NASD Notice to Members 99-21

The Nasdaq Stock Market Eliminates The SOES Five-Minute Presumption

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Executive Summary

On January 13, 1999, The Nasdaq Stock Market, Inc. (Nasdaq®), filed a rule change with the Securities and Exchange Commission (SEC or Commission) that would eliminate the single investment decision aggregation presumption for Small Order Execution System℠ (SOES℠) orders entered within five minutes of each other contained in National Association of Securities Dealers, Inc. (NASD®) *Notice to Members 88-61*.[1] The elimination of the presumption is effective immediately.

Questions regarding the elimination of the five-minute presumption should be directed to Robert E. Aber, Senior Vice President and General Counsel, Office of General Counsel, The Nasdaq Stock Market, at (202) 728-8290; or Thomas P. Moran, Assistant General Counsel, Office of General Counsel, The Nasdaq Stock Market, at (202) 728-8401.

Background And Summary

SOES was developed in 1984 to provide a simple and efficient means to execute the small agency orders of public customers at the inside quote. Trading is done automatically and is negotiation-free. SOES participation is mandatory for all Market Makers in Nasdaq National Market® securities and each Nasdaq issue is assigned a maximum SOES order share size limit of either 200, 500, or 1,000 shares which is determined by the particular trading characteristics of that security.

NASD Rule 4730(c)(3) prohibits the splitting of orders larger than the applicable SOES maximum share size order limit into smaller parts so as to make any of those smaller parts eligible for entry into SOES. For example, it is a violation of NASD rules to break up a 5,000-share order for a Nasdaq security having a 1,000-share SOES order entry limit into five separate 1,000-share segments and then enter each of those five 1,000-share segments into SOES. Likewise, the splitting of a 5,000-share order into a 4,000-share SelectNet℠ order and a 1,000-share SOES order would, in Nasdaq's view, also violate the prohibition on order splitting.

In *Notice to Members 88-61*, the NASD, interpreting Rule 4730(c)(3), established a presumption that orders entered within five minutes of each other into any Nasdaq system were based on a single investment decision and that the share amounts purchased or sold by those trades were to be aggregated together to determine if the orders, when combined, violated Rule 4730's limits on SOES usage.

On January 13, 1999, Nasdaq filed a proposed rule change to eliminate the single investment decision aggregation presumption. Nasdaq eliminated the presumption in response to SEC concerns raised in communications with Nasdaq staff and NASD senior management about various aspects of the presumption including what the Commission perceived as the lack of guidelines as to how the presumption could ever be rebutted.[2] The Commission also questioned the continued use of such a presumption given the advent of the Actual Size Rule (ASR). The ASR now allows Market Makers to display the actual size of their trading interest in their quotes and replaced previous mandates that Market Makers display a minimum share size equal to the SOES order size of the quoted security.

Given the SEC's concerns about the practicability of rebutting the presumption, and the ASR's removal of artificial mandatory minimum quote increments which now increase the ability of Market Makers to manage their exposure to automatic order execution, Nasdaq has determined to eliminate the presumption.

While eliminating the single investment decision presumption, it is important to note that the restrictions on splitting up larger orders to obtain SOES access contained in NASD Rule 4730(c)(3) remain in effect and, if violated, may still serve as the basis for disciplinary action by NASD Regulation, Inc. The elimination of the presumption changes only the procedures for enforcing the rule, and makes no changes to the rule's substantive mandates. In short, the splitting of larger orders into smaller parts to obtain SOES access remains prohibited.

Endnotes

[1] *See* SEC Release No. 34-41015 (February 3, 1999), 64 FR 6415 (February 9, 1999).

[2] Letter from Richard R. Lindsey, Director, United States Securities and Exchange Commission, to Robert E. Aber, Vice President and General Counsel, The Nasdaq Stock Market, Inc. dated June 16, 1997.