

interaction would result based on the execution algorithm selected,<sup>11</sup> but such orders would not be permitted to automatically interact, if at the best price level, like those of Nasdaq Quoting Market Participants.<sup>12</sup> Alternatively, OE Firms may elect to completely avoid interaction with its orders on the opposite side of the market.<sup>13</sup> Quotes/Orders entered by OE Firms that create a locked/crossed market, would be processed like other locking/crossing quotes/orders as set forth in NASD Rule 4710(b)(3).

### III. Summary of Comments and Nasdaq's Response

As noted above, the Commission received three comment letters regarding the proposal, as amended.<sup>14</sup> Two of the commenters strongly supported the proposed rule change, as amended.<sup>15</sup> These commenters believed that allowing OE Firms to participate in SIZE enhances the liquidity of SuperMontage by promoting the entry and display of market interest by a greater number of market participants.<sup>16</sup> In addition, both of these commenters believe that OE Firms' participation in SIZE reduces the fragmentation in the Nasdaq market attributable to the absence of linkages between the NASD Alternative Display Facility, the regional exchanges trading Nasdaq securities pursuant to unlisted trading privileges, and SuperMontage. As a result, one of the commenters believed that the ability of OE Firms to use SIZE could reduce the existence of locked/crossed markets.<sup>17</sup> Further, the commenters stated that providing OE Firms with direct participation in SIZE decreases the execution times for customer orders by eliminating the need to interpose an electronic communications network ("ECN") or market maker between the OE Firm and SuperMontage,<sup>18</sup> as well as credits firms for providing liquidity through SIZE.<sup>19</sup> Finally, the two commenters generally believed that the proposed rule change provides all market participants with a more equal opportunity to interact with

other market participants including market makers and other agency orders via SIZE.

Another commenter, however, described the proposed rule change as a significant market structure change, and suggested that Nasdaq's proposal be subject to additional review.<sup>20</sup> Specifically, the commenter opined that because of the complexity of the proposal and the resources required to implement it, the 90 days for a pilot program of this nature was too short a period for full evaluation and implementation by market participants. The commenter recommended that the pilot program be extended an additional 90 days to give OE Firms sufficient time and resources to adapt their systems and procedures to take advantage of the enhanced access provided by the proposed rule change. The commenter opined that the extension of time would allow the NASD and the Commission to thoroughly analyze the effect of the proposed rule change on the marketplace prior to enacting it as a permanent change to SuperMontage.

Nasdaq disagreed with the STA's characterization that the proposal was a significant market structure change that warranted additional consideration by the Commission.<sup>21</sup> According to Nasdaq, since the pilot's inception, the use of SIZE for non-marketable limit orders submitted by pure OE Firms, and by market makers registered in other stocks, has modestly but steadily increased.<sup>22</sup> Nasdaq also stated the expansion has had no apparent negative impact on public investors and has served to bring increased liquidity to the public Nasdaq market. Nasdaq believes that these measurable improvements should take precedence, in the form of a swift and permanent approval of the proposed rule change, over any potential problems with the pilot that have yet to become manifest. Nasdaq also noted that the concept of the proposal is similar to the access granted to registered brokers in other market centers, whose experience gives no

indication that such access has had an adverse impact on market quality.

### IV. Discussion

After careful review of the proposed rule change, the comment letters, and Nasdaq's response to comments, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>23</sup> Specifically, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 15A of the Act in general,<sup>24</sup> and Section 15A(b)(6) of the Act in particular,<sup>25</sup> which provides that the rules of the association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals of trade, to foster cooperation and coordination with person engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission believes that it is appropriate to permanently approve the pilot. As noted by two of the commenters and Nasdaq, the implementation of the pilot has provided OE Firms with greater access to the system thereby increasing the liquidity of SuperMontage and potentially reducing fragmentation. Further, the Commission is not aware of any problems concerning the pilot since its inception on February 10, 2003.<sup>26</sup>

Also, as previously discussed in the pilot approval order, the Commission believes that the proposal is consistent with the goals of Section 11A(a)(1)(C), particularly Congress' finding that it is

<sup>23</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>24</sup> 15 U.S.C. 78o-3.

<sup>25</sup> 15 U.S.C. 78o-3(b)(6).

<sup>26</sup> The STA commented that the NASD was not obligated to modify SuperMontage to allow expanded OE Firm access until April 28, 2003. The Commission notes that by April 28, 2003, or an earlier date determined by Nasdaq with appropriate notice for the Commission and market participants, Nasdaq was required to have a programming solution in place to inhibit the automatic matching of an OE Firm order against its own order on the opposite side of the market. The pilot allowing OE Firms access to SIZE began on February 10, 2003. The programming solution to inhibit the automatic matching of OE Firm orders was implemented on March 17, 2003. See letter from Jeffrey Davis, Office of General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated February 25, 2003.

<sup>11</sup> See Securities Exchange Release Act No. 47554 (March 21, 2003), 68 FR 15024 (March 27, 2003) (Notice of Filing and Immediate Effectiveness of SR-NASD-2003-39).

<sup>12</sup> Similarly, OE Firms would not be able to use SuperMontage's self-preferencing feature and have buy and sell interest interact on a basis other than a natural interaction based solely on the selected order execution algorithm.

<sup>13</sup> See *supra* note 11.

<sup>14</sup> See *supra* note 7.

<sup>15</sup> See ATD Letter and SLK Letter.

<sup>16</sup> See ATD Letter and SLK Letter.

<sup>17</sup> See ATD Letter.

<sup>18</sup> See SLK Letter.

<sup>19</sup> See ATD Letter.

<sup>20</sup> See STA Letter. The STA also asserted that the pilot should not have been approved on an accelerated basis.

<sup>21</sup> See Response Letter, *supra* note 5.

<sup>22</sup> Nasdaq represents that a recent internal analysis conducted by Nasdaq's Economic Research Department on the use of SIZE during the pilot indicates an increase of approximately 1.5% of total Nasdaq volume is now being executed through SIZE. OE Firms currently represent about 1/3 of the total trading interest being executed through SIZE. Since the launch of the pilot, the number of OE Firms participating in SuperMontage via non-marketable limit orders in SIZE has increased from 0 to roughly 35 firms during the week of April 7, 2003.