

ECN transmits to Nasdaq a revised Attributable Quote/Order.

(iii) If an NNMS ECN's Quote/Order has been zeroed out or if the ECN has been placed into excused withdrawal as described in subparagraphs (b)(1)(C)(i) and (ii) of this rule, the system will continue to access the ECN's Non-Attributable Quotes/Orders that are in the NNMS, as described in rule 4707 and subparagraph (b) of this rule.

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

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

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

1. Purpose

Currently, the rules of the SuperMontage provide that if an NNMS Order Delivery ECN declines,⁵ partially fills, or fails to respond within 30 seconds to a non-directed order delivered to it by the system, without immediately transmitting a revised Attributable Quote/Order at an inferior price, NNMS will zero out all the Quotes/Orders of that ECN on the same side of the market at the price level of the declined order or better.⁶ This processing was incorporated into SuperMontage to ameliorate locked or crossed markets⁷ that had previously occurred in Nasdaq when ECNs declined to trade with other market participants, usually based on a dispute over the imposition, or the amount, of an ECN's quote-access fee. The following example illustrates how the quote/order reduction process currently

operates for an ECN alone at the inside that elected to enter three separate bid quotes/orders at the same price level in SuperMontage:

ECN Quote (#1)—1000 shares @ 20.00
ECN Order (#2)—500 shares @ 20.00
ECN Order (#3)—300 shares @ 20.00

The inside aggregated bid shows 1800 shares @ 20.00.

1. SuperMontage receives an 800 share market sell order.

2. In response, SuperMontage sends an 800 share order to ECN Quote (#1). Upon dispatch, SuperMontage decrements ECN Quote (#1) by the amount of the delivery (800 shares) leaving a display quote of 1000 shares (including 200 shares in ECN Quote (#1)) that remains available for execution.

3. The ECN declines to execute the 800 share order delivered to ECN Quote (#1), and does not immediately transmit a revised Attributable Quote/Order at an inferior price.

4. If not yet executed against by a subsequent incoming order, the ECN's decline results in the removal of ECN Quote (#1) (*i.e.*, the 800 shares originally decremented and the 200 share remainder of ECN Quote (#1)), and Orders (#2) and (#3) from the system.

5. The inside moves to the next best bid less than 20.00 and the system reallocates the 800 shares from the incoming order received in Step 1.

In response to concerns raised by some NNMS Order Delivery ECNs that the above quote decrementation method disadvantages Quotes/Orders entered by them that would otherwise be executed but for the elimination of all the ECN's trading interest on the same side of the market at the declined price level,⁸ Nasdaq has determined to modify the SuperMontage quote/order reduction process. Under the new approach to ECN quote/order decrementation after a decline, partial-fill, or time-out, will no longer result in an ECN's entire trading interest at the declined price level or better being removed from the system. Instead, SuperMontage will only remove the total amount of each individual quote(s)/order(s) to which the orders were delivered by SuperMontage. That is, SuperMontage will remove in their entirety only those Quotes/Orders with which the system attempts to trade with an order delivery ECN, but fails to do because of a decline, partial fill, or time-out. The following example illustrates

how the new quote/order reduction process would operate for an ECN alone at the inside that elected to enter three separate bid quotes/orders at the same price level in SuperMontage:

ECN Quote (#1)—1000 shares @ 20.00
ECN Order (#2)—500 shares @ 20.00
ECN Order (#3) 300 shares @ 20.00

The inside aggregated bid shows 1800 shares @ 20.00.

1. SuperMontage receives an 800 share market sell order.

2. In response, SuperMontage sends an 800 share delivery to ECN Quote (#1). Upon dispatch, SuperMontage decrements ECN Quote (#1) by the amount of the delivery (800 shares) leaving a display quote of 1000 shares in ECN Quote (#1) that remains available for execution.

3. The ECN declines to execute the 800 share delivery to ECN Quote (#1).

4. If not executed against by a subsequent incoming order, the ECN's decline results only in the removal of ECN Quote (#1), *i.e.*, the 800 shares originally decremented and the 200 share remainder of ECN Quote (#1). Orders (#2) and (#3) remain in the system and continue to be eligible for execution.

5. The system reallocates the 800 shares from the incoming order in Step 1 against ECN orders (#2) and (#3) before moving, if necessary, to the next best bid.

In short, only individual Quotes/Orders are removed in full by a decline, partial-fill, or a time-out where no revised Attributable Quote/Order is immediately transmitted at an inferior price; not all trading interest at the declined price level or better. Other ECN Quotes/Orders at a particular price level that are not part of a SuperMontage delivery resulting in a decline or a time-out are retained in the system and remain available for execution and are not traded through. Nasdaq notes that nothing in this new processing of Order Delivery ECN Quotes/Orders after declines, partial-fills, or time-outs allows the creation of a locked or crossed market during the trading day in SuperMontage. As such, Nasdaq believes that the above approach draws an appropriate balance between its need to ensure the smooth operation of its market and the desire of NNMS Order Delivery ECNs to maximize the potential for execution for Quotes/Orders they submit to NNMS.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the

⁵ An ECN's decline to a delivered order must be the result of an access fee-dispute, or otherwise be permitted under the SEC Firm Quote rule. NASD Regulation surveils for violations of the Firm Quote rule.

⁶ Nasdaq notes that it recently filed a proposed rule change to reduce the maximum 30-second response time to a 7 second response time. See Securities Exchange Act Release No. 34-47883 (May 16, 2003), 68 FR 28312 (May 23, 2003) (Notice of File No. NASD-2003-72).

⁷ See Securities Exchange Act Release No. 34-43863 (January 19, 2001), 66 FR 8020 (January 26, 2001).

⁸ For example, Nasdaq notes the concern that the removal of all the ECN's trading interest at the declined price level may prevent other Quotes/Orders that did not specifically decline a delivery from SuperMontage from potentially executing with market participants that have arrangements with the ECN to pay an access fee.