Primex Auction System

Nasdaq Is Establishing
The Primex Auction
System As A New Facility

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KEY TOPICS

- Trading Systems

Executive Summary

The National Association of Securities Dealers, Inc. (NASD®) and Nasdaq® Boards have agreed to establish the Primex Auction System™, a new trading system designed to replicate a competitive trading crowd in an extended electronic environment. Nasdaq will operate the system as a facility of The Nasdaq Stock Market® under an agreement between Nasdaq and Primex Trading N.A., L.L.C., the venture that holds the license to the system. Nasdaq is offering the system as an additional execution service to any NASD member, further enhancing opportunities for price and size improvement. The system, which is scheduled to start operating at the end of the first quarter of 2001, will be available for Nasdaq-listed securities and exchange-listed securities traded in the Nasdaq InterMarket.℠

The Nasdaq-operated Primex facility will allow, on a voluntary basis, market makers and others, including order entry firms and electronic communications networks (ECNs), to enter market orders and executable limit orders into the system for exposure to a broad electronic crowd. These orders may immediately interact with other interest or orders already resident within the Primex Auction System, or may elicit other responses from the crowd during the exposure, all dynamically priced within the context of the best publicly displayed bid and offer. Participants entering orders into the system may place minimum price improvement conditions on the orders they enter to attempt to obtain prices for those orders superior to the best publicly displayed prices. All interaction of trading interest within Primex will be anonymous until the end of the day. Customer orders that do not result in an execution in Primex may be internalized by the firm that entered the order or routed to another Nasdaq execution system.

The system has been designed to increase order exposure and interaction, and provides an effective means for the market at-large to independently price customer orders, particularly in the coming decimal environment. While participation in the Primex Auction System is voluntary, Nasdaq believes it will provide a useful means for seeking price and size improvement in the Nasdaq Stock Market and therefore should assist firms in satisfying their best execution duties. Moreover, the Primex Auction System will provide benefits and incentives for market makers to participate. Market makers that use the system for their customers can still maintain control of their order flow and commit capital for the benefit of their customers' orders.

Primex would be open to any NASD member in good standing and to non-NASD members that an NASD member is willing to sponsor and authorize.

Questions/Further Information

The NASD and Nasdaq Boards want to provide members with information regarding the way the Primex Auction System will operate and the rules that will govern its use. This synopsis is intended to provide members with a detailed overview of the System and its rules.

If you have questions or comments on how the Primex Auction System will operate, please contact Eugene Lopez, Senior Vice President, Department of Trading and Market Services, Nasdaq, at (202) 728-6998; or Richard C. Strasser, Director, Department of Trading and Market Services, Nasdaq, at

(202) 728-8338 **no later than October 16, 2000**.

HOW THE PRIMEX AUCTION SYSTEM AND ITS RULES WILL WORK

This *Notice* is intended to provide NASD members with a descriptive overview of how the Primex Auction System will operate and how the rules governing its use will work. The Primex Auction System will be made available on a voluntary basis to any interested NASD member that is in good standing and has executed the necessary agreements and forms with Nasdaq or its affiliate. Non-NASD members may access Primex through a Participant by becoming a sponsored Subscriber of the Participant. Users will be permitted to access Primex through: a Primex Auction Workstation service; an Application Programming Interface; a FIX programming interface; a Computer to Computer Interface; and possibly, in the future, through an Internet browser. The system will be available through a new network, independent of Nasdaq's existing network. The system offering the Primex facility will interface, however, with other Nasdaq services, such as the Small Order Execution System℠ (SOES℠), Computer Assisted Execution System℠ (CAES℠), Automated Confirmation Transaction Service℠ (ACT℠), and when it becomes available, Super-Montage.

Voluntary Nature Of The System

Nasdaq will offer the Primex facility to any NASD member that chooses to use this type of system to obtain price improvement or enhanced liquidity for its customer or principal orders. The facility is meant to serve as a means, but certainly not as the exclusive acceptable means, for obtaining price improvement. No NASD rule will require an NASD member to use Primex in meeting a member's best execution obligations.

Types Of Primex Participants

There will be two categories of participants in the Primex Auction System: Crowd Participant and Primex Auction Market Maker (PAMM).[1] Becoming a Participant automatically entitles that entity to be a Crowd Participant for **any** eligible security. Crowd Participants may expose orders to the Primex Crowd or respond to the orders of other Participants during an auction. A Participant also may choose to register as a PAMM, on a stock-by-stock basis, which entitles that Participant to certain privileges and subjects it to certain responsibilities for those stocks, as discussed below. All users may expose orders to the Primex Crowd, regardless of their status. The remainder of this *Notice* is divided into three parts: the first part describes the way Participants may enter orders seeking price improvement; the second part describes the way Crowd Participants may respond to orders seeking price improvement; and the third part explains trade processing, anonymity, and sponsored access.

1. Primex Order Entry

Types Of Orders Accepted And Exposure Duration

The Primex Auction System will not be a display facility for limit orders and thus will not be an ECN Display Alternative. The System will accept only market orders and executable limit orders.[2] Only the size and side of an order will be communicated to the Crowd, and only for the time during which the order is available for execution.

Participants will have a range of alternatives regarding the manner in which their orders may be exposed, depending on the characteristics of those orders and the way Participants choose to use the system for their customers. Participants that enter orders will specify the maximum exposure period, which can be "zero" seconds (*i.e.*, immediate), 15 seconds, or 30 seconds. This duration effectively is **the maximum time of the auction** for that order, which is in keeping with a goal of the Primex Auction System to speed the execution process while providing meaningful opportunities for price improvement and enhanced liquidity. Thus, an order may be executed well before the maximum exposure time has expired provided it can be matched with other interest that satisfies any conditions placed on the order by the Participant that entered it, such as a minimum amount of price improvement. Orders entered with a specified price may only be exposed to seek an immediate execution in whole or in part (referred to in the System as a "zero second" auction). Unpriced market orders for at least 10,000 shares or $200,000 in market value may be exposed for immediate execution in a zero second auction as well.

In a zero second auction an order exposed to the Crowd would interact with other orders on the opposite side of the market already being exposed within the System or Indications that respond automatically to orders during an auction. Any unexecuted portion of any order will be returned to the entering Participant at which time it may be internalized, or routed to other Nasdaq execution systems for execution as would be consistent with the Participant broker/dealer's best execution responsibilities. Choices regarding unexecuted portions of orders are

decided by the Participant entering an order at the time of order entry.

Crowd Participant Watch List For Eligible Securities

Crowd Participants may monitor the availability of orders exposed in an auction through the use of a Watch List. Nasdaq will notify a Crowd Participant electronically when an order in a security on that Participant's Watch List is exposed during an auction and available for response by the Crowd Participant.

Conditions And Match Parameters

The Primex Auction System will allow a Participant to place certain conditions and match parameters on the orders that it enters into the System. These vary depending on whether the Participant is a Crowd Participant or a PAMM. All Participants may enter orders (as principal, riskless principal, or agent) and all may place a Minimum Relative Price Improvement condition on agency and riskless principal orders they expose to the System. This condition establishes the minimum amount of price improvement, relative to the best publicly displayed bid or offer (NBBO), that the order must receive before it will be executed against in whole or in part by any Crowd interest.

In addition, PAMMs (but not Crowd Participants) are entitled, but not obligated, to place match parameters on the orders that they expose to the Primex Auction System in stocks in which they are registered as a PAMM. These match parameters provide a PAMM with a level of control over its order flow, allowing the PAMM to commit capital and provide executions to its customer orders in conjunction with the exposure process. There are three types of match parameters: (1) Two Cent Match; (2) 50 Percent Match; and (3) Block Facilitation

Match. In addition, PAMMs may expose clean cross orders to the Crowd.

Two Cent Match Parameter: Orders entered with this parameter will be executed against any interest in the Crowd during its exposure, at the time such interest is available, provided such Crowd interest would provide price improvement that is more than two cents superior to the NBBO at that time. If there is Crowd interest that would provide more than two cents price improvement to the order, in whole or in part, that interest will execute against the order accordingly. If there is Crowd interest for any part of the order but such interest does not satisfy the Two Cent Match parameter, then the entire order will be immediately executed against the PAMM that entered it at the best price that was nonetheless offered by the Crowd, at the time such Crowd interest is available and regardless of the size of that interest. If at the end of the exposure any portion of an order remains unexecuted, that portion will be executed against the PAMM that entered the order at the NBBO at that time.

For example: The NBBO for a security is $20 – 20.10. A PAMM enters a customer order to buy 2,000 shares and has placed a Two Cent Match Parameter on that order. The PAMM selects a maximum exposure period of 15 seconds for the order. A Crowd Participant responds with an offer to sell 1,000 shares for two cents superior to the NBBO (*i.e.*, $20.08). Because the PAMM that entered the original order is willing to match the price of any Crowd interest within two cents of the NBBO, the entire 2,000 shares of the original customer order will be executed against the PAMM that entered it at the improved price of $20.08. Had

the Crowd offered a Response to sell at a price equivalent to $20.07 or less, such Crowd interest would execute against the customer order. If an unexecuted balance still remained at the end of the 15 seconds, such balance of the customer's order would be executed against that PAMM at the best displayed offer at that time.

50 Percent Match: Orders entered with this parameter will be executed against any interest in the Crowd during its exposure at the price(s) and size of such Crowd interest for no more than 50 percent of the order. Any execution with the Crowd will immediately cause the Primex Auction System to provide the order with an additional execution of like size and price against the PAMM that entered it. Any unexecuted portion of the order will be executed immediately against the PAMM that entered it at the NBBO at that time.

For example: The NBBO for a security is $20 – 20.10. A PAMM for that security enters into the Primex Auction System an order to buy 2,000 shares for a customer and places a 50 Percent Match parameter on that order. The PAMM selects an exposure time of 15 seconds. During its exposure, the order elicits the following executions by other Crowd Participants (which could be in the form of Indications, Responses, or contra-side orders to sell): 200 shares at $20.04 and 500 shares at $20.05. Primex will execute these transactions and immediately match each one as they occur by executing an additional 200 shares and 500 shares, at $20.04 and $20.05, respectively, against the PAMM that entered the original customer order. If there is no other interest from the Crowd at the end of the 15-second exposure period, Primex will cause the remaining

balance of 600 shares to be automatically executed against the PAMM that entered the order at the best publicly displayed offer at that time. If the best offer publicly displayed were still $20.10 at this time, this would result in the PAMM selling the balance of 600 shares to the customer at $20.10.

Block Facilitation Match: This parameter is similar to the 50 Percent Match parameter, but it applies to orders that are for at least 10,000 shares. A PAMM entering an order with the Block Facilitation Match can specify a maximum exposure time of 0, 15 or 30 seconds whereas orders with the 50 Percent Match parameter (unless they are of block size) must be exposed for a maximum of 15 or 30 seconds. Any unexecuted portion of an order with this parameter will be executed immediately against the PAMM that entered it at the NBBO.

Clean Cross Exposure

Finally, a PAMM may enter Clean Cross orders for the accounts of two separate customers where the cross is for at least 10,000 shares. Clean Cross orders are exposed in a zero second auction. The two sides of the Clean Cross will execute against each other at the midpoint of the NBBO unless there is superior-priced interest in the Primex Auction System that breaks up either or both sides of the cross. To break up a side of a cross the resident Crowd interest must total at least 10,000 shares in the aggregate and be at a price or prices that are all superior to the bid-ask midpoint by at least a whole cent. Any unexecuted interest will be returned to the PAMM unexecuted.

Market Maker Guarantees

PAMMs may choose to establish pre-set execution guarantees for each customer order they enter. This guarantee allows a PAMM to automatically provide an execution to its own customers within the system, at size levels established by the PAMM, for any unexecuted portion of an order at the end of its exposure.

Phase-In Of Primex Auction Market Maker Obligations

In addition to being able to enter the match parameters and clean cross exposure discussed above, it is anticipated that a PAMM in a given security will be entitled to share in the execution revenues that the Primex Auction System generates. To maintain its status as a PAMM, however, a Participant must demonstrate its commitment to the System and the Crowd, after a brief phase-in period, by exposing a certain minimum number of its customer orders to the System.

Specifically, for the first calendar quarter in which the System is operational, any Participant may become a Primex Auction Market Maker (and thus be entitled to the benefits of being a PAMM) without regard to the percentage of its customer orders it submits to the System. Beginning with the second calendar quarter in which the System is operational, a Participant may maintain its status as a PAMM only if it exposed to the System at least 50 percent of its eligible customer orders (*i.e.*, those under 1100 shares) during the previous calendar quarter. Beginning with the third calendar quarter in which the System is operational, and each calendar quarter thereafter, a Participant may maintain its status as a PAMM only if it submitted at least 80 percent of its eligible customer orders during the previous calendar quarter. Of course, a Nasdaq market maker that chooses not to become a PAMM for any stock will never be

prevented from using the System at any time by either entering orders or responding to auctions as a Crowd Participant.

2. Responding To Orders Seeking Price Improvement

Any Crowd Participant may submit (either as principal or agent) either Indications or Responses to the Primex Auction System to interact with orders that become available in Primex. These Indications or Responses are not exposed or communicated to any Participant, except to the extent they result in an execution with an order. Responses may be either a fixed-price Response (*e.g.*, sell 1,000 shares at $20) or a relative-priced Response (*e.g.*, buy 1000 at the bid plus three cents).

Types Of Indications

There are two types of Indications: (1) Predefined Relative Indication (PRI) and Go-Along Indication. A Crowd Participant may use PRIs to act as "intelligent agents" in the System that respond automatically, at dynamically updated prices, to an order that becomes available during an auction. PRIs have no specific, fixed price. Rather, they are expressed, at the time of their entry, in terms relative to the best bid or offer that exists when the System activates the PRI against orders in an auction. PRIs must be for a certain minimum number of shares depending on the amount of price improvement over the NBBO (if any) that the PRI would offer. For example, a PRI that would respond at the NBBO must be for at least 3000 shares when it is entered, whereas a PRI that offers three cents or more price improvement superior to the NBBO may be for as few as 1,000 shares. The Primex Auction System will never execute an order at a price outside of the current NBBO.

A Crowd Participant may submit a Go-Along Indication to the Primex Auction System to respond automatically to orders that become available during an auction where there has been at least one other contemporaneous Crowd execution at the NBBO. Go-Along Indications have no specific price but will match against orders at the best publicly displayed bid or offer that exists when the Go-Along Indication is activated (provided there is no other interest available within the System). A Go-Along Indication must be for at least 10,000 shares.

Crowd Participant Restrictions On Order Interaction

Crowd Participants may restrict the types of orders with which their Indications and Responses will interact. Specifically, they may elect to have their Responses and Indications interact with all available orders or only with public customer orders (*i.e.*, no proprietary orders). Participants that enter orders, however, may **not** limit the type of interest that may respond to those orders.

Order Interaction

Orders entered by two or more Participants may interact with one another (as well as with Responses and Indications). Responses and Indications may not interact with one another. Market orders that are matched against other market orders being auctioned are executed at the midpoint of the NBBO.

3. Trade Processing, Anonymity And Sponsored Access

The Primex Auction System will process all trade activity among Participants on an anonymous basis until the end of the day. After facilitating an execution, Primex will send an execution report to all Participants involved. The execution report will indicate the details of the transaction but will not contain the identity of the contra-party. For regulatory and other necessary purposes, the NASD, Nasdaq, and the National Securities Clearing Corporation (NSCC) will have the ability to determine the identity of the actual contra-parties at any time. At the end of each trading day, the actual original contra-party for executions obtained within Primex will be made available to the Participants involved through Nasdaq's systems.

Matches within the Primex Auction System are executed and reported through Nasdaq systems for public tape reporting and forwarding to NSCC for clearing, where necessary. Participants (or their clearing firms) will be responsible for the clearance and settlement of all trades executed through the Primex Auction System to the extent permitted by their clearing firm. Thus, for Participants that are correspondents of other clearing firms, such correspondents must be authorized by their clearing firm before using the System. The System provides tools for clearing firms to establish, monitor, and modify clearing limits on a real-time basis. Executions within Primex cannot be re-allocated to different clearing firms after the execution.

Non-NASD members may access Primex through an NASD member Participant by becoming a sponsored Subscriber of that NASD member Participant, to the extent authorized by the member. For Participants that sponsor other Subscribers, the Primex Auction System provides tools for sponsors to establish, monitor, and modify credit limits for their Subscribers on a real-time basis. Firms that sponsor non-NASD members may always monitor all activity and execution reports involving the sponsored entity in real-time through the System.

Endnotes

[1] A PAMM in a Nasdaq-listed security must be registered as a Nasdaq market maker in that security. A PAMM in an ITS/CAES eligible security must be registered as an ITS/CAES market maker in that security.

[2] Executable limit orders include marketable limit orders as well as orders priced at-the-quote or between-the-quote.