

internalization. In addition, some customers value speed more than other factors. Speed has become an indication of execution quality. Nasdaq characterized Primex's use of PRIs as designed to ensure that notwithstanding the need for speed on the order entry side, there would still remain a fair and reasonable opportunity for any and all crowd participants to respond to such order flow if they choose to do so, regardless of the auction selected. Nasdaq argued that Primex's technology allows this immediate interaction.

The NYSE argued that Primex artificially limits the ability of dealers to enter PRIs below established minimum sizes, thereby discouraging trading interest and constraining liquidity. As a result of consultation with members, Nasdaq has modified the minimum size requirements for PRIs to a less burdensome standard requirement of 100 shares.

The NYSE argued that Primex participants may selectively trade against agency orders alone by using a mechanism to screen out professional orders. NYSE contends that this is discriminatory, not an auction, and acts as a disincentive to participation.

Nasdaq responded that this feature ensures that any price improvement or enhanced liquidity opportunities be reserved for public customers, and not necessarily professional traders who could otherwise take advantage of the System's benefits and "pre-empt" the ability of a public customer to receive such benefits.

The NYSE argued that Primex's fee structure penalizes liquidity providers. Fees are charged to liquidity providers, and rebates are given when PRIs result in a trade. The NYSE believes the fee structure formalizes a payment for order flow arrangement to compensate PAMMs when they are displaced from internalizing their own customer orders.

Nasdaq stated that even though the fee structure is not included in the proposed rule change and thus not before the Commission for review, it would respond to the NYSE's arguments. Nasdaq explained that orders exposed in Primex are not charged for an execution so as to avoid any penalty that would discourage participants, particularly dealers, from exposing customer order flow to others. A fee is charged only to those who choose to respond to such order flow with Primex's unique bidding tools. Nasdaq also responded that it is not required to have a uniform pricing principle for all of its systems. The only requirement is an equitable allocation of reasonable fees among members, and

the fees for Primex comply with this standard.

The NYSE argued that Primex fails to provide a market structure that ensures its participants comply with Rule 10a-1 under the Act (the "Short Sale Rule").¹⁹ As a result of consultation with members, Nasdaq has implemented a system modification that will prohibit appropriately marked orders from executing in violation of NASD Rule 3350, the NASD short sale rule.²⁰ In addition, Nasdaq has reprogrammed the System to reject trading interest marked as "short" or "short exempt" in any exchange-listed security eligible for participation in the InterMarket Trading System.²¹

The NYSE argued that Nasdaq has not provided any market data or analysis regarding its trading history for public evaluation. In addition, individual market makers have opted to include Primex executions within their own "market center" reports, rather than as orders routed to and executed on another market system. Primex includes these trades in statistics used in its advertising and press releases.

The Nasdaq responded that it has been working closely with SEC staff to confirm how Rule 11Ac1-5 will be applied to Primex.

V. Amendment No. 2

In Amendment No. 2, Nasdaq seeks permanent approval of the following changes to Nasdaq's application of Primex: (1) Elimination of the end-of-day anonymity feature; (2) implementation of a system modification that will prohibit appropriately marked orders from executing in violation of NASD Rule 3350, the NASD short sale rule; (3) amendments to proposed NASD Rule 5016 to reflect that orders not fully executed in Primex can be forwarded to SuperMontage once it is available for a particular security; (4) the addition of two new conditions that can be attached to orders submitted to Primex, the Anti-Internalization Qualifier ("AIQ") and the All or None ("AON") condition; and (5) amendments to proposed NASD Rule 5020 to reflect that Nasdaq delayed for an additional calendar quarter the rule requiring PAMMs to submit a certain percentage of their orders to the System. The amended rule text follows. New

¹⁹ 17 CFR 240.10a-1.

²⁰ Telephone call among Peter R. Geraghty, Associate Vice President and Associate General Counsel, Nasdaq, Gordon Fuller, Counsel to the Assistant Director, Division, Commission, and Jennifer Lewis, Attorney, Division, Commission, on October 24, 2002. See Amendment No. 2, *supra* note 8.

²¹ See Amendment No. 3, *supra* note 9.

language is italicized; deleted language is in brackets.

5011. Definitions

For purposes of this Rule Series, unless the context requires otherwise:

(a) "Application" or "Nasdaq Application" as used in this Rule Series, and "Nasdaq Application of the Primex Auction System" as used throughout the NASD Rules means the voluntary Nasdaq trading service facility that permits NASD member firms, among other things, to submit orders in Primex Eligible Securities to be exposed to a Crowd of Participants in an [anonymous,] electronic auction format for the purpose of obtaining an execution for their own account or the account of a customer; to have required reports of any resulting trades automatically disseminated to the public and the industry; and to "lock in" these trades as necessary by sending both sides to the applicable clearing agency designated by the Participants involved for clearance and settlement, all in accordance with this Rule Series and other applicable rules and policies of Nasdaq.

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5016. Option to Route Orders Outside of the System After Exposure in the Application

(a) (1) All Market Orders submitted to the Application shall include an identifier as to whether any unexecuted balance, after the order is exposed to the Crowd, should be forwarded to the *SuperSoesSM version of the Nasdaq National Market Execution System*, in the case of a Nasdaq security, or to ITS/CAES, in the case of an exchange-listed security, or whether the order should be returned to the entering Participant. This option to route orders outside of the Application to *SuperSoes* or ITS/CAES is available for Market Orders only. Orders submitted to the Application with a specified, fixed price cannot be automatically forwarded to *SuperSoes* or ITS/CAES [Nasdaq's other execution systems].

Routing identifiers are not displayed, exposed or communicated to any other Participant in the Application.

(2) *For securities eligible for the SuperMontage version of the Nasdaq National Market Executions System, all orders submitted to the Application shall include an identifier as to whether any unexecuted balance, after the order is exposed to the Crowd, should be forwarded to SuperMontage, or whether the order should be returned to the entering Participant. Orders forwarded to SuperMontage will be treated as*