in the original rule proposal to clarify that orders sent to quotes of Order Entry ECNs are not subject to the Oversized Order Requirement in the rule, while orders sent to Full Participant ECNs are subject to this requirement.

<sup>9</sup> 15 U.S.C. 78o-3(b)(6).

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments were neither solicited nor received.

### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-00-30 and should be submitted by June 26, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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<sup>10</sup> 17 CFR 200.30-3(a)(12).

<sup>5</sup> This pause occurs because UTP Exchange and Order Entry ECN quotes are not reachable through the automatic-execution functionality of the NNMS, but only through the order-delivery portion of the system.

<sup>6</sup> While this is also a concern with ECNs, the concern is substantially smaller because ECNs are required to provide an automated response to SelectNet messages, and, in Nasdaq's experience, they generally respond in 5 second or less to orders presented to their quotes. UTP Exchanges are not under the same explicit obligation.

<sup>7</sup> As an illustration of the potential problem, assume the MWSE is alone at the inside bid of \$20 for 1000 shares, Market Maker A enters an order into the automatic-execution functionality of the system, and Market Maker B directs (or preferences) 1,000 shares to the MWSE. No other market maker joins the inside bid of \$20; this causes the system to stop processing orders for 90 seconds. Thereafter, the MWSE waits 2 minutes before responding to MMB's directed/preferenced order either by filing or declining the order. (This delay could occur if there are equipment problems at the MWSE, in Nasdaq, or both.) In this instance, the market effectively is held up for 2 minutes and the automatic-execution functionality is shut off (after 90 seconds) because the MWSE did not respond to the direct/preferenced orders within 90 seconds.