settlement over the jurisdictional amount, would be deleted from the CRD system two years from the date of the report to the complaint to the CRD system. Dismissed or withdrawn arbitration or civil proceedings would also be deleted. All arbitration and civil litigation proceedings involving securities transaction matters and all settlements of $10,000 or more would be reported.

Because there are differences in the information required to be disclosed in the existing and revised Form U–4 and because the revised Form U–4 will not be utilized until the new CRD system is operational in 1997, the proposed changes to the Program will be implemented in two phases. In the first phase, starting with implementation of the proposed disclosure changes in calendar 1996 until the new CRD system is operational, the NASD will review each member's and associated person's existing CRD record against the revised Question 22 on page 3 of Form U–4 and disclose any information that is available to the NASD at that time. The revised Form U–4 will require the reporting of certain written customer complaints that are not required to be reported on the existing Form U–4. Since these ''new'' complaints are not presently required to be reported, these complaints will not be available for disclosure until the revised Form U–4 is in use. In phase two, beginning with the operation of the new CRD system (expected to be in spring 1997), the NASD will disclose all information required to be disclosed in revised Question 22 on page 3.

The NASD believes the proposed rule change is consistent with Sections 15A(b)(6) [4] and 15A(i) [5] of the Act. The NASD believes the proposed rule change will further the goals of these sections of the Act because the increased disclosure will enhance the general public's access to information that will help investors determine whether or not to conduct or continue to conduct business with an NASD member or any of the member's associated persons. The NASD also recognizes the growth in information technology and its customers' increased use thereof; thus, the proposed rule change attempts to accommodate investors by making access to information as convenient as possible.

[4] Section 15A(b)(6) requires that the Association amend its rules to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open market, and in general, to protect investors and the public interest.

[5] Section 15A(i) requires the Association to: (1) Establish and maintain a toll-free telephone listing to receive inquiries regarding disciplinary actions involving its members and their associated persons, and (2) promptly respond to such inquiries in writing.

(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. 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. 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 the file number in the caption above and should be submitted by December 26, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[6]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–30941 Filed 12–4–96; 8:45 am]

BILLING CODE 8010–01–M

[6] 17 CFR 200.30–3(a)(12).

[Release No. 34–38008; File No. SR–NASD–96–43]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to Implementation of the SEC's Order Handling Rules

December 2, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78s(b)(1), notice is hereby given that on November 18, 1996, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The NASD is submitting this rule filing to amend a variety of NASD rules and The Nasdaq Stock Market's (''Nasdaq'') Small Order Execution System (''SOES'') and SelectNet Service to conform to the Commission's new limit order display rule, Rule 11Ac1–4 under the Act [1] (''Display Rule'') and amendments to Rule 11Ac1–1(c)(5) under the Act [2] (''ECN Rule''). These amendments are also being proposed to reflect the order-driven nature of the Nasdaq market that will be brought about by implementation of the Display Rule and ECN Rule. Proposed new language is in italics. Deleted language is in brackets.

Marketplace Rules

* * * * *

4613. Character of Quotations

(a) Two-Sided Quotations

(1) For each security in which a member is registered as a market maker, the member shall be willing to buy and sell such security for its own account on a continuous basis and shall enter and maintain two-sided quotations in The Nasdaq Stock Market, subject to the procedures for excused withdrawal set forth in Rule 4619.

(A) *If a market maker updates the price of its bid or offer without any accompanying update to the size of such bid or offer, the size of the updated*

[1] 17 CFR 240.11Ac1–4.

[2] 17 CFR 240.11Ac1–1.

bid or offer shall be the size of the previous bid or offer.

(B) Notwithstanding any other provision in this paragraph (a), in order to display a limit order in compliance with SEC Rule 11Ac1–4, a registered market maker's displayed quotation size may be for one normal unit of trading or a larger multiple thereof.

(C) A registered market maker must display a quotation size for at least one normal unit of trading or a larger multiple thereof when it is not displaying a limit order in compliance with SEC Rule 11Ac1–4, provided, however, that a registered market maker may augment its displayed quotation size to display limit orders priced at the market maker's quotation.

[(2) Each member registered as a Nasdaq market maker in Nasdaq National Market equity securities shall display size in its quotations of 1,000, 500, or 200 shares and the following guidelines shall apply to determine the applicable size requirement:

(A) a 1,000 share requirement shall apply to Nasdaq National Market securities with an average daily non-block volume of 3,000 shares or more a day, a bid price of less than or equal to $100, and three or more market makers;

(B) a 500 share requirement shall apply to Nasdaq National Market securities with an average daily non-block volume of 1,000 shares or more a day, a bid price of less than or equal to $150, and two or more market makers and

(C) a 200 share requirement shall apply to Nasdaq National Market securities with an average daily non-block volume of less than 1,000 shares a day, a bid price of less than or equal to $250, and that have two or more market makers.

(3) Each member registered as a Nasdaq market maker in Nasdaq SmallCap Market equity securities shall display size in its quotations of 500 or 100 shares and the following guidelines shall apply to determine the applicable size requirement:

(A) a 500 share requirement shall apply to Nasdaq SmallCap Market securities with an average daily non-block volume of 1,000 shares or more a day or a bid price of less than $10.00 a share; and

(B) a 100 share requirement shall apply to Nasdaq SmallCap Market securities with an average daily non-block volume of less than 1,000 shares a day and a bid price equal to or greater than $10.00 a share.

(4) Share size display requirements in individual securities may be changed depending upon unique circumstances as determined by the Association, and a list of the size requirements for all Nasdaq equity securities shall be published from time to time by the Association.]

* * * * *

(e) Locked and Crossed Markets

(1) A market maker shall not, except under extraordinary circumstances, enter or maintain quotations in Nasdaq during normal business hours if:

(A) the bid quotation entered is equal to or greater than the asked quotation of another market maker entering quotations in the same security; or

(B) the asked quotation is equal to or less than the bid quotation of another market maker entering quotations in the same security.

(2) A market maker shall, prior to entering a quotation that locks or crosses another quotation, make reasonable efforts to avoid such locked or crossed market by executing transactions with all market makers whose quotations would be locked or crossed. Pursuant to the provisions of paragraph (b) of this Rule 4613, a market maker whose quotations are causing a locked or crossed market is required to execute transactions at its quotations as displayed through Nasdaq at the time of receipt of any order.

(3) *For purposes of this paragraph, the term ''market maker'' shall include any NASD member that enters into an electronic communications network, as that term is defined in SEC Rule 11Ac1–1(a)(8), a priced order that is displayed in The Nasdaq Stock Market. Such term also shall include an NASD member that operates the electronic communications network when the priced order being displayed has been entered by a person or entity that is not an NASD member.*

* * * * *

IM–4613 Autoquote Policy

(a) General Prohibition—The Association has extended a policy banning the automated update of quotations by market makers in Nasdaq. *Except as provided below,* [T]*t*his policy prohibits systems known as ''autoquote'' systems from effecting automated quote updates or tracking of inside quotations in Nasdaq[, with two exceptions]. [Automated updating of quotations is permitted when the update is in response to an execution in the security by that firm (such as execution of an order that partially fills a market maker's quotation size) or when it requires a physical entry (such as a manual entry to the market maker's internal system which then automatically forwards the update to Nasdaq).] This ban is necessary to offset the negative impact on the capacity and operation of Nasdaq of certain autoquote techniques that track changes to the inside quotation in Nasdaq and automatically react by generating another quote to keep the market maker's quote away from the best market.

(b) Exceptions To the General Prohibition—Automated updating of quotations is permitted when: (1) the update is in response to an execution in the security by that firm (such as execution of an order that partially fills a market maker's quotation size); (2) it requires a physical entry (such as a manual entry to the market maker's internal system which then automatically forwards the update to Nasdaq); (3) the update is to reflect the receipt, execution, or cancellation of a customer limit order; or (4) an electronic communications network as defined in SEC Rule 11Ac1–1(a)(8) is required to maintain a two-sided quotation in Nasdaq for the purpose of meeting Nasdaq system design requirements.

* * * * *

4623 Electronic Communications Networks

(a) The Association may provide a means to permit electronic communications networks, as such term is defined in SEC Rule 11Ac1–1(a)(8), to meet the terms of the electronic communications network display alternative provided for in SEC Rule 11Ac1–1(c)(5)(ii)(A) and (B). In providing any such means, the Association shall establish a mechanism that permits the electronic communications network to display the best prices and sizes of orders entered by Nasdaq market makers (and other entities, if the electronic communications network so chooses) into the electronic communications network, and allows any NASD member the electronic ability to effect a transaction with such price orders that is equivalent to the ability to effect a transaction with a Nasdaq market maker quotation in Nasdaq operated systems.

(b) An electronic communications network that seeks to utilize the Nasdaq-provided means to comply with the electronic communications network display alternative shall:

(1) demonstrate to the Association that it qualifies as an electronic communications network meeting the definition in the SEC Rule;

(2) be registered as an NASD member;

(3) enter into and comply with the terms of a Nasdaq Workstation Subscriber Agreement;

(4) agree to provide for Nasdaq's dissemination in the quotation data made available to quotation vendors the prices and sizes of Nasdaq market maker orders (and other entities, if the electronic communications network so chooses) at the highest buy price and the lowest sell price for each Nasdaq security entered in and widely disseminated by the electronic communications network and

(5) provide an automated execution or, if the price is no longer available, an automated rejection of any order routed to the electronic communications network through the Nasdaq-provided display alternative.

* * * * *

4700 Small Order Execution System (SOES)

4710 Definitions

* * * * *

[(h) The term ''exposure limit'' means the number of shares of a security on either side of the market specified by a Market Maker that it is willing to have executed for its account by unpreferenced orders entered into SOES.

(i) The term ''minimum exposure limit'' for a security means the aggregate number of shares of the security equal to two times the maximum order size for that security.]

(j)–(k). Re-lettered as subparagraphs (h) and (i).

* * * * *

4730 Participant Obligations in SOES

* * * * *

(b) Market Makers

(1) A SOES Market Maker shall commence participation in SOES by initially contacting the SOES Operation Center to obtain authorization for the trading of a particular SOES security and identifying those terminals on which the SOES information is to be displayed and thereafter by an appropriate keyboard entry which obligates the firm, so long as it remains a Market Maker in SOES:

(A) to execute individual preferenced SOES orders equal to or smaller than the applicable maximum order size at the best bid or offer as disseminated by Nasdaq in any security for which it is a SOES market maker;

(B) for any NNM security for which it is a SOES market maker, to execute individual unpreferenced SOES orders equal to or smaller than the market maker's displayed quotation size in any security for which it is a SOES Market Maker; and

(C) for any Nasdaq SmallCap Market security for which it is a SOES market maker, to execute individual unpreferenced SOES orders equal to or smaller than the market maker's displayed quotation size when the market maker's quotation is at the best bid or offer as disseminated by Nasdaq, and, when the market maker's quotation is inferior to the best bid or offer as disseminated by Nasdaq, to execute individual unpreferenced SOES orders up to the lessor of the market maker's displayed quotation size or the smallest quotation size of all the market makers whose quotations are at the best bid or offer as disseminated by Nasdaq.

[(A) for any security for which it is a SOES Market Maker, to execute individual orders in sizes equal to or smaller than the maximum order size; and

(B) for any NNM security for which it is a Market Maker, to execute individual orders equal in the aggregate to the minimum exposure limit.] *A SOES Market Maker's displayed quotation size will be decremented upon the execution of an unpreferenced SOES order equal to or greater than one normal unit of trading; provided, however, that the execution of an unpreferenced SOES order that is a mixed lot (i.e., an order that is for more than a normal unit of trading but not a multiple thereof) will only decrement the SOES Market Maker's displayed quotation size by the number of shares represented by the number of round lots contained in the mixed lot order.* Market Makers shall have a period of time following their receipt of an execution report in which to update their quotation in the security in question before being required to execute another unpreferenced order at the same bid or offer in the same security. This period of time shall initially be established as 15 seconds, but may be modified upon appropriate notification to SOES participants. All entries in SOES shall be made in accordance with the requirements set forth in the SOES User Guide.

[(2) For each security in which a Market Maker is registered, the Market Maker may enter into SOES an exposure limit. For an NNM security, that limit may be any amount equal to or larger than the minimum exposure limit. If no exposure limit is entered for an NNM security, the firm's exposure limit will be the minimum exposure limit.]

(2)[(3)] For each security in which the Market Maker is registered, the Market Maker may elect to have The Nasdaq Stock Market refresh its quotation automatically by an interval designated by the Market Maker, once its *displayed quotation size on either side of the market* [exposure limit] in the security has been *decremented to zero due to SOES executions* [exhausted]. The Nasdaq Stock Market will refresh the market maker's quotation on the bid *or* [and] offer side of the market, *whichever is decremented to zero,* by the interval designated, and will reestablish the Market Maker's displayed size *for one normal unit of trading; provided, however, that a Market Maker may elect to have The Nasdaq Stock Market refresh its bid or offer at the same price if the Market Maker's quotation size prior to any decrementation was equal to or greater than the maximum SOES order size for the security.* [and selected exposure limit. If the market maker elects to utilize The Nasdaq Stock Market automated update feature, it may establish an exposure limit equal to the maximum order size for the securities, regardless of the minimum exposure limit set forth in Rule 4710(i).]

(3)[(4)] *Except as otherwise provided in subparagraph (10) below,* [A]*at* any time a locked or crossed market, as defined in Rule 4613(e) exists for a NNM security, a Market Maker with a quotation for that security in The Nasdaq Stock Market that is causing the locked or crossed market may have orders representing shares equal to the *size of its bid or offer that is locked or crossed* [minimum exposure limit or the firm's exposure limit, whichever is greater,] executed by SOES for that Market Maker's account at its quoted price if that price is the best price. Those orders will be executed irrespective of any preference indicated by the Order Entry Firm.

(4)[(5)] For each security in which a Market Maker is registered, the Market Maker may not enter orders *into SOES for its proprietary account, but may enter orders* on an agency basis into SOES. [, unless a locked or crossed market, as defined in Rule 4613(e), exists for that security. This prohibition against use of SOES does not obviate the Market Maker's duty to give its agency orders best execution in the prevailing market, according to Rule 2320.]

(5)[(6)] The Market Maker may terminate his obligation by keyboard withdrawal from SOES at any time. However, the Market Maker has the specific obligation to monitor his status in SOES to assure that a withdrawal has in fact occurred. Any transaction occurring prior to the effectiveness of the withdrawal shall remain the responsibility of the Market Maker. In the case of a security that is not a NNM security, a Market Maker whose *bid or offer has been decremented to zero due to SOES executions* [exposure limit is exhausted] will be deemed to have withdrawn from SOES and may reenter at any time pursuant to paragraph (a)

above*; provided, however, that a market maker in a Nasdaq SmallCap Market security that does not reenter a quotation by the close of business on the day its quotation is decremented shall be deemed to have withdrawn as a market maker in the security and precluded from entering quotations in that security for twenty (20) business days pursuant to NASD rule 4620.*

(6)[(7)] In the case of an NNM security, a Market Maker will be suspended from SOES if its *bid or offer has been decremented to zero due to SOES executions* [exposure limit is exhausted] and will be permitted a standard grace period, the duration of which will be established and published by the Association, within which to take action to restore *a two-sided quotation in the security for at least one normal unit of trading* [its exposure limit]. A Market Maker that fails to *re-enter a two-sided quotation* [renew its exposure limit] in a NNM security within the allotted time will be deemed to have withdrawn as a Market Maker. Except as provided in subparagraph *(7)*[(8)] below, a Market Maker that withdraws in an NNM security may not reenter SOES as a Market Maker in that security for twenty (20) business days.

(7)[(8)] Notwithstanding the provisions of subparagraph *(6)* [(7)] above: (A) a Market Maker that obtains an excused withdrawal pursuant to Rule 4619 prior to withdrawing from SOES may reenter SOES according to the conditions of its withdrawal; and (B) a Market Maker that fails to maintain a clearing arrangement with a registered clearing agency or with a member of such an agency, and is thereby withdrawn from participation in ACT and SOES for NNM securities, may reenter SOES after a clearing arrangement has been reestablished and the market maker has compiled with ACT participant requirements. Provided however, that if the Association finds that the ACT market maker's failure to maintain a clearing arrangement is voluntary, the withdrawal of quotations will be considered voluntary and unexcused.

(8)[(9)] The Rule 9700 Series of the Code of Procedure shall apply to proceedings brought by Market Makers seeking review of (A) their removal from SOES pursuant to subparagraph *(6)*[(7)] above, (B) the denial of an excused withdrawal pursuant to Rule 4619, or (C) the conditions imposed on their reentry.

(9)[(10)] In the event that a malfunction in the Market Maker's equipment occurs, rendering on-line communications with SOES inoperable, the SOES Market Maker is obligated to immediately contact the SOES Operations Center by telephone to request withdrawal from SOES. For NNM securities, such request must be made pursuant to Rule 4619. If withdrawal is granted, SOES operational personnel will enter the withdrawal notification into SOES from a supervisory terminal. Such manual intervention, however, will take a certain period of time for completion and the SOES Market Maker will continue to be obligated for any transaction executed prior to the effectiveness of his withdrawal.

(10) In the event that there are no SOES market makers at the best bid (offer) disseminated by Nasdaq, market orders to sell (buy) entered into SOES will be rejected and returned to their respective order entry firms.

(c) SOES Order Entry Firms

* * * * *

(2) SOES will *only* accept [both] market and *marketable* limit orders for execution *and will not accept market or marketable limit orders designated as All-or-None (''AON'') orders; provided, however, that SOES will not accept any limit orders, marketable or unmarketable, prior to 9:30 a.m., Eastern Time. For purposes of this subparagraph, an AON order is an order for an amount of securities equal to the size of the order and no less.* Orders may be preferenced to a specific SOES Market Maker or may be unpreferenced, thereby resulting in execution in rotation against SOES Market Makers. A Market Maker may indicate order entry firms from which it agrees to accept preferenced orders. If an order is received by a Market Maker from an order entry firm from which it has not agreed to accept preferencing, the order will be executed at the inside market on an unpreferenced basis and will be subject to a period of time between executions for market makers to update their quotations.

* * * * *

6330 Obligations of CQS Market Makers

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(b) CQS market makers shall be required to input a minimum quotation size of 200 or 500 shares in each reported security (as established and published from time to time by the Association) depending on trading characteristics of the security*; provided that a CQS market maker may input a quotation size less than such minimum quotation size to display a limit order in compliance with SEC Rule 11Ac1–4. A limit order displayed in a CQS market maker's quotation pursuant to SEC Rule 11Ac1–4 must be for at least one normal unit of trading or a multiple thereof.*

* * * * *

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

In its filing with the Commission, the NASD 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. The NASD 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. Introduction and Background

On August 29, 1996, the Commission promulgated a new rule and adopted amendments to other Commission rules that have the effect of transforming The Nasdaq Stock Market (''Nasdaq'') into a combined order-driven market and a competing dealer market.[3] Specifically, the Commission adopted the Display Rule, which requires the display of customer limit orders: (1) that are priced better than a market maker's quote;[4] or (2) that add to the size associated with a market maker's quote when the market maker is at the best price in the market.[5] By virtue of the Display Rule, investors will now have the ability to directly advertise their trading interest to the marketplace, thereby allowing them to compete with market maker quotations and affect the size of bid-ask spreads.[6] In sum, with the Display Rule, Nasdaq will have order-driven aspects akin to an auction market while retaining its

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[3] *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (''Order Handling Rules Adopting Release'').

[4] For example, if a market maker's quote in stock ABCD is 10–10¼ (1000 x 1000) and the market maker receives a customer limit order to buy 200 shares at 10⅛, the market maker must update its quote to 10⅛–10¼ (200 x 1000).

[5] For example, if a market maker receives a limit order to buy 200 shares of ABCD at 10 when its quote in ABCD is 10–10¼ (1000 x 1000) and the NBBO for ABCD is 10–10⅛, the market maker must update its quote to 10–10¼ (1200 x 1000).

[6] There are eight exceptions to the Display Rule: (1) customer limit orders executed upon receipt; (2) limit orders placed by customers who request that they not be displayed; (3) limit orders for odd-lots; (4) limit orders of block size (10,000 shares or $200,000); (5) limit orders routed to a Nasdaq or exchange system for display; (6) limit orders routed to a qualified electronic communications network for display; (7) limit orders routed to another member for display; and (8) limit orders that are all-or-none orders.

competing dealer market structure to provide price continuity and market depth and liquidity.[7]

The other rule changes adopted by the Commission involve amendments to the Commission's firm quote rule, Rule 11Ac1–1 under the Act.[8] The ECN Rule requires market makers to display in their quote any better priced orders that the market maker places into an electronic communications network (''ECN'') such as SelectNet or Instinet. Alternatively, instead of updating its quote to reflect better priced orders entered into an ECN, a market maker may comply with the display requirements of the ECN Rule through the ECN itself, provided the ECN meets two conditions.[9]

This rule filing addresses the changes to the NASD's rules and systems that the NASD and Nasdaq believe must be made to implement the Display Rule and ECN Rule by January 10, 1997. The rule filing also discusses a variety of proposed rule changes that the NASD and Nasdaq believe are necessary in light of the order-driven nature of the Nasdaq market that will be brought about by implementation of the Display Rule and ECN Rule.

2. Proposed Rule Changes to Implement the Display Rule

i. *Minimum Quotation Size Requirements.*

a. *Quote Size When Displaying Customer Limit Orders.*

In order to facilitate the display of customer limit orders in accordance with the Display Rule, the NASD and Nasdaq propose to amend NASD Rules 4613 and 6330 to provide that Nasdaq market makers and CQS market makers may display a quotation size for one normal unit of trading or a larger multiple thereof to reflect the actual size of a customer limit order.[10] Thus, if a market maker's quote for ABCD is 20–20¼, 10 x 10, and it receives a customer limit order to buy 100 shares at 20⅛, the market maker may update its quote to 20⅛–20¼, 1 x 10. By permitting market makers to display the actual size of limit orders in their quotes, market makers will not be responsible for executing any additional shares above the size of the limit order. The NASD and Nasdaq believe this proposed rule change will help to promote the acceptance of limit orders priced inside quoted markets, thereby furthering the investor protection and market transparency objectives sought by the Commission in the Order Handling Rules Adopting Release. Moreover, without these rule changes, in instances where customer limit order are smaller than the applicable minimum quotation size requirement and a market maker's quote is inferior to the limit order price, market makers would be obligated to execute trades at prices superior to their proprietary quotations. The NASD and Nasdaq believe that subjecting market makers to such an order execution requirement would be unfair and create a disincentive for firms to function as market makers.

b. *Quote Size When Displaying Proprietary Market Maker Quotes.*In an environment in which Nasdaq market makers are the only market participants who can impact quotation prices, the NASD and Nasdaq believe it is desirable and appropriate to impose minimum quotation size requirements to ensure an acceptable level of market liquidity and depth. However, now that the Display Rule will permit investors to directly impact quoted prices, the NASD and Nasdaq believe it would be appropriate to treat Nasdaq market makers in a manner equivalent to exchange specialists and not subject them to minimum quote size requirements. In sum, the NASD and Nasdaq believe the new order-driven nature of Nasdaq brought about by the Display Rule will obviate the regulatory justification for minimum quote size requirements because investors will have the capability to display their own orders in the marketplace. The ability for limit orders and ECN orders to be included in Nasdaq quotations should also ensure that market liquidity and price continuity will not be harmed by the elimination of minimum quotation size requirements. In this new environment, the NASD and Nasdaq believe that mandatory quote size requirements impose unnecessary regulatory burdens on market makers which are not consistent with the Act. Accordingly, the NASD and Nasdaq recommend that NASD Rule 4613 be amended to remove any requirements on market maker quotation sizes.

The NASD and Nasdaq also believe that permitting market makers to quote in sizes commensurate with their own freely-determined trading interest will enhance the pricing efficiency of the Nasdaq market. In this connection, several recent economic studies have concluded that exchange specialists rely on quotation size movements just as much as quotation price movements to manage their risk.[11] Indeed, a recent analysis by Nasdaq of quotation size updates by specialists on the New York Stock Exchange (''NYSE'') revealed that 62 percent of the quotation updates involved changes only to the size of the specialist's quotation and that 32 percent involved changes to both price and size. Thus, 94 percent of all quotation updates involved a change in quotation size. The analysis also found that the bid and offer sizes were the same for only 11 percent of the updates.[12] Accordingly, just as exchange specialists rely on quotation size updates in an order-driven market to manage their risk, the NASD and Nasdaq believe Nasdaq market makers should be able to use quotation size updates to effectively manage their risks in Nasdaq's order-driven/competing dealer market structure that will be brought about by the Display Rule. Moreover, the NASD and Nasdaq believe that eliminating artificial constraints on quotation size movements by Nasdaq market makers will enhance the independence and competitiveness of dealers quotations in the Nasdaq market.

The NASD and Nasdaq also believe that elimination of the minimum quotation size requirements is necessary

[7] The Display Rule requirements will become effective on January 10, 1997, for all exchange-listed securities and for the 1,000 Nasdaq securities with the highest average daily trading volume. On March 28, 1997, the Rule will apply to the next 1,500 Nasdaq securities, and on June 30, 1997, the next 2,000 Nasdaq securities. The final phase-in date is August 28, 1997, when the Rule will apply to all remaining Nasdaq securities.

[8] 17 CFR 240.11Ac1–1

[9] Specifically, in order for a market maker to comply with the rule via an ECN, the ECN must: (1) ensure that the best priced orders entered by market makers into the ECN are communicated to Nasdaq for public dissemination; and (2) provide brokers and dealers access to orders entered by market makers into the ECN, so that brokers and dealers who do not subscribe to the ECN can trade with those orders. This access must be equivalent to the access that would have been available had the market makers reflected their superior priced orders in their quotes.

[10] NASD Rule 4613 requires each market maker in a Nasdaq issue to enter and maintain two-sided quotations with a minimum size equal to or greater than the applicable SOES tier size for the security (*e.g.*, 1,000, 500, or 200 shares for Nasdaq National Market (''NNM'') issues and 500 or 100 shares for Nasdaq SmallCap Market issues). NASD Rule 6330 requires registered market makers in exchange-listed securities to display a minimum quotation size of 200 or 500 shares in each reported security (as established and published from time to time by the Association) depending on trading characteristics of the security.

[11] *See, e.g.*, Lee, C., Mucklow, B., and Ready, M, 1993, ''Spread, Depth, and the Impact of Earnings Information: An Intraday Analysis,'' The Review of Financial Studies, 6, 345–74; K. Kavajecz, 1995, ''A Specialist's Quoted Depth and the Limit Order Book,'' Working Paper, J.L. Kellogg Graduate School of Management, Northwestern University; and K. Kavajecz, 1996, ''A Specialist's Quoted Depth as a Strategic Choice Variable,'' Working Paper, The Wharton School of the University of Pennsylvania.

[12] The source of the data used in Nasdaq's analysis was the Trade and Quote (''TAQ'') Database produced by the NYSE. The analysis reviewed over 750,000 quotation updates occurring over four days in 1996 (June 19, July 17, August 14, and September 18).

to ensure that market makers who do not have access to an ECN will not be placed at a competitive disadvantage vis-a-vis those market makers who do have access to an ECN. In particular, since an ECN is not subject to minimum quotation size requirements, market makers with access to an ECN will be able to publicly display a quote/order for as small as 100 shares and maintain their Nasdaq market maker quotation away from the inside market, while market makers without access to an ECN would have no such option. As a result, unless market makers can quote in the same size as ECNs, there will be a disincentive for some firms, particularly smaller firms, to make markets in Nasdaq securities. Finally, allowing market makers to quote smaller markets would likely result in narrower spreads, thereby lowering transaction costs for investors.

ii. *Operation of SOES*.

At present, all market makers in NNM securities must be registered as SOES market makers. SOES is voluntary for market makers in Nasdaq SmallCap securities. The maximum SOES order size for a NNM security is either 1,000, 500, or 200 shares depending on the price and volume of the issue; and the maximum order size for a Nasdaq SmallCap Market security is 500 shares. SOES automatically executes unpreferenced orders in rotation against those market makers who are at the best quoted bid or offer on Nasdaq at the time the order is entered.[13] SOES orders may be routed or ''preferenced'' to a particular market maker for execution at the inside market, regardless of what price the preferenced market maker is quoting. A SOES market maker is obligated to execute SOES orders up to the minimum SOES exposure limit for that stock or such greater exposure limit established by the market maker. The minimum exposure limit for a particular stock is two times the applicable maximum SOES order size (*e.g.* 2,000 shares for stocks in the 1,000 share tier size). If a market maker's exposure limit is exhausted, it is suspended from SOES and placed in a ''closed quote state'' and permitted a five-minute period to restore its exposure limit. If a market maker does not restore its exposure limit within five minutes it is automatically withdrawn from the stock and can not re-enter quotes in the issue for at least twenty business days.

Thus, SOES is currently designed to execute orders against market makers based on the tier size for a particular stock, without regard to the quotation size displayed by a market maker. Because the minimum quotation sizes for market makers are presently aligned with the maximum SOES order sizes, the current design of SOES does not obligate market makers to execute SOES orders larger than their quote size.

Because market maker quotes will at times reflect customer limit orders under the Display Rule, the NASD and Nasdaq believe SOES should be modified to allow market orders to be executed against market makers' displayed quotation sizes instead of SOES tier sizes. Following are discussions of other proposed changes to SOES that relate to the implementation of the Display Rule and the ECN Rule.

a. *Decrementation of Displayed Quotation Sizes After SOES Executions.* In order to avoid instances where a market maker could automatically receive multiple SOES executions because it displayed a customer's limit order at a price superior to the market maker's proprietary quote or increased its quote size because of the limit order, the NASD and Nasdaq propose that SOES be modified to decrement a market maker's displayed quote size upon the execution of unpreferenced SOES orders. For example, if a market maker's quote in ABCD is 10 x 10¼, 10 x 10, and it receives a customer limit order to buy 500 shares at 10⅛, it would update its quote to 10⅛ x 10¼, 5 x 10. Thereafter, if the market maker received a SOES execution at 10⅛ for 500 shares, the size of its bid would be depleted to 0 and the market maker would have to reenter a quotation. With this change, the NASD and Nasdaq believe market makers will be more inclined to accept and display customer limit orders because they will not be subject to mandatory SOES executions larger than the size of the limit orders that they display.[14] In addition, if market makers' displayed quotation sizes are not decremented after SOES executions, market makers would be unfairly subject to the risk and obligation of automatically executing orders at prices superior to their own quotation. Such a requirement would create a disincentive for firms to be market makers and threaten to diminish the liquidity of the Nasdaq market.

b. *Split Order Execution.* As noted above, because SOES presently executes orders based on SOES tier sizes and not market makers' displayed quotation sizes, SOES orders are not subject to partial executions. By decrementing market makers' displayed quotation sizes due to SOES executions, however, the NASD and Nasdaq believe it will be necessary to modify SOES so that it can execute one order against multiple market makers to ensure that SOES orders are automatically executed. As a result, the NASD and Nasdaq also recommend that SOES be amended to not accept ''all-or-none'' orders. For example, if the inside market for ABCD is 10–10¼ and two market makers are each at the inside bid for 500 shares, a SOES market order to sell 1,000 shares of ABCD would be executed at 10, with both market makers selling 500 shares. In addition, because all market maker quotations at the inside could be depleted by the execution of a SOES order, the NASD and Nasdaq believe it is necessary to modify SOES so that market orders may be filled at multiple price levels. For example, if the inside market for ABCD is 10–10¼ and Market Makers A and B are each at the inside bid for 100 shares, with Market Maker C at 9⅞ for 800 shares, a SOES market order to sell 1,000 shares of ABCD would be executed against all three market makers. Specifically, Market Makers A and B would each sell 100 shares at 10 and Market Maker C would sell 800 shares at 9⅞.

c. *Displayed Quotation Sizes Will Constitute Exposure Limits.* A corollary impact of decrementing market maker quotes after SOES executions is that a market maker's displayed quotation size will become its exposure limit. Exposure limits function by capturing and monitoring the amount of SOES volume executed by a market maker at its quoted price, without such SOES volume effecting the market maker's quotation size. Accordingly, by decrementing market maker quotations after SOES executions, a market maker's displayed quotation size will become its exposure limit because SOES will cease executing orders against a market maker once its quote size has gone to zero. Thus, the NASD and Nasdaq propose that the SOES rules be amended to replace references to exposure limits with references to a market maker's displayed size.

d. *Prohibition Against the Entry of Non-Marketable Limit Orders into SOES.* SOES currently accepts both market orders and limit orders. If a limit order is not immediately executable, or non-marketable, (*i.e.*, a limit order to buy (sell) priced below (above) the offer

[13] For Nasdaq SmallCap securities, SOES market makers must execute unpreferenced orders at the inside price regardless of whether they are at the inside market.

[14] The NASD and Nasdaq also propose that displayed quotations not be decremented after the execution of odd-lots and that the execution of a mixed lot order will only decrement a market maker's quotation by the number of shares represented by the number of round lots contained in the mixed lot order.

(bid) price), it is placed in the SOES limit order file and will be subsequently executed if the limit price becomes equal to the best bid or offer. SOES also has a limit order processing facility that matches limit orders priced inside the spread. Limit orders placed into SOES are never publicly disseminated, they are not included in the calculation of the best bid or offer, and they are not matched against incoming market orders. Accordingly, the NASD and Nasdaq believes that the current processing of non-marketable limit orders through SOES and the SOES limit order facility are in direct conflict with the Display Rule.[15] If Nasdaq were to retain these SOES features, Nasdaq believes it would be operating a system that would result in NASD members systematically violating the federal securities laws. In addition, by not matching market orders against limit orders, the NASD and Nasdaq do not believe the current operation of SOES is consistent with the Commission's statements regarding best execution in its Order Handling Rule approval order.[16] Thus, the NASD and Nasdaq propose that non-marketable limit orders be prohibited from SOES. As is currently the case, a marketable limit order will continue to be processed like a market order.

e. *Modifications to the SOES Automated Quotation Update Feature.* The ''auto-refresh'' feature of SOES moves both sides of a market maker's quotation by a pre-determined amount when its exposure limit has been exhausted. Accordingly, because a market maker's displayed quotation size will become its exposure limit under the proposed changes to SOES, the NASD and Nasdaq propose that the auto-refresh feature be modified so that it is activated when a market maker's quotation size is depleted. In addition, because of the possibility that a market maker's quotation at the next price level up or down could be comprised exclusively of customer limit orders and in light of the proposal to eliminate minimum quotation sizes for proprietary market maker quotes, the NASD and Nasdaq propose that market maker quotes be refreshed for 100 shares instead of the SOES tier size. The NASD and Nasdaq also recommend that the auto-refresh feature be modified so that it only updates the side of a market maker's quote that has been decremented. By updating the bid or the offer, but not both, the NASD and Nasdaq believe the auto-refresh feature will not exacerbate or contribute to locked or crossed markets, as has been the case with the current update feature during turbulent market conditions.

The NASD and Nasdaq also propose to amend the auto-refresh feature to allow a market maker to maintain its quote at the inside market. With this auto-refresh feature, those market makers seeking to buy or sell more stock than their displayed quotation can continue to remain at the inside market. Accordingly, only those market makers entering a quotation size equal to or greater than the maximum SOES order size would be able to utilize this feature.

f. *Allowing SOES Market Makers to Enter Agency Orders into SOES.* Currently, absent a locked or crossed market, a SOES market maker is prohibited from entering agency orders into SOES. This rule was implemented to prevent market makers from engaging in ''fair weather'' market making by entering orders into SOES that they do not want to execute themselves during turbulent market conditions. With the Display Rule, however, the quotations disseminated by market makers will at times reflect customer limit orders. Accordingly, in order to ensure that all small investors have access to better-priced customer limit orders displayed in market maker quotes and enhance the price improvement opportunities for all small investors, the NASD and Nasdaq believe it would be appropriate to allow SOES market makers to enter agency orders into SOES.

g. *Processing of Marketable Limit Orders.* Currently, SOES is designed so that marketable limit orders are processed ahead of market orders queued up in SOES. Because a marketable limit order is economically equivalent to a market order as long as the limit price is superior to the inside market,[17] the NASD and Nasdaq believe this system feature unnecessarily advantages investors placing marketable limit orders over investors placing market orders. This is particularly true since investors placing market orders to buy (sell), unlike investors placing marketable limit orders, have placed no upper (lower) limit on price at which they are willing to purchase (sell) the stock. Accordingly, the NASD and Nasdaq recommends that SOES be amended to execute market and marketable limit orders on a time priority basis.

h. *Market Maker Withdrawal from Nasdaq SmallCap Market Securities.* Because SOES is voluntary for Nasdaq SmallCap Market securities, when a market maker's exposure limit is exhausted in one of these securities it does not mean that the market maker has voluntarily withdrawn from the stock because the market maker can continue to quote the issue without participating in SOES. If market maker quotations are decremented after SOES executions, however, it will now be possible for a market maker in a SmallCap security to go into a ''closed quote'' state because its quotation size has been depleted. Accordingly, the NASD and Nasdaq propose that the SOES rules be amended to specify that a market maker in a SmallCap security shall be deemed to have voluntarily withdrawn from a stock if its quote size remains at zero at the close of the trading day, thereby precluding the market maker from being a market maker in the issue for twenty business days.

3. Proposed Rule Changes To Implement the ECN Rule

The NASD and Nasdaq also are amending certain rules and the SOES and SelectNet systems to facilitate the development of a means for ECNs to comply with the requirements of the ECN display alternative permitted under the ECN Rule. As noted above, the ECN Rule provides that market makers and specialists must make publicly available any superior prices that the market maker or specialist privately quotes through certain ECNs. The Commission also adopted an alternative display means to the ECN Rule, the ECN display alternative. Under this alternative, instead of updating its quote to reflect better priced orders entered into an ECN, a market maker may comply with the display requirements of the ECN Rule through the ECN itself, provided that the ECN: (1) ensures that the best priced orders entered by market makers into the ECN are communicated to Nasdaq for public dissemination; and (2) provides brokers and dealers access to orders entered by market makers into the ECN, so that brokers and dealers who do not subscribe to the ECN can trade with those orders. This access must be equivalent to the access that would have been available had the market makers reflected their superior priced orders in their quotes. The Commission stated that it expected the SROs to work cooperatively with the ECNs to display the prices in the

[15] The NASD notes that Nasdaq's proposed NAqcess system would provide for limit order display and execution capabilities consistent with the Commission's Order Handling Rules and hopes that the Commission will act favorably on the proposed system. *See* Securities Exchange Act Release No. 37302 (June 11, 1996), 61 FR 31574 (June 20, 1996).

[16] *See* Order Handling Rules Adopting Release, *supra* note 1, 61 FR at 48324.

[17] That is, a limit order to buy priced above the offer and a limit order to sell priced below the bid.

consolidated quote systems and to provide equivalent access to them.

The NASD and Nasdaq agree with the Commission that the ECN Rule and the ECN display alternative should enhance the transparency of prices in Nasdaq and other markets and can assist broker-dealers in obtaining the best prices for their customers. Indeed, in its comment letter to the Commission during the proposal phase of the ECN Rule, the NASD stated that it supported the broad dissemination of ECN best prices. The NASD also stated, however, that it was concerned that the rule as originally proposed could have the potential to harm market liquidity, because the original proposal could adversely affect the anonymity features of ECNs. The ECN display alternative as adopted by the Commission appears to substantially address this concern. Accordingly, since the Commission adopted its new rule, the NASD and Nasdaq have sought to develop a linkage to any ECN recognized as an ECN by the Commission and that seeks to avail itself of the ECN display alternative.

In order to meet the short time frame between the Commission's adoption of the rule and its effective date, the NASD is proposing to develop an interim approach [18] to a linkage that is based on existing Nasdaq system platforms, SOES and SelectNet. Because the linkage relies in substantial part on SelectNet as the means of accessing the ECN prices, the NASD has called this approach the ''SelectNet Linkage'' approach. The methodology for establishing the SelectNet Linkage and the rule changes required are described below.

i. *Overview of the Operation of the SelectNet Linkage.* To provide a means for ECNs to substantially comply with the requirements of the ECN display alternative by January 13, 1996,[19] Nasdaq has developed an interim approach that substantially meets the terms of Commission Rule 11Ac1–1(c)(5)(ii). The SelectNet Linkage is a display and access linkage that, for purposes of meeting the display requirement of the ECN display alternative, utilizes the methodology currently used for displaying Unlisted Trading Privileges (''UTP'') exchange quotes,[20] and for access purposes, builds upon the existing SelectNet system to reach the priced orders available in the ECN.

Under this approach, ECNs will function in a manner equivalent to UTP exchanges and/or Nasdaq market makers. This allows these ECNs to enter their best-priced orders into Nasdaq for display on the Nasdaq Workstation. To effect transactions against these displayed prices, NASD members that are subscribers to Nasdaq Workstation II service will be permitted to access the ECN prices through the delivery of orders directed to the ECN via the SelectNet system. Accordingly, the NASD and Nasdaq have proposed to establish a new provision within Rule 4600, the Nasdaq Market Maker Requirement section of the NASD Rules, that provides for Nasdaq's display of ECN price information and access to such prices, as well as the minimal obligations required of ECNs that seek to take advantage of the SelectNet Linkage to meet the Commission's ECN display alternative requirements.

Specifically, any ECN seeking to avail itself of the SelectNet Linkage, or any future system Nasdaq develops to meet the ECN display alternative requirements, must: (1) demonstrate to the Association that it qualifies as an ECN meeting the ECN definition found in the Commission's Rule; (2) be registered as an NASD member; (3) enter into and comply with the terms of a Nasdaq Workstation Subscriber Agreement; (4) agree to provide for Nasdaq's dissemination in Nasdaq's quotation data stream that it makes available to quotation vendors the prices and sizes of Nasdaq market maker orders [21] at the highest buy price and the lowest sell price for each Nasdaq security entered in and widely disseminated by the ECN; and (5) provide an automated execution of priced orders displayed through the linkage or, if the price is no longer available, an automated rejection of any order routed to the ECN through the Nasdaq-provided display alternative.

a. *Display of ECN Prices.* For quotation display purposes, Nasdaq will collect the actual prices contained in an ECN's system delivered by ECNs that agree to deliver such prices to Nasdaq, and display and disseminate rounded prices.[22] Assuming that ECNs meet the standards set forth in new Rule 4623, Nasdaq will furnish ECNs that identify themselves to Nasdaq as meeting the terms of the ECN definition in the ECN Rule with market maker identifiers (''MMIDs''). While ECNs will be assigned MMIDs, ECNs will not be registered as market makers. With the exception of certain rules such as the firm quote rule, the two-sided quote requirement,[23] and the locked or

[18] The NASD and Nasdaq continue to examine other means to develop a longer-term mechanism that would provide a permanent means to establish an ECN display alternative that meets every aspect of the Commission's rule. Any such permanent approach will be proposed separately at the appropriate time.

[19] The NASD and Nasdaq note that to comply with prudent standard industry practices regarding the implementation of new or substantially revised software, Nasdaq does not normally introduce extensive new or revised software into production on a Friday. Indeed, pursuant to previous discussions with Commission staff regarding the procedures for implementation of significant, non-emergency software changes, Nasdaq and Commission staff have agreed that significant changes should be implemented over a weekend. Thus, Nasdaq plans to introduce the software on Monday, January 13th. This means that unless the Commission temporarily delays the January 10, 1997 effective date for the ECN Rule, market makers entering priced orders into ECNs on January 10th will be required to operate under the ECN Rule without any ECN display alternative.

[20] 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 Privileges Basis (''Nasdaq/NMS/UTP Plan''), Nasdaq acts as the facilities manager for itself and the UTP Exchanges in collecting, consolidating and disseminating quotes from Nasdaq market makers and UTP exchange specialists that trade Nasdaq securities pursuant to Section 12(f) of the Act. UTP exchange specialists are not subject to SOES executions, nor do UTP exchange specialists have access to SelectNet.

[21] The ECN Rule does not require an ECN to provide non-market maker interest in the data that would be provided under the ECN display alternative. Nasdaq has been informed, however, by several ECNs that have non NASD member participants, e.g., institutions, that these ECNs will deliver to Nasdaq the best prices for each security for which they permit orders to be entered, whether those best prices are from a market maker subject to the rule or an entity not subject to the rule. If the ECN so chooses, it may send priced orders from other entities that are not Nasdaq market makers. Nasdaq will display such prices as it does the other ECN-provided prices.

[22] Nasdaq currently allows the dissemination of quotations in ⅛ths for securities priced over $10 and quotations in $\frac{1}{16}$ths and $\frac{1}{32}$nds for securities priced under $10. ECNs, however, often have priced orders that are quoted in finer increments. Under the ECN Rule, Nasdaq is not required to display the actual price of the finer-incremented order; instead, it is permitted to round the order to the nearest standard quote increment (rounding down for increments on the better-priced bids and up for better-priced offers). The Commission stated that Nasdaq should develop a capability in its quote dissemination system to flag or specially denote that an ECN priced order is rounded, but noted that this capability does not currently exist. Nasdaq is developing a rounding indicator for implementation as soon as possible.

In the interim before such an indicator is available, the NASD and Nasdaq believe that it would be appropriate for the Commission to permit the operation of the SelectNet Linkage without a rounding indicator. Balancing considerations of additional price information being made available in Nasdaq, together with the development of a means of readily accessing such prices, against a temporary inability to flag rounded quotes as such, it appears to the NASD and Nasdaq that the improved transparency of ECN prices and greater electronic access to these prices clearly outweigh the minimal negative transparency effects that may flow from the inability to flag a rounded price. Moreover, because Nasdaq has enhanced SelectNet's access feature to permit ECNs to easily accept a directed order at an improved price, those using the linkage will obtain the price improvement benefits that are among the ECN Rule's goals.

[23] The requirement for ECNs to display two-sided quotes is a temporary requirement, contingent on

Continued

crossed rule discussed below, ECNs will not be subject to standard market maker requirements in the NASD's Rules. Nasdaq will include the ECN prices and sizes in the Nasdaq Workstation II quote montage with the ECN MMID and incorporate the ECN price in the Nasdaq best price calculation, i.e., when it is at the best bid or offer in the market, its price will be included in the inside price.

As it currently does with UTP exchanges, Nasdaq will not include the ECN as a SOES market maker. Consequently, an ECN utilizing the SelectNet Linkage will not be subject to SOES executions. Because ECNs act solely as agents on behalf of customers, the NASD and Nasdaq believe that ECNs should not be required to have their ECN orders exposed to SOES executions because it exposes the ECN to the risk of double executions and the consequent need to take a principal position. The risk of double executions arises because, with electronic order entry capabilities, once an order is displayed in multiple execution systems, the same order can be nearly simultaneously accessed by different counterparties. For example, an ECN could have a single customer order to buy 1,000 shares displayed in its own system to its own subscribers. If the ECN were also accessible at that price in SOES, the ECN could have the single 1,000 share order executed simultaneously in SOES and in its own system. This double execution would means that the ECN would be required to take a principal position for one of the executions. Exposure to proprietary executions would change the model under which ECNs have operated and would likely have a serious negative effect on ECNs, causing them to change the approach that they typically take.

As the NASD has noted in its comment letter to the Commission, ECNs provide an important liquidity function in the markets and any adverse effect on them could cause a shift in the way the markets operate. The NASD believes that the approach that it is taking in allowing ECNs to function in a mode similar to UTP exchanges on this interim basis permits the ECN to continue to provide liquidity, while enhancing the degree of price information available to ECN subscribers and non-subscribers alike. Moreover, as discussed immediately below, the NASD and Nasdaq believe that the electronic access capability that it will provide NASD members that are not subscribers to a particular ECN almost immediate execution of orders delivered to the ECN through this linkage.

b. *Access to ECN Prices.* Access to ECN prices displayed in Nasdaq would be achieved through SelectNet. NASD members could direct orders up to the size displayed in the ECN quote. The ECN would have the ability to accept at the displayed price, or accept at an improved price if its actual price is at an increment better than that actually displayed.[24] Alternatively, the ECN, subject to firm quote rule obligations, could decline to act on the order, if the order has already been executed in its own system. The NASD and Nasdaq believe that, regardless of the specific action taken by the ECN on Nasdaq's delivery of an order through SelectNet, the ECN should automate these functions to provide virtually immediate responses to members entering orders seeking to access the ECN orders. The Nasdaq Workstation Subscriber Agreement will establish specific system performance standards generally requiring the ECN to respond to the orders within a few seconds of delivery. The only purpose in providing this decline capability is to permit the ECN the briefest time possible for its electronic system to review its own file to determine whether the priced order displayed in Nasdaq has already been executed in the ECN's own system. There is no intent in providing this capability to allow the ECN to decide whether it wants to accept a particular delivered order because it may find a better order elsewhere.

Accordingly, as NASD members and subscribers to the Nasdaq Workstation II service, ECNs will be subject to contractual obligations to demonstrate that their systems are properly designed to operate in high volume trading environments and that they have adequate security and other operational procedures in place to maintain the integrity of Nasdaq systems. Additionally, each ECN will be required as a subscriber to meet response time performance standards when orders are delivered through SelectNet for ECN action. ECNs that are not willing or are unable to comply with such system requirements will not be permitted to establish a SelectNet Linkage for ECN display alternative purposes.

ii. *Other Rule Changes Necessitated By The Development of the SelectNet Linkage.* As explained in greater detail below and in addition to the ECN display alternative rule described above, the following rule changes are necessary to implement the SelectNet Linkage approach by January 13, 1996:

a. *SelectNet Changes.* The NASD and Nasdaq are proposing several changes to the current operation of Nasdaq's SelectNet system to provide access to the ECN priced orders that is equivalent to the access that would have been available if such prices were published in the market maker's own quotation in Nasdaq. SelectNet is an automated order routing and execution system that allows a member to direct buy or sell orders in Nasdaq securities to a single market maker (preferenced orders) or broadcast orders to all market makers in the security. Upon receiving a SelectNet order, a member can accept the order, decline it, or send a counter-offer to the originating member. The NASD and Nasdaq believe that the SelectNet system as modified through these rule changes meets the ECN display alternative equivalent access requirement. As the Commission noted in its Adopting Release for the ECN Rule, equivalent automated access ''could be achieved either through an electronic linkage to SOES or by other means agreed upon with the NASD.'' [25] As to be designed, SelectNet will allow any NASD member to access electronically the best prices available in ECNs. This access to ECN prices is the same as that which an NASD member has via SelectNet, and in fact, under the performance standards that ECNs must agree to be permitted to take advantage of the SelectNet Linkage, ECN response time will be much more rapid than that required of market makers.

To establish the equivalent access link, the NASD and Nasdaq propose to eliminate the SelectNet Broadcast feature and allow only the entry of a SelectNet order directed to a specific market maker or ECN. The NASD and Nasdaq believe that it is necessary to eliminate the Broadcast feature for several reasons. The Broadcast feature of SelectNet brings the system within the Commission's definition of an ECN.[26]

Nasdaq's development of a capability that permits ECNs to display a one-sided quote. Nasdaq recognizes that ECNs often have orders only on one side of the market. Currently, however, because Nasdaq's quote display system was built to display market maker quotations and market makers are required by rule to furnish both a bid and offer, Nasdaq's system would be unable to recognize an ECN price unless that price were also entered with a corresponding bid or offer. Accordingly, until such time that Nasdaq can build a one-sided ECN priced order display capability, ECNs must enter two-sided ''quotations.'' The NASD and Nasdaq believes that the one-sided ECN order entry capability should be available in the first quarter of 1997.

[24] See discussion below regarding the execution of SelectNet orders at rounded ECN prices when such orders are priced at increments finer than those permitted to be displayed in the consolidated quote system.

[25] Order Handling Rules Release, *supra* note 3, 61 FR at 48314.

[26] ECN Rule 11Ac1–1(a)(8).

Under the Commission's ECN Rule, an ECN is defined to include ''any electronic system that widely disseminates to third parties orders entered therein by an exchange specialist or OTC market maker, and permits such orders to be executed against in whole or in part.'' The SelectNet Broadcast feature meets the terms of the Commission's definition and accordingly, market makers that entered priced orders into SelectNet would be required to display such prices in their Nasdaq quotes or Nasdaq would be required to develop an ECN linkage for SelectNet to display those orders in the Nasdaq inside. Nasdaq cannot develop an ECN linkage for SelectNet Broadcast by January 10th and accordingly, market makers that entered priced orders into SelectNet Broadcast would be required to change their quotes in the Nasdaq Workstation display. Moreover, the SelectNet Broadcast feature is a very significant drain on network capacity resources that are more appropriately devoted to establishing the ECN linkage for directed orders.

The NASD and Nasdaq also propose to change SelectNet to permit an ECN or market maker receiving an order through SelectNet at a specific price to execute that order at a price reflecting price improvement without having to go through the currently designed counter-offer mechanism. Today, when a market maker receives a SelectNet order, it can do one of several things. For example, it can accept at the price sent by the order entry firm; or it can counter with a different price or size. As soon as the market maker puts in a different price, however, the currently-operating system treats the new price as a counteroffer message. Because ECNs are likely to hold orders at increments that can not be shown in Nasdaq, when it attempts to accept the order at a better price, e.g., a 1/16th better, the SelectNet system would treat the new price as a counter offer. Accordingly, to comply with the ECN Rule requirement that orders be executed at their actual prices, Nasdaq will change SelectNet to prevent the counter mechanism from operating in such a situation and will deliver to the order entry firm and the ECN an execution report at the improved price.

b. *SOES Rule Change.* The NASD and Nasdaq also propose to amend the SOES Rules to permit the system to reject orders entered when an ECN or UTP Exchange alone sets the inside market. Specifically, the NASD and Nasdaq propose to add a new subsection to the SOES Rules (Rule 4730(b)(10)) to state that when there are no SOES market makers at the best bid or offer that is being disseminated by Nasdaq, orders entered into SOES will be returned to the order entry firm to permit the order entry firm to direct the order to the entity establishing the best price. This situation arises because although UTP exchanges and ECNs can establish the best price in the Nasdaq inside, they are not required to participate in SOES as market makers and therefore are not accessible through SOES.

Because the ECN quote is incorporated in Nasdaq's inside price but is not accessible through SOES under this approach, and SOES is programmed to execute at the best price displayed, SOES, as currently designed and operating, executes orders against the next available Nasdaq market maker whether that Nasdaq market maker is at that price or at an inferior price. This execution process exacerbates the current problem surrounding the lack of market maker and UTP exchange specialist parity of execution obligations in SOES and raises a possibility for ''gamesmanship,'' where a person could enter an order into an ECN that drives the Nasdaq inside and obtain multiple SOES automated executions against Nasdaq market makers that are not even displaying the ECN price. The NASD and Nasdaq do not believe that any approach that lends itself to this type of serious trading abuse should be pursued.

To resolve this potential for abuse, Nasdaq's SOES system could be revised to ignore the ECN or UTP quote and execute SOES orders at the Nasdaq market maker's inferior price. While this approach eliminates gaming concerns, it raises best execution concerns—the customer's order entered in SOES would be executed at a price inferior to the best price displayed in Nasdaq's inside market. Consequently, the NASD and Nasdaq will not revise SOES to execute market orders at prices that are inferior to the best market prices.

Instead, the NASD and Nasdaq believe that the best available interim response to potential gaming is to return unexecuted SOES orders to the entering member during such time that a SOES-inaccessible price drives the inside. Although brokers who automatically route orders to SOES initially could find any significant number of rejections caused by this approach to be problematic, the ''order rejection'' solution to the gaming problems clearly eliminates the gaming concern and therefore eliminates serious market quality concerns. Moreover, to the extent that order entry firms are concerned with the return of market orders, the NASD and Nasdaq believe that the handling of rejected orders can be dealt with satisfactorily by order entry firms through the firms' development of automated means to determine when an ECN or UTP exchange is alone at the inside and to deliver orders at such times through the SelectNet directed order capability. Order entry firms that enter orders into SOES during the period when an ECN is alone at the inside market will be informed that the order has been rejected and they may choose to route that order into SelectNet to access the ECN order driving the inside market or take other measures, such as routing the order to a market maker that guarantees the best price.[27]

c. *Locked or Crossed Market Rule Amendments.* The NASD and Nasdaq also propose to amend the locked or crossed market rule, Rule 4613(e), to clearly indicate that the locked or crossed market rule applies to NASD members, including the ECN itself, when prices entered into ECNs and provided to Nasdaq for dissemination in the consolidated quote stream would be locked or crossed through the entry of a priced order into an ECN. Locked or crossed markets can cause investor confusion because investors seeing the bid or the offer at the same price or at crossed prices do not know the true price of the security at that moment. Further, because broker-dealers that operate internal automated execution systems drive those execution systems by means of a data stream based on the Nasdaq best bid and offer, those systems may not operate when the inside is locked or crossed.

Accordingly, the NASD and Nasdaq propose to make clear that market makers using ECNs must continue to comply with Rule 4613(e). Further, the NASD and Nasdaq propose to extend the scope of the locked or crossed rule to clarify that its requirements apply to the ECNs and other NASD members when the ECN, as an NASD member acting as agent, represents an institutional order or other non-NASD member order the price of which would lock or cross the best bid or offer in Nasdaq.[28] In other words, under the

[27] The NASD and Nasdaq recognize that it would be preferable to integrate the market order system more closely with the display of prices. Consequently, the NASD and Nasdaq continue to develop a longer-term approach to the ECN display alternative that would better integrate the two systems. When such system is available, the NASD and Nasdaq will submit a new rule filing to replace the current SelectNet Linkage approach with a seamlessly integrated system that would not require the rejection of orders in a market order delivery system.

[28] The NASD and Nasdaq believe that an ECN should be required to hold an order in its system

Continued

newly-expanded locked or crossed rule, ECNs must comply with Nasdaq's rule that before a market is locked or crossed the locking or crossing party must first make reasonable efforts to execute the quote that would be locked.[29]

4. Modifications to Autoquote Policy

Currently, the NASD's Autoquote Policy does not explicitly state that it is permissible for a market maker to autoquote to display a customer limit order. Because of the requirements of the Display Rule and the benefits to investors and the marketplace to be derived from the Display Rule, the NASD and Nasdaq believe the Autoquote Policy should be amended to clarify that it is permissible to autoquote to display a customer limit order. In this connection, the NASD has previously issued an interpretation stating that it is permissible to autoquote to display a customer limit order. In addition, in order to eliminate any ambiguity as to whether the effectiveness of the NASD's Autoquote Policy lapsed upon completion of the roll-out of Nasdaq Workstation II, the NASD and Nasdaq propose to extend the effectiveness of the Autoquote Policy until such time as Nasdaq has had an opportunity to respond to the Commission's questions and concerns regarding autoquoting raised in its order adopting the Display Rule and the ECN Rule and implement any changes to the Policy as a result of such analysis.

In addition, the NASD and Nasdaq are amending the Autoquote Policy to make clear that on a temporary basis, for as long as Nasdaq requires ECNs to enter two-sided quotes because of existing systems limitations, ECNs are permitted to autoquote to maintain a continuous two-sided market. As explained above, the requirement for ECNs to display two-sided quotes is a temporary requirement, contingent on Nasdaq's development of a system capability that permits ECNs to display a one-sided quote. Until such time that Nasdaq can build a one-sided ECN priced order display capability, ECNs must enter two-sided ''quotations.'' The NASD and Nasdaq believes that the one-sided ECN order entry capability should be available in the first quarter of 1997. Thus, on a temporary basis, an ECN as defined in SEC Rule 11Ac1–1(a)(8) will be permitted to autoquote to maintain a two-sided quotation in Nasdaq. When Nasdaq system design requirements are changed, this exception to the autoquote policy will lapse.

Because the proposed rule changes and Nasdaq system modifications contained in this filing are designed to implement the Display Rule and ECN Rule, the NASD and Nasdaq believe they are consistent with Sections 11A(a)(1)(C), 15A(b)(6), 15A(b)(9) and 15A(b)(11) of the Act and Rules 11Ac1–1 and 11Ac1–4 thereunder. Section 11A(a)(1)(C) provides that it is in the public interest to, among other things, assure the economically efficient execution of securities transactions and the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities. Section 15A(b)(6) requires that the rules of a national securities association be 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. Section 15A(b)(9) requires that rules of an Association not impose any burden on competition not necessary or appropriate to furtherance of the purposes of the Act. Section 15A(b)(11) requires the NASD to, among other things, formulate rules designed to produce fair and informative quotations. Finally, as described above, effective January 10, 1996, the Display Rule and ECN Rule will require the display of customer limit orders and certain orders placed by Nasdaq market makers into ECNs.

Specifically, by facilitating the display and accessibility of customer limit orders and orders placed by market makers into ECNs, the NASD and Nasdaq believe the proposed rule changes will enhance the transparency of the Nasdaq market, facilitate the best execution of investors' orders, and promote the integrity of the Nasdaq market. In addition, with more robust quotations, the NASD and Nasdaq believe there will be greater quote competition, improved price discovery, and greater market depth and liquidity. Moreover, the NASD and Nasdaq believe the proposed rule changes will increase the likelihood that customer limit orders will be executed, improve the opportunities for investors to receive best execution of their orders, and strengthen the ability of investors to monitor the quality of their order executions. Accordingly, the NASD and Nasdaq believe the proposed rule changes are consistent with all of the above-cited Sections of the Act and the rules thereunder.

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

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Comments were neither solicited nor received by the self-regulatory organization.

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 NASD 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. 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. 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

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and not enter it into Nasdaq's quote dissemination system until it has made a reasonable effort to reach the entity represented on the other side of the market.

[29] It should be noted that if an ECN locks or crosses the market, is alone at that price, and a SOES order is entered against the ECN price that is causing the lock or cross, SOES will be programmed to reject such orders, rather than executing them against a Nasdaq market maker at a different price level.

submissions should refer to the file number in the caption above and should be submitted by December 26, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[30]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–31079 Filed 12–3–96; 1:39 pm]

BILLING CODE 8010–01–P

DEPARTMENT OF TRANSPORTATION

Office of the Secretary

[Order 96–11–31; Dockets OST–96–1023 and OST–96–1071]

Applications of Gulf and Caribbean Cargo, Inc., d/b/a Gulf & Caribbean Air, for Certificate Authority

AGENCY: Department of Transportation.

ACTION: Notice of Order to Show Cause.

SUMMARY: The Department of Transportation is directing all interested persons to show cause why it should not issue orders finding Gulf & Caribbean Cargo, Inc., d/b/a Gulf & Caribbean Air, fit, willing, and able, and awarding it certificates of public convenience and necessity to engage in interstate and foreign scheduled air transportation of persons, property, and mail.

DATES: Persons wishing to file objections should do so no later than December 20, 1996.

ADDRESSES: Objections and answers to objections should be filed in Dockets OST–96–1023 and OST–96–1071 and addressed to the Documentary Services Division (C–55, Room PL–401), U.S. Department of Transportation, 400 Seventh Street, S.W., Washington, D.C. 20590, and should be served upon the parties listed in Attachment A to the order.

FOR FURTHER INFORMATION CONTACT: Mr. James Lawyer, Air Carrier Fitness Division (X–56, Room 6401), U.S. Department of Transportation, 400 Seventh Street, S.W., Washington, D.C. 20590, (202) 366–1064.

Dated: November 29, 1996.

Charles A. Hunnicutt,

Assistant Secretary for Aviation and International Affairs.

[FR Doc. 96–30974 Filed 12–4–96; 8:45 am]

BILLING CODE 4910–62–P

[30] 17 CFR 200.30–3(a)(12) (1989).

Coast Guard

[CGD 96–064]

Differential Global Positioning System; Geiger Key, Florida: Environmental Assessment and Finding.

AGENCY: Coast Guard, DOT.

ACTION: Notice of availability.

SUMMARY: The Coast Guard has prepared an Environmental Assessment (EA) and Finding of No Significant Impact (FONSI) for establishment of a broadcast site of the Differential Global Positioning System (DGPS) service at Geiger Key, Florida. The EA concludes that there will be no significant impact on the environment and that preparation of an Environmental Impact Statement will not be necessary. This EA incorporates minor textual clarifications noted during further review and includes copies of the US Army Corps of Engineers and State of Florida wetlands permits. This Notice announces the availability of the EA and FONSI.

FOR FURTHER INFORMATION CONTACT: LCDR Gene Schlechte, United States Coast Guard Navigation Center at (703) 313–5888. Copies of the EA and FONSI may be obtained by calling Mr. Schlechte, or by faxing him at (703) 313–5920. Copies of the EA—without enclosures—are also available on the Electronic Bulletin Board System (BBS) at the Navigation Information Service (NIS) in Alexandria, Virginia, at (703) 313–5910. For information on the BBS, call the watchstander of NIS at (703) 313–5900.

SUPPLEMENTARY INFORMATION:

Background

As required by Congress, the Coast Guard is preparing to install the equipment necessary to implement the Differential Global Positioning System (DGPS) service in the southeastern United States. DGPS is a new radionavigation service that improves upon the 100 meter accuracy of the existing Global Positioning System (GPS). USCG DGPS fielded sites are achieving accuracies on the order of 1 meter. For vessels, this degree of accuracy is critical for precise electronic navigation in harbors and harbor approaches and will reduce the number of vessel grounding, collisions, personal injuries, fatalities, and potential hazardous cargo spills resulting from such incidents.

After extensive study, the Coast Guard has selected a preferred alternative site at Geiger Key, Monroe County, FL. Significant concerns were raised about installing DGPS equipment at an alternate site located at U.S. Coast Guard Base Key West, Monroe County, FL. At the Base Key West site, close proximity of the docking facilities to the transmitting antenna has the potential to adversely affect Coast Guard and Naval vessels carrying ordnance. The radio frequency radiation of the antenna also has the potential of interfering with Group Key West communications adjacent to the proposed project area. In addition, the density of existing structures and the planned growth (new construction) of the base has the potential to create satellite signal reception errors due to multipath distortion from the buildings, vessels, and vehicles. Such errors would adversely affect the performance and safety function of the DGPS service.

Selected Installation at Geiger Key, FL

(a) Site—The Geiger Key, FL, site is located on the U.S. Naval Air Station (NAS) Key West, FL. The site is located on Geiger Key lying and being in the County of Monroe, State of Florida being more particularly described as follows: Lot 1, 2, 3, 4, 5, 30, 31, 32, 33, 34, Block 16 of ''Boca Chica Ocean Shores'' as recorded in Plat Book 5 on Page 49 of Public Records of Monroe County, Florida.

(b) Radiobeacon Antenna—The Coast Guard will install a 74 foot self supporting whip antenna with an accompanying ground plane. A ground plane for this 74 foot antenna consists of approximately 120 copper radials (6 gauge copper wire) installed 6 inches (or less) beneath the soil and projecting outward from the antenna base. The optimum radial length is 300 feet, but this length may be shortened to fit within property boundaries. Wherever possible, a cable plow method will be used in the radial installation to minimize soil disturbance. DGPS signal transmissions will be broadcast in the marine radiobeacon frequency band (283.5 to 325 KHz) using less than 35 watts (effective radiated power). Signal transmissions at these low frequencies and power levels have not been found to be harmful to the surrounding environment.

(c) DGPS Antennas—Two 30-foot masts to support six small (4 inches by 18 inches diameter) receiving antennas will be required. The masts will be installed on concrete foundations. The antennas support the primary and backup reference receivers and integrity monitors.

(d) Equipment shelter—DGPS transmitting equipment will be housed in a 10 foot 8 inch by 16 foot 8 inch shelter.