# Nasdaq National Market Execution System

SEC Approves New Systems And Rules Governing Delivery, Negotiation, And Execution Of Orders For Nasdaq National Market Securities; **Effective Date: July 10, 2000**

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Institutional
- Legal & Compliance
- Operations
- Senior Management
- Systems
- Trading & Market Making

## KEY TOPICS

- Nasdaq National Market Execution System
- SelectNet
- Small Order Execution System
- Trading

## Executive Summary

On January 14, 2000, the Securities and Exchange Commission (SEC) approved rule changes that establish a new platform for the trading of Nasdaq National Market® (NNM) securities and amend the rules governing SelectNet®. This *Notice to Members* is being issued to alert members to the implementation of these changes.

Nasdaq® will establish "The Nasdaq National Market Execution System" (NNMS) as the primary trading platform for NNM securities. NNMS will be based on the architecture of the Small Order Execution System℠ (SOES℠), but will be enhanced in several ways that will be explained later in this *Notice*.

Under the rule changes, SelectNet generally will be used to deliver negotiable orders to Market Makers and Electronic Communication Networks (ECNs) that participate in NNMS. SelectNet orders for NNM securities will no longer be "liability orders."

SmallCap℠ SOES will continue to operate as it does today. Additionally, market participants will be able to use SelectNet to deliver liability orders in SmallCap issues.

The system changes and applicable rules governing SelectNet and NNMS will take effect on July 10, 2000. Attachment A contains the amended rule language. Attachment B includes a question/answer section dealing with common questions regarding NNMS.

## Questions/Further Information

Questions regarding this *Notice* may be directed to the following:

- For legal issues: the Nasdaq Office of General Counsel, at (202) 728-8294.

- For technical issues: Peter Martyn or Paul Niche, Nasdaq Product Development, at (212) 858-4322.

- For trading issues: Dan Franks, Nasdaq Market Operations, at (203) 385-6250.

- For market regulation questions: Market Regulation Legal Department, at (301) 590-6410.

## 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.[1] 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 NNM securities.

SelectNet, approved in January 1988, is an electronic screen-based order routing system that allows market participants to negotiate securities transactions in Nasdaq securities through computer communications, rather than relying on the telephone.[2] SelectNet added communications options and electronic access to Nasdaq's trade reporting, order comparison, and settlement facilities. Unlike SOES, SelectNet offers the opportunity to negotiate for a larger size or a price superior to the current inside quote.

In addition, participants may limit the amount of time an order will be in effect (from 3 to 99 minutes), specify a day order, or indicate whether price or size is negotiable or whether a specific minimum quantity is acceptable. Participants may accept, price-improve, counter, or decline a SelectNet order, consistent with the firm quote requirements of SEC Rule 11Ac1-1 and National Association of Securities Dealers, Inc. (NASD®) Rule 4613(b). Upon agreement to terms, the execution is "locked-in," reported to the tape, and sent to clearing for comparison and settlement.

SelectNet currently allows subscribers to direct, or "preference," orders to specified Market Makers or to broadcast orders to all market participants. Although SelectNet is an order delivery service, rather than an order execution service, a preferenced SelectNet order presented to a Market Maker at its displayed quote gives rise to liability under SEC Rule 11Ac1-1 for the Market Maker to execute the transaction at that price and size of its quote.[3]

SelectNet links Nasdaq to ECNs in conjunction with the SEC's Order Handling Rules,[4] which require a Market Maker to make publicly available any superior prices that the Market Maker quotes privately 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-priced orders to an ECN provided that the ECN disseminates these priced orders to the public quotation system and provides broker/dealers equivalent access to these orders. SelectNet will continue to perform this function in the new trading environment for ECNs that choose not to take

automatic execution against their quotes through NNMS.

While SOES and SelectNet have provided, and continue to provide, valuable services to market participants for the ultimate benefit of investors, the maintenance of two separate execution systems operating independently and simultaneously creates the potential for "dual liability" for Market Makers. Multiple access points to a Market Maker's quote, through a combination of SOES and SelectNet as well as through a firm's internal order receipt/execution facilities, can subject Market Makers to unintended double liability for orders that reach their quote at or near the same time through disparate, asynchronous systems. The potential for unexpected order liability reduces Market Maker incentives to commit capital and display larger quote sizes, thereby depriving the Nasdaq market of valuable liquidity. Nasdaq's new automated execution environment is designed to remedy these problems.

## Nasdaq's New Trading Environment

The SEC has approved modifications to Nasdaq's negotiation and automatic execution systems to deal with the problem of dual liability. As a general matter, SelectNet, through rule and system changes, will be reestablished as a non-liability, order delivery and negotiation system for NNM securities. The current automatic execution system for small orders from public customers, SOES, will be substantially enhanced for the trading of NNM securities through the following changes:

(1) increasing the maximum order size for NNM securities to 9,900 shares;

(2) allowing market participants (including Market Makers) to enter proprietary orders into the new system and to obtain automatic execution for their proprietary and agency orders in NNM securities;

(3) reducing the current 17-second delay between executions against the same Market Maker to five seconds;

(4) enabling NNM orders to interact on an automatic basis with Market Makers' displayed size and reserve size.[5] These rule changes will reduce dual liability, improve the speed of executions, and increase access to the full depth of a security's trading interest by all market participants; and

(5) eliminating the "No Decrementation" and preferencing functionality that currently exists in SOES.

### Changes To SelectNet

SelectNet will be transformed to an order delivery and negotiation system through rule changes prohibiting the use of SelectNet for the entry of any preferenced orders directed to Market Makers in NNM securities unless such orders are at least 100 shares in excess of the displayed amount of an NNMS Market Maker's quote to which they are directed (over-sized order requirement). In addition, such orders must also be designated as either:

(1) an "All-or-None" (AON) order of a size that is at least 100 shares greater than the displayed amount of the NNMS

Market Maker's quote to which the order is directed; or

(2) a "Minimum Acceptable Quantity" (MAQ) order with an MAQ value of at least 100 shares greater than the displayed amount of the NNMS Market Maker's quote to which the order is directed.

SelectNet will automatically reject preferred messages that fail to meet these requirements.[6] The over-sized order requirement will also apply to orders directed to ECNs that take automatic execution against their quotes in NNMS. These changes will ensure that Market Makers and ECNs that take automatic execution are not subject to potential dual liability arising under the firm quote rule as the result of receiving orders from different systems. Recipients of over-sized NNM SelectNet orders will have the option to execute or initiate electronic negotiation in response to the message.

ECNs will have the ability to be accessed through the SelectNet linkage, or fully participate in NNMS and be subject to automatic execution through NNMS. Nasdaq currently is working with Unlisted Trading Privilege (UTP) Exchanges to integrate them into the automatic execution functionality of NNMS. If this occurs, UTP Exchanges may be accessed via NNMS, and they may access Nasdaq market participants that take automatic execution via NNMS.

### Nasdaq National Market Execution System (NNMS)

NNMS will be the Nasdaq market's primary trading and execution medium. NNMS transforms the current operating execution systems for small orders from public customers into a more efficient, automated facility for the

handling of all NNM orders of less than 9,900 shares. NNMS will execute automatically against Market Makers' quotes—displayed and reserve size—as more fully described below.

**Order Entry Parameters.** First, the maximum order size for NNM securities entered into NNMS will be 9,900 shares. Second, NASD members (including Market Makers) will be allowed to use NNMS on a proprietary basis, including being able to obtain automatic execution for orders sent to other NNMS participants, when trading NNM securities. Third, the interval delay between automatic executions against the same Market Maker will be five seconds. Fourth, the system will have a reserve size feature for quotes. NNMS will permit interaction of orders against a Market Maker's "reserve size" after yielding priority to displayed quotes at the same price. Additionally, Market Makers will have the option of having their quotes automatically refreshed from that reserve to a size level of their choosing. If no particular size is designated by the Market Maker, the quote will automatically be refreshed by NNMS at a 1,000-share displayed-size level.[7]

**Reserve Size.** Participants in NNMS will be able to indicate a reserve size amount which will not be displayed in Nasdaq. Rather, reserve size will refresh quotes that have been decremented to zero, and will be accessed automatically if all displayed interest is exhausted. The reserve size feature of NNMS will yield priority to all displayed quotes at the same price level, so that the system will execute against displayed size in time priority and then against the reserve size in time priority. NNMS will require those using the NNMS reserve-size feature to display at

least 1,000 shares in their quotes. Moreover, quotes at the inside of the market that are to be refreshed at the same price level must be refreshed to at least 1,000 shares in order for a Market Maker to continue using reserve size.[8]

Consider the following scenario: three Market Makers, ranked in time priority A, B, and C, are each at the best bid and each displaying 1,000 shares and all with 5,000 shares in reserve, and a 9,000-share market order is entered. The system will handle the order as follows: NNMS would automatically first take out the displayed 3,000 shares, then take out the entire 5,000-share reserve size of Market Maker A (MMA) and 1,000 shares of Market Maker B's (MMB) reserve size in time priority, filling the order. MMB would then have 4,000 shares in reserve size and Market Maker C (MMC) would have 5,000 shares in reserve size.[9] MMA's quote would be completely decremented and drop from the inside market. Since MMB's total displayed and reserve quote would not be completely decremented (4,000-reserve share size remaining) it would retain its time priority and, assuming it remains the best bid, remain at the top of the quote montage with its displayed size refreshed from its remaining reserve size. In order to continue quoting shares in reserve size, MMB would have to have selected a 1,000+ share refresh size. MMC, based on its 5,000-share reserve size remainder, would retain the number two slot in the executive rotation and also have the option of having its displayed quote automatically refreshed from reserve to a size of its choosing. MMC would likewise be subject to a 1,000+ share display refresh minimum to be allowed to continue to quote reserve size. MMA's fully exhausted quote may be automatically

refreshed away from the inside market using Nasdaq's automatic quote update function.

As always, failure to update a fully exhausted quote will result in the system placing the Market Maker's quote in a "closed" state that, if not updated within five minutes, will be cause for suspension of the Market Maker's quote for 20 business days. Market Makers will still have the ability, through Nasdaq's automatic quote update facility, to pre-select a tick value and size, and have Nasdaq refresh their proprietary quote away from the inside market. If a Market Maker's quote is refreshed to a different price or size level, another order will not be delivered to that Market Maker for five seconds after that quote is refreshed at the new price or size level.

**"No Decrementation" Eliminated.**
NNMS will not offer the "NO DEC" feature for NNM securities. NO DEC, which currently allows continuous executions against a Market Maker's quote at the same price, is unnecessary in an environment where a Market Maker can manage its quotes by displaying its actual size and refresh its quote at a size it determines.

**Preferencing Eliminated.**
Similarly, Nasdaq is also eliminating the existing SOES preferencing feature for NNM securities because it is inconsistent with the processing of orders in time priority. Preferencing in an automatic execution system also reduces Market Maker incentives to aggressively compete for orders by showing the full size and true price of its trading interest.

***ECN And UTP Exchange Participation***

ECNs will have two options for participation in NNMS, and the manner in which they choose to participate shall be governed by an addendum to the NWII Subscriber Agreement for ECNs. Specifically, ECNs can choose to be Order-Entry ECNs or Full-Participant ECNs.

1) Order-Entry ECNs (OE ECNs) will participate in Nasdaq in substantially the same manner as ECNs do today. That is, market participants would be able to access OE ECN quotes via the SelectNet linkage and to send preferenced SelectNet messages of any size (up to 999,999 shares) to such ECNs. The oversized order requirement for a preferenced SelectNet order would not apply to OE ECNs. OE ECNs that want to access other Market Maker quotes would need to request order-entry capability in NNMS. That is, OE ECNs would enter orders into NNMS for automatic execution against quotes of Market Makers and other ECNs that choose to accept automatic execution against their quotes. OE ECNs can also send preferenced SelectNet orders to NNMS Market Makers subject to the over-sized order restrictions described above.[10]

2) Full-Participant ECNs will agree to provide automatic execution against their quotes for orders entered into NNMS, similar to Market Makers. Like OE ECNs, Full-Participant ECNs will use NNMS to obtain automatic execution of orders they send to NNMS Market Makers or other Full-Participant ECNs. Full-Participant ECNs will use SelectNet to deliver liability orders to OE ECNs.

National securities trading pursuant to grants of UTP will continue to have access to the full range of SelectNet's capabilities as their primary linkage with Nasdaq. UTP Exchanges will continue to receive, and be obligated to execute, preferenced SelectNet liability orders. Additionally, UTP Exchanges will retain their ability to send SelectNet preferenced liability orders to Market Makers. Thus, a Market Maker will face dual liability on the sporadic occasions when its quote is accessed simultaneously by a UTP Exchange via SelectNet and also by an NNMS Market Maker or Order Entry Firm via NNMS.

As noted above, Nasdaq currently is working with UTP Exchanges to integrate them into the automatic execution functionality of NNMS. If this occurs, UTP Exchanges may be accessed via NNMS, and they may access Nasdaq market participants that take automatic execution via NNMS.

***Nasdaq SmallCap***

For Nasdaq SmallCap securities, the trading rules for automatic execution will not change. Participation in the automatic execution system for SmallCap will remain voluntary, and be available only for the small orders of public customers. Maximum order size limits will remain in effect as well as the prohibition against splitting larger orders to avoid those limits. Restrictions on access by market professionals will likewise be maintained. Lastly, SelectNet in the SmallCap environment will not change. Specifically, the over-sized order requirement will not apply to SmallCap issues. Thus, Market Makers that receive SelectNet orders in SmallCap issues at their quoted price and size will owe an obligation to honor these orders under the SEC's and NASD's firm quote rules.

## System Examples

The following are some representative examples of how NNMS will operate.

### *Example 1*

There are three Market Makers at the inside bid displaying the following quotations when an 8,000-share market order to sell is entered into the system:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (AQR) (to new price and/or size) |
|---|---|---|---|---|---|
| MMA | $20 | 1,000 | 5,000 | 1,000[11] | Not being used |
| MMB | $20 | 2,000 | 2,000 | 1,000 | Not being used |
| MMC | $20 | 1,000 | 1,500 | 1,000 | Not being used |
| MMD | $19 15/16 | 1,000 | 0 | 0 | AQR to 1/16th away, 1,000 shares |

Four thousand shares are instantaneously taken from the displayed size of MMA, MMB, and MMC, and 4,000 shares are instantaneously taken from MMA's reserve size, resulting in one execution of 5,000 shares for MMA, one execution of 2,000 shares for MMB, and one execution for 1,000 shares for MMC. (In instances where an order is entered into the system and that order would interact with both a market participant's displayed size and reserve size [consistent with displayed/reserve and price/time priority system rules],[12] the system will execute one transaction—**not** two—against the market participant to minimize transaction costs.) The aforementioned transactions yield the following quotes:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMA | $20 | 1,000 | 0 | N/A | Not being used |
| MMB | $20 | 1,000 | 1,000 | 1,000 | Not being used |
| MMC | $20 | 1,000 | 500 | 500 | Not being used |
| MMD | $19 15/16 | 1,000 | 0 | 0 | AQR to 1/16th away, 1,000 shares |

Next a 3,500-share market order to sell is entered into the system. (Note that the system will not deliver an order to MMA, MMB, or MMC until five seconds after the previous execution has elapsed.)[13] After five seconds has elapsed, 3,000 shares are executed instantaneously against the displayed size of MMA, MMB, and MMC, and 500 shares are executed instantaneously against the reserve size of MMB. (As noted above, there will only be one execution against MMB for a total of 1,500 shares.) This yields the following quotations:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMB | $20 | 500 | 0 | N/A | Not being used |
| MMC | $20 | 500 | 0 | N/A | Not being used |
| MMD | $19 15/16 | 1,000 | 0 | 0 | AQR to 1/16th away, 1,000 shares |
| MMA | **closed quote** | **closed quote** | X | X | X |

Note that MMA is decremented to zero and placed in a closed-quote status. MMA has five minutes in which to re-enter its quotes. If MMA fails to do so, it will be "Timed-out-of-the-Box," and will be withdrawn from market making for 20 days.[14]

## Example 2

The following quotes are being displayed in Nasdaq when a 1,500-share market order to sell is entered into the system:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMA | $20 | 500 | 1,000 | 1,000 | AQR to 1/16th away, 1,000 shares |
| MMB | $19 15/16 | 1,000 | N/A | N/A | Not being used |
| MMC | $19 15/16 | 1,000 | N/A | N/A | AQR to 1/8th away, 1,000 shares |
| MMD | $19 7/8 | 1,000 | 10,000 | 1,000 | Not being used |

The 1,500-share order is executed instantaneously against MMA's displayed and reserved size, and MMA is refreshed for 1,000 shares, 1/16th away from its previous bid, yielding the following quotes:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMB | $19 15/16 | 1,000 | N/A | N/A | Not being used |
| MMC | $19 15/16 | 1,000 | N/A | N/A | AQR to 1/8th away, 1,000 shares |
| MMA | $19 15/16 | 1,000 | N/A | N/A | AQR to 1/16th away, 1,000 shares |
| MMD | $19 7/8 | 1,000 | 10,000 | 1,000 | Not being used |

Immediately, a 4,000-share market order to sell is entered into the system, and the following occurs:

    A) 2,000 at $19 15/16 is executed against MMB's and MMC's displayed size; and

    B) *2,000 shares held in queue momentarily*.

Note that 2,000 shares are held in queue and are not immediately delivered to MMA because MMA's quote must be reset to $19 15/16.[15] After five seconds passes, the remaining 2,000 shares are executed as follows: 1,000 at $19 15/16 is executed against MMA; a new inside bid is established at $19 7/8 and 1,000 at $19 7/8 is executed instantaneously against MMD's displayed size.

## *Example 3*

There are three market participants at the inside bid of $20, displaying the following quotations:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMA | $20 | 1,000 | 4,000 | 1,000 | AQR to 1/16th away, 4,000 shares |
| MMB | $20 | 1,000 | 2,000 | 1,000 | Not being used |
| MMC | $20 | 1,000 | 4,000 | 1,500 | N/A |
| MMD | $19 15/16 | 500 | 0 | 0 | AQR to 1/16th away, 500 shares |

An 8,000-share sell market order is entered into the system, at which time 3,000 shares are instantaneously allocated against the displayed size of MMA, MMB, and MMC; 4,000 are allocated against MMA's reserve; and 1,000 are allocated against MMB's reserve. (As noted above, the system will execute one transaction against MMA for a total of 5,000 shares, and one transaction against MMB for a total of 2,000 shares.) The following quotes will appear in the Nasdaq montage:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMB | $20 | 1,000 | 0 | N/A | Not being used |
| MMC | $20 | 1,500 | 2,500 | 1,500 | N/A |
| MMD | $19 15/16 | 500 | 0 | 0 | AQR to 1/16th away, 500 shares |
| MMA | $19 15/16 | 4,000 | N/A | N/A | AQR to 1/16th away, 4,000 shares |

## *Example 4*

The following market participants are at the inside bid displaying the following quotations, when a 6,500-share sell market order is entered into the system:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMA | $20 | 500 | 0 | 0 | AQR to 1/16th away, 500 shares |
| ECN1(OE) | $20 | 1,000 | 0 | N/A | N/A |
| MMB | $20 | 2,000 | 0 | N/A | AQR 1/8 away, 1,000 shares |
| ECN2(FP) | $20 | 4,000 | 0 | N/A | N/A |
| MMC | $19 15/16 | 5,000 | 0 | N/A | Not being used |

Note that ECN1(OE) represents an ECN that opts to be accessible through SelectNet only, and not subject to automatic execution through the system. ECN2(FP) represents a fully participating ECN that agrees to accept automatic execution against its quotations.

As to the 6,500-share order, the system executes automatically 6,500 shares against the displayed sizes of MMA, MMB, and ECN2(FP), thus filling the entire order. ECN1(OE) does not receive an execution through the system against its 1,000-displayed size because it has opted to accept orders through SelectNet. At this point, ECN1(OE) is alone at the inside, and if after 90 seconds no other Market Maker or fully participating ECN joins ECN1(OE) at the inside (and if ECN1(OE) is not accessed via SelectNet and moves its quote), the system will shut down and return all orders in queue to the appropriate market participant.[16]

## *Example 5*

There are three Market Makers at the inside bid displaying the following quotations when a 9,000-share market order to sell is entered into the system:

| Market Participant | Bid Price | Displayed Size | Reserve Size | Refresh (from Reserve) | Autoquote Refresh (to new price and/or size) |
|---|---|---|---|---|---|
| MMA | $20 | 1,000 | 5,000 | 1,500 | Not being used |
| MMB | $20 | 2,000 | 1,000 | 1,000 | Not being used |
| MMC | $20 | 3,000 | 2,000 | 1,000 | N/A |

Here, the system will instantaneously take the displayed size of MMA, MMB, and MMC and 3,000 shares are taken instantaneously from the reserve size of MMA since its reserve size has time priority.

## Endnotes

[1] *See* Exchange Act Rel. No. 21743 (Feb. 12, 1985).

[2] *See* Exchange Act Rel. No. 25263 (Jan. 11, 1988). *See also*, Exchange Act Rel. No. 25690 (May 11, 1988) (order granting permanent approval of SelectNet).

[3] 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. *See* SEC Rule 11Ac1-1.

[4] SelectNet is also used by UTP Exchanges to access Nasdaq Market Makers. *See* Exchange Act Rel. No. 34-38191 (Jan. 22, 1997).

[5] Nasdaq recently filed a rule proposal that would permit the separate display of customer orders by Market Makers in Nasdaq through a Market Maker agency identification symbol ("Agency Quote"). *See* SR-NASD-99-09.

[6] SelectNet will continue to accept orders of any size (subject to the 999,999-share system limit) for Nasdaq SmallCap securities.

[7] *See* NASD Rule 4710(g) and proposed Rules 4701(g) and 4710(d)(3).

[8] This restriction will not apply for interim executions against a Market Maker's non-updated quote. For example, should a Market Maker displaying an initial quotation of 1,000 shares with 5,000 shares in reserve be automatically accessed by NNMS for 300 shares in displayed size, that Market Maker will still be allowed to continue to display its remaining 700 shares and keep 5,000 available in reserve size. Should the Market Maker subsequently update either its displayed or reserve sizes, or its quoted price, the Market Maker will be obligated to increase its displayed size to 1,000 shares in order to continue to use the NNMS reserve size feature.

[9] Like Nasdaq's other automatic execution systems, NNMS will impose a $0.50 per side fee for each execution. To reduce user cost and facilitate the use of the NNMS reserve size functionality, a simultaneous and instantaneous execution against an NNMS participant's displayed and reserve size will be treated for billing purposes as a single execution.

[10] This would allow ECNs to access Market Makers through two systems, but would limit dual liability that Market Makers currently face since they will only be receiving orders requiring them to execute from NNMS.

[11] Note that under new NASD Rule 4710(b)(2)(A), the refresh size for a market participant using reserve size is a minimum of 1,000 shares.

[12] *See* NASD Rule 4710(b)(1)(B).

[13] *See* NASD Rule 4710(b)(5).

[14] *See* NASD Rule 4710(b)(6).

[15] *See* NASD Rule 4710(b)(1)(D).

[16] *See* NASD Rule 4710(b)(10).

## ATTACHMENT A

*(Note: Following is the amended rule language.)*

### 4611. Registration as a Nasdaq Market Maker

(a) - (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 Nasdaq National Market Execution System (NNMS) with respect to that security and be subject to the NNMS Rules as set forth in the Rule 4700 Series. Participation in the Small Order Execution System (SOES) shall be voluntary for any Nasdaq Market Maker registered to make a market in a Nasdaq SmallCap security.

(g) No Change

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### 4613. Character of Quotations

(a) Two-Sided Quotations

(1) For each security in which a member is registered as a Market Maker, the member shall be willing to buy and sell such security for its own account on a continuous basis and shall enter and maintain two-sided quotations in The Nasdaq Stock Market, subject to the procedures for excused withdrawal set forth in Rule 4619.

(2) A registered Market Maker in a security listed on The Nasdaq Stock Market must display a quotation size for at least one normal unit of trading (or a larger multiple thereof) when it is not displaying a limit order in compliance with SEC Rule 11Ac1-4, provided, however, that a registered Market Maker may augment its displayed quotation size to display limit orders priced at the Market Maker's quotation.

(b) - (e) No Change

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### 4618. Clearance and Settlement

(a) A Market Maker shall clear and settle transactions in Nasdaq securities through the facilities of a registered clearing agency that uses a continuous net settlement system. This requirement may be satisfied by direct participation, use of direct clearing services, or by entry into a correspondent clearing arrangement with another member that clears trades through such an agency.

(b) Notwithstanding paragraph (a), transactions in Nasdaq securities may be settled "ex-clearing" provided that both parties to the transaction agree.

(c) All transactions through the Nasdaq National Market Execution System, SOES, and SelectNet services 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) - (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 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, the Rules for the Small Order Execution System, as set forth in the Rule 4750 Series, and the Rule 4700 Series governing the Nasdaq's National Market Execution System.

(d) No Change

### 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 a security may not re-register as a Market Maker in that security for twenty (20) business days. Withdrawal from participation as a Market Maker in a Nasdaq National Market security in the Nasdaq National Market Execution System 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 Service and thereby terminates its registration as a Market Maker in Nasdaq National Market and SmallCap issues 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.

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## 4632. Transaction Reporting

(a) - (d) No Change

(e) Transactions Not Required To Be Reported

The following types of transactions shall not be reported:

(1) transactions executed through the Computer Assisted Execution System (CAES), the Nasdaq National Market Execution System (NNMS), or the SelectNet service;

(2) - (6) No Change

(f) No Change

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## 4700. NASDAQ NATIONAL MARKET EXECUTION SYSTEM (NNMS)

## 4701. Definitions

(a) The term "Nasdaq National Market Execution System" or "NNMS" shall mean the automated system owned and operated by The Nasdaq Stock Market, Inc. which enables NNMS participants to execute transactions in active NNMS authorized securities; to have reports of the transactions automatically forwarded to the National Market Trade Reporting System, if required, for dissemination to the public and the industry, and to "lock in" these trades by sending both sides to the applicable clearing corporation(s) designated by NNMS participant(s) for clearance and settlement; and to provide NNMS participants with

sufficient monitoring and updating capability to participate in an automated execution environment.

(b) The term "NNMS participant" shall mean either an NNMS Market Maker or NNMS Order Entry Firm registered as such with the Association for participation in NNMS.

(c) The term "NNMS eligible securities" shall mean designated Nasdaq National Market (NNM) equity securities.

(d) The term "active NNMS securities" shall mean those NNMS eligible securities in which at least one NNMS Market Maker is currently active in NNMS.

(e) The term "NNMS Market Maker" shall mean a member of the Association that is registered as a Nasdaq Market Maker and as a Market Maker for purposes of participation in NNMS with respect to one or more NNMS eligible securities, and is currently active in NNMS and obligated to execute orders for the purchase or sale of an active NNMS security at the Nasdaq inside bid and/or ask price.

(f) The term "NNMS Order Entry Firm" shall mean a member of the Association who is registered as an Order Entry Firm for purposes of participation in NNMS which permits the firm to enter orders of limited size for execution against NNMS Market Makers.

(g) The term "automatic refresh size" shall mean the default size to which an NNMS Market Maker's quote will be refreshed pursuant to NASD Rule 4710(b)(2), if the Market Maker does not designate to Nasdaq an alternative refresh size. The maximum order refresh size default size shall be 1,000 shares.

(h) The term "Automated Confirmation Transaction Service" or "ACT" shall mean the automated system owned and operated by The Nasdaq Stock Market, Inc. which compares trade information entered by ACT participants and submits "locked-in" trades to clearing.

(i) The term "Agency Quote" shall mean the quotation that a registered NNMS Market Maker is permitted to display pursuant to the requirements of NASD Rule 4613(b).

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## 4705. NNMS Participant Registration

(a) Participation in NNMS as an NNMS Market Maker requires current registration as such with the Association. Such registration shall be conditioned upon the NNMS Market Maker's initial and continuing compliance with the following requirements:

(1) execution of an NNMS participant application agreement with the Association;

(2) membership in, or access arrangement with, a clearing agency registered with the Commission which maintains facilities through which NNMS compared trades may be settled;

(3) registration as a Market Maker in The Nasdaq Stock Market pursuant to the Rule 4600 Series and compliance with all applicable rules and operating procedures of the Association and the Commission;

(4) maintenance of the physical security of the equipment located on the premises of the NNMS Market Maker to prevent the

unauthorized entry of information into NNMS; and

(5) acceptance and settlement of each NNMS trade that NNMS identifies as having been effected by such NNMS Market Maker, or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified NNMS trade by the clearing member on the regularly scheduled settlement date.

(b) Pursuant to Rule 4611(f), participation as an NNMS Market Maker is required for any Nasdaq Market Maker registered to make a market in an NNM security.

(c) Participation in NNMS as an NNMS Order Entry Firm requires current registration as such with the Association. Such registration shall be conditioned upon the NNMS Order Entry Firm's initial and continuing compliance with the following requirements:

(1) execution of an NNMS participant application agreement with the Association;

(2) membership in, or access arrangement with, a clearing agency registered with the Commission which maintains facilities through which NNMS compared trades may be settled;

(3) compliance with all applicable rules and operating procedures of the Association and the Commission;

(4) maintenance of the physical security of the equipment located on the premises of the NNMS Order Entry Firm to prevent the unauthorized entry of information into NNMS; and

(5) acceptance and settlement of each NNMS trade that NNMS identifies as having been effected by such NNMS Order Entry Firm or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified NNMS trade by the clearing member on the regularly scheduled settlement date.

(d) The registration required hereunder will apply solely to the qualification of an NNMS participant to participate in NNMS. Such registration shall not be conditioned upon registration in any particular eligible or active NNMS securities.

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

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## 4710. Participant Obligations in NNMS

(a) Registration

Upon the effectiveness of registration as an NNMS Market Maker or NNMS Order Entry Firm, the NNMS participant may commence activity within NNMS for exposure to orders or entry of orders, as applicable. The operating hours of NNMS may be established as appropriate by the Association. The extent of participation in Nasdaq by an NNMS Order Entry Firm shall be determined solely by the firm in the exercise of its ability to enter orders into Nasdaq.

(b) Market Makers

(1) An NNMS Market Maker in an

NNMS Security shall be subject to the following requirements:

(A) For each NNM security in which it is registered as an NNMS Market Maker, the Market Maker must execute individual orders against its quotation including its Agency Quote (if applicable), in an amount equal to or smaller than the combination of the displayed quotation and reserve size of such quotation(s). For purposes of this rule, the term "reserved size" shall mean that an NNMS Market Maker or a customer thereof wishes to display publicly part of the full size of its order or interest with the remainder held in reserve on an undisplayed basis to be displayed in whole or in part as the displayed part is executed. To utilize the reserve size function, a minimum of 1,000 shares must initially be displayed in the Market Maker's quote (including the Agency Quote), and the quotation must be refreshed to 1,000 shares consistent with subparagraph (b)(2)(A) of this rule.

(B) Orders entered into NNMS shall be automatically executed against displayed quotations and reserve size, including Agency Quotes (if applicable), in price/time priority. For quotations at the same price level, NNMS will yield priority to all displayed quotations over reserve size, so that the system will execute against displayed quotations in time priority and then against reserve size in time priority.

(C) The size of a displayed quotation will be decremented upon the execution of an NNMS order in an amount

equal to or greater than one normal unit of trading; provided, however, that the execution of an NNMS order that is a mixed lot (i.e., an order that is for more than a normal unit of trading but not a multiple thereof) will only decrement a displayed quotation's size by the number of shares represented by the number of round lots contained in the mixed lot order.

(D) After NNMS has executed an order against a Market Maker's displayed quote and reserve size (if applicable), that Market Maker shall not be required to execute another order at its bid or offer in the same security until a predetermined time period has elapsed from the time the order was executed, as measured by the time of execution in the Nasdaq system. This period of time shall initially be established as five (5) seconds, but may be modified upon Commission approval and appropriate notification to NNMS participants.

(E) All entries in NNMS shall be made in accordance with the requirements set forth in the NNMS User Guide, as published from time to time by Nasdaq.

(2) Refresh Functionality

(A) Reserve Size Refresh — Once an NNMS Market Maker's displayed quotation size on either side of the market in the security has been decremented to zero due to NNMS executions, Nasdaq will refresh the Market Maker's displayed size out of reserve size to a size-level designated by the NNMS Market Maker, or in the

absence of such size-level designation, to the automatic refresh size. If the Market Maker is using the reserve size function for its proprietary quote or Agency Quote, the Market Maker must refresh to a minimum of 1,000 shares, consistent with subparagraph (b)(1)(A) of this rule.

(B) Autoquote Refresh — Once an NNMS Market Maker's displayed quotation size and reserve size on either side of the market in the security has been decremented to zero due to NNMS executions, the NNMS Market Maker may elect to have The Nasdaq Stock Market refresh the Market Maker's quotation as follows:

(i) Nasdaq will refresh the Market Maker's quotation price on the bid or offer side of the market, whichever is decremented to zero, by an interval designated by the NNMS Market Maker; and

(ii) Nasdaq will refresh the Market Maker's displayed size to a level designated by the NNMS Market Maker, or in the absence of such size level designation, to the automatic refresh size.

A Market Maker's Agency Quotation shall not be subject to the functionality described in this subparagraph.

(3) Except as otherwise provided in subparagraph (b)(10) of this rule, at any time a locked or crossed market, as defined in Rule 4613(e), exists for an NNMS security, a Market Maker with a quotation for that security (including an Agency Quote) that is causing the locked or crossed market may have orders

representing shares equal to the size of the bid or offer that is locked or crossed executed by NNMS against the Market Maker's quote (including an Agency Quote) at the quoted price if that price is the best price. During locked or crossed markets, NNMS will execute orders against those Market Makers that are locked or crossed in predetermined time intervals. This period of time initially shall be established as five (5) seconds, but may be modified upon approval by the Commission and appropriate notification to NNMS participants.

(4) For each NNM security in which a Market Maker is registered, the Market Maker may enter orders into NNMS for its proprietary account as well as on an agency or riskless principal basis.

(5) An NNMS Market Maker may terminate its obligation by keyboard withdrawal (or its equivalent) from NNMS at any time. However, the Market Maker has the specific obligation to monitor its status in NNMS to ensure that a withdrawal has in fact occurred. Any transaction occurring prior to the effectiveness of the withdrawal shall remain the responsibility of the Market Maker.

(6) An NNMS Market Maker will be suspended from NNMS if its bid or offer has been decremented to zero due to NNMS executions and will be permitted a standard grace period, the duration of which will be established and published by the Association, within which to take action to restore a two-sided quotation in the security for at least one normal unit of trading. An NNMS Market Maker that fails

to reenter a two-sided quotation within the allotted time will be deemed to have withdrawn as a Market Maker ("Timed Out of the Box"). Except as provided below in this subparagraph and in subparagraph (b)(7) of this rule, an NNMS Market Maker that withdraws in an NNM security may not re-register as a Market Maker in that security for twenty (20) business days. The requirements of this subparagraph shall not apply to a Market Maker's Agency Quote.

(A) Notwithstanding the above, a Market Maker can be reinstated if:

(i) the Market Maker makes a request for reinstatement to Nasdaq Market Operations as soon as practicable under the circumstances, but within at least one hour of having been Timed Out of the Box, and immediately thereafter provides written notification of the reinstatement request;

(ii) it was a Primary Market Maker at the time it was Timed Out of the Box;

(iii) the Market Maker's firm would not exceed the following reinstatement limitations:

a. for firms that simultaneously made markets in less than 250 stocks during the previous calendar year, the firm can receive no more than four (4) reinstatements per year;

b. for firms that simultaneously made markets in 250 or more but less than 500 stocks during the previous calendar year, the firm can receive no more

than six (6) reinstatements per year;

c. for firms that simultaneously made markets in 500 or more stocks during the previous calendar year, the firm can receive no more than twelve (12) reinstatements per year; and

(iv) the designated Nasdaq officer makes a determination that the withdrawal was not an attempt by the Market Maker to avoid its obligation to make a continuous two-sided market. In making this determination, the designated Nasdaq officer will consider, among other things:

a. whether the market conditions in the issue included unusual volatility or other unusual activity, and/or the market conditions in other issues in which the Market Maker made a market at the time the firm was Timed Out of the Box;

b. the frequency with which the firm has been Timed Out of the Box in the past;

c. procedures the firm has adopted to avoid being inadvertently Timed Out of the Box; and

d. the length of time before the Market Maker sought reinstatement.

(B) If a Market Maker has exhausted the reinstatement limitations in subparagraph (b)(6)(A)(iii) above, the designated Nasdaq officer may grant a reinstatement request if he or she finds that such reinstatement is necessary for

the protection of investors or the maintenance of fair and orderly markets and determines that the withdrawal was not an attempt by the Market Maker to avoid its obligation to make a continuous two-sided market in instances where:

(i) a member firm experiences a documented problem or failure impacting the operation or utilization of any automated system operated by or on behalf of the firm (chronic system failures within the control of the member will not constitute a problem or failure impacting a firm's automated system) or involving an automated system operated by Nasdaq;

(ii) the Market Maker is a manager or co-manager of a secondary offering from the time the secondary offering is announced until ten (10) days after the offering is complete; or

(iii) absent the reinstatement, the number of Market Makers in a particular issue is equal to two (2) or less or has otherwise declined by 50% or more from the number that existed at the end of the prior calendar quarter, except that if a Market Maker has a regular pattern of being frequently Timed Out of the Box, it may not be reinstated notwithstanding the number of Market Makers in the issue.

(7) Notwithstanding the provisions of subparagraph (6) above: (A) an NNMS Market Maker that obtains an excused withdrawal pursuant to Rule 4619 prior to withdrawing from NNMS may reenter NNMS according to the conditions of its withdrawal;

and (B) an NNMS Market Maker that fails to maintain a clearing arrangement with a registered clearing agency or with a member of such an agency, and is thereby withdrawn from participation in ACT and NNMS for NNM securities, may reenter NNMS after a clearing arrangement has been reestablished and the Market Maker has compiled 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.

(8) The Market Operations Review Committee shall have jurisdiction over proceedings brought by Market Makers seeking review of their removal from NNMS pursuant to subparagraphs (b)(6) or (b)(7) of this rule.

(9) In the event that a malfunction in the NNMS Market Maker's equipment occurs, rendering on-line communications with NNMS inoperable, the NNMS Market Maker is obligated to immediately contact Nasdaq Market Operations by telephone to request withdrawal from NNMS and an excused withdrawal from Nasdaq. Such request must be made pursuant to Rule 4619. If withdrawal is granted, Nasdaq Market Operations personnel will enter the withdrawal notification into NNMS from a supervisory terminal. Such manual intervention, however, will take a certain period of time for completion and the NNMS Market Maker will continue to be obligated for any transaction executed prior to the effectiveness of his withdrawal.

(10) In the event that there are no NNMS Market Makers at the best bid (offer) disseminated by Nasdaq, market orders to sell (buy) entered into NNMS will be held in queue until executable, or until 90 seconds has elapsed, after which such orders will be rejected and returned to their respective Order Entry Firms.

(c) NNMS Order Entry Firms

All entries in NNMS shall be made in accordance with the procedures and requirements set forth in the NNMS User Guide. Orders may be entered in NNMS by the NNMS Order Entry Firm through either its Nasdaq terminal or computer interface. The system will transmit to the firm on the terminal screen and printer, if requested, or through the computer interface, as applicable, an execution report generated immediately following the execution.

(d) Order Entry Parameters

(1) NNMS will only accept market and marketable limit orders for execution and will not accept market or marketable limit orders designated as All-or-None ("AON") orders; provided, however, that NNMS will not accept any limit orders, marketable or unmarketable, prior to 9:30 a.m., Eastern Time. For purposes of this subparagraph, an AON order is an order for an amount of securities equal to the size of the order and no less.

(2) Additionally, NNMS will only accept orders that are unpreferenced, thereby resulting in execution in rotation against NNMS Market Makers, and will not accept preferenced orders.

(3) NNMS will not accept orders that exceed 9,900 shares, and no participant in NNMS shall enter

an order into the system that exceeds 9,900.

(e) Electronic Communication Networks

An Electronic Communications Networks, as defined in SEC Rule 11Ac1-1(a)(8), may participate in NNMS if it complies with NASD Rule 4623 and executes with the Association a Nasdaq Workstation Subscriber Agreement, as amended, for ECNs.

## 4711. Clearance and Settlement

All transactions executed in NNMS shall be cleared and settled through a registered clearing agency using a continuous net settlement system.

## 4712. Obligation to Honor System Trades

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

## 4713. Compliance with Rules and Registration Requirements

Failure by an NNMS participant to comply with any of the rules or registration requirements applicable to NNMS identified herein shall subject such NNMS participant to censure, fine, suspension or revocation of its registration as an NNMS Market Maker and/or Order Entry Firm or any other fitting penalty under the Rules of the Association.

## 4714. Fees Applicable to NNMS

(a) A fee for orders executed through NNMS shall be assessed, to be allocated as follows: the NNMS Market Maker executing the order shall be assessed $0.50 per transaction and the NNMS Order Entry Firm or NNMS Market Maker entering the order shall be assessed $0.50 per order.

(b) For each order entered by an NNMS Order Entry Firm or an NNMS Market Maker that is canceled, the NNMS Order Entry Firm or NNMS Market Maker that cancels such order shall be assessed a fee of $0.25.

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## 4720. SelectNet Service

(a) Cancellation of a SelectNet Order

No member shall cancel or attempt to cancel an order, whether preferenced to a specific Market Maker or electronic communications network, or broadcast to all available members, until a minimum time period of ten (10) seconds has expired after the order to be canceled was entered. Such ten (10) second time period, shall be measured by the Nasdaq processing system processing the SelectNet order.

(b) Prohibition Regarding The Entry of Conditional Orders

No member shall enter an order into SelectNet that is preferenced to an electronic communications network covered by Rule 4623 that has any conditions regarding responses to the order, e.g . preferenced SelectNet orders sent to electronic communications networks shall not be All-or-None, or subject to minimum execution size above a normal unit of trading, or deemed non-negotiable.

(c) Prohibition Regarding the Entry of Certain Preferenced Orders to Nasdaq National Market Execution System Market Makers

No member may direct a SelectNet preferenced order to a Nasdaq National Market Execution System ("NNMS") Market Maker (as defined in NASD Rule 4701) including that Market Maker's Agency Quote (as defined in NASD Rule 4613) unless that order is designated as:

(1) an "All-or-None" order ("AON") and is at least one normal unit of trading (i.e. 100 shares) in excess of the displayed quote to which the preferenced order is directed; or

(2) a "Minimum Acceptable Quantity" order ("MAQ"), with a MAQ value of at least one normal unit of trading in excess of the displayed quote to which the preferenced order is directed.

The prohibition of this paragraph shall not apply to preferenced orders sent by a UTP Specialist to an NNMS Market Maker or to preferenced orders sent by an NNMS Market Maker to a UTP Specialist. For purposes of this rule a "UTP Specialist" shall mean a broker/dealer registered as a specialist in Nasdaq securities pursuant to the rules of an exchange that is a signatory to 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 Exchanges On An Unlisted Trading Privilege Basis ("Nasdaq/NMS/UTP Plan").

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## 4750. SMALLCAP SMALL ORDER EXECUTION SYSTEM (SOES)

## 4751. Definitions

(a) The term "Small Order Execution System" or "SOES" shall mean the automated system owned and operated by The Nasdaq Stock Market, Inc. which enables SOES participants to execute transactions of limited size in active SOES authorized securities (i.e., Nasdaq SmallCap securities); to have reports of the transactions automatically forwarded to Nasdaq for dissemination to the public and the industry, and to "lock in" these trades by sending both sides to the applicable clearing corporation(s) designated by the SOES participant(s) for clearance and settlement; and to provide SOES participants with sufficient monitoring and updating capability to participate in an automated execution environment.

(b) The term "SOES participant" shall mean either a SOES Market Maker or SOES Order Entry Firm registered as such with the Association for participation in SOES.

(c) The term "SOES eligible securities" shall mean all Nasdaq SmallCap securities.

(d) The term "active SOES securities" shall mean those SOES eligible securities in which at least one SOES Market Maker is currently active in SOES.

(e) The term "SOES Market Maker" shall mean a member of the Association that is registered as a Nasdaq Market Maker and as a Market Maker for purposes of participation in SOES with respect to one or more SOES eligible securities, and is currently active in SOES and obligated to execute

orders for the purchase or sale of an active SOES security at the Nasdaq inside bid and/or ask price.

(f) The term "SOES Order Entry Firm" shall mean a member of the Association who is registered as an Order Entry Firm for purposes of participation in SOES which permits the firm to enter orders of limited size for execution against SOES Market Makers.

(g) The term "maximum order size" shall mean the maximum size of individual orders for a security that may be entered into or executed through SOES. The maximum order size for each security shall be published from time to time by the Association. In establishing the maximum order size for each SmallCap security, the Association will give consideration to the average daily non-block volume, bid price, and number of Market Makers for each security. Maximum order size for Nasdaq SmallCap securities shall be 500 shares and may be adjusted on an issue by issue basis, depending upon unique characteristics of the issue as determined by the Association.

(h) The term "agency order" shall mean public customer orders which are executed by the SOES Order Entry Firm on an agency basis. It shall also include, for purposes of these rules, an order entered into SOES on a principal basis by a SOES Order Entry Firm that is not a Market Maker in the SOES security, in SOES or otherwise, where the SOES Order Entry Firm has contemporaneously received an order from a customer and executes the transaction on a riskless principal basis.

(i) The term "Automated Confirmation Transaction Service" or "ACT" shall mean the automated system owned and operated by The Nasdaq Stock Market, Inc. which compares trade information entered by ACT participants and submits "locked-in" trades to clearing.

## 4752. SOES Participant Registration

(a) Participation in SOES as a SOES Market Maker requires current registration as such with the Association. Such registration shall be conditioned upon the SOES Market Maker's initial and continuing compliance with the following requirements:

(1) execution of a SOES participant application agreement with the Association;

(2) membership in, or access arrangement with, a clearing agency registered with the Commission which maintains facilities through which SOES compared trades may be settled;

(3) registration as a Market Maker in The Nasdaq Stock Market pursuant to the Rule 4600 Series and compliance with all applicable rules and operating procedures of the Association and the Commission;

(4) maintenance of the physical security of the equipment located on the premises of the SOES Market Maker to prevent the unauthorized entry of information into SOES; and

(5) acceptance and settlement of each SOES trade that SOES identifies as having been effected by such SOES Market Maker, or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified SOES trade by the clearing member on the regularly scheduled settlement date.

(b) Pursuant to Rule 4611(f), participation as a SOES Market Maker shall be voluntary for any Nasdaq Market Maker registered to make a market in a Nasdaq SmallCap security.

(c) Participation in SOES as a SOES Order Entry Firm requires current registration as such with the Association. Such registration shall be conditioned upon the SOES Order Entry Firm's initial and continuing compliance with the following requirements:

(1) execution of a SOES participant application agreement with the Association;

(2) membership in, or access arrangement with, a clearing agency registered with the Commission which maintains facilities through which SOES compared trades may be settled;

(3) compliance with all applicable rules and operating procedures of the Association and the Commission;

(4) maintenance of the physical security of the equipment located on the premises of the SOES Order Entry Firm to prevent the unauthorized entry of information into SOES; and

(5) acceptance and settlement of each SOES trade that SOES identifies as having been effected by such SOES Order Entry Firm or if settlement is to be made through another clearing member, guarantee of the acceptance and settlement of such identified SOES trade by the clearing member on the regularly scheduled settlement date.

(d) The registration required hereunder will apply solely to the

qualification of a SOES participant to participate in SOES. Such registration shall not be conditioned upon registration in any particular eligible or active SOES securities.

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

## 4753. Participant Obligations in SOES

(a) Registration

Upon the effectiveness of registration as a Market Maker or SOES Order Entry Firm, the SOES participant may commence activity within SOES for exposure to orders or entry of orders, as applicable. The operating hours of SOES may be established as appropriate by the Association. A SOES Market Maker may withdraw from and reenter SOES at any time, and without limitations, during the operating hours of SOES. The extent of participation in Nasdaq by a SOES Order Entry Firm shall be determined solely by the firm in the exercise of its ability to enter orders into Nasdaq.

(b) Market Makers

(1) A SOES Market Maker shall commence participation in SOES by initially contacting the Nasdaq Market Operations Center to obtain authorization for the trading of a particular SOES security and identifying those terminals on which the SOES information is to be displayed and thereafter by an appropriate keyboard entry which obligates the firm, so long as it remains a Market Maker in SOES:

(A) to execute individual preferenced SOES orders equal to or smaller than the applicable maximum order size at the best bid or offer as disseminated by Nasdaq in any security for which it is a SOES Market Maker; and

(B) to execute individual unpreferenced SOES orders equal to or smaller than the Market Maker's displayed quotation size when the Market Maker's quotation is at the best bid or offer as disseminated by Nasdaq, and, when the Market Maker's quotation is inferior to the best bid or offer as disseminated by Nasdaq, to execute individual unpreferenced SOES orders up to the lessor of the Market Maker's displayed quotation size or the smallest quotation size of all the Market Makers whose quotations are at the best bid or offer as disseminated by Nasdaq.

A SOES Market Maker's displayed quotation size will be decremented upon the execution of an unpreferenced SOES order equal to or greater than one normal unit of trading; provided, however, that the execution of an unpreferenced SOES order that is a mixed lot (i.e., an order that is for more than a normal unit of trading but not a multiple thereof) will only decrement the SOES Market Maker's displayed quotation size by the number of shares represented by the number of round lots contained in the mixed lot order. After SOES has executed an order against a Market Maker, that Market Maker shall not be required to execute another unpreferenced order at the same bid or offer in the same security until a predetermined time period has elapsed from the time the order was executed, as measured by the time of execution in the Nasdaq system, provided the Market Maker has not updated its quotation (bid, offer, or size) within such time period, in which case the Market Maker will become immediately eligible to receive another execution of an unpreferenced order. This period of time shall initially be established as 17 seconds, but may be modified upon Commission approval and appropriate notification to SOES participants. All entries in SOES shall be made in accordance with the requirements set forth in the SOES User Guide.

(2) For each security in which the Market Maker is registered, the Market Maker may elect to have The Nasdaq Stock Market refresh its quotation automatically by an interval designated by the Market Maker, once its displayed quotation size on either side of the market in the security has been decremented to zero due to SOES executions. The Nasdaq Stock Market will refresh the Market Maker's quotation on the bid or offer side of the market, whichever is decremented to zero, by the interval designated, and will establish the Market Maker's displayed size to the maximum order size for that security; provided, however, that a Market Maker may elect to have The Nasdaq Stock Market refresh its bid or offer at the same price if the Market Maker's quotation size prior to any decrementation was equal to or greater than the maximum SOES order size for the security.

(3) Except as otherwise provided in subparagraph (10) below, at any time a locked or crossed market, as defined in Rule

4613(e), exists for a SmallCap security, SOES will execute orders against the quotations of SOES Market Makers at the inside price and in an amount equal to or smaller than the Market Maker's displayed quotation size. Those orders will be executed irrespective of any preference indicated by the Order Entry Firm. During locked or crossed markets, SOES will execute orders against those Market Makers that are locked or crossed in predetermined time intervals. This period of time initially shall be established as five (5) seconds, but may be modified upon necessary Commission approval and appropriate notification to SOES participants.

(4) For each security in which a Market Maker is registered, the Market Maker may not enter orders into SOES for its proprietary account, but may enter orders on an agency or riskless principal basis into SOES. As used in this context, "riskless principal" means an order on a principal basis entered into SOES on behalf of a customer by a Market Maker and which otherwise meets the requirements of the term "riskless principal" as used in Rule 4632(d)(3)(B).

(5) The Market Maker may terminate its obligation by keyboard withdrawal (or its equivalent) from SOES at any time. However, the Market Maker has the specific obligation to monitor its status in SOES to ensure that a withdrawal has in fact occurred. Any transaction occurring prior to the effectiveness of the withdrawal shall remain the responsibility of the Market Maker. A Market Maker for which the bid or offer

has been decremented to zero due to SOES executions and that does not reenter a quotation by the close of business on the day its quotation is decremented shall be deemed to have withdrawn as a Market Maker in the security and precluded from re-registering in that security for twenty (20) business days pursuant to NASD Rule 4620.

(6) A Market Maker that fails to reenter a two-sided quotation in a SmallCap security within the allotted time will be deemed to have withdrawn as a Market Maker ("SOESed out of the Box"). Except as provided below in this subparagraph and in subparagraph (7), a Market Maker that withdraws in a SmallCap security may not re-register as a Market Maker in that security for twenty (20) business days.

(A) Notwithstanding the above, a Market Maker can be reinstated if:

(i) the Market Maker makes a request for reinstatement to Market Operations as soon as practicable under the circumstances, but within at least one hour of having been SOESed out of the Box, and immediately thereafter provides written notification of the reinstatement request;

(ii) the Market Maker's firm would not exceed the following reinstatement limitations:

a. for firms that simultaneously made markets in less than 250 stocks during the previous calendar year, the firm can receive no more than four (4) reinstatements per year;

b. for firms that simultaneously made markets in 250 or more but less than 500 stocks during the previous calendar year, the firm can receive no more than six (6) reinstatements per year;

c. for firms that simultaneously made markets in 500 or more stocks during the previous calendar year, the firm can receive no more than twelve (12) reinstatements per year; and

(iii) the designated Nasdaq officer makes a determination that the withdrawal was not an attempt by the Market Maker to avoid its obligation to make a continuous two-sided market. In making this determination, the designated Nasdaq officer will consider, among other things:

a. whether the market conditions in the issue included unusual volatility or other unusual activity, and/or the market conditions in other issues in which the Market Maker made a market at the time of the SOES exposure limit exhaustion;

b. the frequency with which the firm has been SOESed out of the Box in the past;

c. procedures the firm has adopted to avoid being inadvertently SOESed out of the Box; and

d. the length of time before the Market Maker sought reinstatement.

(B) If a Market Maker has exhausted the reinstatement limitations in subparagraph (b)(6)(A)(ii) above, the designated Nasdaq officer may grant a reinstatement request if he or she finds that such reinstatement is necessary for the protection of investors or the maintenance of fair and orderly markets and determines that the withdrawal was not an attempt by the Market Maker to avoid its obligation to make a continuous two-sided market in instances where:

(i) a member firm experiences a documented problem or failure impacting the operation or utilization of any automated system operated by or on behalf of the firm (chronic system failures within the control of the member will not constitute a problem or failure impacting a firm's automated system) or involving an automated system operated by Nasdaq;

(ii) the Market Maker is a manager or co-manager of a secondary offering from the time the secondary offering is announced until ten (10) days after the offering is complete; or

(iii) absent the reinstatement, the number of market makers in a particular issue is equal to two (2) or less or has otherwise declined by 50% or more from the number that existed at the end of the prior calendar quarter, except that if a Market Maker has a regular pattern of being frequently SOESed out of the Box, it may not be reinstated notwithstanding the number of Market Makers in the issue.

(7) Notwithstanding the provisions of subparagraph (6) above: (A) a Market Maker that obtains an excused withdrawal pursuant to Rule 4619 prior to withdrawing from SOES may reenter SOES according to the conditions of its withdrawal; and (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 is thereby withdrawn from participation in ACT and SOES, may reenter SOES after a clearing arrangement has been reestablished and the Market Maker has compiled with ACT participant requirements. 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.

(8) The Market Operations Review Committee shall have jurisdiction over proceedings brought by Market Makers seeking review of their removal from SOES pursuant to subparagraphs (5), (6), or (7) above.

(9) In the event that a malfunction in the Market Maker's equipment occurs, rendering on-line communications with SOES inoperable, the SOES Market Maker is obligated to immediately contact the Nasdaq Market Operations Center by telephone to request withdrawal from SOES and an excused withdrawal from Nasdaq. Such request must be made pursuant to Rule 4619. If withdrawal is granted, Nasdaq Market Operations personnel will enter the withdrawal notification into SOES from a supervisory terminal. Such manual

intervention, however, will take a certain period of time for completion and the SOES Market Maker will continue to be obligated for any transaction executed prior to the effectiveness of its withdrawal.

(10) In the event that there are no SOES Market Makers at the best bid (offer) disseminated by Nasdaq, market orders to sell (buy) entered into SOES will be held in queue until executable, or until 90 seconds has elapsed, after which such orders will be rejected and returned to their respective Order Entry Firms.

(c) SOES Order Entry Firms

(1) All entries in SOES shall be made in accordance with the procedures and requirements set forth in the SOES User Guide. Orders may be entered in SOES by the SOES Order Entry Firm through either its Nasdaq terminal or computer interface. The system will transmit to the firm on the terminal screen and printer, if requested, or through the computer interface, as applicable, an execution report generated immediately following the execution.

(2) SOES will only accept market and marketable limit orders for execution and will not accept market or marketable limit orders designated as All-or-None ("AON") orders; provided, however, that SOES will not accept any limit orders, marketable or unmarketable, prior to 9:30 a.m., Eastern Time. For purposes of this subparagraph, an AON order is an order for an amount of securities equal to the size of the order and no less. Orders may be preferenced to a specific SOES Market Maker or may be

unpreferenced, thereby resulting in execution in rotation against SOES Market Makers. A Market Maker may indicate Order Entry Firms from which it agrees to accept preferenced orders. If an order is received by a Market Maker from an Order Entry Firm from which it has not agreed to accept preferencing, the order will be executed at the inside market on an unpreferenced basis and will be subject to a period of time between executions for Market Makers to update their quotations.

(3) Only agency orders no larger than the maximum order size, as defined herein, received from public customers may be entered by a SOES Order Entry Firm into SOES for execution against a SOES Market Maker. Agency orders in excess of the maximum order size may not be divided into smaller parts for purposes of meeting the size requirements for orders entered into SOES.

(4) No member or person associated with a member shall utilize SOES for the execution of agency orders in a security in which the member is a Nasdaq Market Maker but is not a SOES Market Maker.

## 4754. Clearance and Settlement

All transactions executed in SOES shall be cleared and settled through a registered clearing agency using a continuous net settlement system.

## 4755. Obligation to Honor System Trades

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

## 4756. Compliance with Rules and Registration Requirements

Failure by a SOES participant to comply with any of the rules or registration requirements applicable to SOES identified herein shall subject such SOES participant to censure, fine, suspension or revocation of its registration as a SOES Market Maker and/or Order Entry Firm or any other fitting penalty under the Rules of the Association.

## 4757. Fees Applicable to SOES

(a) A fee for orders executed through SOES shall be assessed, to be allocated as follows: the SOES Market Maker executing the order shall be assessed $0.50 per transaction and the SOES Order Entry Firm or SOES Market Maker entering the order shall be assessed $0.50 per order.

(b) For each order entered by a SOES Order Entry Firm or a SOES Market Maker that is canceled, the SOES Order Entry Firm or SOES Market Maker that cancels such order shall be assessed a fee of $0.25.

## ATTACHMENT B

### Questions And Answers

**1.** When will the rule changes take effect and NNMS begin operation?

**A.** The rule changes and NNMS are scheduled for implementation on July 10, 2000.

### Technical Issues

**2.** Will there be instructions for setting up the new trading functionality?

**A.** Yes. SelectNet, NNMS, and SOES user guides are being prepared. These user guides will be available to all subscribers describing new features and how to setup NWII. The guides will be published on:
*www.nasdaqtrader.com*.

**3.** How will market participants enter orders into NNMS?

**A.** Nasdaq will release a new version of NWII which will allow users to enter orders from NWII SOES windows rather than using NWII Harris screens.  You can also use automated order-entry and management systems to facilitate trading operations via Application Programming Interface (API) or Computer-to-Computer Interface (CTCI) interfaces.

**4.** What changes will be required for CTCI and API to accommodate SOES/SelectNet?

**A.** Generally other than larger-sized orders and executions, there are no CTCI format changes for the SOES/SelectNet modifications. An API for SOES was published in November 1999 to allow firms access through the API as well as CTCI. Software producers and in-house systems will have to change

how they access the market to take advantage of the new rules. Testing is currently available for API and CTCI interfaces.

### Pricing

**5.** Can you explain the fee structures for NNMS and SelectNet?

**A.** The fee structures for NNMS, SelectNet, and SmallCap SOES are designed to benefit market participants that provide liquidity to the market, and charge a fair price to those that access liquidity. To reinforce that policy, the pricing for automatic executions in NNMS and SmallCap SOES will be changed to parallel the current SelectNet pricing structure. Unlike the past, Nasdaq will not charge a fee to a market participant that is executed against by NNMS and SmallCap SOES (*i.e.*, the liquidity provider).

SelectNet trades of all Nasdaq securities will be priced as follows:

* $.70 per order executed for the first 25,000 liability orders monthly;

* $.50 per order executed for the next 25,000 liability orders;

* $.10 per order executed for all remaining liability orders; and

* $.90 per order executed for all non-liability orders.

NNMS trades of National Market securities and SOES trades of SmallCap securities will be priced as follows:

* $.50 per order executed for the first 150,000 orders under 2,000 shares monthly;

* $.30 per order executed for all remaining orders under 2,000 shares;

* $.90 per order executed for orders over 2,000 shares; and

* free for executions received.

### Trading Issues

**6.** If I am a market participant that currently does not have access to SOES, how do I obtain order entry capability in NNMS?

**A.** A market participant that does not have access to SOES, but would like access to NNMS should contact Nasdaq Subscriber Services at (800) 777-5606.

**7.** Is participation in NNMS mandatory for Market Makers?

**A.** Yes. Participation in NNMS (*i.e.*, automatic execution) is mandatory for broker/dealers that are registered as Market Makers in a Nasdaq National Market security, similar to SOES today. Participation in SmallCap SOES will continue to be voluntary. Participation in NNMS is voluntary for UTP Exchanges, ECNs, and alternative trading systems (ATS).

**8.** How will market participants access Market Maker quotes?

**A.** All registered broker/dealers, ECNs, and ATSs may enter orders into NNMS for automatic execution to access Market Maker quotes. Additionally, a market participant may be able to access ECN and UTP Exchange quotes, based on the method that these participants choose to participate in Nasdaq. Specifically, some ECNs have expressed interest in participating in an automatic-execution environment. If they choose to do so, they will be automatically executed against based upon their displayed and reserve size. Additionally, Nasdaq is also discussing with UTP Exchanges the

possibility that they will accept automatic execution as well. Nasdaq will keep the membership apprised of the result of these discussions.

Any ECN/ATS that notifies Nasdaq that it will accept SOES executions will have a fifth-character identifier of "+" when it begins trading in the automatic-execution environment. Since the implementation of the SEC Order Handling Rules, all ECNs/ATSs have had a fifth-character identifier of "#"; ECNs/ATSs that do not participate in "SuperSOES" will continue to display a "#". A UTP may have a "#" appended as the fifth character if it does not participate in the automatic-execution environment.

**9.** How will market participants access ECNs' quotes when they are at the inside?

**A.** ECNs will have the choice of having their quotes accessed through SelectNet as they do today or through the automatic execution functionality of NNMS. ECNs that choose to accept automatic execution ("Full Participant ECNs" with the "+" indicator) will be accessible through NNMS. Order Entry ECNs (*i.e.*, ECNs that do not accept automatic execution against their quote and continue to display the "#" indicator) will be accessible through a SelectNet liability order.

**10.** Are Market Makers and other broker/dealers permitted to enter proprietary orders into NNMS?

**A.** Yes. Since NNMS will be the only method for sending liability orders to Market Makers and market participants that take automatic execution through NNMS, all Nasdaq market participants may enter proprietary orders in NNMS.

The prohibition on entering proprietary orders as described in *NASD Notice to Members 88-61* will continue to apply in the Nasdaq SmallCap SOES.

**11.** Is there a prohibition on splitting up orders as existed in SOES?

**A.** No. The prohibition against splitting up orders has been removed. Although a market participant may only enter orders of up to 9,900 shares into the NNMS, this is a system constraint. A market participant is not prohibited from entering an order into the NNMS that is greater than 9,900 shares by splitting up the order into multiples of 9,900 shares. For example, if a market participant wished to enter an order for 15,000 shares into the system, the market participant could enter a 9,000 share order and 6,000 share order into the NNMS.

The prohibition on splitting up of orders as described in *NASD Notice to Members 88-61* will continue to apply in the Nasdaq SmallCap SOES.

**12.** Is dual liability being eliminated?

**A.** In most circumstances, yes. Dual liability may result if a market participant receives an order through SelectNet to which it owes liability under the SEC and NASD firm quote rules and immediately thereafter receives an execution against its quote through SOES. Nasdaq is eliminating most instances of dual liability in NNM securities by requiring market participants to send over-sized, conditioned SelectNet messages to Market Makers and any other market participants that participate in the automatic execution functionality of NNMS. Thus, dual liability will be virtually eliminated.

The over-sized, conditioned order requirement does not apply to OptiMark orders and to UTP Exchanges if that UTP Exchange does not take automatic execution via NNMS. Thus, Market Makers may continue to receive liability SelectNet orders from these two entities.

**13.** If a Market Maker receives a SelectNet liability order from a UTP Exchange, is there still the potential for dual liability?

**A.** Yes, depending on the sequence in which the auto-ex notification and the SelectNet liability order are received. If the auto-ex notification is received prior to the SelectNet order, the SelectNet order can be declined. As noted above, however, Nasdaq is working with UTP Exchanges to incorporate them into NNMS auto-ex function. This would eliminate dual liability from UTP Exchange orders.

**14.** Are there any changes affecting SmallCap stocks?

**A.** With the exception of the pricing structure described above, trading of SmallCap securities will not change. Market participants will use SOES and SelectNet as they do today, maximum order sizes will remain as they are today, and order-splitting and the entry of proprietary orders will still be prohibited.

**15.** If there are 10 Market Makers at the inside, how can a market participant trade 20,000 shares, and will there be a delay in execution?

**A.** It would take at least three orders, given the new maximum order size of 9,900. If these are the only orders entered against the 10 Market Makers, you would execute against all 10 Market Makers up to

the total of their displayed and reserve sizes. If these orders are competing with other orders in time sequence, they may get some, all, or none of what is entered, based on the time priority of the orders, and what the 10 Market Makers had as their displayed and reserve size. In addition, there is a five-second interval delay between executions against the same Market Maker at the same price.

**16.** Will firms' obligations regarding the entry of locking/crossing quotes during normal market hours, as set out in NASD Rule 4613(e), change when NNMS is implemented?

**A.** While the obligations under NASD Rule 4613(e) do not change, the mechanism for complying with the rule changes slightly because SelectNet will no longer be used to send liability orders to Market Makers.

More specifically, as Nasdaq and NASD Regulation have stated previously, a market participant must use reasonable means to avoid locking/crossing the market during market hours. "Reasonable means" has been interpreted previously to include sending a preferred SelectNet order(s) to the firm(s) that would be locked/crossed at the bid or offer price. *See NASD Notice to Members 97-49*. In light of the changes to SelectNet, the market participant will first have to determine how the party (or parties) it will lock/cross is eligible to receive "liability orders" and then send the order(s) to the party (or parties) through the appropriate Nasdaq system or systems — NNMS, SelectNet, or both. For example, if MMA would lock/cross a single or multiple Market Makers, it would be consistent with NASD Rule 4613(e)

for MMA to send orders through NNMS, since the Market Makers are subject to automatic execution. Similarly, if MMA would lock/cross a single or multiple ECNs that do not participate in automatic execution, it would be consistent with NASD Rule 4613(e) for MMA to send a SelectNet preferred order to the ECN(s) because ECNs are able to receive liability orders only through SelectNet. If MMA would lock/cross a combination of Market Makers and ECNs that do not participate in automatic execution, it would be consistent with NASD Rule 4613(e) for MMA to send orders through both the NNMS and SelectNet systems. It would not be consistent with the NASD Rule 4613(e) for MMA to send a preferred order through SelectNet if MMA were locking/crossing a Market Maker since the Market Maker would owe no liability to the SelectNet message, nor would it be consistent with NASD Rule 4613(e) for MMA to send an order into NNMS if MMA were locking an ECN that is not subject to automatic execution.

**17.** Does a Market Maker's obligations under the SEC Limit Order Display Rule (SEC Rule 11Ac1-4) change in instances where a Market Maker receives a customer limit order that would locks/crosses the market?

**A.** Similar to Question 16, while the obligations do not change, the mechanism for complying with the obligation varies slightly. Under the SEC Limit Order Display Rule, a Market Maker must display an eligible limit order as soon as practicable, but no later than 30 seconds after receipt under normal market conditions. The Commission has stated, however, that if a limit order that would lock/cross the market is marketable against

another firm's quote, "the Market Maker may attempt to execute the order against that quote prior to displaying the order. For example, a Market Maker may send a SelectNet message to the Market Maker or ECN displaying the existing quote. Although attempting to execute against the quote may result in the display of the customer limit order more than 30 seconds after receipt, the Division believes that such action would not violate the Limit Order Display Rule's immediacy requirement." *See* Letter from Richard Lindsey, Director, Division of Market Regulation, SEC, to Joseph Hardiman, President, NASD, dated November 22, 1996.

Thus, before displaying a limit order that would lock/cross the market, the Market Maker may attempt to execute the order against the quote that it would lock/cross. As noted in Question 16, since certain market participants are not eligible to receive liability orders through SelectNet, the market participant will first have to determine how the party or parties it will lock/cross is eligible to receive "liability orders" and send the order(s) into the appropriate Nasdaq system or systems — NNMS, SelectNet, or both.

**18.** Will odd-lot processing be included in the new system?

**A.** Yes. In the NNMS, odd lots will be processed against only those Market Makers that are at the inside bid or offer, in round-robin fashion. An odd-lot execution does not decrement a Market Maker's quote. If, however, a Market Maker has reserve size in the system, an odd-lot execution will decrement the reserve size held in Nasdaq. The system cannot decrement displayed quotes in Nasdaq,

because Nasdaq can only display round lots (*i.e.*, 100 shares or multiples thereof). Since reserve size is not displayed in the Nasdaq Quotation Montage, but rather is held within the system, it is possible to decrement reserve size by the amount of an odd-lot execution.