

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 a written submission 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 at the Commission's Public Reference Room. Copies will also be available for inspection and copying at the principal office of CHX. All submissions should refer to file number SR-CHX-97-25 and should be submitted by April 2, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39718; File No. SR-NASD-98-17]

Self-Regulatory Organizations; Notice of Filing of Amendment No. 1 to a Proposed Rule Change by National Association of Securities Dealers, Inc., Relating to an Integrated Order Delivery and Execution System

March 4, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on February 19, 1998, the National Association of Securities Dealers, Inc.

("NASD"), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq.³ On March 3, 1998, the NASD filed Amendment No. 1 to the proposed rule change.⁴ 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 Change

Nasdaq is proposing new rules and amendments to existing rules of the NASD to establish an integrated order delivery and execution system, featuring a voluntary limit order book and market maker sponsored direct access by non-members. The text of the proposed rule change is contained in an Exhibit attached to this notice.

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 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.

³ On December 22, 1997, the NASD filed a proposal (SR-NASD-97-93) that was substantially similar to the proposal discussed in this filing. The NASD withdrew that filing when it filed this proposal. See letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, dated February 18, 1998. On February 20, 1998, the NASD filed a technical amendment adding certain language regarding handling of non-directed orders. See fax from Andrew S. Margolin, Senior Attorney, Office of General Counsel, Nasdaq, to Jeffrey R. Schwartz, Special Counsel, Division of Market Regulation, dated February 20, 1998. This technical amendment is discussed in footnote 42 below.

⁴ See letter from Robert E. Aber, Vice President and General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, dated March 3, 1998 ("Amendment No. 1"). Amendment No. 1 corrected several technical errors and added language to Section D.3.b. noting that SR-NASD-98-05 changed the manner in which Nasdaq handles SOES orders.

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

A. General

Nasdaq is proposing a new integrated order delivery and execution system ("System"). The System responds to the demands of investors and NASD members for a marketplace that provides for fast and efficient access to the best prices in the market and effective integration of price discovery, execution, and trade reporting. When combined with a broadly accessible voluntary limit order file featuring order anonymity and full display of limit order interest, Nasdaq's new System will further enhance the satisfaction of a wide range of market participant needs. The System represents a logical evolution of Nasdaq in light of the changes and growth in trading behavior, particularly as a result of the new SEC Order Handling Rules.⁵ The System is designed to leverage the benefits of these rules while complementing Nasdaq's competing dealer market structure.

While Nasdaq seeks to incorporate more order-driven features in the Nasdaq environment, Nasdaq will retain the benefits of a competitive dealer network by maintaining incentives for market makers that also contribute significantly to Nasdaq's liquidity. These incentives include a reduction in market maker exposure to unintended multiple executions through Nasdaq's systems, enhanced compliance with the Firm Quote Rule, the ability for certain market makers to sponsor access by institutional customers, and a means of reducing the cost of capital by providing a low cost limit order book sponsored by Nasdaq. Importantly, because the design of the System is based on the ability of market makers to quote their actual size, Nasdaq also believes that a disincentive for some market makers would be removed, thus attracting more liquidity and pricing efficiency in the Nasdaq market.⁶

These incentives and benefits are important, in that Nasdaq continues to

⁵ See Exchange Act Release No. 37619A (September 6, 1996) 61 FR 48290 (September 12, 1996) ("Adopting Release").

⁶ Indeed, the Commission noted in its approval of the Actual Size Rule pilot (discussed further in Section B.3. below) that "the 1000 share minimum quote size represents a barrier to entry for market making. Lowering this barrier to entry could attract more market makers, thereby increasing liquidity and competition across the market." See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415, at 2425 (January 16, 1997) (order approving certain changes related to implementation of the SEC Order Handling Rules).

¹⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

believe that market makers represent a key component of Nasdaq's strength, providing necessary liquidity for the market in all Nasdaq securities, but especially for lesser known and start-up issuers. The new System will provide market makers with a tool that allows them efficient and immediate access to the best prices in the market, levels the competitive playing field between market makers and electronic communications networks ("ECNs"), and provides market makers with incentives to risk capital and supply liquidity. In designing this proposed System, Nasdaq also has been mindful that the System also should provide investors and other traders with immediate and automatic executions. The NASD and Nasdaq have attempted to fulfill Nasdaq's mission to provide accessible linkages to providers of liquidity as displayed in a centralized system, thus facilitating a more efficient marketplace. In summary, the System will bring together a broad range of participants into a single, integrated electronic system that will maximize the role of each participant to the ultimate benefit of all participants in the Nasdaq Stock Market as a whole—individual and institutional investors, order-entry broker-dealers, market makers, and ECNs.

B. Integration of Order Delivery and Execution Systems

The new System will combine and enhance the functions of two distinct trading mechanisms that currently form the core of the Nasdaq trading environment: the Small Order Execution Service ("SOES") and SelectNet. As described later in the filing, the new System will eliminate the two separate systems, but preserve in one integrated system the features and functionality of an automatic order execution system, SOES, and the order delivery and negotiation features of SelectNet. The efficiency of this new integrated system should enhance the ability of traders to trade, while minimizing regulatory concerns associated with dual, non-integrated systems that are used to simultaneously access the same quote.

1. Background

SOES was developed in 1984 to provide a simple and efficient means to execute small agency orders at the inside quote, report trades for public dissemination, and send trades to clearing for comparison and settlement.⁷ Trading is done automatically and is

negotiation-free. In response to the October 1987 market break, SOES was enhanced in several respects to provide individual investors with guaranteed liquidity and assured access to market makers in times of market disruption. In particular, SOES participation was made mandatory for all market makers in Nasdaq National market securities, and minimum quote size requirements were instituted.⁸ These minimum quote size requirements, generally for 1,000 shares, continue to exist today except for 150 designated securities for which market makers may quote their "actual size" pursuant to a pilot program approved by the SEC.⁹

SelectNet, originally referred to as the Order Confirmation Transaction Service, was approved by the Commission in January 1988 to provide an alternative to verbal contact among trading desks for negotiating trades.¹⁰ SelectNet also was developed in response to the difficulties experienced in the Nasdaq market during the market break of October 1987.¹¹

SelectNet is an electronic, screen-based order routing system allowing market makers and order-entry firms (collectively referred to as "participants") to negotiate securities transaction in Nasdaq securities through computer communications rather than relying on the telephone. Unlike SOES, SelectNet offers the opportunity to negotiate for a price superior to the current inside quote. In addition, SelectNet participants may provide that an order or counter-offer will be in effect for anywhere from 3 to 99 minutes, specify a day order, or indicate whether price or size are negotiable or whether a specific minimum quantity is acceptable. Participants may accept, counter, or decline a SelectNet order. Once agreement is reached, the execution is "locked-in" and reported to the tape for public dissemination and

sent to clearing to comparison and settlement.

SelectNet allows subscribers to direct, or "preference" orders to specified market makers or to broadcast orders to all market makers. Although SelectNet is an order delivery service, rather than an order execution service, a preferred SelectNet order presented to a market maker at its displayed quote generally gives rise to a liability under SEC Rule 11Ac1-1 ("Firm Quote Rule") for the market maker to execute the transaction at that price.¹²

More recently, Nasdaq established SelectNet as the link to ECNs in conjunction with the SEC's Order Handling Rules. Specifically, an amendment to SEC Rule 11Ac1-1 now requires an OTC market maker to make publicly available any superior prices that the market maker privately quotes through an ECN. A market maker may comply with this requirement by changing its quote to reflect the superior price, or in the alternative, may deliver better prices orders to an ECN provided that the ECN disseminates these priced order to the public quotation system and provides broker-dealers equivalent access to these orders ("ECN Display Alternative"). The SelectNet linkage was implemented to facilitate this dissemination and equivalent access.¹³

2. Issues Related to the Current Operation of Nasdaq's Non-Integrated Order Delivery and Execution Systems

While SOES and SelectNet each provide valuable services to market participants for the benefit of investors, there are a number of problems associated with maintaining these two separate systems side-by-side, which are well understood by the SEC, NASD, and market participants. Most troublesome are the problems members have in managing multiple points of execution. This manifests itself most noticeably when a market maker's quote is subject to multiple access virtually simultaneously, through a combination of SOES and SelectNet, from the same or different market participants. Because the Firm Quote Rule obligates a member to execute orders presented to it at its

⁸ See Exchange Act Release No. 25791 (June 9, 1988) 53 FR 22594 (June 16, 1988) (order approving amendments to rules governing the operation of SOES).

⁹ See Section B.3. for discussion of actual size.

¹⁰ See Exchange Act Release No. 25263 (January 11, 1988) 53 FR 1430 (January 19, 1988) (order approving SelectNet on a temporary, accelerated basis). See also, Exchange Act Release No. 25523 (March 28, 1988) 53 FR 10965 (April 4, 1988) (order extending temporary approval of SelectNet); Exchange Act Release No. 25690 (May 11, 1988) 53 FR 17523 (May 17, 1988) (order granting permanent approval of SelectNet).

¹¹ The service was enhanced and renamed SelectNet in 1990. See Exchange Act Release No. 28636 (November 21, 1990) 55 FR 49732 (November 30, 1990). In 1992, the service was expanded to add pre-opening and after-hours sessions, so that today SelectNet is available for members to negotiate and execute orders from 9:00 a.m. until 5:15 p.m. (ET). See Exchange Act Release No. 30581 (April 14, 1992) 57 FR 14596 (April 21, 1992).

¹² There are two exceptions to the Firm Quote Rule: (1) prior to the receipt of the order, the market maker has communicated to its exchange or association a revised quotation size or revised bid or offer; or (2) prior to the receipt of the order, the market maker is in the process of effecting a transaction in a security when an order in the same security is presented, and immediately after the completion of such transaction, the market maker communicates to its exchange or association a revised quotation size or revised bid or offer.

¹³ See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415 (January 16, 1997) (order approving certain changes related to implementation of the SEC Order Handling Rules).

⁷ See Exchange Act Release No. 21743 (February 12, 1985) 50 FR 7432 (February 22, 1985) (order approving rule change describing SOES).

displayed quote, a firm may be subject to unintended double liability while trying to effectively manage executions from SOES and liability orders from SelectNet at the same time. This is compounded further when market makers also are handling orders received by phone as well as orders within their own internal execution systems.

The potential for this problem is exacerbated by an exponential increase in the use of SelectNet during the last few years, and in particular during the past several months. For example, for the period of October, 1996 through September, 1997, both the number of transactions and dollar volume executed through SelectNet has increased nearly six-fold.¹⁴ In addition, SelectNet has represented an increasing proportion of Nasdaq's total trades and dollar volume during the same period—from approximately 5% to nearly 15%. This trend may be attributed to several related factors, including: (1) The growing importance of electronic access within the Nasdaq market and a corresponding migration away from the "phone trades" to automated systems; (2) increase in the use of SelectNet by market makers as a vehicle for trading in size without negotiation, given that market makers are prohibited from using SOES for proprietary transactions; (3) implementation of the SEC's Order Handling Rules and the related role SelectNet plays in providing a link between Nasdaq and ECNs,¹⁵ and (4) a heightened awareness of trading obligations by market participants.

As a result, there also has been a corresponding increase in regulatory and compliance burdens for both market participants and staff of NASD Regulation, Inc., ("NASDR"), who are responsible for investigating complaints that may involve "backing away" from published quotes, and enforcing the Firm Quote Rule.¹⁶ Indeed, in a letter from staff of the SEC's Division of Market Regulation responding to a request for interpretive guidance on the Firm Quote Rule in this context, the SEC acknowledged the difficulty in articulating a "bright line" test on what constitutes backing away, and noted that the double execution problem arising from Nasdaq providing two automated order delivery and execution

systems could be eliminated by integrating these two systems.¹⁷

Given these practical and regulatory problems, the NASD and Nasdaq believe that it would be prudent to combine the two systems as soon as practicable. Integration would facilitate the orderly processing of electronic orders through one communications facility while easing associated regulatory and compliance burdens, in addition, to assist market makers in complying with the Firm Quote Rule, Nasdaq is proposing a System feature to provide market makers with a means to indicate to staff of NASDR that the market maker has received an order via the telephone to trade at the market maker's Nasd-displayed quotation and that for a period of time while the System market maker handles the telephone order, the System should not deliver additional orders for execution.¹⁸ This "Firm Quote Compliance Facility" will create an electronically time stamped record that will be critical in NASDR's efforts to reconstruct activity that may involve backing away.¹⁹

In developing an integrated System, Nasdaq seeks to provide the most equitable and efficient means of access among market participants. A key design requirement of such a system dictates that orders communicated through Nasdaq be delivered in strict time priority, regardless of whether the order is sent to a specific participant (directed) or to any participant at the best available quote (non-directed). This would be impossible in the current environment given the nature of two separate and asynchronous order delivery and execution systems. Most importantly, this also will assist market makers in managing their displayed quotations, further enhancing the efficiency of the market.

¹⁷ See letter from Richard R. Lindsey, Director, Market Regulation, To Richard G. Ketchum, Executive Vice President and Chief Operating Officer, NASD, and Mary L. Schapiro, President NASDR, dated July 16, 1997.

¹⁸ See Section D.10. below and proposed NASD Rule 4960.

¹⁹ As part of the undertakings pursuant to the Commission's administrative proceeding, the NASD is required to upgrade substantially its capability to enforce the Firm Quote Rule by implementing a process for backing away complaints to be addressed as they are made during trading day do that valid complaints may be satisfied with a contemporaneous trade execution, and taking other appropriate actions. See Exchange Act Release No. 37538 (August 8, 1996), Administrative Proceeding File No. 3-9056 (Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions).

3. Relationship of Proposal To Actual Size Rule

It is important to note that the integration of Nasdaq's order delivery and execution infrastructure and the ability of members to enter orders of virtually unlimited size, as set forth in this filing, is based on the ability of market makers to quote their actual size, as opposed to artificial minimum quote size requirements currently in effect for most stocks in SOES today. Under current rules, market makers generally are required to quote a minimum of 1,000 shares on the bid and the offer (for some less active issues, the minimum is 500 or 200 shares).

With the introduction of the SEC Order Handling Rules in January of 1997, market makers are now obligated to display customer limit orders in their quotations. Given the full implementation of these rules, which have altered Nasdaq's structure from a predominantly quote-driven market toward a more order-driven market, Nasdaq believes that the rationale for minimum quote size requirements no longer exists. We believe these changes warranted consideration of eliminating the requirement that market makers quote artificial minimum size of 1,000 shares. On January 20, 1997, therefore, we began a pilot covering 50 Nasdaq securities allowing market makers to quote their actual size, thereby reducing minimum quotation size requirements to a least one normal unit of trading and allowing market makers to quote in accordance with their freely-determined trading interest ("Actual Size Rule").²⁰ On November 10, 1997, the Actual Size Rule pilot was expanded to include an additional 100 securities.²¹ These securities represent a broad range of securities listed on the Nasdaq Stock Market. We are monitoring this pilot and expect to report its effects on the market to the SEC in early 1998.²²

The changes to Nasdaq systems set forth in this proposal are designed to complement market makers quoting in

²⁰ See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415 (January 16, 1997) (order approving, among other things, Actual Size Rule pilot for first fifty stocks phased in under Order Handling Rules).

²¹ See Exchange Act Release No. 39285 (October 29, 1997) 62 FR 59932 (order approving an expansion of the Actual Size pilot to 150 stocks and extending the pilot until March 27, 1998).

²² No other equity market requires minimum quote sizes greater than 100 shares. Empirical analysis thus far has demonstrated that the removal of minimum quote size requirements under the Actual Size Rule pilot has not degraded market quality, and there is no basis to conclude that such requirements are necessary. See NASD Economic Research Department, Effects of the Removal of Minimum Sizes for Proprietary Quotes in The Nasdaq Stock Market, Inc. (June 5, 1997).

¹⁴ In comparison, average daily volume of Nasdaq during the same period has increased a relatively modest 30 percent.

¹⁵ Growth in SelectNet usage closely tracks expansion in the number of Nasdaq stocks covered by the SEC Order Handling Rules.

¹⁶ The NASD has rules similar to the SEC Firm Quote Rule. See NASD Rules 3320 and 4613(b).

actual size. To the extent that the Actual Size Rule is not approved for all Nasdaq securities, an alternative proposal is being made to minimize the exposure to market makers at artificial quote sizes. This is particularly necessary given the potential under the new System to access market maker quotes for much larger size than the current SOES tier sizes would otherwise permit. Such alternative provisions are noted in this filing where relevant, and are also identified in the text of the proposed rule change accordingly.²³

As part of the new System, Nasdaq is proposing to eliminate certain rules that currently are in place for the operation of SOES. As indicated, SOES was designed exclusively for individual retail customers orders restricted to a maximum size. These order sizes correspond to a market maker's minimum quote size requirements. Specifically, NASD Rule 4730(c)(3) permits only agency orders from public customers no larger than the maximum order size²⁴ to be entered into SOES ("Maximum Order Size Rule"). That rule also prohibits large orders from being divided into smaller parts to be entered into SOES. A related interpretation of this rule prohibits behavior designed to circumvent the order size limits. Specifically, as set forth in Notice to Members 88-61 (August 25, 1988), trades entered within a five minute period are presumed to be part of a "single investment decision" and are aggregated accordingly ("Five Minute Rule"). Because Nasdaq is proposing to replace all the SOES rules, and because the System is based on the ability of market makers to quote actual size, the Maximum Order Rule and its related interpretation (including the Five Minute Rule) become unnecessary, and therefore those rules would be eliminated.

However, if the NASD's proposal to eliminate artificial quote size requirements for all Nasdaq securities is not approved by the time that the new integrated order delivery and execution system is approved, the NASD believes that certain order entry features of the new System would not be appropriate in an artificial quote size environment. Specifically, the NASD proposes in the alternative that all of the existing

restrictions on order entry by non-market makers should continue. Thus, in the absence of prior approval of the Actual Size Rule, non-market makers should not be permitted to enter orders larger than 1,000 shares for non-directed orders, and the prohibition on splitting of orders and the Five Minute Rule be retained.²⁵

C. Limit Order Book

The System also will feature a voluntary limit order book ("Limit Order File" or "File") for the display and matching of limit orders. Use of the Nasdaq Limit Order File will be completely voluntary on the part of NASD members that have customer limit orders to display or proprietary interest that such members may want to display anonymously. It should be emphasized that the NASD and Nasdaq Boards, in authorizing this rule filing, agreed that the NASD had not intention to create a regulatory environment that would mandate NASD member use of the Limit Order File. Furthermore, the proposal does not require members to protect orders in the Limit Over File beyond the member's best execution obligations. The new Limit Order File will simply be an additional means for members and their customers to display priced orders to the entire market. Thus, the proposed File merely provides another option for displaying orders and is intended to supplement, not supplant, the exiting options, *i.e.*, a market maker's quotation or a linked ECN.

The Limit Order File will facilitate the opportunity to obtain price improvement by allowing member firms to display customer limit orders or their own trading interest between the best dealer or ECN bid and offer, and by facilitating interaction with other orders within the File or with other participants who access the File, resulting in a prompt, cost-effective execution at the best available price. The best priced orders in the Limit Order File will be publicly displayed in Nasdaq's quote montage and in a

separate "Top of File" display. When the Limit Order File contains the best priced orders in the market, such prices will be used to calculate the Nasdaq "inside" quote, providing increased transparency and pricing efficiency.

These orders, which can be accessed by other market participants, will be entered and displayed anonymously. That is, the member that enters the order will not have its identifier (its MMID symbol) displayed with the order. Initially, the NASD is proposing that after any resulting execution of a File order, the identity of the party entering the order will be revealed to any counter-parties to the execution in an execution report that is sent immediately after execution to the parties to the trade. The NASD continues to analyze the anonymity feature and, at a future date and subject to a new rule proposal, may provide either anonymity of executions in the File until the end of the trading day or complete anonymity of executions through settlement. However, at this stage, the NASD believes that anonymity up until execution provides sufficient protection to traders from negative market impact costs caused by premature disclosure of trading interest. As explained in more detail later, the NASD believes that it would be useful if commenters specifically addressed the needs of traders and investors with respect to these differing levels of anonymity.

Importantly, the Limit Order File can be used by market makers to satisfy the customer limit order display rule, SEC Rule 11Ac1-4 ("Display Rule"), which would otherwise require a market maker to update its own quote immediately to reflect a customer limit order. Specifically, an exception to the Display Rule applies when limit order are immediately displayed in an NASD-sponsored system that publishes the best priced orders and permits access by other broker-dealers. As indicated, the Top of File of the Nasdaq book is included in the Nasdaq quote montage, and therefore a market maker may, upon receipt of a customer limit order, deliver it to the File immediately to satisfy the requirements of the Display Rule, pursuant to SEC Rule 11Ac1-4(c)(5).

In addition, a market maker may choose to use the File to display orders priced better than its published quote without reflecting the order in its quote as would be required pursuant to recent amendments to SEC Rule 11Ac1-1. Specifically, this is permissible under paragraph (c)(5) of that rule because the best priced orders contained in the Limit Order File are publicly disseminated in Nasdaq and are

²³ See, e.g., proposed rules 4940(b)(3) and 4950(c).

²⁴ Rule 4710(g) establishes the maximum order size for a Nasdaq National Market security at 200, 500, or 1,000 shares, depending on the trading characteristics of the security, such as the average daily non-block volume, bid price, and number of market makers. The maximum order size for Nasdaq SmallCap securities is 500 shares. The Maximum size for each security is published from time to time by the NADAD.

²⁵ The only exception to the elimination of the old SOES Rules concepts on limits on order entry is the continuation of the prohibition that registered persons that have access to order entry systems should not be permitted to enter orders for their own accounts. Nasdaq believes that it is appropriate to continue this prohibition because of the time and place advantage that such persons may have over others not similarly situated. As a policy matter, therefore, Nasdaq believes it would be inconsistent with the obligations of member firms and their associated persons to facilitate access that could potentially place the personal interests of registered personnel ahead of their customers. The prohibition, however, would no longer extend to accounts of immediate family members of such registered persons.

available for execution by other broker-dealers.

As indicated, the Limit Order File offers Nasdaq market makers a voluntary mechanism to display customer limit orders when the market maker chooses not to display such orders in its own quote or in an ECN. Because the Limit Order File is completely voluntary, market makers should be able to continue to attract limit orders from investors and other broker-dealers by offering value-added features to customers that a generic file such as that proposed by Nasdaq can not provide.

The Limit Order File also responds to the needs and desires of a significant element of the investor community: the institutional "buy-side" trader. The Institutional Committee of the Security Traders Association (STA) recently completed a survey of such institutional traders, wherein STA found that an overwhelming majority of institutions were aware of Nasdaq's initiative to establish a limit order book accessible to all market participants, and voiced strong support for it.²⁶ As explained in Sections D.5. and D.6. below, the File will provide investors and others with the ability to anonymously display orders. STA's survey indicated that some level of anonymity was an important feature for institutional investors. By providing anonymity as to the identity of the party entering the order, the File can help to reduce market impact costs that may affect the ability of institutions to obtain low-cost executions. In addition, because the Limit Order File will be fully viewable to all subscribers of Nasdaq's Workstation service and through vendor terminals, Nasdaq will be providing added transparency to the market by displaying the entire supply and demand schedule in the File.

Overall, the NASD believes that the development of a Nasdaq-operated, voluntary limit order file will benefit investors and members and, therefore, is in the best interest of the marketplace. The NASD and Nasdaq note that virtually every other major equity market around the world, including now the London Stock Exchange, provides a market-run limit order facility for the display of limit orders; each of those markets that recently added an electronic limit order book did so to respond to investor needs. For investors, both retail and institutional,

the proposed voluntary File creates an additional and efficient mechanism for investors to display priced orders and to potentially trade at reduced spreads without the intermediation of a dealer, a Congressional goal embedded in the Exchange Act. For retail investors, the Limit Order File should promote greater confidence in Nasdaq's market structure because it offers another vehicle for transparency and more efficient execution of limit orders. In addition, the File should work toward reducing the perception among some retail investors that the playing field is tilted in favor of broker-dealers and larger investors.

D. Description of New Rules

1. Overview and Scope

The new System will replace completely the existing SOES and SelectNet systems. The functionality previously contained in these two separate systems will be integrated into a single system, which should alleviate many of the concerns market makers have had with exposure to multiple points of simultaneous execution liabilities. The new System will permit all registered participants to send orders to access either the best market maker quote or ECN order, or orders visible in the Nasdaq Limit Order File, and to obtain immediate or rapid executions of such orders.

As occurs in today's environment, the new System will have three types of registered executing participants: market makers, ECNs and UTP exchange specialists. Quotations provided by these three entities will be displayed on Nasdaq Workstation and disseminated through information vendors. Registered NASD members, and certain customers that are sponsored by NASD members, will be able to deliver orders of varying size through the new System to electronically access the displayed quotations. Market maker and ECN display obligations will be the same as today. As provided for in the proposed rules, market makers must maintain two-sided quotations and be firm up to the displayed size of such quotations. The System will provide for market makers an automated quotation update facility similar to that which is provided today.²⁷

²⁷ The automated quotation update facility will refresh a market maker's quotation at an increment chosen by the market maker. The facility will not permit a refresh at the same price as that being quoted when the quotation size was reduced to zero. When the facility refreshes the quotation, the size of the refresh quotation will be 1,000 shares. If the market maker wishes to quote in a size other than 1,000 shares, the market maker must manually enter that size after the quote has been refreshed.

The NASD and Nasdaq, however, are proposing a slight change to its current operation. After a market maker's quote is exhausted, that is, the System has decreased the displayed size to zero, if the market maker is not using the system-provided automated quotation update facility or the System's supplemental size feature,²⁸ the market maker's quote (both the bid and the offer sides, regardless of which side was reduced to zero) will be placed in a closed quote state for *three* minutes, instead of the current five minutes. At the end of that time period, if the market maker has not on its own updated its quotation or voluntarily withdrawn its quote from the market, the System will refresh the side of the quotation that was reduced to zero to 1,000 shares at the lowest bid or highest offer (depending on whether the quote is a bid or offer, respectively) currently being displayed in that security and reopen the market maker's quotation. The NASD is proposing to make these two changes to the current approach because it believes that in the proposed electronic environment, five minutes is too long a period to have a quote closed on the Nasdaq screen, and because it believes that restoring the quote at the lowest ranked bid or highest ranked offer price and ensure that market makers maintain continued participation in the market and are available to provide liquidity in a manner consistent with their market making obligations.²⁹

2. Order Entry

The rules permit any size order up to 999,999 shares to be entered. As indicated, however, it is important to note that this large size permitted for order entry is based on the ability of market makers to display actual size in their quotations.³⁰ Thus, in the context of non-directed orders, discussed further in Section D.3.b., the System will permit order delivery for execution to each market maker, ECN or the Nasdaq Limit Order File *only up to the size of the quote or order that is displayed*.³¹

²⁸ Supplemental size is discussed further in Sections D.3.a and D.4.a. See, also, proposed rules 4950(d)(6), 4950(e)(3)(D), and 4950(f).

²⁹ Under current NASD Rule 4730, a market maker whose quote is decremented to zero and fails to restore its quote in the allotted time will be deemed to have withdrawn as a market maker ("SOESed out of the Box"). Subject to certain specified exceptions, the market maker is prohibited from re-entering quotations in that security for twenty (20) business days.

³⁰ See Section B.3. for discussion of actual size.

³¹ As explained below in Section D.3.a., any order entry firm is permitted to direct an order to a specific market maker, ECN, or UTP Exchange

²⁶ See STA Institutional Study (<http://securitytraders.org/newslett/news/release1/right.htm>), October, 1997. According to STA, the results were based on 154 responses received from buy-side traders out of approximately 800 who were mailed the survey.

The minimum life for such orders shall be 10 seconds. The NASD believes that orders in the System should have a minimum life to alleviate potential problems that could occur with fleeting or ephemeral prices that are flashed to the market for brief periods of time and are virtually inaccessible by other market participants.

a. *Customer Orders.* All members may enter orders on behalf of customers. If the Actual Size Rule is approved for all Nasdaq stocks on a permanent basis, Nasdaq would eliminate the current SOES rule prohibiting the splitting of orders and requiring the aggregation of orders within a five minute period, including orders from immediate family members of associated persons, to evade the maximum order size limits found in SOES.³² However, even in an actual size environment, the NASD plans to maintain the current restriction on the ability of registered representatives that have access to Nasdaq order entry capabilities to enter orders for their own accounts into this system. The NASD believes that maintaining this restriction is important to minimize the time and place advantages that these professionals may continue to have.

If the Actual Size Rule is not approved, however, the NASD proposes, in the alternative, to maintain the existing restrictions and to limit the size of orders entered by non-market makers to 1,000 shares. The NASD believes that this alternative, contingent approach is appropriate to ensure that market makers' risk is minimized and that their capital is not accessed in an essentially unfettered manner in an artificial quote size environment.

b. *Proprietary Orders.* Also contingent on the expansion and approval of the Actual Size Rule for all Nasdaq stocks, the proposed rules permit any NASD member to enter proprietary orders into the System for immediate execution, order delivery, or display in the Limited Order File. The NASD believes that any NASD member, whether it is an order entry firm or a market maker in a particular stock, should be permitted to enter proprietary orders. The rationale for permitting a broad use of proprietary orders is that entry of such orders may provide additional liquidity to the market and that any member is currently able to enter such orders through an ECN. It would be illogical to

specialist. The size of such directed orders is not constrained by the executing participant's displayed quote size. However, the executing participant's liability to fill the order under the Firm Quote Rule is limited to the amount of shares publicly displayed in the quotation.

³² See NASD Notice to Members 88-61 (August 25, 1988).

limit the use of Nasdaq's Limit Order File when the same activity is already permissible through other vehicles. It should be noted, however, that the NASD intends to monitor principal trading activity by NASD members not registered as market makers to determine if it may be necessary to adopt a rule similar to that found in the exchange-listed market environment, where SEC rules require Third Market Makers that effect more than 1% of the volume of a particular stock to register and quote as a Third Market Maker.³³ In any event, without the approval of the Actual Size Rule for all Nasdaq securities, the NASD is proposing an alternative to prohibit the entry of any principal orders by non-market makers.

3. Types of Electronic Access Orders

The System will permit the entry of two types of orders that seek to access displayed prices on the Nasdaq screen: directed and non-directed orders.

a. *Directed Orders.* Directed orders are orders that an order-entry firm chooses to send to a specific market maker, ECN or UTP exchange for delivery and execution.³⁴ The directed order concept is an attempt to preserve certain features found in SelectNet where firms seek to access a particular market maker's quotation and commence electronic negotiation. During normal market hours,³⁵ these orders are processed in

³³ In connection with the approval of the SEC Order Handling Rules, the SEC adopted an amendment to Rule 11Ac1-1 to improve transparency and provide the public with information about significant market participants. The amendment requires OTC market makers and exchange specialists to provide continuous two-sided quotations for any exchange-listed security when they are responsible for more than 1% of aggregated transaction volume in that security. See Adopting Release, at 48317. Prior to this amendment, mandatory quotations were only required from OTC market makers and exchange specialists who transacted more than 1% of the volume in a Rule 19c-3 security. In addition, the SEC has proposed a similar rule for Nasdaq securities. See Exchange Act Release No. 37620 (August 29, 1996) 61 FR 48333 (September 12, 1996) (proposal to amend SEC Rule 11Ac1-1).

³⁴ The proposed rules continue to limit the ability of a member to send orders to a UTP Exchange by the directed order mechanism only. In other words, NASD members that uses Nasdaq's system to access the quotation of a UTP Exchange must send that order as a directed order to the Exchange. The NASD plans to discuss with UTP Plan participants participation in the non-directed order handling process.

³⁵ Outside of normal market hours, e.g., from 9:00 a.m. until 9:30 a.m. and from 4:00 p.m. until 5:15 p.m., the only means to reach a market maker quote or an ECN order through Nasdaq's electronic system will be through the directed order feature. Such orders must be sent to a specific quote with the appropriate MMID identified. Such orders will not have any Firm Quote Rule liability attached to them, unless during the post 4:00 p.m. period, a market maker or ECN intentionally re-opens its quote that is automatically placed in a closed quote

sequence with all other orders that may be sent to a particular market maker, ECN or UTP exchange. Therefore, a directed order would not enjoy any preferential delivery treatment over other, non-directed orders (discussed below) delivered to the same market maker, ECN or UTP. Directed orders do not interact with orders in the Limit Order File³⁶ or with other quotes displayed in the Nasdaq quote montage. That is, all orders are time-sequenced without regard to their classification as directed or non-directed, and thus a directed order would not be delivered to, or executed against, a participant until any order previously delivered to that participant was processed first.

Upon order entry, a member that wishes to send an order to a specific market maker, ECN or a UTP exchange would be required to specifically enter the MMID for the quote that it wants to access. The directed order will be entered into the System and placed in a time-sequenced queue with all other orders, both directed and non-directed, that have been entered for that security. Depending on the time sequence of the directed order, the order will be delivered to the particular MMID identified by the order entry firm when the order's turn for delivery arrives. Once delivered to that MMID, the directed order will be handled for execution purposes as described below in the non-directed order context. That is, if the order is 1,000 shares or less and the market maker or ECN quotation is equal to or greater than the size of the order, the System will automatically execute the order and decrease the displayed quote size by the amount executed. If the order is larger than 1,000 shares but less than 5,000 shares, the order will be delivered to the market maker or ECN for action for a period of 17 seconds. If the order is 5,000 shares or greater, it will be delivered to the market maker or ECN for action for a period of 32 seconds. If the recipient of the order has done nothing at the end of the applicable period, the System will execute the order up to the displayed quote size of the recipient. During the

state by Nasdaq at 4:00 p.m. A market maker that opens its quote momentarily, however, solely for the purpose of adjusting its quote to reflect the elimination of customer limit orders, will not be subject to Firm Quote Liability. See letter from Howard L. Kramer, Senior Associate Director, Market Regulation, to Robert E. Aber, Vice President and General Counsel, Nasdaq, dated August 25, 1997.

³⁶ Nasdaq will provide a system capability to reach the Limit Order File directly—the takeout facility. A takeout order will be a System-provided feature that permits a member to directly interact with orders displayed in the Limit Order File, but only those orders that were entered by that member, either for itself or its customer.

delivery period, the recipient is permitted to accept, partially execute, or decline the order. Any partial execution or decline must be done in compliance with the Firm Quote Rule; all such actions will be forwarded to NASDR for its review.

Directed orders may be sent to a particular executing participant at a price or size that is not being displayed by that participant. For example, if a market maker is quoting 20 bid for 1,000 shares (with no supplemental size), an order entry firm may choose to direct to that market maker an order for 10,000 shares at 20. The market maker has several options available when that order is received. First, pursuant to the market maker's firm quote obligation, the market maker may immediately choose to accept 1,000 shares and decline the balance. In the alternative, the market maker could choose to accept any additional amount up to 10,000 shares. Under another alternative, the market maker may choose to do nothing, in which case at the end of 32 seconds (because the order sent is 5,000 shares or greater) 1,000 shares will be automatically executed against the market maker at 20 and its quote will be decreased to zero.

Directed orders (as well as non-directed orders) will be able to interact with a market maker's supplemental size. As explained below, market makers will be permitted to enter a supplemental size that will replenish their displayed quote sizes when the System executes an order against the displayed quote.³⁷ If a directed order larger than a market maker's displayed size is sent to a market maker that is using supplemental size, and the market maker does not respond to that order within the 17 or 32 second period, depending on the size of the order entered, the order will execute against the market maker's displayed size and its supplemental size. For example, if MMA is displaying 20 bid for 1,000 shares with a supplemental size of 10,000 shares, and order entry Firm B sends a directed order to sell 8,000 shares to MMA at 20, and MMA does not respond with an accept, partial or decline response within 32 seconds, the System will execute the entire order against MMA for 8,000 shares.

All directed orders that are delivered for a response (as opposed to being automatically executed), will be

designated by the System as "liability" or "non-liability" orders when delivered. A liability order is an order that a broker-dealer is required to respond to consistent with the obligations imposed by the SEC and NASD Firm Quote Rules.³⁸ For example, if Market Maker A is quoting 20 bid for 1,000 shares, a directed order that is sent to MMA to sell 1,000 shares at 20 is a liability order. In other words, MMA must respond consistent with the Firm Quote Rule. If MMA is quoting 20 bid for 1,000 shares, and the order entry firm directs an order to sell 20,000 shares at 20¹/₁₆ to MMA, such an order would be a non-liability order for which MMA has no responsibility to respond. MMA could, however, choose to accept the order at the higher price. MMA also could do nothing with such order and at the end of 32 seconds the order would time out and be returned to the order entry firm. If the directed order sent to MMA were priced to sell at 20 for 20,000 shares, MMA would have Firm Quote Rule liability for 1,000 shares.

b. *Non-Directed Orders.* Non-directed orders are orders that are not sent to a particular market maker or ECN. That is, when the member entering the System does not specify the particular market maker, ECN or UTP exchange it wants to access, the order will be sent to the next available executing participant³⁹ quoting at the best price displayed in Nasdaq. Non-directed orders may be priced orders or market orders. The first non-directed order in time sequence interacts with the best quote or order in the Nasdaq quote montage (market maker quotes, ECN orders, or Limit Order File orders) in price/time sequence, that is, with the best priced quote or order. If two or more quotes or orders are at the same price, then the non-directed order interacts with the

first such quote or order in time sequence.

For example, MMA is quoting a bid of 20 for 1,000 shares; MMB is also quoting a bid of 20 for 1,000 shares, but posted its quote 10 seconds after MMA; and MMC is quoting 19⁷/₈ bid for 1,000 shares. Another member seeks to sell 500 shares at the market in that security and enters a non-directed order for that amount. Upon entry into the System, the order is sent to MMA for execution. As explained below in Section D.4.a. on Order Execution Parameters, this order will automatically execute against MMA, and MMA's quote size will be decreased by the System to 500 shares at 20 bid. If two non-directed orders to sell 1,000 shares each had been entered, the first order entered (as time-stamped by Nasdaq) would be automatically executed against MMA, the second order would be automatically executed against MMB and, assuming that neither market maker was using the supplemental size feature provided by the System, both 20 bid quotes would be decreased to 0 size and MMC at 19⁷/₈ would become the best bid in Nasdaq for this security. If an order entry firm entered a non-directed 2,000 share sell market order, the System will split that order, and send 1,000 shares to MMA and 1,000 shares to MMB at the same time for automatic execution.

The NASD believes that it is appropriate to place all providers of liquidity in the Nasdaq market on the same footing with respect to order executions through Nasdaq's systems. Thus, this proposal contemplates that ECNs, as well as market makers, should be subject to automatic executions of non-directed and directed orders. In the current environment, quotes of linked ECNs that are displayed in Nasdaq are accessible only through Nasdaq's SelectNet system, a system which is not an automatic execution system like SOES.⁴⁰ Market makers, however, are accessible through both systems. As proposed, Nasdaq believes that quotes of linked ECNs should also be

³⁸ Market makers that use supplemental size do not have liability under the Firm Quote Rule for the amount of shares contained in the supplemental size facility. However, the System will reach into a market maker's supplemental size to execute directed orders that are larger than displayed size, unless the market maker declines the order prior to the expiration of the 17 or 32 second period normally allotted for directed orders. If the market maker declines any portion of the order when using supplemental size, the System will close the market maker's quote and reduce the supplemental size to zero.

³⁹ At this time, non-directed orders cannot be sent to UTP Exchanges because Nasdaq and the UTP Participants have not addressed order handling in the context of the proposed System. As noted above, Nasdaq plans to discuss the matter with the other UTP Plan participants to seek a resolution of order delivery and execution in the new System. Until such a resolution is reached, firms seeking to access a UTP Exchange's quote through Nasdaq systems must send a directed order to that exchange.

³⁷ The amount of interest entered into supplemental size by a System market maker may be any amount up to 99,000 shares, provided that the facility will refresh quotations in a minimum increment of 1,000 shares. There will not be an ability to maintain unlimited supplemental size (i.e., a "No Dec" feature will not be available).

⁴⁰ To facilitate the implementation of the SEC Order Handling Rules at the beginning of 1997, the NASD established, on an interim basis, a linkage to facilitate the operation of the ECN Display Alternative. See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415 (January 16, 1997). The ECN Display Alternative relieves an exchange specialist or OTC market maker of the requirement to publicly quote any superior prices that it privately displays through an ECN if that ECN: (1) Ensures that the best priced orders entered by market makers and specialists in the ECN are communicated to an exchange or Nasdaq for public dissemination; and (2) provides brokers and dealers access to orders entered by exchange specialists and OTC market makers into the ECN, so that brokers and dealers who do not subscribe to that ECN can trade with those orders. See SEC Rule 11Ac1-1.

automatically executed against by other market participants on the same terms as market makers. Without an equivalent execution mechanism, ECNs would have an unfair advantage. Market makers are thus placed at a competitive disadvantage with respect to the display and execution of limit orders. Further, the disparity in executions may provide market makers with an incentive to change their status from market makers to ECNs, at a cost to market liquidity. Customers seeking to obtain executions quickly may be placed at a disadvantage if one customer receives an automatic execution against a market maker, while another customer may have to wait for an ECN to respond.

The current dichotomy between ECNs and market makers in the execution of orders has caused other anomalies with the processing of orders through the SOES system. As indicated, SelectNet was chosen as the linkage through which participants could deliver orders to access orders displayed in the ECN because ECNs were unable to provide automated executions through participation in SOES. As a consequence, Nasdaq had to implement systems changes designed to suspend automated execution in SOES whenever an ECN or UTP Exchange is alone at the inside market.

This suspension of SOES when ECNs are at the inside quote has resulted in an unintended consequence, however, that has caused significant concern. Specifically, while the ECN quote effectively halts executions in SOES for a security, it may also cause SOES orders to be rejected back to the sending firm. Thus, there is the potential for an ECN customer to enter an order to essentially control the inside price, and then create an advantage in SOES for the ECN customer or another order entry firm to then jump ahead of orders that would have been executed in that issue if they had not been returned. This has become problematic because the ECN then changes its quote almost immediately, before it can be accessed through either SelectNet or its own internal system. Once the ephemeral quote disappears and a new dealer inside has been established, a new SOES order enters the system which then executes as the first order against the first market maker at the new inside price. Customer orders of order-entry firms may be disadvantaged, in that orders entered earlier in time would be forced to go to the back of the queue. The NASD notes that it recently implemented a software modification intended to address this situation. Specifically, when an ECN or UTP participant is alone at the inside, orders

sent through SOES are now held in queue for up to 90 seconds, instead of being rejected immediately, unless they become executable against a market maker that joins or becomes the inside quote. While this modification preserves the sequence in which customer orders are processed in SOES for a period of time, the NASD does not believe that this is the optimal solution.⁴¹

The NASD also is concerned about complaints from various SOES system users that, although difficult to verify, nonetheless allege that some traders may be using ECNs to affect the way the system handles automatic executions in that system. The NASD does not want to design a new system with the same potential problems. Consequently, the NASD believes that the fairest approach to delivery and execution of orders in the new System is to treat all participants equally and require that all participants receiving orders through the System be subject to the same obligations, including automatic executions of smaller sizes. In developing the new System and proposing this level playing field, Nasdaq recognizes that every effort must be made to work with ECNs on changing the current approach. Nasdaq will discuss with ECNs ways to avoid the possibility of double executions against an ECN's displayed order and will work closely with each ECN to provide an appropriate mechanism. Finally the NASD and Nasdaq note that there should be sufficient programming lead time provided to ECNs to permit them to properly program their own execution processes so as to coordinate those processes with Nasdaq's new order delivery and execution system.⁴²

4. Order Execution Parameters

a. *Execution Parameters For Non-Directed Orders.* Non-directed orders that match against an order in the Limit Order File are executed immediately. Non-directed orders delivered to a market maker or an ECN will be handled in three different ways

depending on the size of the order, or portion of the order,⁴³ delivered and the size of the quote displayed by the market maker or ECN:

- If the order, or portion of an order, is 1,000 shares or less, an order delivered to a market maker or ECN will be executed automatically, up to the displayed quote size. The market maker or ECN will have up to 17 seconds thereafter to adjust its quote.⁴⁴
- If the order is greater than 1,000 shares and less than 5,000 shares, and the quote is equal to or greater than the order size, the order will be presented for 17 seconds for action by the market maker or ECN. The market maker or ECN may accept, decline, or do nothing,⁴⁵ if no response is received within that time, the System will default to an execution against the quotation up to the displayed quote size.
- If the order is 5,000 shares or larger and the quote displayed is equal to or greater than the order size, the order will be presented for review for 32 seconds.⁴⁶ The market maker or ECN may accept, decline, or do nothing. If there is no response after this time, the system will default to an execution.

These default action features allow market makers and ECNs the ability to act consistently with the Firm Quote Rule and decline large sized orders that are delivered to them while in the process of effecting an execution internally at their displayed quote, but before they have had the chance to

⁴³ As discussed below, non-directed orders may be split up and delivered to multiple participants at the best price. Thus, an order that is larger than a participant's displayed quotation may be split such that only a portion of the original order is delivered to that participant, with the balance being delivered to the remaining participants up to their displayed size. The size of this delivered portion is determinative of how the System applies the execution parameters outlined herein. See letter from Andrew S. Margolin, Senior Attorney, Office of General Counsel, Nasdaq, to Jeffrey R. Schwartz, Special Counsel, Division of Market Regulation, dated February 20, 1998.

⁴⁴ If a market maker or ECN updates its quotation price before 17 seconds has elapsed, it will be eligible immediately thereafter for additional order delivery. Similarly, if the original execution did not eliminate the entire size displayed at that price, the executing participant is eligible within five seconds for additional delivery up to the size of the quote remaining. For example, if MMA displayed a quote of 20 for 1,000 shares, and the System automatically executed 500 shares against that market maker, five seconds after the first execution the System would be able to deliver an execution for the remaining 500 shares.

⁴⁵ A market maker may decline the order only to the extent permissible under the Firm Quote Rule. Any declinations are forwarded to NASDR.

⁴⁶ The intent here is to provide, in effect, two periods of 15 seconds each. Two additional seconds of communications time must be added to reflect the time necessary for an execution report to be received back from the System.

⁴¹ See Exchange Act Release No. 39637 (February 10, 1998) 63 FR 8242 (February 19, 1998) (notice of filing and immediate effectiveness of SR-NASD-98-05 relating to modifications to SOES).

⁴² When Nasdaq and the ECNs first established the linkage under the Order Handling Rules in early 1997, given the very short time frames for implementation of the new SEC rules, Nasdaq and the ECNs did not have sufficient time to undertake major re-programming efforts. Thus, in late fall 1996, Nasdaq and the ECNs, with SEC approval, agreed to use the existing SelectNet system as the most convenient application to establish a trading link between Nasdaq and the ECNs. See Exchange Act Release No. 38156 (January 10, 1997) 62 FR 2415 (January 16, 1997) (order approving certain changes related implementation of the SEC Order Handling Rules).

update that quote.⁴⁷ In any event, whether the order is executed immediately or is delivered for review, executing participants will have, depending on the order size, 17 or 32 seconds between orders to be able to adjust their quotes before delivery of an additional order or execution. These time periods provide appropriate windows of time to permit market makers to manage their quote commensurate with the risk and exposure of larger sized orders.

The System will split non-directed orders that are larger than sizes displayed in quotes to quickly execute orders and minimize issues related to queues of non-directed orders. For example, assume that an order entry firm enters a 5,000 share order to buy when five market makers or ECNs are each quoting 1,000 shares at the best offer. When the order is entered, the System will split the order into five 1,000 share lots and automatically execute against each of the market makers and/or ECNs at the inside offer. Each executing participant then has up to 17 seconds to update its quote, although each may do so sooner, in which case additional orders may be delivered more quickly.

A market maker's use of the supplemental size feature affects the way non-directed orders may be executed. If a market maker using supplemental size is alone at the inside price and a non-directed order larger than the market maker's displayed quote size is entered, the order will be delivered up to the size of the market maker's displayed size and supplemental size for a period of 17 or 32 seconds, depending on the size of the order delivered. At the end of the time period, the order will be executed against the market maker, unless prior to the end of the time period, the market maker took other action, such as accepting all or part of the order, or declining the order. For example, if a market maker is alone at the best offer of 20, and is displaying 1,000 shares while its supplemental size is at 5,000 shares, a non-directed order to buy 4,000 shares will be delivered in *toto* to that market maker for 17 seconds. If the market maker does nothing, the order will be executed at the end of 17 seconds for 4,000 shares, and the market maker's quote will be refreshed at 1,000 shares, with 1,000 shares remaining in supplemental size.

Nasdaq plans to make the System flexible to allow participants to adjust execution parameters. Thus, all parameters for order size for delivery

and execution that are minimum sizes can be adjusted by executing participants as long as such adjustments exceed the minimum standards established by Nasdaq in this filing. For example, an executing participant can adjust the parameters for automatic executions to allow automated executions for orders larger than 1,000 shares.

b. *Limit Order File Executions.* The matching process between orders displayed in the File is simple. Non-directed orders that match against an order in the Limit Order File are executed immediately. For example, assume the best bid is an ECN showing an order to buy at 20 for 1,000 shares. Subsequently, a member enters a non-directed order to buy 100 shares at 20¹/₁₆. This limit order is displayed anonymously, as described below, in the Nasdaq Limit Order File and sets a new inside bid. Thereafter, another member enters a market order to sell 100 shares. The limit order and the market order will be matched and automatically executed against each other at 20¹/₁₆. If the market order to sell were for 1,000 shares, 100 shares would execute automatically against the limit order and the remaining 900 shares would be executed automatically against the next best bid, the 20 bid of the ECN. The ECN's displayed size would be reduced to 100 shares.⁴⁸

5. Limit Order Display

Nasdaq will display limit orders entered into the Limit Order File in three separate ways. First, Nasdaq will display the Top of File, *i.e.*, the best limit order to buy and the best limit order to sell, in the Nasdaq quote montage, where it will be ranked in price/time sequence with all other quotes and orders entered into Nasdaq, and which will be used to calculate the inside quote. Nasdaq will also display the Top of file in a separate window on the Nasdaq Workstation. Both of these displays will be dynamically updated, *i.e.*, the System will automatically change the prices as orders enter and execute. Finally, Nasdaq will maintain for all Nasdaq Workstation subscribers and vendors a Full File display that will be available on a query/response basis. In other words, the user must enter a key stroke to obtain information regarding all of the orders displayed in the Full File. To obtain new information about the status of orders in the Full File, the subscriber must re-inquire of

⁴⁸ If a market maker or ECN order seeks to quote at a price that would lock or cross the Limit Order File, the market maker or ECN is required by rule to first enter a directed order that would execute against the order in the file.

the System. At the first stage of implementation, Nasdaq, for capacity reasons, will not dynamically update the Full File. All orders displayed in the Limit Order File will be displayed anonymously, *i.e.*, the System will not attach the MMID of the member entering the order to that order for display purposes.

6. Anonymity of Executions in the File

As proposed in this filing, Nasdaq will display all orders in the File on an anonymous basis. Upon execution of any such order, either when another limit order matches it, or when it interacts with a Nasdaq displayed quote, the System will provide to all parties involved in the execution an execution report that identifies the contra-party to the trade. For example, when MMA enters a limit order into the File at 20 bid, it is displayed without an identifier indicating that MMA entered the order. Subsequently, MMB enters a limit order to sell at 20. Because the two limit orders match, they will execute against each other. When the execution occurs, MMA will receive a report from the system identifying MMB as the contra-party and MMB will receive a report indicating that MMA was its contra-party.

Nasdaq is also evaluating whether additional anonymity for executions should be provided in the future. There are two options under consideration: anonymity until the end of the trading day and anonymity throughout the settlement cycle. End of day anonymity would work as follows. When an order that is displayed in the Limit Order File is executed, either by matching against another order entered into it or when a market maker or ECN executes the order, the System will preserve the anonymity of the firm entering the order until the end of the trading day provided that the party entering the order into the File chose to keep its order anonymous following execution. The contra-party would receive the indicator "NSDQ" as the MMID for the other side to the trade. The true identity of the firm entering the order would not be revealed to the contra-party until after trading for the day has ceased. Nasdaq would provide to each party that received an anonymous execution a report after 5:15 p.m. with the identity of the party that entered the order into the File.

For example, assume that the inside market for a security is 19¹⁵/₁₆–20¹/₈, 10 x 10. MMA enters a non-directed proprietary limit order to sell 1,000 shares at 20 into the File, and indicates upon order entry that it wants the order to be executed anonymously. The order

⁴⁷ See SEC Rule 11Ac1-1.

will be placed on the File at 20 for 1,000 shares; because the limit order is the best sell order in the market, the inside will change to $19^{15}/_{16}$ —20, 10×10 . At this time, order entry firm X ("OEFX") enters a buy market order for 1,000 shares. OEFX's order is automatically executed against the limit order at 20. OEFX receives a report confirming that its market order was executed for 1,000 shares at 20 against NSDQ.

As another example, assume the same facts as above, except that MMD wants to move its bid of $19^{15}/_{16}$ to 20. Under the locked/crossed market rule, it must make an effort to avoid locking the market by attempting to takeout the locking offer, in this case the limit order to sell at 20.⁴⁹ When MMD enters a non-directed order to buy 1,000 shares at 20, that order will match against the limit order to sell at 20 and MMD will receive a report indicating that it bought 1,000 shares at 20 from NSDQ. After 5:15, MMD will receive a report that indicated that this sell order was actually executed against MMA.

Under a full anonymity proposal, the NASD could create a structure to keep the contra-parties anonymous as to each other throughout the settlement cycle. The NASD continues to evaluate the means by which such anonymity could be provided. Before either end of day or full anonymity would be offered, the NASD and Nasdaq would have to propose any such approach as a new rule proposal or as an amendment to this filing. The NASD believes at this time that it would be helpful if commenters offered their views generally on the need for particular levels of anonymity in the File.

7. Sponsored Access by Non-Members

A critical component of the new System will permit institutions and other customers of NASD members to obtain direct electronic links to the System through arrangements that are sponsored by an NASD member. Under such an arrangement, a customer and an NASD member will be able to sign an agreement that permits Nasdaq to provide the customer with the electronic capability to enter orders into the System directly from its trading desk. Such orders can be limit or market orders that access prices displayed in Nasdaq (if they are market orders), or are displayed in the Limit Order File (if they are limit orders). Only market makers that are Primary Market Makers under NASD Rule 4612 are eligible to

enter into a sponsored arrangement for access by non-members.⁵⁰

8. The Opening Process for Orders in the Limit Order File

Limit orders can be entered as good-till-canceled ("GTC") or good-till-date ("GTD"). Because of this capability, the File may carry over limit orders from one trading day to the next. In addition, the System will allow limit orders to be entered prior to the market opening and also will permit the entry of market orders that will be able to interact with limit orders in the Limit Order File at the opening of the file for executions. Consequently, at the opening of the market at 9:30, the Nasdaq Limit Order File could contain a number of limit and market orders.

Nasdaq believes that the following approach to execution of all such orders entered into the System prior to market open best accommodates customer requirements that executions occur as rapidly as possible and at prices as near as possible to the prevailing market at the open. At 9:30, when quotations are first opened in the System, Nasdaq will take a snapshot of the best quotes (the "9:30 Inside"). Thus, the 9:30 Inside includes market makers, ECNs and UTP exchanges, but not the Top of File of Nasdaq's Limit Order File. The opening process will use the 9:30 Inside to validate the executions of orders in the File.

The System will process the orders in the File at 9:30 by first matching the best priced limit order to buy against the best contra-side limit order to sell, bound by the 9:30 Inside. The system will continue to pair off matching buy and sell limit orders in the File, until all possible limit order matches that can take place at or within the 9:30 Inside have occurred. Limit orders that match other limit orders will be matched at a midpoint, giving price improvement to both where possible. If limits would match outside of the 9:30 Inside, then no execution takes place, as the opening match is bounded by the 9:30 Inside. After all possible limit-to-limit matches have occurred, the System will then match market orders to any remaining limit orders that are priced at or within the 9:30 Inside and execute such matches at the limit order price.

If the 9:30 Inside is locked at 9:30, the System will execute as many orders as it can match at that price. The remaining unmatched orders will be processed at 9:30 pursuant to normal

business hours processing. For example, assume that the best bids and offers at 9:30 are priced at 20, and four limit orders are in the File at 9:30, each for 1,000 shares. There are limit orders to buy at 20 and $20^{1}/_{16}$, and limit orders to sell at $19^{15}/_{16}$ and $20^{1}/_{16}$. The system will execute the buy limit at $20^{1}/_{16}$ against the sell limit at $19^{15}/_{16}$ at a price of 20. The two remaining orders (buy at 20 and sell at $20^{1}/_{16}$) will not be executed. If the 9:30 Inside is crossed at 9:30 for a particular security, the System will not perform the opening match process for that security. Instead, in this situation, each order will be matched or delivered for execution, as the case may be, according to normal business hours processing. That is, limit orders that are marketable against the 9:30 Inside, and may market orders that have been entered prior to 9:30 will be delivered or executed against such prices in time sequence, commencing at 9:30. Once the crossed market has been eliminated, the File will be populated as during the normal intra-day process and executions will continue according to normal processing as discussed above. Thus, immediately after the match process is concluded, any market or marketable limit orders that do not match against limit orders in the opening process shall be delivered to or automatically executed against (depending on the size of the order) executing participants or the Limit Order File according to normal business hours processing as set forth above for non-directed orders. Execution reports for orders executed during the opening process will be discussed starting at 9:30 a.m.

9. Odd-Lot Processing

The new System will accept and execute orders less than one normal unit of trading, i.e., odd-lot orders less than 100 shares. The System will provide a separate mechanism for processing and executing these orders as distinct from normal units of trading. First, odd-lot priced orders will not be displayed in the Limit Order File, nor will they match against any displayed File orders. Instead, the System will hold odd-lot orders in a separate file and automatically execute such odd-lots against market makers whenever the odd-lot order becomes marketable.⁵¹ For example, if a member enters a market order for 50 shares into the System, it will immediately and automatically

⁵⁰ The NASD notes that under the current Primary Market Maker qualification rule, all Nasdaq market makers qualify as Primary Market Makers. Nasdaq plans to amend the qualification standards to establish more stringent qualifying criteria.

⁵¹ An odd-lot order becomes marketable when the best price in Nasdaq moves to the price of the odd-lot limit order. Odd-lot orders that are marketable at entry or become marketable will execute against the first market maker in rotation for odd-lot processing at the best price or at the odd-lot order's price.

⁴⁹ See NASD Rule 4613(e).

execute the order against the market maker that is first in rotation for execution of such orders. The automatic execution will not decrease the market maker's displayed size.

10. Firm Quote Compliance Facility

To assist market makers in complying with the Firm Quote Rule, System market makers shall be provided with a means to indicate that the market maker has received an order via the telephone to trade at the market maker's Nasdaq-displayed quotation and that for a period of time while the market maker handles the telephone order, the System should not deliver additional orders for execution.

The market maker shall send via the System a message that records the time indicating when the market maker entered the message regarding the telephone order. When the System receives the message, the System shall not present an order to that market maker until 17 seconds after receipt of the original message. The System will provide the market maker with a reference number that shall be attached to the execution report that may occur as a result of the telephone order. A System market maker may only send one such message through the System for each telephone order necessitating the message. Sending such message without a corresponding transaction may be a violation of just and equitable principles of trade. Surveillance systems will be implemented to detect a pattern or practice of entering messages without corresponding transactions.

11. Amendments to Related Rules

In addition to the specific new rules proposed regarding the operations of the System, several rules found in NASD Rule Series 4600 and throughout the NASD Manual will have to be conformed in technical, non-substantive ways. In particular, Rule 4613 (Character of Quotations), will be amended to eliminate the references to SOES Tier Sizes for quotations of market makers. Rule Series 4700 (SOES Rules) will be rescinded entirely, and other rules referencing SOES will be rescinded or conformed accordingly, including Rule 4611(f) (Registration as a Nasdaq Market Maker), Rule 4619 (Withdrawal of Quotations and Passive Market Making), Rule 4620 (Voluntary Termination of Registration), Rules 4632 and 4642 (Trade Reporting)⁵² and Rule 4618(c) (Clearance and Settlement).

⁵² It should be noted that the rules governing the trade reporting of Nasdaq National Market securities found in NASD Rule 4632 are part of an effective transaction reporting plan approved by the Commission under SEC Rule 11Aa3-1.

E. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Exchange Act,⁵³ in particular subparagraphs (b)(2), (b)(6), (b)(9), and (b)(11), and Section 11A of the Exchange Act, in that the proposed rule change is designed to enhance the protection of investors and provide for the fairest and most efficient mechanism for transactions in the market for Nasdaq securities. Section 15A(b)(6) requires that the rules of a registered 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; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. The proposed rule change represents a significant effort to provide for an integrated order delivery and execution system where all market participants and investors may be brought together in a single system and where all orders are processed and distributed in a fair and orderly fashion to achieve immediate or rapid executions at the best available price. This also is consistent with Section 11A(a)(1)(B) of the Exchange Act, which sets forth findings of Congress that new data processing and communications techniques create the opportunity for more efficient and effective market operations.

The integrated nature of the System will address issues related to unintended "double liability" that can be incurred by market makers, thus reducing a disincentive for market maker participation, and, along with the Firm Quote compliance Facility, should significantly ease the associated regulatory and compliance burdens involving the Firm Quote Rule and related NASD rules. Importantly, this also will enhance the NASD's ability to assure compliance with the Firm Quote Rule. Thus, the proposed rule change also comports with the requirements of subparagraph (b)(2) of Section 15A, which requires the association to be

Accordingly, any proposed amendments to these rules are proposed amendments to the transaction reporting plan contemplated by that SEC rule.

⁵³ 15 U.S.C. § 78o-3.

organized to enforce compliance by its members and associated persons with the provisions of the Exchange Act, rules thereunder, and the rules of the association.

In addition, the proposed rule change to establish a Nasdaq limit order book is designed to facilitate the display of the best priced limit orders in Nasdaq. Because the Top of File will be displayed in the quote montage, this facility is consistent with Section 15A(b)(11), which requires that the rules of a registered national securities association be designed to produce fair and informative quotations, prevent fictitious or misleading quotations and to promote orderly procedures for collecting, distributing, and publishing quotations. In this context, the proposed rule change also is consistent with the SEC's Order Handling Rules, in particular Rules 11Ac1-1 and 11Ac1-4, in that the book may be used by members to satisfy the requirements of the Display Rule with respect to customer orders, and is consistent with the ECN Display Alternative for market maker display of orders priced better than the market maker's public quote.

Finally, the proposed rule change is consistent with Section 11A(a)(1)(C) of the Exchange Act, which states, among other things, that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and order markets to assure (1) economically efficient execution of securities transactions; (2) fair competition among brokers and dealers; (3) the availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities; (4) the practicability of brokers executing investors' orders in the best market; and (5) an opportunity for investors' orders to be executed without the participation of a dealer. The NASD and Nasdaq believe that the System advances all of these goals by providing an integrated order delivery and execution system and Limit Order File designed to provide maximum transparency and efficient executions at the best price for the benefit of all investors and market participants.

(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 Exchange Act, as amended.

(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

With 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 Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 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 File No. SR-NASD-98-17 and should be submitted by April 2, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁵⁴

Jonathan G. Katz,
Secretary.

Exhibit 1—Text of the Proposed Rule Change

The text of the proposed rule change as amended is as follows. (Additions are italicized; deletions are bracketed.)

4611. Registration as a Nasdaq Market Maker

- (a) through (e) No Change.

(f) Unless otherwise specified by the Association, each Nasdaq market maker that is registered as a market maker in a Nasdaq National Market security shall also at all times be registered as a market maker in the Small Order Execution System (SOES) with respect to that security and be subject to the SOES Rules as set forth in the Rule 4700 Series.]

- (g) Re-designated as paragraph (f).

4613. Character of Quotations

- (a) Two-Sided Quotations

[(1)] No Change.

[(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 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 on 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.]

- (b) No Change.

(c) No Change.

(d) No Change.

(e) No Change.

4618. Clearance and Settlement

- (a)-(b) No Change.

[(c) All SOES transactions shall be cleared and settled through a registered clearing agency using a continuous net settlement system.]

4619. Withdrawal of Quotations and Passive Market Making

- (a) No Change.

- (b) No Change.

(c) Excused withdrawal status may be granted to 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 withdrawn from participation in the Automated Confirmation Transaction service, thereby terminating its registration as a market maker in Nasdaq National Market issues. Provided however, that if the Association finds that the market maker's failure to maintain a clearing arrangement is voluntary, the withdrawal of quotations will be considered voluntary and unexcused pursuant to Rule 4620 [and the Rules for the Small Order Execution System, as forth in the Rule 4700 Series] and Rule 4940.

4620. Voluntary Termination of Registration

(a) A market maker may voluntarily terminate its registration in a security by withdrawing its quotations from The Nasdaq Stock Market. A market maker that voluntarily terminates its registration in the System in a security may not re-register as a market maker in that security for twenty (20) business days.]; [Withdrawal from SOES participation as a market maker in a Nasdaq National Market security shall constitute termination of registration as a market maker in that security for purposes of this Rule;] provided, however, that 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 withdrawn from participation in the Automated Confirmation Transaction System and thereby terminates its registration as a market maker in [Nasdaq National Market issues] the System may register as a market maker at any time after a clearing arrangement has been reestablished and the market maker has complied with ACT participant requirements contained in Rule 6100.

- (b) No Change.

(c) No Change.

(d) No Change.

4632. Transaction Reporting

- (a) through (d) No Change.

(e) Transactions Not Required To Be Reported.

The following types of transactions shall not be reported:

(1) transactions executed through the System or Computer Assisted Execution System (CAES);

- (f) No Change.

4642. Transaction Reporting

- (a) through (d) No Change.

(e) Transactions Not Required To Be Reported.

The following types of transactions shall not be reported:

(1) Transactions executed through the System or Computer Assisted Execution System (CAES) [; the Small Order Execution System (SOES) or the SelectNet service].

- (f) No Change.

4700. Small Order Execution System

Rules 4710, 4720, 4730, 4740, 4750, 4760, and 4770 are being rescinded in their entirety.

⁵⁴ 17 CFR 200.30-3(a)(12).

4900. Nasdaq Trading System

4910. Definitions

(a) The term "Automated Confirmation Transaction service" ("ACT"), for purposes of the System rules, shall mean the automated system owned and operated by The Nasdaq Stock Market, Inc. which accommodates trade reporting of transactions executed through the System and submits locked-in trades to clearing.

(b) The term "automated quotation update facility" shall mean the facility in the System that allows the System to automatically refresh a System market maker's quotation in any security that the System market maker designates when the System market maker's displayed size (and supplemental size, if any has been reduced to zero. The facility will update either the bid or the offer side of the quote using a quotation interval designated by the market maker, depending upon the side of the market on which the execution has occurred and refresh the market maker's displayed size at an amount pre-determined by the market maker.

(c) The term "customer order" shall mean an order from, or on behalf of, a person that is not a registered broker-dealer, except that for the purposes of these Rules, the term customer shall include registered options market makers. An order will not be considered an agency order if it is for any account of a person associated with the member firm entering the order or any account controlled by such an associated person.

(d) The term "directed order" shall mean an order (agency or proprietary) entered into the System by a participant that is directed to a particular Executing Participant.

(e) The term "displayed size" shall mean the actual size of the quote displayed to the market as required by Rule 4613(a).

(f) The term "ECN" shall mean an electronic communications network that is registered and displaying orders in Nasdaq pursuant to Rule 4623 of the NASD Rules.

(g) The term "Executing Participant" shall include any of the following participants: (1) System market makers; (2) electronic communications networks ("ECNs"); and (3) UTP Exchange Specialists.

(h) The term "Firm Quote Rules" shall mean SEC Rule 11Ac1-1 and NASD Rules 3320 and 4613(b).

(i) The term "inside market" shall mean the best bid and associated size from Executing Participants and the best System limit order(s) to buy, as ranked by price, and the best offer and associated size from Executing Participants and the best System limit order(s) to sell, as ranked by price, displayed by Nasdaq.

(j) The term "liability order" shall mean an order that when delivered to an Executing Participant imposes obligations on the Executing Participant to respond to such order in compliance with the Firm Quote Rules.

(k) The term "limit order" shall mean an order entered into the System that is a priced order.

(l) The term "marketable limit order" shall mean a limit order that, at the time it is entered into the System, if it is a limit order

to buy, is priced at the current inside offer or higher, or if it is a limit order to sell, is priced at the inside bid or lower.

(m) The term "non-directed order" shall mean an order entered into the System and not directed to any particular Executing Participant.

(n) The term "open quote" shall mean a System market maker's quotation price and displayed size in an eligible security against which orders may be executed through the System during normal business hours, as specified by the NASD, or at such times that a market maker has notified Nasdaq pursuant to Rule 4617 that it is open for business. For the purposes of these Rules, a market maker has a "closed quote" when (1) it is outside of normal business hours; (2) its displayed quotation size has been decreased through System executions to zero; or (3) it has been deemed "closed" pursuant to Rule 4940 below.

(o) The term "Order Entry Participant" shall mean shall mean a member of the Association that is registered as a participant authorized to enter orders on behalf of customers in the System pursuant to Rule 4920 below. A System market maker is deemed to be an Order Entry Participant in any security in which it is registered as a System market maker.

(p) The term "participant" shall mean a person registered with the NASD and authorized to undertake activity in the system.

(q) The term "proprietary order" shall mean an order for the principal account of a broker or dealer.

(r) The term "registered options market maker" shall mean an exchange member registered with a national securities exchange as a market maker or specialist pursuant to the rules of such exchange for the purpose of regularly engaging in market making activities as a dealer or specialist in an option of a Nasdaq-listed security.

(s) The term "sponsored participant" shall mean a customer that is an institution (as defined in NASD Rule 3110(c)(4)) or registered options market maker that has entered into a sponsorship arrangement accepted by Nasdaq pursuant to Rule 4920(e) below.

(t) The term "supplemental size" shall mean the size that a System Market Maker chooses to maintain in the System-provided supplemental size feature that refreshes the System Market Maker's displayed size by the System Market Maker's pre-determined amount after the displayed size has been reduced to zero following a System-generated execution.

(u) The term "System" shall mean the order delivery and execution system owned and operated by The Nasdaq Stock Market, Inc. (a wholly owned subsidiary of the National Association of Securities Dealers, Inc.).

(v) The term "System eligible security" shall mean any security listed on the Nasdaq National Market or Nasdaq SmallCap Market.

(w) The term "System market maker" shall mean a member of the Association that is registered and quoting with an open quote as a Nasdaq market maker pursuant to the

requirements of Rule 4600 of the NASD Rules and is registered pursuant to Rule 4920 below as a market maker in one or more System-eligible securities.

(x) The term "UTP exchange" shall mean any registered national securities exchange that has unlisted trading privileges in Nasdaq securities pursuant to the Nasdaq/NMS/UTP Plan.

(y) The term "UTP exchange specialist" shall mean a broker-dealer registered as a specialist in Nasdaq securities pursuant to the rules of an exchange that: (1) is a signatory as either a participant or limited participant in 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 Exchange On An Unlisted Trading Privilege Basis ("Nasdaq/NMS/UTP Plan"); (2) provides for electronic access that permits a UTP exchange specialist to enter proprietary orders and permits System executions against a UTP exchange specialist at its published quote pursuant to these Rules; and (3) permits all transactions to be cleared and settled through a registered clearing agency using a continuous net settlement system.

4920. Registration Requirements

(a) Prior to entering or executing orders into the System, participants seeking to participate in the System shall register and be authorized by Nasdaq as Executing Participants, Order Entry Participants or sponsored participants, provided that each such participant meets the conditions set forth below:

(1) Executing Participants: Registration as an Executing Participant shall be conditioned on the participant's initial and continuing compliance with the following requirements:

(A) Membership in a clearing agency registered with the Securities and Exchange Commission which maintains facilities through which system-compared trades may be settled; or entry into a correspondent clearing arrangement with an NASD member that clears trades through such clearing agency;

(B) registration as: (i) a market maker or an ECN (as the case may be) in Nasdaq pursuant to the Rule 4600 series of the NASD Rules and compliance with all applicable rules and operating procedures of the Association and the SEC; or (ii) as an exchange specialist in good standing with an exchange that is a participant in the Nasdaq/UTP Plan and compliance with all applicable rules and operating procedures of the Association, its UTP Exchange and the SEC;

(C) maintenance of the security of any system that allows access to Nasdaq systems so as to prevent improper use or access of Nasdaq Systems, such as the unauthorized entry of orders or other data into Nasdaq-operated systems; and

(D) acceptance and settlement of each trade that is executed through the facilities of the System, or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified System trades by the clearing

member on the regularly scheduled settlement date.

(2) Order Entry Participants: Registration as an Order Entry Participant shall be conditioned upon the participant's initial and continuing compliance with the following requirements:

(A) membership in a clearing agency registered with the Securities and Exchange Commission which maintains facilities through which System-compared trades may be settled; or entry into a correspondent clearing arrangement with an NASD member that clears trades through such clearing agency;

(B) compliance with all applicable rules and operating procedures of the Association and the Securities and Exchange Commission;

(C) maintenance of the security of any system that allows access to Nasdaq systems so as to prevent Nasdaq systems from being improperly used or accessed; such as the unauthorized entry of orders or other data into the System or Nasdaq; and

(D) acceptance and settlement of each trade that is executed through the facilities of the System, or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified System trades by the clearing member on the regularly scheduled settlement date.

(3) Sponsored Participants: Registration as a sponsored participant shall be conditioned on the participant's and the participant sponsor's initial and continuing compliance with the following requirements:

(A) execution of, and continuing compliance with, at least one valid sponsorship agreement, as set forth in paragraph (e);

(B) membership of the sponsoring NASD member in a clearing agency registered with the Securities and Exchange Commission which maintains facilities through which System-compared trades may be settled; or such sponsoring NASD member's entry into a correspondent clearing arrangement with an NASD member that clears trades through such clearing agency;

(C) the sponsoring NASD member's acknowledgment that the sponsored participant will maintain the security of any system that allows access to Nasdaq-operated systems so as to prevent Nasdaq systems from being improperly used or accessed, such as through the unauthorized entry of orders or other data into Nasdaq-operated systems;

(D) the sponsoring NASD member's acceptance and settlement of each trade that is executed by the sponsored participant through the facilities of the System, or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified System trades by the clearing member on the regularly scheduled settlement date.

(b) Upon effectiveness of a participant's registration to participate in the System, participants may commence activity within the System for entry and/or execution of orders, as applicable, and their obligations as established in this rule will commence.

(c) Pursuant to Rule 4600 of the NASD Rules, participation as a System Market

Maker is required by any Nasdaq market maker registered to make a market in a Nasdaq security. Pursuant to Rule 4623 of the NASD Rules, when an ECN is displaying an order in Nasdaq, such displayed order must be accessible for execution through the System.

(d) Each system participant shall be under a continuing obligation to inform the Association of noncompliance with any of the registration requirements set forth above.

(e) Sponsorship agreements:

(1) A System Market Maker that is a Primary Market Maker pursuant to Rule 4612 in a particular security may establish for such security a sponsorship arrangement with customers that permits the customer to enter directly from the customer's facility orders for display, delivery, or execution in Nasdaq's System and receive execution reports by means of a Nasdaq-authorized protocol provided by the System Market Maker, the customer or a third party vendor of such services.

(2) Sponsorship arrangements must be pursuant to Nasdaq-authorized sponsorship agreements. A Sponsored Participant may enter into sponsorship agreements with more than one sponsoring NASD member. A sponsorship agreement shall include, among other things, terms establishing the customer's agreement to comply with all applicable NASD Rules governing the entry, execution, reporting, clearing and settling of orders in System-eligible securities;

(3) The sponsoring member must agree that it is responsible for all orders entered into the System by the sponsored participant that identify the sponsoring NASD member as the sponsor and that any execution that occurs in the System as a result of such order is binding in all respects on the sponsoring member so identified;

(f) Limitations on liability for System malfunctions: The Association and its subsidiaries shall not be liable for any losses or damages arising out of the use of the System. Any loss or damages related to a failure of the System to deliver, display, execute, compare, submit for clearance and settlement, or otherwise process an order or message entered in the System shall be absorbed by the member entering the message, or the member sponsoring the customer that entered the message.

4930. Operating Hours of The System

Subject to any trading halt imposed by the SEC or NASD, or any system malfunction or emergency condition that warrants interruption of the operation of the System, the operating hours of the System shall be as follows:

(a) For directed orders, the System shall be open and capable of permitting the execution of such orders from 9:00 a.m. (ET) to 5:15 p.m. (ET).

(b) For non-directed orders, the System will commence normal operations at 9:30 a.m. (ET) and close at 4:00 p.m. (ET), i.e., normal business hours as defined in Rule 4617, except as provided for in the opening procedures set forth below. Non-directed orders that are limit orders may be entered at any time from 8:00 a.m. (ET) until 6:00 p.m. (ET) for processing in the System during

normal operations. Non-directed market orders may be entered at any time from 8:00 a.m. (ET) until 4:00 p.m. (ET).

4940. Participant Obligations in the System

(a) Executing Participants

(1) A System Market Maker, ECN, or UTP Exchange Specialist shall commence participation in the System by initially contacting Nasdaq Market Operations to obtain authorization for order delivery and execution purposes in particular Nasdaq securities and identifying those devices through which such delivery and executions shall occur. Thereafter, on-line registration on a security-by-security basis is permissible, consistent with the requirements of Rule 4600 of the NASD Rules.

(2) Participation as a System Market Maker, ECN, or UTP Exchange Specialist obligates the participant, upon presentation of a market order or marketable limit order through the service, to execute such order as provided in Rule 4950 below. The System will transmit to the participant on the Nasdaq Workstation Service, or through a computer interface, as applicable, an execution report generated following each execution.

(3) A System Market Maker may elect to use the Nasdaq-provided automated quotation update facility in one or more securities in which it is registered. The facility will refresh the market maker's quotation automatically by a quotation price and size interval designated by the market maker, once its displayed size in the security has been reduced to zero size by executions that occur against the market maker in the System. The facility will refresh the market maker's quotation on either the bid or the offer side of the market, depending on the side that was reduced to zero size, by the price interval and size designated by the market maker.

(4) A System Market Maker may terminate its obligation by withdrawal from the System at any time. However, the market maker has the specific obligation to monitor its status in the System to assure that a withdrawal has in fact occurred. Except as otherwise permitted by Rule 11890 regarding the Association's authority to declare clearly erroneous transactions void, any transaction occurring prior to the effectiveness of the withdrawal will remain the responsibility of the market maker. A System Market Maker whose displayed size is reduced to zero on one side of the market will have a closed quote in Nasdaq and the System with respect to both sides of its market and will be permitted a standard grace period of three minutes within which to take action to restore its displayed size, if the market maker has not authorized use of the automated quotation update facility. A market maker that fails to renew its displayed size in a security within the allotted time will have its quotation on the side of the market that has been reduced to zero restored by the System at the lowest bid price (for a bid) or the highest offer price (for an offer) displayed in that security. Except as provided in subparagraph (5) below, a market maker that withdraws from a security may not re-register in the System as a market maker in that security for twenty (20) business days.

(5) Notwithstanding the provisions of subparagraph (4) above:

(A) a market maker that obtains an excused withdrawal pursuant to Rule 4619 of the NASD Rules prior to withdrawing from the System may reenter the System according to the conditions of its withdrawal;

(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 its thereby withdrawn from participation in ACT and the System, may reenter the System after a clearing arrangement has been reestablished and the market maker has complied 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 pursuant to Rule 4620 and these rules.

(6) In the event that a malfunction in the participant's System devices occurs rendering electronic communications with the System inoperable, the System participant is obligated to immediately contact Nasdaq Market Operations by telephone to request a closed quote status. If the closed quote status is granted, Market Operations personnel will enter such status notification into the System from a supervisory terminal. Such manual intervention, however, will take a certain period of time for completion and, unless otherwise permitted by the Association pursuant to its authority under Rule 11890, the System participant will continue to be obligated for any transaction executed prior to the effectiveness of its closed quote.

(b) Order Entry Participants

(1) An NASD member that is not registered as a market maker or as an ECN in a particular security must register as an Order Entry Participant to be able to enter orders into the System. Order Entry Participants can enter orders into the System only after an application for registration is reviewed and accepted by Nasdaq.

(2) Entry of Customer Orders: Executing Participants and Order Entry Participants are permitted to enter customer orders.

(3) Entry of Proprietary Orders: Provided that System market makers are permitted to enter quotations for actual size pursuant to Nasdaq market maker quotation rules, any Order Entry participant is permitted to enter proprietary orders into the System for display, delivery, and execution purposes. If, however, at the time that the new system is available for use, System market makers are not permitted to quote in actual size for all Nasdaq securities, only System market makers, UTP Exchange specialists, and registered option market makers may place proprietary orders for their market making accounts into the System. Proprietary orders may be entered only for securities for which the market maker or specialist is registered as a market maker or specialist. Any such proprietary order must be entered by an associated person of the market maker or specialist who is actively engaged in a market making capacity for that particular security.

(4) Proprietary Orders:

(A) Display and Execution—Proprietary orders are subject to the same display and

execution processes and requirements as agency orders.

(B) Surveillance Requirements—A member that enters a proprietary order must designate the order with the appropriate designator to identify the order as proprietary.

(5) Time In Force Orders: The following types of orders may be entered into the System:

(A) day orders;

(B) good-till-canceled ("GTC"); and

(C) good-till-date ("GTD").

The System will not accept all or none ("AON") orders; orders with minimum size of executions; or other conditioned orders.

4950. Entry, Display, and Execution of Orders

(a) Types of Orders That May be Entered: The System will accept limit orders, marketable limit orders, market orders, and odd-lot orders. All such orders have a minimum life of 10 seconds during which period such orders may not be canceled by the participant entering the order.

(b) Order Price Increments: All priced orders submitted for execution in the System are subject to the same policy for price increments as market maker quotes. For securities priced at \$10 or more, the minimum order increment shall be $\frac{1}{16}$ th. For stocks priced less than \$10, the minimum order increment shall be $\frac{1}{32}$ th.

(c) Order Size: Any round or mixed lot order up to 999,999 shares may be entered into the System for normal display and execution processing provided that System market makers may quote in actual size. If market makers are not permitted to quote in actual size, Order Entry Participants that are not System Market Makers or registered options market makers may only enter orders up to 1000 shares for non-directed orders. Odd-lot orders are subject to a separate display and execution process set forth below.

(d) Directed Orders:

(1) General Provisions—During normal business hours (i.e., 9:30 a.m. to 4:00 p.m.), orders entered into the System may be directed to a particular Nasdaq Market Maker, ECN, or UTP Exchange Specialist for execution.

(2) No Display of Directed Orders—Directed orders are not displayed in the Nasdaq Limit Order File and do not interact with any order displayed there, i.e., directed orders do not match against limit orders in the Nasdaq Limit Order File.

(3) Price and Size of Directed Orders—Directed orders must be priced orders in round or mixed lots and can be of any size permitted in the System in accordance with paragraph (c) above.

(4) Processing of Directed Orders: Directed orders will be processed in time sequence with non-directed orders entered into the System; that is, a directed order will be queued with all other orders (directed and non-directed) and will not be delivered to a particular Executing Participant designated by the Order Entry Participant until orders in sequence ahead of it are delivered for execution.

(5) Liability for Directed Orders: Nasdaq Market Makers and ECNs that receive

directed orders at or better than their quoted price (e.g., an order to sell at a price equal to or below their bid) are obligated to execute such orders up to their size displayed at the time that the order is delivered, in accordance with the same parameters for processing executions for non-directed orders in Rule 4950(e)(3), unless an exception to the SEC and NASD Firm Quote Rules applies. Directed orders that are sent at a price inferior to the price displayed (e.g., an order to sell at a price higher than their quoted bid) at the time of delivery or for a size greater than that currently displayed size do not obligate the Executing Participant to execute at that price or for any amount greater than the displayed size, except as provided for when the System Market Maker makes use of the supplemental size feature. All directed orders that impose liability on the Executing Participant will be designated as such on the order message delivered to such participant.

(6) Interaction of Directed Orders With Market Maker Supplemental Size: If a System Market Maker has elected to use supplemental size, and it receives a directed order greater than its displayed size, and such order is equal to or less than its supplemental size, the system shall either automatically execute such order if it is 1000 shares or less, or wait for a response from the market maker for either 17 seconds, if the order delivered is more than 1,000 shares, but less than 5,000 shares, or 32 seconds, if the order is 5,000 shares or greater, before executing the order up to the amount of its displayed size and its supplemental size. If the market maker accepts a partial amount or declines the order within the allotted time period, the market maker's supplemental size above the partial acceptance or the decline shall be eliminated by the System.

(7) Time In Force and Execution Process for Directed Orders: Order Entry Participants may cancel any directed order 10 seconds after entry. Directed orders will be delivered to or executed against an Executing Participant, except for a UTP Exchange Specialist, in the same manner as non-directed orders, as described in subparagraph (e)(3) below, except that non-liability orders priced inferior to the displayed price or at size larger than displayed size will be delivered for interaction by the Executing Participant. All orders directed to a UTP Exchange Specialist shall be delivered for the UTP Exchange Specialist's response. Delivery and/or execution of a directed order shall reduce the displayed size of the Executing Participant by the amount delivered or executed against the displayed size. Time in force for all delivered directed orders shall be the time parameters set forth in subparagraph (e)(3) below.

(8) Directed Orders Outside of Normal Market Hours: From 9:00 a.m. to 9:30 a.m. (ET) (pre-open directed orders) and from 4:00 p.m. to 5:15 p.m. (ET) (post-close directed orders) the System will permit the entry of directed orders. As long as an Executing Participant's quotation is in a closed quote state, the Executing Participant has no liability for that directed order. If an Executing Participant has chosen to open its quote after market close and a directed order is delivered, the order is treated as a liability

order subject to the same obligations described in subparagraph (d)(5) above, except that a market maker that opens its quote momentarily, solely for the purpose of adjusting its quote to reflect the elimination of customer limit orders, will not be subject to Firm Quote Liability. Directed orders outside of normal market hours cannot be canceled within 10 seconds; the time in force shall be one minute.

(e) Non-directed Orders:

(1) General Provisions: Unless an order is directed to a particular Executing Participant pursuant to paragraph (d) above, an order entered into the system shall be considered a non-directed order that shall be displayed and/or executed according to the provisions of this subparagraph. If a non-directed order is executable at the time it is ready to be delivered for execution (i.e., it is a market order or marketable limit order), it shall be delivered for execution in time sequence based on the time the order is received in the System. Delivery for execution shall occur against the next available participant (either an Executing Participant or the Nasdaq Limit Order File) based on a price and time priority ranking. If a non-directed order is a limit order that is not executable at the time it is received in Nasdaq's System, it shall be delivered to the Nasdaq Limit Order File for immediate display in the File.

(2) Entry of Non-Directed Orders: Round lot and mixed lot orders of any size permitted pursuant to paragraph (c) of this rule may be entered into the System on a non-directed basis. Orders will be processed in the time sequence that they are received in Nasdaq's System. Orders will be delivered to the best price quoted in Nasdaq's System for execution purposes. Market orders and marketable limit orders that are larger than the displayed size of a participant will be split by the System and will be delivered to multiple participants to obtain an execution at the best prices available. Similarly, market orders and marketable limit orders priced through the best prices will be executed against multiple Executing Participants until the orders are fully executed. Marketable limit orders that cannot be fully executed because all displayed size at the marketable limit order's price is exhausted shall become a limit order displayed in the Nasdaq Limit Order File and subject to execution as described below.

(3) Processing of Non-Directed Orders: Non-directed orders shall be delivered to the Executing Participant or the Nasdaq Limit Order File at the best price on a time priority basis. Non-directed orders delivered in this process are delivered in size up to the size displayed by the Executing Participant or Limit Order File, except as provided when a market maker chooses to use supplemental size as described below in paragraph (f). Executing Participants are responsible for executing orders delivered at their prices and up to their displayed size, unless an exception to the Firm Quote Rules applies. The System will take the following actions based on the prices and size displayed and the execution parameters chosen by the Executing Participants:

(A) Minimum Parameters For Automatic Execution: If the size of an order, or part of

an order, presented to an Executing Participant is 1,000 shares or less, the System will deliver the order in a size amount that is either (i) up to the displayed size of the Executing Participant's quotation or (ii) the full size of the order if such displayed quotation size is greater than the order size, and immediately execute the order against the participant at the time of delivery and decrease the displayed quote by the size of the order executed. The system will permit up to a 17-second delay after execution to permit the Executing Participant to update its quotation before another non-directed order is delivered to that participant.

(B) Default Execution: If the size of an order, or part of an order, presented is greater than 1,000 shares but less than 5,000 shares, and an Executing Participant is displaying a quotation size of 1,000 shares or greater but less than 5,000 shares, the System will deliver an amount of the order up to the Executing Participant's displayed size for execution and will decrease the displayed size by the amount delivered immediately upon action by the Executing Participant. The executing party has up to 17 seconds from delivery to accept, decline, partial, price improve, or do nothing with the delivered order. If the Executing Participant declines the order, the Executing Participant's quotation shall be immediately placed in a closed quote state. If the Executing Participant does not respond to the order, the System will automatically execute the order.

(C) Large Size Default Execution: If the size of an order, or part of an order, presented is 5,000 shares or greater, and an Executing Participant is displaying a quotation size of 5,000 shares or greater, the System shall deliver the order to the Executing Participant for execution and will decrease the displayed size by the amount delivered immediately upon action by the Executing Participant. The executing party has up to 32 seconds from delivery to accept, decline, partial, price improve, or do nothing with the delivered order. If the Executing Participant declines the order, the Executing Participant's quotation shall be immediately placed in a closed quote state. If the Executing Participant does not respond to the order, the System will automatically execute the order.

(D) Non-Directed Order Interaction with Market Maker Supplemental Size: If a market maker using supplemental size is alone at the inside price, and a non-directed order larger than its displayed size becomes available for delivery, the entire order, up to the market maker's displayed size and its supplemental size, shall either be automatically executed if it is up to 1000 shares, or presented to the market maker for its action for up to 17 seconds, if the order is greater than 1,000 shares but less than 5,000 shares, or up to 32 seconds if the order is 5,000 shares or greater. If the market maker accepts a partial amount less than its remaining supplemental size or declines the order, the remainder of the market maker's supplemental size shall be eliminated and the market maker's quote shall be placed in a closed quote state until the market maker updates its quote, or three minutes, whichever time period is shorter. If the market maker does nothing within 17 or 32 seconds, depending on the size of the

order presented, the amount of the order presented to the market maker shall be executed against the market maker.

(f) Supplemental Size: The System will permit System market makers to establish supplemental size to their displayed size, i.e., a System market maker may establish additional, undisplayed size that becomes displayed in market maker-established size increments in the market maker's quotation after the System has executed an order that decreases the market maker's displayed size to zero. The amount of interest entered into the supplemental size feature may be any amount established by the market maker, up to 99,000 shares, provided that a market maker may not use the supplemental size feature unless it is quoting in size of at least 1,000 shares and the refreshed size of the quotation maintained by the supplemental size facility is in a minimum increment of 1,000 shares.

(g) Limit Order File: The System will maintain a Limit Order File that will hold and display limit orders entered on a voluntary basis by participants. The System will display and execute limit orders entered into the File in the following manner:

(1) Display of Limit Orders: Limit Orders entered into the Limit Order File will be ranked according to price and time sequence. The best-ranked limit order to buy and the best-ranked limit order to sell in the file and the aggregate size of such orders associated with such prices (i.e., the "Top of File") will be displayed dynamically in a window on Nasdaq presentation devices and in the Nasdaq quote montage where it will be ranked in price and time sequence with market maker quotations and ECN-displayed orders. In addition, Nasdaq will maintain for all Nasdaq subscribers a full file display that will contain the prices and aggregate sizes of all limit orders contained in the file. This full file display is not updated dynamically and must be accessed on a query basis. Marketable limit orders shall not be displayed in the Limit Order File.

(2) Execution of Limit Orders Displayed In The Limit Order File: When orders that are entered into the Nasdaq Limit Order File are ranked first in priority in the System, the System will match non-directed market and marketable orders against the best-priced limit orders and immediately execute the orders and report such executions to the consolidated trade reporting System for trade reporting and the appropriate clearing agency as a locked-in trade.

(3) Short Sale Limit Orders: The System will permit the entry and execution of limit orders that are short sales. The System will not permit the execution of short sale orders that would violate the NASD's Short Sale Rule, Rule 3350 of the NASD's Conduct Rules.

(4) Mixed Lot Orders: The System will display only the round lot portion of a mixed lot order in the Top of File and Nasdaq Quote Montage. The System will match the full size of a mixed lot order only when such order can match exactly against another mixed lot order. In cases where there is no exact match of mixed lot orders, the System will match the round lot portions of such matching orders, and maintain the remaining odd lot

portions of such orders for odd-lot processing.

(5) **Opening Process:** At 9:30 a.m. (ET) the System will commence an opening match process as follows to attempt to execute as many limit orders as possible held on the Limit Order File as of 9:30 together with any market orders also held at that time. At 9:30, the System will first match limit orders to limit orders, based on price/time priority, by providing executions bounded by the 9:30 inside quotation until all possible executions are exhausted. The 9:30 "inside" for this purpose includes quotations of ECNs and UTP exchanges, but does not include the Top of File, Limits that cross other limits, where both limits are outside the 9:30 inside, will be executed at the mid-point of the 9:30 inside. Limits that cross other limits where one limit is at or within the 9:30 inside but the other is outside will be executed at a price that would provide price improvement for both orders if possible, provided the execution is at or within the 9:30 inside. Any remaining limits that cross other limits, both of which are within the 9:30 inside, will be executed at the midpoint of the two limit orders, providing price improvement to both. Next, the System executes as many market orders as possible against any remaining limit orders, provided the limit order is for a price at or within the 9:30 inside. If the inside quotation is locked at 9:30, the System will execute as many orders as can match at that price, with the remaining unmatched orders to be processed at 9:30 pursuant to normal business hours processing. If the inside quotation is crossed at 9:30 for a particular security, the System will not execute the File orders in that security. In this situation, each order will be matched or delivered for execution, as the case may be, according to normal business hours processing. Any market orders that do not match against limit orders in the opening shall be delivered, starting 9:30, to Executing Participants or the Limit Order File for execution purposes according to normal business hours processing as set forth above for non-directed orders. Execution reports for orders executed during the opening will be disseminated starting at 9:30 a.m.

(6)(A) **Display of limit orders:** All orders entered and displayed in Limit Order File shall be displayed anonymously.

(B) **Execution of Limit Orders:** When limit orders are executed, the System shall provide an execution report to any participant that participates in the execution and shall include the identifier of each such participant.

(h) **Odd-Lot Processing:**

(1) **Acceptance and Display:** Odd lot orders, and the remainder of mixed lot orders that could not be executed in the normal manner, and are less than 100 shares, (market, limit, and marketable limit) shall be accepted and processed by the System in a separate process. Odd lot limit orders will not be displayed or matched in the Nasdaq Limit Order File.

(2) **Execution Process:** An odd lot order shall be executed automatically against the next available Nasdaq market maker in rotation, when such odd lot order becomes executable. When the odd lot order becomes

executable, it will execute at the best price available in the market against the market maker even if that market maker is not quoting that price. Odd lot executions shall not decrease the market maker's displayed size.

4960. Firm Quote Compliance Facility

(a) To assist System Market Makers in complying with the Firm Quote Rules, System Market Makers shall be provided with a means to indicate the NASD Regulation's Market Regulation that the System Market Maker has received an order via the telephone to trade at the System Market Maker's Nasdaq-displayed quotation and that for a period of time while the System Market Maker handles the telephone order, the System should not deliver additional orders for execution.

(b) The System Market Maker shall send via the System a message that creates a time record indicating when the Market Maker entered the message regarding the telephone order. When the System receives the message, the System shall not present an order to that Market Maker until 17 seconds after receipts of the original message. The System will provide the System Market Maker with a reference number that shall be attached to the execution report that may occur as a result of the telephone order. A System market maker may only send one such message through the System for each telephone order necessitating the message. Entering messages without corresponding transactions shall be a violation of just and equitable principles of trade.

4960. Clearance and Settlement

All transactions executed in the System shall be transmitted to the National Securities Clearing Corporation to be cleared and settled through a registered clearing agency using a continuous net settlement system.

4970. Obligation to Honor System Trades

If a trade reported by a participant, or clearing member acting on its behalf, is reported by the System to clearing at the close of any trading day, or shown by the activity reports generated by the System as constituting a side of a System trade, such System participant, or clearing member acting on its behalf, shall honor such trade on the scheduled settlement date.

4980. Compliance With Procedures And Rules

Failure of a participant or person associated with a participant to comply with any of the rules or requirements of the System may be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of the Conduct Rules. No member shall effect a System transaction for the account of a customer, or for its own account, indirectly or through the offices of a third party, for the purpose of avoiding the application of these rules. Members are precluded from doing indirectly what is directly prohibited by these rules. All entries in the System shall be made in accordance with the procedures and requirements set forth in the User Guide.

failure by a non-member participant to comply with any of the rules or requirements applicable to the System shall subject the NASD member sponsoring such non-member to censure, fine, suspension or revocation of its registration as a participant or any other fitting penalty under the Rules of the Association.

4990. Termination of System Service

The Association may, upon notice, terminate System service to a participant in the event that a participant fails to abide by any of the rules or operating procedures of the System or the Association, or fails to pay promptly for services rendered.

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BILLING CODE 8010-01-M

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

Noise Exposure Map Notice; Receipt of Noise Compatibility Program and Request for Review Hulman Regional Airport Terre Haute, IN

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice.

SUMMARY: The Federal Aviation Administration (FAA) announces it's determination that the noise exposure maps submitted by Hulman Regional Airport Authority for Hulman Regional Airport under the provisions of Title I of the Aviation Safety and Noise Abatement Act of 1979 (Public Law 96-193) and 14 CFR part 150 are in compliance with applicable requirements. The FAA also announces that it is reviewing a proposed noise compatibility program that was submitted for Hulman Regional Airport under part 150 in conjunction with the noise exposure map, and that this program will be approved or disapproved on or before August 19, 1998.

EFFECTIVE DATE: The effective date of the FAA's determination on the noise exposure maps and of the start of its review of the associated noise compatibility program is February 20, 1998. The public comment period ends April 21, 1998.

FOR FURTHER INFORMATION CONTACT: Prescott C. Snyder, Airport Environmental Program Manager, 2300 East Devon Avenue, Des Plaines, Illinois 60018. [Telephone Number (847) 294-7538/Fax Number (847) 294-7046] Comments on the proposed noise compatibility program should also be submitted to the above office.

SUPPLEMENTARY INFORMATION: This notice announces that the FAA finds