

NASD NOTICE TO MEMBERS 96-65

New SEC Rules On Order Handling And Execution Of Customer Orders

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Executive Summary

On August 29, 1996, the Securities and Exchange Commission (SEC) adopted significant market structure rules under the Securities Exchange Act of 1934 (Act) involving the handling and execution of customer limit orders. This *Notice to Members* is being issued to alert members to these important changes by providing a general description of the new rules and a complete copy of the SEC release as published in the *Federal Register*. Members are urged to review the SEC release to determine exactly how the rules affect them, paying specific attention to the SEC discussion on best execution, which is summarized at the end of this Notice.

The changes include a new rule, SEC Rule 11Ac1-4 (Display Rule), governing the display of limit orders that will require market makers to display in their quote, the price and full size of customer limit orders, and several amendments to SEC Rule 11Ac1-1 (Quote Rule), including: (1) the requirement that market makers display in their quote any better priced orders that the market maker places into an electronic communications network (ECN) such as SelectNet or Instinet, unless an alternative provided by the rule is available; (2) mandatory market-maker registration in exchange-listed securities for market makers that account for one percent or more of the trading volume in any such security; and (3) an expanded definition of the term *OTC Market Maker* to include broker/dealers that internalize order flow or hold themselves out only to particular firms.

The Quote Rule amendments will become effective January 10, 1997. The Display Rule requirements will be phased-in beginning January 10, 1997, according to the implementation schedule included at the end of this Notice.

Questions about this Notice may be directed to the Office of General Counsel, The Nasdaq Stock Market, at (202) 728-8294.

Limit-Order Display Rule

New SEC Rule 11Ac1-4 will require the display of customer limit orders: (1) that are priced better than a market maker's quote; or (2) that add to the size associated with a market maker's quote when the market maker is at the best price in the market.

For example, if a market maker's quote in stock ABCD is 10 - 10 1/4 (1000 x 1000) and the market maker accepts a customer limit order to buy 200 shares at 10 1/8, the market maker must update its quote to 10 1/8 - 10 1/4 (200 x 1000).

Market makers also must increase the size of their quotes if they receive a customer limit order priced at their quote and their quote is at the national best bid or offer (NBBO). For example, if a market maker receives a limit order to buy 200 shares of ABCD at 10 when its quote in ABCD is 10 - 10 1/4 (1000 x 1000) and the NBBO for ABCD is 10 - 10 1/8, the market maker must update its quote to 10 - 10 1/4 (1200 x 1000). However, if the customer's limit order was of *de minimis* size in comparison to the market maker's displayed quote size, the market maker would not have to update its quote to reflect the size of the limit order. In its release, the SEC states that a limit order (or limit orders in the aggregate) would be *de minimis* relative to a market maker's quote if it is less than or equal to 10 percent of the market maker's displayed size. If a market maker receives a customer limit order priced at its quote and the market maker is not at the NBBO, it is not obligated to reflect the limit order in its quote size.

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The Display Rule requires that a specialist or market maker update its quote immediately to reflect a customer limit order. According to the SEC, this means that a specialist or a market maker must effect its update within 30 seconds of receiving the order.

There are eight exceptions to the Display Rule requirements: (1) customer limit orders executed upon receipt; (2) customers who request that the limit order not be displayed; (3) odd-lot orders; (4) block-sized orders; (5) limit orders immediately displayed in a Nasdaq® or exchange system; (6) limit orders immediately delivered to an ECN that complies with a new provision of the Quote Rule (ECN Display Alternative); (7) customer limit orders delivered to another firm that complies with the Display Rule for those orders; and (8) all-or-none limit orders.

The Quote Rule

The SEC amended its Quote Rule to add Rule 11Ac1-1(c)(5) (ECN Rule), which will require market makers in Nasdaq or exchange-listed stocks to reflect in their quotes any better priced orders that they place into an ECN. The SEC also adopted an ECN Display Alternative provision, which is explained below.

The Basic ECN Rule

The core requirement of the ECN Rule provides that, if a market maker is quoting stock ABCD at 10 – 10 1/4 (1000 x 1000), and places an order to buy 3000 shares of ABCD at 10 1/8 in an ECN, the market maker must also update its quote to 10 1/8 – 10 1/4 (1000 x 1000). It is important to note that the market maker is not required to display the full size of the superior priced order placed into the ECN in its quote. Rather, the market maker is only obligated to display up to the applicable minimum quote size

under NASD® Rule 4613 (formerly Part V, Section 2 to Schedule D of the NASD By-Laws). An ECN is defined by the SEC to include “any electronic system that widely disseminates to third parties orders entered therein by an exchange specialist or OTC market maker, and permits such orders to be executed against in whole or in part.” ECNs do not include crossing systems or broker/dealer internal order routing systems.

The ECN Display Alternative

Instead of updating its quote to reflect better priced orders entered into an ECN, a market maker may comply with the display requirements of the Rule through the ECN itself, provided the ECN meets two conditions:

(1) the ECN must ensure that the best priced orders entered by market makers into the ECN are communicated to Nasdaq for public dissemination; and

(2) the ECN must provide broker/dealers access to orders entered by market makers into the ECN, so that broker/dealers who do not subscribe to the ECN can trade with those orders. This access must be equivalent to the access that would have been available had the market makers reflected their superior priced orders in their quotes.

In contrast to the situation in which a market maker updates its quote to reflect a superior priced order entered into an ECN, under this ECN Display Alternative the full size of the ECN order **must** be publicly displayed.

In addition, because ECNs frequently permit trading in minimum price increments narrower than the minimum quotation increments on Nasdaq or the exchanges, the SEC has interpreted the ECN Rule to pro-

vide that a market maker would be in compliance with the Rule if the ECN displaying its order (or market receiving the order from the ECN) were to disseminate its order rounded up or down to the nearest acceptable minimum quotation increment. Rounded orders would have to be denoted with some type of identifier. The SEC has not required that Nasdaq or the exchanges change their minimum quotation increments at this time.

Mandatory Market-Maker Registration In Exchange-Listed Securities

The mandatory market-maker registration requirement provides that any market maker or exchange specialist that accounts for one percent or more of the trading volume in any exchange-listed security must publicly disseminate quotations in that security. This eliminates a current regulatory disparity between the treatment of Rule 19c-3 securities and non-Rule 19c-3 securities under the Quote Rule. Presently, market makers and exchange specialists in non-Rule 19c-3 securities must publicly disseminate quotations if they are the “principal” market for a security and market makers and exchange specialists in Rule 19c-3 securities must publicly disseminate quotes if they account for one percent or more of the volume in the security. Accordingly, the net effect of the Rule will be to require more market makers and exchange specialists in non-Rule 19c-3 securities to publicly disseminate quotations. Contemporaneous with the approval of this Rule amendment, the SEC separately solicited comment on a proposal to extend the *one-percent test* to Nasdaq securities.

Expanded Definition Of OTC Market Maker

The SEC also expanded the defini-

tion of the term *OTC Market Maker* under the Quote Rule to include dealers that internalize their order flow or who hold themselves out only to particular firms. With respect to exchange-listed securities, a firm will now be obligated to publicly quote a security if its volume exceeds one percent of the total volume in the security, even if the volume was attributable to and derived from internalized order flow. Additionally, the ECN Rule requires a market maker who enters an order into an ECN that does not qualify for the ECN Display Alternative to continue to quote publicly regardless of the number of shares traded by that market maker in the security. Assuming the SEC approves its proposal to expand the *one-percent test* to include Nasdaq securities, this definitional change will require more market makers to register as Nasdaq market makers.

SEC Discussion Of Best Execution And Protection Of Limit Orders

The SEC has deferred action on a proposal that would require broker/dealers to provide price improvement opportunities for customer orders. In its release, however, the SEC reiterates a broker/dealer's obligation to provide best execution to customers. Although the SEC recognizes the practical necessity of automating the handling of small orders and indicates that automated routing or execution of customer orders is not necessarily inconsistent with best execution, it emphasizes that the duty of best execution requires broker/dealers that route orders for automatic execution to periodically assess the quality of competing markets to assure that its

order flow is directed to markets providing the most beneficial terms for their customers' orders. Moreover, where a member has access to systems offering better prices, members should take this into account when attempting to provide best execution to their customers.

Although the new Display Rule and the amendments to the Quote Rule are expected to improve the ability of a broker/dealer to obtain better executions for customers, the SEC believes that various markets and market makers, along with new technology making these participants more accessible, may continue to provide opportunities for executions at prices superior to the enhanced national best bid and offer for customer orders.

Among the specific statements made by the SEC, it is important to note how the SEC's discussion of best execution affects the way that limit orders and market orders should be handled under the NASD's existing limit order protection interpretation under Rule 2320 (formerly under Article III, Section 1 of the NASD Rules of Fair Practice). The SEC specifically stated that when a member holds a limit order priced better than its quote, and subsequently receives a market order on the opposite side of the market from the limit order, it is no longer appropriate for the member to execute the market order at the broker/dealer quote price and subsequently execute the limit order. Now the market order must receive the benefit of the better limit order price. **Accordingly, prior statements by the NASD that otherwise permit a member to execute a market order at a price inferior to a**

limit order while executing the limit order at its limit price are superceded by the SEC's interpretation.¹

To the extent that a member executes these orders manually, this interpretation is currently in effect. It is recognized, however, that some members may have automated execution systems not currently designed to comply with this new interpretation.

These members should make every effort to make any necessary system changes as soon as practicable, with a view toward achieving compliance by the first phase-in date of the Display Rule on January 10, 1997.

Effective Date Phase-In Schedule

The effective date for the amendments to the Quote Rule is January 10, 1997. The Display Rule requirements will become effective on January 10, 1997, for all exchange-listed securities and for the 1,000 Nasdaq securities with the highest average daily trading volume for the previous quarter. On March 28, 1997, the Rule will apply to the next 1,500 Nasdaq securities, and on June 30, 1997, the next 2,000 Nasdaq securities. The final phase-in date is August 28, 1997, when the Rule will apply to all remaining Nasdaq securities. A list of Nasdaq securities subject to the Rule will be published in advance of each phase-in date.

Questions about this Notice may be directed to the Office of General Counsel, The Nasdaq Stock Market, at (202) 728-8294.

¹ See Notice to Members 96-10, 95-67, 95-43, and 94-58 (question #8).

**SECURITIES AND EXCHANGE
COMMISSION****17 CFR Part 240**

[Release No. 34-37619A; File No. S7-30-95]

RIN 3235-AG66

Order Execution Obligations

AGENCY: Securities and Exchange Commission.

ACTION: Final Rules.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting a new rule requiring the display of customer limit orders and amending a current rule governing publication of quotations to enhance the quality of published quotations for securities and to enhance competition and pricing efficiency in our markets. These rules have been designed to address growing concerns about the handling of customer orders for securities.

Specifically, the Commission is adopting new Rule 11Ac1-4 ("Display Rule") under the Securities Exchange Act of 1934 ("Exchange Act") to require the display of customer limit orders priced better than a specialist's or over-the-counter ("OTC") market maker's quote or that add to the size associated with such quote. The Commission also is adopting amendments to Rule 11Ac1-1 ("Quote Rule") under the Exchange Act to require a market maker to publish quotations for any listed security when it is responsible for more than 1% of the aggregate trading volume for that security and to make publicly available any superior prices that a market maker privately quotes through certain electronic communications networks ("ECNs") ("ECN amendment"). Finally, the Commission is deferring action on proposed Rule 11Ac1-5 ("Price Improvement Rule").

EFFECTIVE DATE: January 10, 1997. For specific phase-in dates for the Display Rule, see section III.A.3.d of this Release.

FOR FURTHER INFORMATION CONTACT: Elizabeth Prout Lefler or Gail A. Marshall regarding amendments to the Quote Rule and David Oestreicher regarding the Display Rule at (202) 942-0158, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5-1, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:**I. Introduction and Summary**

On September 29, 1995, the Commission issued a release¹ proposing for comment new Rules 11Ac1-4 and 11Ac1-5 and amendments to Rule 11Ac1-1² under the Exchange Act.³ As proposed, new Rule 11Ac1-4 would require the display of customer limit orders that improve certain OTC market makers' and specialists' quotes or add to the size associated with such quotes. The proposed amendments to the Quote Rule would require OTC market makers and specialists who place priced orders with ECNs to reflect those orders in their published quotes. The proposed Quote Rule amendments also would require OTC market makers and specialists that account for more than 1% of the volume in any listed security to publish their quotations for that security ("Mandatory Quote Rule"). The Price Improvement Rule would have required OTC market makers and specialists to provide their customer market orders an opportunity for price improvement; it also would have included a non-exclusive safe harbor to satisfy the price improvement obligation.

The Commission received 152 comment letters (from 145 commenters) in response to the Proposing Release.⁴ Commenters generally supported the Display Rule and the Mandatory Quote Rule, with some commenters suggesting specific modifications or alternatives to the proposed rules. Commenters also supported the objectives of the ECN amendment, but many expressed concerns that diminishing the anonymity of such systems would threaten their viability. Most commenters believed the Price Improvement Rule would be costly to implement and would not be necessary if the other proposals were adopted.

After considering the comments and relevant economic research, and based

¹ Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995) ("Proposing Release").

² 17 CFR 240.11Ac1-1.

³ 15 U.S.C. 78a to 78II (1988).

⁴ The comment letters and a summary of comments have been placed in Public File No. S7-30-95, which is available for inspection in the Commission's Public Reference Room. The Commission received comments on the proposals from 77 individual investors, ten industry associations, seven exchanges and the National Association of Securities Dealers ("NASD"), eight academics, 41 market participants and the United States Department of Justice. In addition, the Commission met with representatives of broker-dealers, self-regulatory organizations ("SROs"), industry associations, and the U.S. Department of Justice to discuss the proposals. The Commission has conducted its own economic analysis of the likely economic effects of the various proposals.

on the Commission's experience with the development of the national market system ("NMS") and its knowledge of current market practices, the Commission is adopting the Display Rule and the proposed amendments to the Quote Rule, with certain modifications. The Commission believes that these modifications are consistent with the proposals and responsive to many of the concerns voiced by the commenters.

The Display Rule adopted today requires OTC market makers and specialists to display the price and full size of customer limit orders when these orders represent buying and selling interest that is at a better price than a specialist's or OTC market maker's public quote. OTC market makers and specialists also must increase the size of the quote for a particular security to reflect a limit order of greater than *de minimis* size when the limit order is priced equal to the specialist's or OTC market maker's disseminated quote and that quote is equal to the national best bid or offer.

The Commission has modified the proposed Display Rule in some respects in response to comments. The proposal included an exception to permit a specialist or OTC market maker to deliver a limit order to an exchange or registered national securities association ("association") sponsored system that complies with the Display Rule. This exception has been expanded to permit delivery to ECNs that display and provide access to these orders. Additionally, with regard to implementation of the rule, the Commission has provided for a phase-in over a one year period for non-exchange-traded securities covered by the Display Rule.

Today, the Commission also is adopting two significant amendments to the Quote Rule. These amendments are designed to ensure that more comprehensive quotation information is made available to the public. The first amendment requires a specialist or OTC market maker to make publicly available the price of any order it places in an ECN if the ECN price is better than the specialist's or OTC market maker's public quotation. The Commission has adopted this amendment as proposed, with an alternative ("ECN display alternative") that deems OTC market makers and specialists in compliance with the Quote Rule if prices these OTC market makers and specialists enter into an ECN are publicly disseminated and the ECN provides access to other broker-

dealers to trade at those prices.⁵ Thus, OTC market makers and specialists may comply directly with the ECN amendment by changing their public quote to reflect their ECN order, or by using an ECN that facilitates their compliance with the rule as described above.

Implementation of the ECN display alternative requires the cooperation of the SROs in order to include the ECN prices in the public quotation system and to provide equivalent access to these quotations. The Commission expects the SROs to work expeditiously with ECNs that wish to avail themselves of this alternative to develop rules or understandings of general applicability. The Commission is prepared to act if necessary to ensure implementation of the ECN display alternative prior to the effective date of the Quote Rule.

The second amendment to the Quote Rule expands the categories of securities covered by the Mandatory Quote Rule. As amended, the Quote Rule will require that OTC market makers and specialists publish quotes in any listed security if their volume in that security exceeds 1% of the aggregate volume during the most recent calendar quarter. Previously, these requirements applied only to certain listed securities.⁶

The Commission is deferring final action on the Price Improvement Rule at this time. The Commission will consider the effect of the new Display Rule and the amendments to the Quote Rule adopted today before determining the appropriate course of action on that proposal.

In a parallel action, the Commission today is proposing for comment an additional amendment to the Quote Rule. The proposed amendment would require OTC market makers and specialists that account for more than 1% of the volume in any Nasdaq security to publish their quotations for that security.⁷

II. Basis and Purpose of the Display Rule and Quote Rule Amendments

Twenty years ago, Congress directed the Commission—having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets—to use the

Commission's authority granted under the Exchange Act to facilitate the establishment of a national market system for securities.⁸ Congress further determined that the public interest, investor protection and the maintenance of fair and orderly markets required the NMS to feature:

- (i) Economically efficient executions;
- (ii) Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- (iii) Public availability of quotation and transaction information;
- (iv) An opportunity to obtain best execution; and
- (v) An opportunity to obtain execution without dealer intervention to the extent consistent with economically efficient executions and the opportunity to obtain best execution.⁹

The years since the 1975 Amendments have witnessed dramatic developments in the U.S. securities markets. Last sale reporting, which enables investors to determine the current market for a security, has been extended to OTC-traded securities. The Consolidated Quotation System ("CQS"), which allows investors to view in a single source quotes disseminated from dispersed market centers, did not exist in 1975. The Intermarket Trading System ("ITS"), which permits investors' orders in certain exchange-listed securities to be routed to the market center displaying the best quotation, has greatly facilitated quote competition. Moreover, technological developments not envisioned twenty years ago have enabled market centers to handle volume levels many times greater than those that led to the "back office" crisis of the late 1960s and early 1970s. Taken together, these and other developments have made it possible for investors' orders to be executed much more rapidly and at far lower cost.

The Commission recognized that U.S. equity markets had undergone significant changes since passage of the 1975 Amendments and were likely to undergo further changes of equal magnitude.¹⁰ Accordingly, the Commission announced in July 1992 that its Division of Market Regulation ("Division") would undertake a study of

the structure of the U.S. equity markets and of the regulatory environment in which those markets operate.¹¹

In January 1994, the Division published a study,¹² which reviewed, among other things, market practices and structures that could affect the ability of customers to obtain opportunities for better prices. The Market 2000 Study noted that U.S. equity markets had evolved since 1975 to provide a much wider array of trading venues to meet the diverse needs of investors and made a series of recommendations intended to facilitate the further development of a national market system. As expected, U.S. equity markets have continued to evolve since the Market 2000 Study was published.

This evolution of the markets is reflected in part by comparing trading volumes and the venues in which orders are executed. In 1976, the New York Stock Exchange ("NYSE") average daily trading volume was approximately 21.2 million shares.¹³ By 1995, average daily trading volume exceeded 346 million shares.¹⁴ Third market trading, *i.e.*, OTC trading of listed securities, in NYSE-listed issues accounted for 4.57% of consolidated volume in 1976.¹⁵ By 1995, third market trading increased to 7.94% of consolidated volume.¹⁶ In 1987, the NYSE handled almost 74% of trades of NYSE-listed issues reported on the consolidated tape; in 1995, it handled 70.22% of such trades.¹⁷

Comparable figures for The Nasdaq Stock Market ("Nasdaq") are even more

¹¹ *Id.*

¹² Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (January 1994) ("Market 2000 Study" or "Study").

¹³ 1982 NYSE Fact Book.

¹⁴ 1995 NYSE Annual Report.

¹⁵ 1982 NYSE Fact Book.

¹⁶ 1995 NYSE Fact Book.

¹⁷ Regional exchanges, namely, the Boston Stock Exchange ("BSE"), the Philadelphia Stock Exchange ("Phlx"), the Cincinnati Stock Exchange ("CSE"), the Chicago Stock Exchange ("CHX"), and the Pacific Stock Exchange ("PSE"), have captured a significant share of volume in NYSE-listed issues, particularly with respect to smaller investor orders. In 1995, the regional exchanges accounted for 9.96% of consolidated volume in NYSE-listed issues but accounted for 19.01% of trades of NYSE-listed issues reported on the consolidated tape. *Id.* They also accounted for approximately 35% of share volume in trades of 100 to 2,099 shares. Shapiro, *U.S. Equity Markets: Recent Equity Developments*, in *Global Equity Markets: Technological, Competitive, and Regulatory Challenges 21* (R. Schwartz ed. 1995). In January 1996, trades of 100–499 shares represented between 65–72% of all trades in NYSE-listed issues on regional exchanges; such trades represented only 37% of all trades on the NYSE. Ross, Shapiro and Smith, *Price Improvement of SuperDOT Market Orders on the NYSE* (NYSE Working Paper 96–01) (March 11, 1996 draft) (prepared for the NYSE Conference for the Search for Best Price) ("Ross, Shapiro and Smith").

⁵ This alternative means of compliance with the ECN amendment is referred to hereinafter as the "ECN display alternative".

⁶ Additional amendments to the Quote Rule adopted today provide that certain Quote Rule provisions that previously applied to market makers that elected to quote a Nasdaq National Market security now also will apply to market makers electing to quote a Nasdaq SmallCap security. See section III.B.d.iii.

⁷ See Securities Exchange Act Release No. 37620 (August 28, 1996) ("Companion Release").

⁸ Pub. L. No. 94–29, 89 Stat. 97 (1975) ("1975 Amendments").

⁹ Exchange Act section 11A(a)(1), 15 U.S.C. 78k–1(a)(1). This Section also recites the Congressional findings that: The securities markets are an important national asset which must be preserved and strengthened; and new data processing and communications techniques create the opportunity for more efficient and effective market operations.

¹⁰ See Securities Exchange Act Release No. 30920 (July 14, 1992), 57 FR 32587 (July 22, 1992) ("Market 2000 Concept Release").

dramatic. In 1975, Nasdaq annual volume was approximately 1.39 billion shares.¹⁸ By 1995, Nasdaq annual volume increased to 101.2 billion shares,¹⁹ which means that more shares traded hands on three average trading days in 1995 than in all of 1975. In 1993, volume in all proprietary trading systems combined represented 13% of the total volume in Nasdaq/National Market securities;²⁰ by January 1996, volume on Instinet alone represented approximately 15% of total Nasdaq volume and 20% of total volume for the 250 Nasdaq stocks with the highest median dollar volume.²¹

The Study addressed the development of certain practices, such as internalization,²² payment for order flow²³ and the non-disclosure of certain customer trading interest to all market participants, that raise a variety of market structure and customer order handling concerns. For example, brokers today may quote one price publicly to retail customers, while showing a better price privately to other investors and dealers on an ECN. In addition, the quotes displayed to public investors may not accurately reflect the best price for a security because limit orders, which specify the price at which customers will buy or sell a security, are not uniformly required to be included in the quote.

The Study recommended that the exchanges and the NASD consider taking action to respond appropriately to certain of these developments. Since that time, Nasdaq market makers holding customer limit orders have been prohibited from trading ahead of those orders,²⁴ and some market makers have

begun to offer price improvement opportunities in OTC transactions to their retail customers.²⁵ In addition, the NYSE now requires almost all limit orders transmitted through SuperDOT to be displayed to the market.²⁶ Further, Commission rules require enhanced disclosure of payment for order flow practices on customer confirmations and account statements, as well as upon opening new accounts.²⁷

Notwithstanding the progress achieved in this period, the Commission believes that further regulatory initiatives are warranted at this time. These changes, as indicated in the Proposing Release, are intended to address current market practices that inhibit opportunities for order interaction and that are inconsistent with Congress's vision of the national market system. These changes also address certain problems in Nasdaq. The Commission recently reported that, among other things: (i) Nasdaq market makers widely followed a pricing convention concerning the increments they used to adjust their displayed quotes; (ii) adherence to the pricing convention was not the result of natural economic forces, often impacted the fairness and accuracy of public quotation information and interfered with the economically efficient execution of customer transactions; (iii) the pricing convention impaired the ability of investors to ascertain the best market for their trades, increased the costs of transactions, and resulted in unfair discrimination among classes of market participants; (iv) numerous market makers collaborated in ways that misled and disadvantaged their customers and other market participants and frequently failed to honor their price quotations; and (v) many market makers have not consistently reported their trades on time or appropriately designated them as late as required by NASD rules.²⁸

The Commission has taken specific regulatory and enforcement actions to address these problems.²⁹ The Display Rule and Quote Rule amendments

¹⁸ 1992 Nasdaq Fact Book.
¹⁹ 1995 NASD Annual Report.
²⁰ Market 2000 Study at Appendix IV-2.
²¹ The Introduction of NAqcess into the Nasdaq Stock Market: Intent and Expectation. NASD Economic Research Staff, June 6, 1996 ("NASD Study"), Exhibit D to Securities Exchange Act Release No. 37302 (June 11, 1996), 61 FR 31574 (June 20, 1996) (Notice of Filing of Amendment No. 2 to Proposed Rule Change by National Association of Securities Dealers Relating to the NAqcess System and Accompanying Rules of Fair Practice) ("NAqcess Release 2").

²² Internalized orders are customer orders routed by a broker-dealer to an affiliated specialist or executed by that broker-dealer as a market maker.

²³ The Commission now requires enhanced disclosure of payment for order flow practices on customer confirmations and account statements, as well as upon opening new accounts. Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006 (November 2, 1994) (adopting rules requiring enhanced disclosure of payment for order flow practices on customer confirmations, and account statements, as well as upon opening new accounts) ("Payment for Order Flow Release"). See also Securities Exchange Act Release No. 35473 (March 10, 1995), 60 FR 14366 (March 17, 1995).

²⁴ Securities Exchange Act Release No. 34279 (June 29, 1994), 59 FR 34883 (July 7, 1994)

²⁵ See, e.g., Louis, *Schwab Debuts New Trading System*, San Francisco Chronicle, October 17, 1995, at D1.

²⁶ Securities Exchange Act Release No. 36231 (September 14, 1995), 60 FR 48736 (September 20, 1995).

²⁷ See Payment for Order Flow Release *supra* note 23.

²⁸ Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD, the Nasdaq Market, and Nasdaq Market Makers, Securities Exchange Act Release No. 37542 (August 8, 1996) ("21(a) Report").

²⁹ See *id.*

adopted today should bring about other, significant changes in the operation of Nasdaq, by ensuring the disclosure of customer and market maker buying and selling interest that heretofore has been hidden from many market participants. At the same time, the new rules will benefit investors in the exchange markets by increasing transparency in those markets and improving opportunities for the best execution of customer orders.

The Commission firmly believes that the actions it is taking today are consistent with the regulatory framework for a national market system established by Congress in the 1975 Amendments. Congress envisioned a national market system supported by accurate and reliable public quotation and transaction information, and fair competition among market centers. Congress also believed that linking all markets for qualified securities through communication and data processing facilities would foster efficiency, enhance competition, increase information available to market participants and contribute to the best execution of customer orders.³⁰

The Commission recognizes that investors will lose confidence in the fairness of the markets unless market structures and practices treat all investors fairly. The regulatory initiatives adopted today address current market practices that hinder competition among markets and affect the prices at which customer orders are executed. The Display Rule and Quote Rule amendments enhance transparency and facilitate best execution of customer orders in a manner that preserves maximum flexibility for the markets to design and implement trading and communication systems that are consistent with the objectives of the national market system. These rules contribute to the achievement of the full potential of the national market system as envisioned by Congress. They represent one more step to facilitate the development of an efficient, competitive and transparent national market system in which all market participants can achieve best execution of their orders.

III. Discussion

A. Display of Customer Limit Orders

1. Introduction

As discussed above, the 1975 Amendments contain an explicit statutory mandate for the establishment of a national market system. Congress considered mandating certain minimum

³⁰ See Exchange Act section 11A(a)(1)(D), 15 U.S.C. 78k-1(a)(1)(D).

components of the national market system, but instead created a statutory scheme granting the Commission broad authority to oversee the implementation, operation and regulation of the national market system.³¹ At the same time, Congress charged the Commission with the responsibility to assure that the national market system develop and operate in accordance with specific goals and objectives.³² The Commission believes that the adoption of a limit order display rule furthers these goals and objectives determined by Congress.

Specifically, the display of customer limit orders advances the national market system goal of the public availability of quotation information, as well as fair competition, market efficiency, best execution and disintermediation. The enhanced transparency of such orders increases the likelihood that limit orders will be executed because contra-side market participants will have a more accurate picture of trading interest in a given security. Further, this increased visibility will enable market participants to interact directly with limit orders, rather than rely on the participation of a dealer for execution.

Moreover, as noted in the Proposing Release, the display of limit orders that are priced better than current quotes addresses at least three regulatory concerns. First, displaying customer limit orders in the quotation can increase quote competition. If the quotes from a market or market maker represent only market maker buying and selling interest in a given security, the market or market maker faces less price competition than if customer buying and selling interest is made public. As a result, the price discovery process may be constrained. Second, the display of limit orders can narrow quotation spreads. Third, because many markets and market makers offer automatic executions of small orders at the best displayed quotes, the display of limit orders that improve the best displayed quotes can result in improved executions for these orders.

Limit orders currently are handled differently in the various auction and dealer markets. Generally, the rules of

most exchanges require that a limit order be displayed in the quotation for a security when it improves the best bid or offer. NYSE specialists, for example, must reflect a customer limit order in their quotations at the limit price when requested to do so.³³ In addition, the NYSE's order handling procedures assume that all limit orders routed to a specialist through SuperDOT contain a display request.³⁴ Therefore, except in the unusual and infrequent circumstance where a specialist believes market conditions suggest the likelihood of imminent price improvement, a limit order received by a specialist through SuperDOT should be reflected in the specialist's quote as soon as practicable following receipt of the order.³⁵ According to the NYSE, 93% of all SuperDOT limit orders that improve the best bid or offer displayed are reflected in the specialist's quote within two minutes of receipt, while 98% of such limit orders are reflected within five minutes of receipt.³⁶

A recent NYSE policy statement requires specialists to display the full size of all orders received through SuperDOT as well as orders received by specialists manually that are subsequently entered into the electronic book.³⁷ When a member requests that less than the full size of the order be shown, the specialist is obligated to show the size requested. Specialists must display as soon as practicable any order that, in relation to current market conditions in a particular security, represents a material change in the supply or demand for that security. This

³³ See NYSE Rule 79A.10 (when a limit order is presented to the specialist by a floor broker, the floor broker must affirmatively request that the specialist display the limit order; failure to so request leaves the decision whether to display the limit order to the discretion of the specialist); see also NYSE Rule 60 (requiring specialists to promptly report, *inter alia*, the best bid and offer in the trading crowd in each reported security in which the specialist is registered).

³⁴ NYSE Information Memo 93-12 (Mar. 30, 1993).

³⁵ *Id.*

³⁶ Telephone Conference between Edward A. Kwalwasser, Executive Vice President, NYSE, and Holly H. Smith, Associate Director, Division of Market Regulation, SEC, January 9, 1995.

Other exchanges also have rules regarding dissemination of bids and offers. However, no uniform standard has been adopted among the exchanges. Generally, the rules either cite, in whole or in part, language from the Quote Rule, or are drafted in such a manner as to allow for broad interpretation with respect to the display of limit orders. See, e.g., BSE Guide, Rules of the Board of Governors, Chapter II, Sec. 7, (CCH) ¶ 2020; PSE Guide, Rules of the Board of Governors, Rule 5.6(f), (CCH) ¶ 3979; American Stock Exchange Guide, General and Floor Rules, Rule 115, (CCH) ¶ 9265; CHX Guide, Article XX, Rule 7, (CCH) ¶ 1688; Phlx Guide, Rules 105 and 229 (CCH) ¶ 2105 and 2229; Cincinnati Stock Exchange Rules, Rule 11.9.

³⁷ See *supra* note 26.

requirement includes increasing the size of a quotation for orders at the same price as the current bid or offer. If the quotation already reflects significant supply or demand, and the specialist receives an order that is *de minimis* in relation to such supply or demand, the specialist may take a reasonable time (generally not more than two minutes) before updating the size of the quotation.³⁸

Currently in the OTC market, the quote for any security typically represents a dealer's own bid and offer. The rules of the NASD do not require market makers to display customer limit orders, whether or not they better the best bid or offer for the security.³⁹ Generally, customer limit orders in OTC securities either will be routed to a broker-dealer's market making desk or to another market maker for execution if the customer's firm does not make a market in the security. In the past, market makers typically did not execute limit orders until the best bid (for sell orders) or offer (for buy orders) displayed on Nasdaq reached the limit price. This practice has changed, however, in recent years. In June 1994, the Commission approved a rule change filed by the NASD that prohibits broker-dealers from trading ahead of their customers' limit orders.⁴⁰ This rule was expanded in May 1995, to prohibit broker-dealers from trading ahead of customer limit orders they accept from other brokers.⁴¹ The NASD also has filed a proposed rule change that would require, in certain circumstances, the display of customer limit orders for exchange-listed securities traded OTC.⁴²

³⁸ The NYSE provides the following example of when a specialist may take a reasonable time to update the size of the quotation: If the market in XYZ security is 20 (5,000)—20¼ (50,000), and the specialist receives an order to sell 200 shares at 20¼, such order would be considered *de minimis* and the specialist would be permitted to wait a reasonable period of time (but not more than two minutes) before changing the size of the offer to 50,200.

³⁹ See *NASD Manual*, Rule 4613.

⁴⁰ See Manning I, *supra* note 24.

⁴¹ See Manning II, *supra* note 24.

⁴² See Securities Exchange Act Release No. 35471 (March 10, 1995), 60 FR 14310 (March 16, 1995). The NASD proposal, applicable to exchange-listed securities traded OTC, generally would require a market maker either to execute immediately a limit order of less than the minimum quotation size priced better than the market maker's quotation, or display the order in its quotation for an amount equal to the minimum quotation size. Market makers would have to display a limit order greater than the minimum quotation size for that security but would not have to display the full size of the order. Any portion of the order not displayed, however, would have to be executed at a price at least as favorable as the displayed price if the displayed portion is executed in its entirety. At the NASD's request, the Commission has postponed

Continued

³¹ S. Rep. No. 75, 94th Cong., 1st Sess. 8-9 (1975) ("Senate Report").

³² *Id.* at 9. Among other things, Congress found it in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure an opportunity for investors' orders, in both dealer and auction markets, to be executed without the participation of a dealer, to the extent that this was consistent with economically efficient executions of such orders in the best market. Exchange Act Section 11A(a)(1)(c), 15 U.S.C. 78k-1(a)(1)(C).

The exchanges and the NASD use automated trading systems to route and, in some instances, execute orders up to a predetermined size. Some of these systems accept limit orders. Each system, however, may differ in its handling of limit orders that are not executed immediately upon receipt. For example, the NYSE's SuperDOT system routes limit orders to the specialists' posts where they are handled in accordance with NYSE rules governing specialist representation of such orders. The American Stock Exchange's ("Amex") PER system routes limit orders in the same manner as SuperDOT and the orders are handled in accordance with Amex rules. The NASD's Small Order Execution System ("SOES") treats limit orders priced at the current inside market as market orders that are immediately executed.⁴³ All other limit orders reside in a limit order file that can be viewed only by market makers.⁴⁴ SOES does not provide an opportunity for limit orders to interact with incoming market orders. The Commission has published for comment a NASD proposal to replace SOES with "NAqcess," a system that would include a limit order file designed to display certain customer limit orders.⁴⁵

The disparate treatment of limit orders across markets was raised as an issue in the Market 2000 Study. The

final action on the NASD's proposal in order to permit the NASD to evaluate its proposal in light of the Commission's actions on the proposals it is adopting today.

⁴³ Preferred orders (*i.e.*, orders routed to a specific market maker pursuant to a pre-existing agreement) are executed immediately at the inside quote. Unpreferred orders are executed against market makers in a security in rotation. SOES, however, does not execute an unpreferred order against a single market maker more than once every 15 seconds.

⁴⁴ The current SOES rules have been extended, with certain changes that do not affect the handling of limit orders, through January 31, 1997. Securities Exchange Act Release No. 37502 (July 30, 1996), 61 FR 40869 (August 6, 1996).

⁴⁵ See Securities Exchange Act Release No. 36548 (December 1, 1995), 60 FR 60392 (December 8, 1995) ("NAqcess Release 1"); NAqcess Release 2, *supra* note 21. As proposed, NAqcess would act as an order delivery system with a limited public limit order file.

Limit orders up to 9,900 shares would be permitted in NAqcess for the top 250 Nasdaq National Market securities, defined by median daily dollar volume, and for 1,000 shares for all other Nasdaq securities. Market makers would be allowed to query the entire limit order file. All other market participants would be limited to viewing the top of the NAqcess limit order file (*i.e.*, the best priced buy and sell limit orders, and the size associated with those orders—the NAqcess inside market). This inside market would be factored into the calculation for the inside quote for each Nasdaq security. Although use of NAqcess would be voluntary, limit orders not entered in NAqcess would be provided with market-wide price protection under the proposal.

Commission received numerous comments concerning whether the optimal degree of pre-trade disclosure of limit orders was being achieved within the U.S. equity markets. Some commentators alleged that specialists and third market dealers sometimes fail to display limit orders priced better than the displayed quotation.⁴⁶ Questions also were raised about the lack of limit order exposure on Nasdaq. After considering these comments, the Division recommended in the Study that the securities exchanges consider whether to encourage the display of all limit orders in listed stocks priced better than the best intermarket quotes, unless the ultimate customer requests that the order not be displayed. The Market 2000 Study also recommended the display of limit orders in Nasdaq stocks when the orders are at prices better than the best Nasdaq quotes, unless the customer requests that the order not be displayed.⁴⁷

2. Discussion

a. Basis for Adoption of the Rule

After carefully considering all of the comments as well as economic research regarding the Display Rule, and based on the Commission's experience and knowledge of current market practices and conditions, the Commission believes that adoption of the Display Rule will promote transparency and enhance execution opportunities for

⁴⁶ See generally Thomas H. McInish & Robert A. Wood, *Hidden Limit Orders on the NYSE*, 21 J. Portfolio Mgmt. 19 (No. 3, Spring 1995) ("McInish & Wood Study"). The authors asserted that NYSE specialists only display about 50% of limit orders that better existing quotes. In their opinion, this practice represents a serious policy issue because it places both public investors and regional exchanges at a disadvantage. They asserted that hiding limit orders impedes strategic decisions on order placement; results in publicly submitted market orders receiving inferior prices; hampers the monitoring of order executions; reduces the probability of a limit order being executed; results in a delay in reporting limit order executions; interferes with the ability of the regional exchanges to execute public orders; and artificially improves NYSE performance relative to the regional exchanges using a common benchmark. The authors also claimed that NYSE Rule 60 is ambiguous in that the specialists may have some leeway in choosing what to disclose in their quotes.

In its comment letter to the Market 2000 Study, however, the NYSE asserted that its publicly disseminated best bid or offer includes all firm trading interest announced on the floor as required by the exchange's rules. See Letter from William H. Donaldson, Chairman and Chief Executive Officer, NYSE, to Jonathan G. Katz, Secretary, SEC at 25-26 (November 24, 1992). In addition, the NYSE issued a policy statement that reiterates that specialists have an obligation to reflect in their quotes certain limit orders received manually or via SuperDOT that are not executed on receipt. See *supra* note 26.

⁴⁷ Market 2000 Study, at IV-6.

customer orders, and encourage liquidity.⁴⁸

The Commission stresses, however, that the rule is not meant to displace any SRO rules that provide additional order handling protections to customer limit orders. Instead, the Commission rule represents only a minimum display standard.

The Commission believes that limit orders are a valuable component of price discovery. The uniform display of such orders will encourage tighter, deeper, and more efficient markets. Limit orders convey buying and selling interest at a given price. The display of limit orders can be expected to narrow the bid-ask spread when this buying and selling interest is priced better than publicly disclosed prices.⁴⁹ Both large and small orders stand to benefit from the Display Rule's effect on price discovery.⁵⁰ In fact, the importance of

⁴⁸ See, *e.g.*, Letter from Thomas F. Ryan, Jr., President and Chief Operating Officer, Amex, to Jonathan G. Katz, Secretary, SEC, dated February 1, 1996 ("Amex Letter"); Letter from David E. Shaw, Ph.D., Chairman, D.E. Shaw & Co., to Jonathan G. Katz, Secretary, SEC, dated January 9, 1996 ("D.E. Shaw Letter") (rule will promote transparency); Letter from Paul A. Merolla, Vice President, Associate General Counsel, Goldman, Sachs & Co., to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("Goldman Sachs Letter") (rule would benefit marketplace); Letter from Craig S. Tyle, Vice President and Senior Counsel, Securities and Financial Regulation, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("ICI Letter") (increased transparency of customer limit orders in all markets could produce benefits to the markets and investors); Letter from Donald L. Crooks, Managing Director, Lehman Brothers, Inc., to Jonathan G. Katz, Secretary, SEC, dated February 26, 1996 ("Lehman Letter") (rule promotes transparency and results in improved opportunities for execution of customer orders); Letter from Bernard L. Madoff and Peter B. Madoff, Bernard L. Madoff Investment Securities, to Jonathan G. Katz, Secretary, SEC, dated January 12, 1996 ("Madoff Letter") (rule will help achieve true price discovery and fairness to investors); Letter from Andrew E. Feldman, Director and Associate General Counsel, Smith Barney Inc., to Jonathan G. Katz, Secretary, SEC, dated January 29, 1996 ("Smith Barney Letter") (rule will promote transparency and assist in achieving best execution of orders). *But see* Letter from Charles R. Hood, Senior Vice President and General Counsel, Instinet, to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("Instinet Letter") (exceptions to rule eliminate potential positive impact on transparency).

⁴⁹ For example, limit order trading allows investors the opportunity to trade at prices superior to those represented by the prevailing inside bid and offer. See NASD Study, *supra* note 21.

⁵⁰ According to SuperDOT trade data analyzed by the Commission's Office of Economic Analysis ("OEA"), customer limit orders account for 50% of all NYSE customer trades originating from orders routed through SuperDOT ("customer trades") of 100-500 shares; 66% of all customer trades of 600-1,000 shares; 71% of all customer trades of 1,100-3,000 shares; and 74% of all customer trades of 3,100-9,900 shares. The Commission believes that these high percentages are based, at least in part, on the fact that limit orders routed through SuperDOT are required to be displayed in the

limit orders in the trading process was documented in recent studies.⁵¹ The author quantified the impact of exposing limit orders on quoted spreads and effective transaction costs. Using NYSE data, he determined that the quote spreads resulting from participation of the limit order book were approximately 4 to 6 cents smaller than the spreads not set by the limit order book. Further, trading costs on the NYSE were approximately 3–4 cents less per share on a “round trip” transaction when both the purchase and the sale were executed against the limit order book.⁵²

The uniform display of limit orders also will lead to increased quote-based competition. Market makers will not only be competing amongst themselves,

specialist's quote. The Commission believes that these percentages help demonstrate the benefits associated with limit order display for both large and small order sizes. In addition, OEA data shows that NYSE customer limit orders routed through SuperDOT narrow the NYSE quote 22% of the time and match the quote 39% of the time for customer limit orders of 100–1,000 shares; narrow the quote 17% of the time and match the quote 43% of the time for customer limit orders of 1,100–3,000 shares; and narrow the quote 14% of the time and match the quote 46% of the time for customer limit orders of 3,100–9,900. OEA data also shows that, when the NYSE bid-ask spread was ¼ point or more, customer limit orders routed through SuperDOT narrow the NYSE spread between 41% and 50% of the time, depending on the size of the customer order.

⁵¹ See Jason T. Greene, *The Impact of Limit Order Executions on Trading Costs in NYSE Stocks* (An Empirical Examination), December 1995 (“Greene Study”); see also Jason T. Greene, *Limit Order Executions and Trading Costs for NYSE Stocks*, June 1996 (“Greene Study II”).

⁵² The Commission further believes that the display requirement will improve price transparency in securities with diverse trading characteristics. Based on SuperDOT trade data, the Commission's OEA has determined that for NYSE securities with an average daily trading value (“ADTV”) of under \$100,000, customer limit orders account for 57% of all NYSE customer trades originating from orders routed through SuperDOT (“customer trades”) of 100–500 shares; 69% of all customer trades of 600–1,000 shares; 76% of all customer trades of 1,100–3,000 shares; and 83% of all customer trades of 3,100–9,900 shares. Limit orders also are frequently used for securities with higher ADTVs. For example, for NYSE securities with an ADTV of over \$5,000,000, customer limit orders account for 48% of all NYSE customer trades of 100–500 shares; 68% of all customer trades of 600–1,000 shares; 72% of all customer trades of 1,100–3,000 shares; and 73% of all customer trades of 3,100–9,900 shares. Moreover, OEA data shows that for NYSE securities with an ADTV of under \$100,000, customer limit orders routed through SuperDOT narrow the NYSE quote 30% of the time and match the quote 32% of the time. For less liquid securities, therefore, the display of customer limit orders narrows spreads, improves price discovery, and increases market depth. For NYSE securities with an ADTV of \$5,000,000 or more, customer limit orders routed through SuperDOT narrow the NYSE quote 18% of the time and match the quote 41% of the time.

The NASD has suggested that the greater the size of the displayed spread, the greater the use of limit orders. See NASD Study, *supra* note 21.

but also against customer limit orders represented in the quote. The Commission believes that this result will reduce the possibility of certain trading behavior on Nasdaq that was recently the subject of a Commission investigation.⁵³ As reported in the 21(a) Report, Nasdaq market makers widely adhered to a “pricing convention,” whereby Nasdaq market makers maintained artificially inflexible quotations and as a result often traded with the public at prices unduly favorable to such market makers.⁵⁴ In addition, the Commission determined that Nasdaq market makers adhered to a “size convention” that deterred Nasdaq market makers from narrowing their quotes to create a new inside market unless the market makers were willing to trade at least 2,000 to 5,000 shares at that price, rather than the minimum quotation size as determined by NASD rules.⁵⁵ This practice prevented the dissemination of improved quotes when a trader sought to trade stock only at a size equal to the minimum quotation size. Thus, the true buying and selling interest in a given security was not reflected in the published quotes.

In addition to the Commission's actions, and those of the Department of Justice in connection with its investigation of the Nasdaq market, the Commission believes the requirement to display customer limit orders in market maker quotes would inhibit market makers from engaging in the conduct described above. Moreover, the display of limit orders reduces the potential for certain other conduct described in the 21(a) Report, including market maker collaboration and coordination of trade and quote activities. Market makers will be less able to improperly coordinate such behavior due to the display of

⁵³ See 21(a) Report, *supra* note 28. The investigation identified a number of practices in the Nasdaq market that are similar to practices identified in the 1963 Special Study. See SEC, Report of Special Study of Securities Markets (1963). For example, the 1963 Special Study discussed cooperation and information sharing between traders, as well as other non-competitive practices. *Id.* at pt. 2, 576–577.; See also Competitive Impact Statement of the U.S. Department of Justice Antitrust Division, *United States v. Alex. Brown & Sons, et. al.*, (S.D.N.Y. 1996).

⁵⁴ As a result of this convention, most Nasdaq stocks were quoted only in increments of ¼. Under the convention, stocks with a dealer spread of ¾ or more would only be quoted in even-eighths (*i.e.*, ¼, ½, ¾), thereby giving rise to a minimum inside spread of ¼. Stocks with dealer spreads less than ¾ would be quoted in both even and odd-eighths, thereby allowing a minimum inside spread of ⅛. The pricing convention significantly limited the flexibility and competitiveness of price quotations in the Nasdaq market.

⁵⁵ See 21(a) Report, *supra* note 28.

competing customer order flow and the resulting transparency of ultimate buying and selling interest. The Commission believes that the display requirement will both foster renewed quote-based competition among market makers and introduce new competition from customer limit orders.

The Commission also believes that overall market liquidity should be enhanced due to the increased trading volume that is expected to result from the display of limit orders.⁵⁶ As noted previously, customer limit orders account for a significant percentage of total customer orders on the NYSE, where customer limit orders generally are required to be displayed when they represent a better price.⁵⁷ Moreover, previous Commission initiatives designed to enhance transparency have resulted in increased competition and liquidity for the markets.⁵⁸

Customers also will be better able to monitor the quality of their executions. Currently, the failure to display limit orders often results in inferior or missed executions for these orders. The Commission has received frequent complaints from customers whose limit orders have not been filled while other executions are reported at prices inferior to their limit order prices. Requiring the display of customer limit orders in specialist and market maker quotes, although not guaranteeing that such limit orders will be executed, will help ensure that other orders are not executed at inferior prices until better priced limit orders are executed. Similarly, customers entering market orders will be able to determine whether their orders are receiving the best price available. Customers also will be in a better position to compare the execution quality provided by different broker-dealers.⁵⁹

The absence of a uniform limit order display requirement across all markets has contributed to the controversy among market participants regarding the availability of true price improvement

⁵⁶ See Greene Study and Greene Study II, *supra* note 51 (limit orders affect the quoted spread, provide liquidity to traders that demand immediacy of execution, and may contribute to reduced trading costs); NASD Study, *supra* note 21 (the liquidity supplied by limit orders reduces trading costs of market participants); OEA Data, *supra* notes 50 and 52 (limit orders narrow spreads, improve price discovery, and increase market depth).

⁵⁷ See OEA Data, *supra* notes 50 and 52.

⁵⁸ See Market 2000 Study at Study IV. See also discussion at section III.A.b.iii., *infra*; Simon & Colby *The National Market System For Over-The-Counter Stocks* (“Simon and Colby”), 55 Geo. Wash. L. Rev. 17 (1986).

⁵⁹ The Commission notes that if the Display Rule leads some market makers to charge commissions for handling limit orders, Commission rules require disclosure of such charges. See 17 CFR 240.10b–10.

opportunities. Many claim that "hidden" limit orders in exchange markets contribute to distorted price improvement figures for these markets.⁶⁰ This potential distortion also hinders a customer's ability to monitor execution quality. Pursuant to the Display Rule, the vast majority of limit orders will be publicly disclosed, thus enabling a more accurate comparison of price improvement opportunities, and enabling customers and broker-dealers to make more informed order routing decisions.⁶¹

Moreover, the Commission believes that the display of limit orders will benefit orders routed to automated execution systems. To the extent these systems execute orders at prices based on the best displayed quotation for a particular security,⁶² customers whose orders are executed through these systems will receive the benefit of prices that more accurately reflect buying and selling interest in the market.

In sum, the Commission believes the adoption of the Display Rule is an important step in furthering the goals expressed by Congress in the 1975 Amendments. The Display Rule will provide enhanced opportunities for public orders to interact with other public orders, consistent with

⁶⁰ See James J. Angel, *Who Gets Price Improvement on the NYSE?*, Working Paper, December 1994. In studying the availability of price improvement on the NYSE, the author noted that over 18% of the market orders that were price improved were filled by SuperDOT limit orders. Based on this percentage, the author estimated the percentage of orders price improved by "hidden" limit orders and determined that if such limit orders were represented in the specialist's quote rather than "hidden," spreads would have been narrower and NYSE price improvement statistics would have declined. See also, McNish & Wood Study, *supra* note 46; Mitchell A. Petersen & David Fialkowski, *Posted Versus Effective Spreads: Good Prices or Bad Quotes*, 35 J. Fin. Econ. 269 (1994) (the fact that so many orders execute inside the posted spreads indicates that quotes do not represent the true supply and demand of a given security, and may be based, in part, on the failure to display public limit order interest in the quote). Cf. Ross, Shapiro and Smith, *supra* note 17 (although the authors did not examine limit orders in detail, and discounted the effect of "hidden" limit orders on their statistics, the authors found that limit orders provide 27% of the price improvement afforded to SuperDOT market order volume).

⁶¹ See, e.g., Amex Letter (rule would help eliminate hidden limit orders); Letter from Frederick Moss, Chairman of the Board, CSE, to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("CSE Letter") (elimination of hidden limit orders will eliminate illusion of superior price improvement); Letter from Harold S. Bradley, Vice President and Director of Trading, Investors Research Corporation, to Jonathan G. Katz, Secretary, SEC, dated January 13, 1996 ("Investors Research Letter") (hidden limit orders are not justified).

⁶² Compare discussion of best execution at section III.C.2.

congressional goals.⁶³ In addition, the display requirement will, among other things, narrow quotes, enhance market liquidity, and improve an investor's ability to monitor the quality of its executions.⁶⁴ This will create a better environment for execution of both limit and market orders without the participation of a dealer. The increased order interaction will result in quicker and more frequent executions of customer limit orders. The Display Rule, therefore, will increase the likelihood that limit orders will be executed, a result that the Commission believes is consistent with the duty of best execution.

b. Response to Comments⁶⁵

The Commission proposed Rule 11Ac1-4 to establish minimum display requirements for customer limit orders that improve a specialist's or OTC market maker's best bid or offer for a particular security as well as the size of such orders. In addition, the rule requires the display of the size of certain limit orders priced at the national best bid or offer ("NBBO"). Although the rule generally would mandate the display of limit orders, market makers and specialists still would retain some flexibility in handling limit orders accepted for execution.

Specifically, the rule allows an OTC market maker or specialist, immediately upon receipt of a limit order, to: (1) Change its quote and the size associated with its quote to reflect the limit order; (2) execute the limit order; (3) deliver the limit order in an exchange- or

⁶³ See 15 U.S.C. 78k-1(a)(1)(C)(v).

⁶⁴ The Commission notes that a few commenters are concerned about the potential effects of the Commission's proposals on institutional customers. See Goldman Sachs Letter; Letter from Howard J. Schwartz, Chairman and Chief Executive Officer, and James Hanrahan, Managing Director—Trading, Lynch, Jones & Ryan, Inc., to Jonathan G. Katz, Secretary, SEC, dated February 9, 1996 ("LJR Letter"); Letter from A.B. Krongard, Chairman, SIA Board of Directors, and Bernard L. Madoff and Robert Murphy, Co-Chairmen, Order Execution Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, dated February 26, 1996 ("SIA Letter"). The Commission believes that the Display Rule will benefit both retail and institutional customers, while preserving the access to the markets that institutional customers have today. For example, an institutional customer's block size limit order would not be subject to the rule unless such customer requests that the order be displayed. Moreover, any customer, whether individual or institutional, can request that its non-block size limit order not be displayed. The Commission also notes that increased quote competition and enhanced transparency should improve the prices at which institutions and market makers begin their negotiations for the execution of institutional orders. See also 21(a) Report, *supra* note 28.

⁶⁵ For further discussion of the views of commenters, see the Summary of Comments, *supra* note 4.

association-sponsored system that complies with the requirements of the rule; or (4) send the limit order to another market maker or specialist who complies with the requirements of the rule. The rule would require a specialist or OTC market maker to display a customer limit order when the order was "held" by the specialist or OTC market maker. If the specialist or OTC market maker immediately sends the order to a system or to another specialist or OTC market maker that complies with the rule, the specialist or OTC market maker that routed the order would have satisfied its obligation to display the order. These alternatives are intended to allow market makers, specialists, and market centers an opportunity to continue to provide their valuable services while offering customers the best available execution opportunities.

The Display Rule as adopted maintains these alternatives as proposed. Additionally, to better achieve its aims and to respond to comments, the Commission has made some modifications to the proposed rule. For example, the Commission has decided to permit a specialist or OTC market maker to deliver a limit order to certain ECNs as an alternative to representing the limit order in its quote. This change is an extension of the proposed exception that permits a specialist or OTC market maker to deliver a limit order to an exchange- or association-sponsored system that complies with the Display Rule. Moreover, with regard to implementation of the rule, the Commission is providing for a four-stage phase-in over a one year period for non-exchange-traded securities.

Of the commenters who specifically addressed the proposed Display Rule, an overwhelming majority strongly support the inclusion of customer limit orders in the quote.⁶⁶ One commenter

⁶⁶ See, e.g., Amex Letter; Letter from Marshall E. Blume, Director, Howard Butcher Professor of Financial Management, The Wharton School of the University of Pennsylvania, to Jonathan G. Katz, Secretary, SEC, dated January 11, 1996 ("Blume Letter"); Letter from George W. Mann, Jr., Senior Vice President and General Counsel, BSE, to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("BSE Letter"); Letter from Robert H. Forney, CHX, to Jonathan G. Katz, Secretary, SEC, dated January 23, 1996 ("CHX Letter"); D.E. Shaw Letter; Letter from Antitrust Division, U.S. Department of Justice, to SEC, dated January 26, 1996 ("DOJ Letter"); Letter from Preston Estep, Estep Trading Partners L.P., to Jonathan Katz, Secretary, SEC, dated December 21, 1995 ("Estep Letter"); Goldman Sachs Letter; ICI Letter; Lehman Letter; Madoff Letter; Letter from William A. Lupien, Chairman and Chief Executive Officer, Mitchum, Jones & Templeton, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 8, 1996 ("MJT Letter"); Letter from Joseph R. Hardiman, President, National

notes that true price discovery and fairness for public investors can only be achieved when limit orders are reflected in the NBBO.⁶⁷ Other commenters, expressing strong support for the proposed rule, believe that market-wide limit order procedures will improve the markets by enhancing overall market transparency⁶⁸ and eliminating the advantages derived by some markets from hidden limit orders.⁶⁹ The Department of Justice states that the proposed rule encourages quote competition, which is likely to reduce spreads,⁷⁰ and allows customer orders to interact with one another.⁷¹ In this regard, several commenters recognize that the proposed rule would assist in achieving best execution of customer orders⁷² by increasing the opportunities for execution of limit orders, and improving the prices for market orders.⁷³ Another commenter states that the proposed rule is consistent with investor expectations and will act to protect retail customer interests.⁷⁴

Other commenters oppose the proposal. Several commenters in this group have raised the following general concerns regarding the proposed rule.

i. Distinction Between Markets

Several commenters argue that the Display Rule does not take into account distinctions between auction and dealer markets. Some of these commenters, discussing the Proposing Release as a whole, argue that the Commission's proposals would "auctionize" the dealer market.⁷⁵ One commenter warns that,

Association of Securities Dealers, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("NASD Letter"); Letter from James E. Buck, Senior Vice President and Secretary, NYSE, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("NYSE Letter"); Letter from David S. Pottruck, President and Chief Operating Officer, The Charles Schwab Corporation, to Jonathan G. Katz, Secretary, SEC, dated May 7, 1996 ("Schwab Letter II"); SIA Letter; Letter from William R. Rothe, Chairman, and John L. Watson III, President, Security Traders Association, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("STA Letter"); Letter from John F. Luikart, President and Chief Executive Officer, Sutro & Co., to Jonathan Katz, Secretary, SEC, dated January 16, 1996 ("Sutro Letter").

⁶⁷ Madoff Letter.

⁶⁸ See, e.g., Amex Letter; CHX Letter; CSE Letter; D.E. Shaw Letter; ICI Letter; Investors Research Letter; Lehman Letter; Smith Barney Letter.

⁶⁹ See, e.g., Amex Letter (rule would help eliminate hidden limit orders); CSE Letter (elimination of hidden limit orders will eliminate illusion of superior price improvement); Investors Research Letter (hidden limit orders are not justified).

⁷⁰ DOJ Letter.

⁷¹ *Id.*; see also Amex Letter; Lehman Letter.

⁷² See, e.g., Lehman Letter; Smith Barney Letter.

⁷³ Lehman Letter.

⁷⁴ D.E. Shaw Letter.

⁷⁵ See, e.g., Letter from R. Steven Wunsch, President, AZX, Inc., to Jonathan G. Katz, Secretary,

because auction and dealer markets are fundamentally different, a single set of rules for both auction and dealer markets would reduce quote quality and damage overall market integrity in dealer markets.⁷⁶ Although the SIA reports that the consensus view of its Ad Hoc Committee on Order Execution is to require a market maker to reflect customer limit orders in the quote, the SIA argues that the adoption of the proposed rule, without suggested modifications, could adversely affect the dealer market so as to weaken competition between dealer and auction markets.⁷⁷

The Commission believes that the application of the principles underlying the limit order display rule to the dealer market is neither a new nor radical concept. In 1975, Congress envisioned an NMS in which public limit orders in qualified securities would have a central role.⁷⁸ Congress anticipated that the NMS would make all specialists and market makers aware of public customer limit orders held anywhere in the system, and provide enhanced protection and priority for limit orders in stocks qualified for trading in a national market system.⁷⁹ The Commission has consistently recognized since 1975 that, in order to satisfy this Congressional vision, multiple-market display of limit orders was an important component for qualified securities.⁸⁰

SEC, dated January 15, 1996 ("AZX Letter"); Goldman Sachs Letter; Letter from David Rich, Vice President, Jefferies & Company, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 25, 1996 ("Jefferies Letter"); Letter from Robert W. Murphy, President, RPM Specialist Corporation, to Jonathan G. Katz, Secretary, SEC, dated February 26, 1996 ("RPM Letter"); Letter from Robert A. Schwartz, Professor of Finance and Economics, and Yamaichi Faculty Fellow, Leonard N. Stern School of Business, New York University, and Robert A. Wood, Distinguished Professor of Finance, Fogelman College of Business and Economics, University of Memphis, to Jonathan G. Katz, Secretary, SEC, dated January 23, 1996 ("Schwartz & Wood Letter"); SIA Letter.

⁷⁶ RPM Letter.

⁷⁷ SIA Letter. *Cf.* Letter from A.B. Krongard, Chairman, SIA Board of Directors, and Bernard L. Madoff, Chairman, Trading Committee, to Jonathan G. Katz, Secretary, SEC, dated August 1, 1996 ("SIA NAqcess Letter") (the SIA, in its letter to the Commission regarding the NASD's NAqcess proposal, states that the Commission's Order Execution Obligations proposal would narrow quotation spreads, improve transparency, and provide customers with best execution of their orders, consistent with the 1975 Amendments).

⁷⁸ Senate Report, *supra* note 31.

⁷⁹ *Id.* The Senate Report stressed the need to establish a mechanism by which specialists and market makers could be made aware of customer orders within the NMS. The Senate Report was "satisfied that [the legislation] grant[ed] the Commission complete and effective authority to implement a system for the satisfaction of public limit orders." *Id.* at 18.

⁸⁰ See Securities Exchange Act Release No. 15671 (March 22, 1979), 44 FR 20360 (April 4, 1979)

More recently, the Market 2000 Study recommended that the SROs, including the NASD, consider requiring the display of customer limit orders,⁸¹ and the NASD, in a proposed rule change filed with the Commission, proposed that CQS market makers display in their quotes certain customer limit orders for exchange-listed securities traded OTC.⁸² The NASD also has proposed a mechanism for the display and protection of customer limit orders in Nasdaq securities.⁸³

Although some commenters claim that the Commission is attempting to "auctionize" the dealer market, the display requirement is based on transparency and agency concerns, including a broker-dealer's obligation to provide its customers with best execution.⁸⁴ The display of customer limit orders will act to narrow spreads, improve price discovery, and increase market depth. The enhanced transparency resulting from the Display Rule will increase the likelihood that customer limit orders will be executed, improve the execution prices of market orders, and strengthen an investor's ability to monitor the quality of executions.⁸⁵ These results further several Congressional goals.

In keeping with Congressional intent, the Commission believes the treatment of limit orders should reflect the very real changes in market structure that have taken place since the enactment of the 1975 Amendments. These changes include the development of a robust, liquid OTC dealer market that attracts significant investor trading interest, that trades at many multiples of the volume extant in 1975, and that is characterized by the inclusion of thousands of securities that meet the NMS designation.⁸⁶ In addition, the

(Development of a National Market System Status Report). See also Securities Exchange Act Release No. 18738 (May 13, 1982), 47 FR 22376 (May 24, 1982) (proposing limit order display requirement for Rule 19c-3 securities).

⁸¹ Market 2000 Study, at IV-6.

⁸² See *supra* note 42.

⁸³ See *supra* note 45.

⁸⁴ See NASD Study, *supra* note 21 (enhancements to limit order handling, within the dealer market structure, will create significant benefits for investors). See also Manning II, *supra* note 24 (Commission's extension of limit order protection to Nasdaq does not suggest an intention to "auctionize" the dealer market).

⁸⁵ See Senate Report, *supra* note 31 at 16-18 (discussing desirability of incorporating certain auction market principles, such as limit order display and protection, for certain qualifying securities in dealer markets).

⁸⁶ To date, approximately 4,000 Nasdaq securities have qualified for the NMS designation. In order to qualify as an NMS security, transaction reports are required to be reported on a real-time basis pursuant to an effective transaction reporting plan

Continued

Commission believes that application of the Display Rule should also benefit investors in those securities that do not yet meet the NMS designation.⁸⁷ As noted earlier, the Commission believes that the increased use of limit orders in these securities will lead to a narrowing of spreads and ameliorate certain anti-competitive practices that have developed in the Nasdaq market.⁸⁸ The Commission has determined that certain practices on Nasdaq have contributed to artificially wide spreads for OTC securities.⁸⁹ The display of customer limit orders in all Nasdaq securities will promote accurate pricing and convey the true buying and selling interest in such securities.

A few commenters believe that the Display Rule was proposed solely to address problems in the OTC market, and accordingly there is no need for a uniform rule applicable to exchange markets.⁹⁰ As noted previously, the Commission's intention is to create a minimum standard for the handling of limit orders across all markets, consistent with market transparency, competition, and best execution principles. Currently, the national securities exchanges do not handle limit orders uniformly, and in fact the non-display of retail-size limit orders is permitted under certain circumstances. The rule will ensure that investors benefit from the display of limit orders, no matter where an order is sent for execution.⁹¹ A minimum standard also addresses concerns regarding the prevalence of hidden limit orders.⁹² The

approved by the Commission. See 17 CFR 240.11Aa2-1 and 11Aa3-1.

⁸⁷ As discussed below, the Display Rule will apply only to "covered securities." At the present time, the Commission does not believe the rule should be extended to securities for which market makers are not required to quote continuous firm two-sided markets, such as OTC Bulletin Board securities.

⁸⁸ See *supra* discussion at section III.A.2.a.

⁸⁹ 21(a) Report, *supra* note 28.

⁹⁰ See, e.g., BSE Letter; NYSE Letter; RPM Letter; Letter from David E. Humphreys, Executive Director, The Specialist Association, to Jonathan G. Katz, Secretary, SEC, dated February 2, 1996 ("Specialist Assoc. Letter").

⁹¹ See, e.g., Greene Study & Greene Study II, *supra* note 51.

⁹² See generally McInish & Wood Study, *supra* note 46 (hidden limit orders result in, among other things, artificial price improvement statistics and inferior order executions); *Traders Accuse Specialists of Holding Back Limit Orders*, Investment Dealers' Digest, 8, (February 14, 1994) (some traders have continued to accuse NYSE specialists of hiding limit orders even after the NYSE issued an Information Memo reminding specialists of their duties); Greene Study and Greene Study II, *supra* note 51 (one explanation for the significantly lower bid-ask spreads in the 1994-95 sample than in the 1990 sample, and the increase in the percentage of transactions at the quoted prices from the 1990 sample to the 1994-95 sample, may be that NYSE specialists were more

Commission believes, therefore, that a market-wide limit order display requirement is most consistent with the duty of best execution and the expectations of investors.

ii. Distinction Between Quotes and Orders

Some commenters maintain that the rule blurs the distinction between quotations and orders.⁹³ One commenter states that limit orders represent only a finite trading interest while quotes represent the "actual" market for a security; thus, displaying limit orders would not reflect the "true" state of the market and impair the quality of quotation information.⁹⁴ The commenter suggests that a separate limit order file would be more appropriate in light of these distinctions.⁹⁵ In this vein, several commenters mention the NASD's proposed NAQcess system,⁹⁶ suggesting that the Commission postpone implementation of the Display Rule until the Commission has an opportunity to assess the effects of NAQcess.⁹⁷ A few commenters suggest the implementation of an industry-wide consolidated limit order book as an

diligent in reflecting the limit order book in their quotes as per Information Memo 93-12); Amex Letter (rule would help eliminate hidden limit orders); CSE Letter (elimination of hidden limit orders will eliminate illusion of superior price improvement); Investors Research Letter (hidden limit orders are not justified).

⁹³ See, e.g., Letter from Raymond L. Aronson, Senior Managing Director, Bear, Stearns & Co. Inc., to Jonathan G. Katz, Secretary, SEC, dated February 1, 1996 ("Bear Stearns Letter"); Instinet Letter; Letter from Carol L. Cunniff, Executive Vice President, Ruane, Cunniff & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated February 23, 1996 ("Ruane Letter"); Letter from Charles R. Schwab, Chairman and Chief Executive Officer, The Charles Schwab Corporation, to Jonathan G. Katz, Secretary, SEC, dated January 25, 1996 ("Schwab Letter"). *But see* Schwab II Letter (supporting the Display Rule).

⁹⁴ Ruane Letter.

⁹⁵ *Id.* See also Bear Stearns Letter (discussion of proposed central limit order file for The Nasdaq Stock Market so as to preserve distinction between dealer quotes and agency or proprietary orders).

⁹⁶ See *supra* note 45.

⁹⁷ See, e.g., Letter from A.B. Krongard, Chief Executive Officer, Alex. Brown & Sons, Inc., to Jonathan G. Katz, Secretary, SEC, dated February 29, 1996 ("Alex. Brown Letter"); Letter from Albert G. Lowenthal, Chairman of the Board, Fahnstock & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("Fahnstock Letter"); Jefferies Letter; Letter from Gerard S. Citera, Deputy General Counsel, First Vice President, PaineWebber Incorporated, to Jonathan G. Katz, Secretary, SEC, dated February 9, 1996 ("PaineWebber Letter"); Schwab Letter; STA Letter; Letter from Charles Snow, Counsel, Securities Traders Association of New York, to Jonathan G. Katz, Secretary, SEC, dated January 30, 1996 ("STANY Letter"); see also Letter from C. Robert Paul, III, Associate General Counsel, Dean Witter Reynolds, Inc., to Jonathan G. Katz, Secretary, SEC, dated January 31, 1996 ("Dean Witter Letter"); Goldman Sachs Letter.

alternative or a logical outgrowth of the Display Rule.⁹⁸

The Commission believes that the display of limit orders is an essential component of accurate price discovery. A quote provides market participants with information regarding a market maker's or specialist's trading interest at a given price. A market maker or specialist could be willing to purchase or sell additional shares above its quoted size.⁹⁹ Entry of a customer limit order that improves the quote serves a similar purpose. A limit order accurately represents trading interest for a specific volume of a security at the limit price. There are few practical differences between customer limit orders and a market maker's quotation that is firm only for its quoted size. Nonetheless, the proposed rule was not intended to equate customer limit orders with market maker quotes. Instead, the proposed rule was designed to facilitate greater transparency of customer trading interest, with the expectation that orders would have an increased opportunity for best execution without the interaction of a dealer. In the Commission's opinion, these objectives are more difficult to achieve if customer trading interest is not routinely represented in publicly displayed quotes. The Commission notes that the Display Rule provides other means by which a market maker or specialist may comply with the requirements of the rule in the event a specialist or market maker elects not to display customer trading interest in its quote.¹⁰⁰

Further, the Commission does not agree with the suggestion that the Commission postpone the adoption of the Display Rule until the Commission has had an opportunity to evaluate the NASD's NAQcess proposal.¹⁰¹ Although

⁹⁸ See, e.g., DOJ Letter; MJT Letter; Schwab Letter; Letter from Junius W. Peake, Monfort Distinguished Professor of Finance, University of Northern Colorado, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("Peake Letter"); Letter from Jeffrey P. Ricker, CFA, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("Ricker Letter"); Letter from Peter W. Jenkins, Chairman, and Holly A. Stark, Vice Chairman, Institutional Committee, Securities Traders Association, to Jonathan G. Katz, Secretary, SEC, dated January 19, 1996 ("STAIC Letter").

⁹⁹ Under Commission rules, the market maker's quote is only required to be firm up to its published size. See 17 CFR 240.11Ac1-1(c)(2).

¹⁰⁰ For example, a market maker or specialist may deliver a customer limit order immediately upon receipt to another market maker or specialist, or to an ECN or an exchange or association sponsored system pursuant to the rule. Section 240.11Ac1-4(c)(5) and (6).

¹⁰¹ The Commission notes that the proposed NAQcess system is a significant and controversial proposal which has generated approximately 1,100 comment letters. The Commission is in the process

the NASD has argued that limit orders entered into NAQcess, as proposed, would result in greater display of OTC limit order prices, there is no assurance that market makers will enter such orders into NAQcess rather than hold the orders internally.¹⁰² Therefore, the Commission believes that the Display Rule is necessary to ensure display of these orders in the OTC market.¹⁰³ If approved, NAQcess can assist in compliance with the Display Rule to the extent that the system incorporates customer limit orders in the consolidated quote stream, thereby allowing market makers to enter limit orders in NAQcess rather than displaying limit orders in their quotes.¹⁰⁴ As noted earlier, the Commission has identified important benefits associated with limit order display. Accordingly, the Commission believes that it is not necessary to observe the effects of NAQcess in order to determine the benefits of the limit order display requirement.

iii. Liquidity

Several commenters assert that application of the Display Rule to Nasdaq securities could reduce liquidity in the Nasdaq market.¹⁰⁵ These commenters believe that market maker profits may decline due to narrowed spreads or increased compliance costs, with the result that many firms will decide not to make the necessary capital commitment to continue their market making operations. The commenters conclude that as the number of market makers in a security declines, liquidity will be adversely affected, leading to wider spreads. Moreover, some commenters believe that the decrease in liquidity will impair the capital formation process, especially for

of reviewing the comments and has yet to decide what action to take on the proposal.

¹⁰² See NAQcess Releases, *supra* note 45. As noted above, limit orders not entered in NAQcess would be provided with market-wide price protection.

¹⁰³ In any event, NAQcess will not address at all the issues of disparate limit order handling practices or hidden limit orders in the exchange markets.

¹⁰⁴ See Section 240.11Ac1-4(c)(5).

¹⁰⁵ See, e.g., Alex. Brown Letter; Bear Stearns Letter; Dean Witter Letter; Letter from Robert F. Mercandino, Senior Vice President, Dillon, Read & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated March 15, 1996 ("Dillon Letter"); Jefferies Letter; Lehman Letter; Letter from Robert J. McCann, Managing Director, Co-Head, Global Equity Markets, Merrill Lynch, Pierce, Fenner & Smith Incorporated, to Jonathan G. Katz, Secretary, SEC, dated January 26, 1996 ("Merrill Letter"); NASD Letter; PaineWebber Letter; Letter from David P. Semak, Vice President Regulation, PSE, to Jonathan G. Katz, Secretary, SEC, dated January 15, 1996 ("PSE Letter"); SIA Letter.

securities that are not mature enough for auction trading.¹⁰⁶

At least one commenter states that the usefulness of limit orders could be diminished by the refusal of some market makers to accept such orders, or by the imposition of high commission costs charged to recoup lost profits on spreads.¹⁰⁷ Other commenters believe, however, that it will be difficult for market makers to increase their commissions for limit orders.¹⁰⁸ They believe commission charges would not compensate for lost trading profits or prevent the ebb of market liquidity.¹⁰⁹

Other commenters believe the proposed rule will not have a negative impact on market liquidity. One commenter explicitly states that the benefits of the proposed rule would outweigh any potential adverse effects on liquidity.¹¹⁰ Another commenter says that the proposed rule would not result in any significant reduction in market making activity.¹¹¹ The CSE notes that it has not noticed any negative effects on market liquidity as a result of the implementation of its own limit order display rule.¹¹² Yet another commenter states that although it currently does not trade OTC securities, it expects that many market participants, including the commenter, would begin trading such securities if the proposed rule was adopted, thereby increasing market liquidity.¹¹³

The display of limit orders is designed, among other objectives, to publicize accurate market interest and increase quote competition.¹¹⁴ The Commission understands that certain costs, including a diminution in market maker profits, are associated with this increased market transparency. For example, a market maker that holds a customer limit order has, in effect, a private "option" to execute the order as principal. The longer this "option" remains open, the more time the market

maker has to determine whether it can profit from executing the order as principal.¹¹⁵ This private market maker "option," however, is potentially detrimental to the execution opportunities for the limit order. The Display Rule will limit this "option" and expose the order to market-wide trading interest. Moreover, increased price competition from limit orders may reduce market maker profits through the narrowing of spreads.¹¹⁶ As a result, the Display Rule may force less efficient competitors to stop making markets in some of the securities they now quote.

Although the rule could lead to a reevaluation by some market makers of the services they wish to provide, after considering the available evidence, and in light of its experience, the Commission does not believe that there will be a significant negative impact on the markets for covered securities. The Commission is not convinced that the loss of some market competitors in securities with many market makers would impair liquidity in these securities.¹¹⁷ The Commission believes that customer orders are the ultimate source of liquidity to the markets, and that adoption of a rule that improves the handling of such orders will have the effect of enhancing market liquidity.¹¹⁸ The Commission believes that a limit order display requirement will encourage new limit orders in securities to be entered, thus providing additional liquidity to the market from customers.¹¹⁹ The potential of limit orders to narrow quotes also may encourage the entry of additional market

¹¹⁵ The Commission recognizes that there is also a cost associated with holding that limit order, because a market maker is required to execute that limit order if it has engaged in a transaction for its own account that would have satisfied the limit order. See Manning I & II, *supra* note 24.

¹¹⁶ See *supra* notes 53-55 and accompanying text (display of customer limit orders in market maker quotes will act to eliminate certain trading behavior on Nasdaq and foster quote competition).

¹¹⁷ See, e.g., STAIC Letter (limit orders are critical to market liquidity).

¹¹⁸ The Commission does not thereby denigrate the contribution OTC market makers provide in a dealer market. The Commission notes, however, that most market makers provide primarily intra-day liquidity to customers, and generally seek to end the trading day with a limited inventory position in order to minimize inventory risk. Customer limit orders represent buying or selling interest at specified prices for their stated duration, which may be longer than intra-day. Market makers holding customer limit orders rely in part on these limit orders in quoting their own prices to buy and sell securities.

¹¹⁹ See Greene Study & Greene Study II, *supra* note 51 (limit orders affect the quoted spread and provide liquidity); NASD Study, *supra* note 21 (limit orders, like market maker quotes, supply liquidity to the markets); OEA Data, *supra* notes 50 and 52.

¹⁰⁶ See, e.g., NASD Letter; SIA Letter.

¹⁰⁷ Letter from David K. Whitcomb, Professor of Finance and Economics, Rutgers University Graduate School of Management, to Secretary, SEC, dated January 12, 1996 ("Whitcomb Letter").

¹⁰⁸ See, e.g., Letter from Irving M. Pollack, Alan B. Levenson, and Robert H. Rosenblum, Fulbright & Jaworski L.L.P., on behalf of Herzog, Heine and Geduld, Inc., to Jonathan Katz, Secretary, SEC, dated January 16, 1996 ("HHG Letter"); STA Letter.

¹⁰⁹ *Id.*

¹¹⁰ Lehman Letter.

¹¹¹ Letter from Daniel G. Weaver, Ph.D., Assistant Professor of Finance, Marquette University, to Jonathan G. Katz, Secretary, SEC, dated January 10, 1996 ("Weaver Letter").

¹¹² CSE Letter.

¹¹³ The commenter noted further that it does not currently trade OTC securities because it cannot be sure that its order will be represented to the whole market. Estep Letter.

¹¹⁴ See Market 2000 Study, at Study IV.

orders.¹²⁰ The Commission believes that the additional liquidity due to narrower spreads and increased customer orders will outweigh any potential loss of liquidity provided by market makers.

As noted above, some commenters expressed concern regarding the effect of the Display Rule on the availability of liquidity to small issuers.¹²¹ In response to these comments, the Commission's OEA examined market maker participation in 4,839 Nasdaq issuers over a one month period in 1996. The findings indicate that: (1) the median number of market makers in a security is not appreciably lower for initial public offering ("IPO") issuers or for securities with the smallest market capitalization; (2) broker-dealers that participated in IPO underwriting syndicates were active participants in aftermarket trading, but were not alone in providing significant market maker liquidity; and (3) in Nasdaq securities with the smallest market capitalization (\$2 million or less), the single most active market maker in an issue typically participated in one-third or fewer trades. Thus, there is no convincing evidence that Nasdaq issuers, including IPO issuers, are dependent for liquidity on any one market maker. The pattern of market making activity indicates that significant liquidity is provided by market makers who are not the "most active" market makers in a security. Because there does not appear to be high concentration in market making, and because of the Commission's belief that customer order flow is a critical source of market liquidity, the Commission believes that the proposals adopted today will not unduly impact liquidity for small or new issuers.

Furthermore, Commission experience has been that enhancements to transparency result in improved liquidity.¹²² The Commission believes

that these improvements are attributable, at least in part, to the impact of transparency on market integrity and investor confidence. In addition, while market maker profits per trade may be reduced as spreads are narrowed, increased volume over time may result in stable profit levels.¹²³

It also may become feasible for market makers to charge customers commissions for handling limit orders, even if that is not the current practice today. As noted earlier, some commenters claim that the Display Rule will have a disparate impact on wholesale Nasdaq market makers in that such market makers would not be able to offset the increased costs associated with limit order display through charges or commissions.¹²⁴ The Commission believes, however, that the systems costs associated with the Display Rule should not be overly burdensome,¹²⁵ nor should systems costs or any reduced market maker profitability from declining spreads be more extensive for wholesale market makers than for integrated market makers. Although

adoption of its "Manning" rules would severely impact market liquidity. See Market 2000 Study. However, there has been no evidence offered to the Commission of adverse liquidity consequences caused by these limit order protections, and the Commission is not aware of any significant diminution in liquidity. Further, as discussed in the Market 2000 Study, other transparency initiatives, such as the adoption of real-time transaction and quotation reporting, have resulted in increases in the competitiveness and liquidity of both listed and OTC equity markets despite market maker protestations to the contrary prior to adoption of these initiatives. See *Id.* at Study IV. See also Simon & Colby, *supra* note 58. Even the creation of Nasdaq itself was met with much opposition. The result of this major structural change was far from the predicted "death knell" of the OTC market. Rather, OTC market strength and liquidity have flourished since Nasdaq's inception. Based on the Commission's experience with other market structure initiatives, therefore, the Commission believes that improvements in order handling, market transparency, and efficiency will likely improve market liquidity.

¹²³ Although the display requirement may decrease a market maker's per trade profit due to narrowed spreads, the Commission believes that this decrease will be made up for in part by expected increases in trading volume attributable to enhanced liquidity and pricing efficiency. See *supra* note 24. The Commission believes this potential impact on market maker profits is justified in light of the benefits that will accrue to investors and the markets as a whole. Moreover, even if market makers' profits from trading do decline, market makers may be able to obtain increased revenues from commissions or other fees charged directly to customers. Because these other revenue sources are more transparent to customers than are revenues from market maker trading with customers on a proprietary basis, increased reliance on these other revenue sources will enable customers to make more informed trading decisions.

¹²⁴ See, e.g., HHG Letter.

¹²⁵ See Memorandum from Stephen L. Williams, S.L. Williams Co. to Richard R. Lindsey, Director, Division of Market Regulation, SEC (July 29, 1996) ("Williams Study").

exchange specialists and integrated firms may find it easier than wholesale firms to charge commissions initially, the Commission notes that wholesale firms are not prohibited from attempting to compensate for handling limit orders, either through negotiated fee arrangements, or reducing any payment made for order flow for limit orders.¹²⁶

iv. Discretion

Several commenters are concerned that the Display Rule would eliminate their discretion to determine the best way in which to execute a customer's order. The commenters also claim that customers rely on the judgment of a market professional in choosing whether to display a limit order.¹²⁷ For example, the NYSE believes that its current procedures allow broker-dealers to achieve the best prices for their customers.¹²⁸ Other commenters suggest that if the rule were amended to require the display of representative size, a dealer would retain some discretion on

¹²⁶ The level of these fees, of course, would be determined by competitive forces in the marketplace. Any fees passed on to non-broker-dealer customers would have to be disclosed in a clear fashion to the customer, and otherwise comply with applicable law. For example, NASD Rule 2440 states, in part, that if a member acts as agent for a customer in a transaction, the customer shall not be charged more than a fair commission or service charge, taking into consideration all relevant circumstances. See also NASD Regulatory & Compliance Alert Vol. 7, No. 4 (December 1993). At least one commenter argued that because spreads are ascertainable from public quotations and commissions are not, a rule that encourages charging commissions does not satisfy the goal of increased transparency. See Letter from Bruce C. Hackett, Managing Director, Salomon Brothers Inc., to Jonathan G. Katz, Secretary, SEC, dated January 25, 1996 ("Salomon Letter"). The Commission notes, however, that Rule 10b-10 under the Exchange Act requires customer confirmations to disclose commissions and, for listed and Nasdaq securities, the difference between the reported price and the price to the customer. Based on this disclosure, execution costs could actually become better known to customers if explicit fees are charged. Therefore, the Commission believes that the Display Rule will allow a customer to more easily monitor the execution quality of its limit orders, even if subject to fees for limit order executions. In addition, this situation should foster competition with respect to the amount, if any, firms will charge for the execution of a customer limit order.

¹²⁷ See, e.g., NYSE Letter; RPM Letter; Specialist Assoc. Letter.

¹²⁸ See, e.g., NYSE Letter; Specialist Assoc. Letter. According to the NYSE, a customer can choose to benefit from the display of its order or to benefit from relying on the specialist's discretion, depending on whether the order is sent to the post via SuperDOT, or is manually submitted. The NYSE also notes that enabling a specialist to use discretion in the handling of limit orders is important in light of the fact that the NYSE defines a limit order as an order to buy or sell at a specified price, or at a better price, if obtainable after the order is represented in the trading crowd. See NYSE Rule 13.

¹²⁰ See NASD Study, *supra* note 21 (those investors that demand immediate execution, e.g. those entering market orders, will pay less for executions due to the augmented liquidity supplied by limit orders); Greene Study and Greene Study II, *supra* note 51 (limit orders provide liquidity to traders that demand immediacy of execution and may contribute to reduced trading costs); OEA Data, *supra* notes 50 and 52 (display of limit orders narrows spreads, improves price discovery, and increases market depth for a variety of securities, including those NYSE securities that are thinly traded).

¹²¹ This concern also was raised in the context of the ECN Amendment to the Quote Rule.

¹²² In several instances in the past, commenters have claimed that other Commission initiatives to increase transparency would act to reduce liquidity; others have warned that such initiatives would decrease the competitiveness of the U.S. markets in relation to foreign counterparts. These claims, however, have not been borne out. For example, many industry participants argued that the NASD's

how best to execute the order.¹²⁹ To preserve discretion, at least one commenter argues that the rule should apply only when the customer requests that its order be displayed.¹³⁰

The Commission believes that the rule appropriately establishes a presumption that limit orders should be displayed, unless such orders are of block size, the customer requests that its order not be displayed, or one of the exceptions to the rule applies. The exception allowing a customer to request that its limit order not be displayed gives the customer ultimate control in determining whether to trust the display of the limit order to the discretion of a market professional, or to display the order either in full, or in part, to other potential market interest.¹³¹

v. Systems Burdens

Based on their belief that compliance with the Display Rule would result in a large increase in quotation traffic, a number of commenters maintain that the rule would require major overhauls of the order handling systems used by brokers, market makers and markets. For example, one commenter believes that it would be impossible to comply with the rule without additional automated systems.¹³² The commenter concludes that the costs associated with new systems and additional staff necessary to monitor a more volatile market would contribute to wider spreads and higher commissions.¹³³ In addition, one SRO claims that quotation traffic must be kept at manageable levels in order to allow entities to continue to manually process limit orders, thus eliminating the need for entities to bear the costs associated with automation of such orders.¹³⁴ Other commenters also note their concern over the potential operational costs associated with the rule.¹³⁵ The STA states that an in-depth review is needed to determine the costs

for new equipment and technology necessary to comply with the rule.¹³⁶

A few commenters are concerned that the increased quotation traffic that may be associated with the rule could pose a threat to the integrity of the central quotation system.¹³⁷ One commenter suggests that the rule be suspended for the first 30 minutes of trading.¹³⁸ Another commenter argues that modifying the rule to require only the display of representative size could act to alleviate some of the traffic concerns.¹³⁹

The Commission recognizes that achieving greater transparency for limit orders depends upon the existence of systems that are capable of the smooth and efficient display of trading interest. The Commission believes that the Display Rule will not substantially increase the quotation burden for exchange markets, where systems currently exist for the display of quotes.¹⁴⁰ In the OTC market, the Display Rule will result in additional quotation entries for market makers that display customer limit orders in their quotes. The Commission believes, however, that current systems can handle the additional volume, or can be expanded at moderate cost to handle the additional volume.¹⁴¹ Further, the

¹³⁶ STA Letter.

¹³⁷ See, e.g., Letter from Thomas J. Jordan, Financial Information Forum, to Jonathan G. Katz, Secretary, SEC, dated January 12, 1996 ("FIF Letter"); PaineWebber Letter; PSE Letter. This concern was expressed with respect to the proposal that the Commission adopt both the Display Rule and Price Improvement Rule. The fact that the Commission has deferred action on the Price Improvement Rule, as discussed below, should substantially diminish any system capacity concerns. Moreover, the Commission's decision not to require display of *de minimis* orders also should minimize system capacity concerns.

¹³⁸ FIF Letter. According to FIF, the heaviest traffic volume usually occurs within the first 30 minutes of trading.

¹³⁹ PSE Letter. The PSE notes, however, that the rule, even if modified, still may result in an increase in staffing costs. *Id.*

¹⁴⁰ For example, SuperDOT data indicates that 57% of all customer trades originating from orders routed through SuperDOT are limit orders. Of these limit orders, 20% narrowed the NYSE quote. See *supra* note 52. According to the NYSE, 93% of such orders are reflected in the NYSE quote within two minutes of receipt. See *supra* note 36 and accompanying text (teleconference). See also CSE Letter (costs associated with implementing such a system are minimal, especially in light of the benefits to the public); Paperwork Reduction Act discussion at section VII, *infra*.

¹⁴¹ The Commission notes that many small to medium broker-dealers utilize shared trading systems that enable such broker-dealers to streamline their OTC market making and back office responsibilities. Subscribers to such systems benefit by sharing costs associated with the application of improved technologies, rather than creating and updating systems of their own. Therefore, it is assumed that any changes deemed necessary to these shared systems to facilitate efficient

Commission notes that the Display Rule contains an exception to the display requirement for limit orders of *de minimis* size priced at the NBBO when the market maker's or specialist's quote matches the NBBO.¹⁴² The Display Rule also allows a specialist or OTC market maker several ways to comply with the rule by routing the order elsewhere without displaying the limit order in its own quote by transmitting a customer limit order to an exchange-or association-sponsored system or to a qualifying ECN.

Additionally, a few commenters believe that the Commission should give more consideration to the Display Rule's impact on automatic execution systems.¹⁴³ These commenters express concern that a market maker could be exposed to multiple transactions from its own customers in the firm's automatic execution system, which executes orders at the NBBO, even if the NBBO represents a customer limit order as opposed to the price at which a market maker is willing to trade. They claim this result is unfair, especially if the automatic system has a minimum share requirement that exceeds the customer limit order.

The Commission acknowledges the concern of some commenters regarding the rule's interaction with automated execution systems. However, because customer limit orders reflect actual trading interest, it has been the Commission's intention to enhance customer order executions throughout the markets by requiring the display of these customer limit orders.¹⁴⁴ Where a limit order represents the best quote, a

compliance with the Display Rule also would be shared by all subscribers.

In addition, the Commission specifically evaluated the costs associated with implementation of the Display Rule. Based on this evaluation, the Commission concluded that most market makers will not be required to invest substantial amounts of money in systems development in order to comply with the Display Rule as adopted. See Williams Study, *supra* note 125. See also CSE Letter (costs of implementing a system for display of limit orders are minimal).

¹⁴² See, § 240.11Ac1-4(b)(1)(ii). See also § 240.11Ac1-4(b)(2)(ii).

¹⁴³ See, e.g., Dillon Letter; HHG Letter; Merrill Letter; PaineWebber Letter; Schwab Letter.

¹⁴⁴ The Commission recognizes that SROs may have rules regarding the minimum quotation sizes associated with a specialist's or market maker's quote. The Commission believes that SROs should consider amending such rules and modifying certain systems to allow a specialist or market maker to quote in sizes smaller than the minimum quotation size when such quote represents a customer limit order. With these changes, a specialist or market maker that displays a customer limit order in its quote pursuant to the Display Rule would not be responsible for executing as principal any additional shares at the limit price where the size of the customer limit order is less than the minimum quotation size set by the SRO.

¹²⁹ See, e.g., Madoff Letter; NASD Letter; SIA Letter.

¹³⁰ Jefferies Letter.

¹³¹ See discussion of the exceptions to the Display Rule at section III.A.3.c., *infra*. See also § 240.11Ac1-4(c)(2); § 240.11Ac1-4(c)(4) (permitting a customer with a block size limit order to request that the order be displayed pursuant to the Display Rule). The Commission does not mean to imply that a specialist or OTC market maker that is not displaying a limit order pursuant to the request of its customer may not change its quotation in that security based on the specialist's or market maker's own trading interest.

¹³² PaineWebber Letter.

¹³³ *Id.*; see also Bear Stearns Letter (noting that the display rule would increase the volatility of quotes and, as a result, market makers would have a difficult time keeping up with the rapid changes in bids, offers, and quote sizes).

¹³⁴ PSE Letter.

¹³⁵ See, e.g., Alex. Brown Letter; Bear Stearns Letter; Jefferies Letter.

market maker can respond by sending its customer order to the market maker displaying the limit order at the NBBO, thereby attempting to execute the limit order setting that price and removing it as the NBBO.¹⁴⁵ Moreover, where the size of a limit order represented in the best quote is smaller than the size eligible for execution in an automated execution system, the Commission believes that it is not inconsistent with best execution principles for market makers and specialists using automated execution systems to take into account the size of the limit order quote in determining the price at which an order, or portions thereof, should be automatically executed. The Commission believes, however, that in such a case the market maker or specialist should provide the customer order an execution at the displayed price at least up to the displayed size of the limit order.¹⁴⁶ For example, if customer limit orders compose the NBBO of 10 1/4–10 1/2 (100 × 300), and a market maker receives a market order to sell 1,000 shares via an automatic execution system, the market maker may automatically execute 100 shares of the order at 10 1/4, and the remaining portion of the order at the next best bid.

3. The Operation of the Rule as Adopted¹⁴⁷

The rule as adopted applies to: (i) every member of an exchange that is registered by that exchange as a specialist or has been authorized by an exchange to perform functions substantially similar to that of a specialist ("specialist"); and (ii) OTC market makers.¹⁴⁸ The rule as adopted applies to specialists that trade on the floor of an exchange;¹⁴⁹ third market makers;¹⁵⁰ members of a national securities association that are OTC

¹⁴⁵ The Commission notes that the NASD's NAqcess system, as proposed, would permit market makers to send orders, including proprietary orders, to other market makers through the system. See *supra* note 45. See also ITS Plan. Moreover, the Commission believes that the NASD should consider modifying its SOES system to allow OTC market makers to route customer orders for execution against limit orders displayed by another market maker in the same security.

¹⁴⁶ If the market maker or specialist attempted but was unable to execute the displayed limit order through a reasonable and efficient means, such as sending an order through an automated system for an OTC security, the market maker or specialist would not be expected to give that limit order price to its customer.

¹⁴⁷ SRO rules that impose more stringent standards would continue to apply.

¹⁴⁸ Although the Commission consolidated certain sections of the proposed rule for clarity, the rule as adopted applies to the same entities identified in the proposed rule.

¹⁴⁹ Section 240.11Ac1-4(b)(1).

¹⁵⁰ Section 240.11Ac1-4(b)(2).

market makers;¹⁵¹ and specialists that trade an OTC security pursuant to unlisted trading privileges ("UTP").¹⁵² These market makers are required to reflect immediately in their bid or offer the price and the full size of each customer limit order they hold at a price that would improve their bid or offer in the security.¹⁵³ In addition, all market makers covered by the rule are obligated to reflect in their quotes the full size of a customer limit order that: (1) is priced equal to their bid or offer; (2) is priced equal to the national best bid or offer for the security; and (3) represents more than a *de minimis* change in relation to the size associated with their bid or offer.¹⁵⁴

a. "Covered Securities" and "Customer Limit Orders"

Rule 11Ac1-4 applies to "customer limit orders" in "covered securities." A covered security is defined as any reported security and any other security for which transaction reports, last sale data or quotation information is disseminated through an automated quotation system that is sponsored by a registered securities association. This definition is designed to encompass all exchange-listed securities, Nasdaq National Market securities and Nasdaq SmallCap securities.¹⁵⁵

¹⁵¹ Section 240.11Ac1-4(b)(2).

¹⁵² Section 240.11Ac1-4(b)(1).

¹⁵³ Section 240.11Ac1-4(b)(1)(i) and (b)(2)(i). The Commission wants to clarify that references to a specialist's or OTC market maker's bid or offer include instances where the bid or offer is a proprietary quote, as well as instances where the bid or offer represents a customer limit order. Further, if a market maker is not quoting publicly (e.g., a market maker that does not meet the 1% threshold of the Quote Rule), it still must publish a quotation that displays the limit order, or avail itself of one of the exceptions. Moreover, the Commission notes that some commenters suggest that the rule should require broker-dealers that are not specialists or OTC market makers to immediately transmit limit orders they receive to an entity or system that will display the orders in a manner consistent with the rule. See, e.g., CSE Letter; Madoff Letter; Whitcomb Letter. Also, at least one commenter believes that institutional firms trading in block size should be considered "OTC market makers" for purposes of the rule and subject to the display requirement. Amex Letter. See generally *infra* notes 191–193 and accompanying text. The fact that the Commission has not adopted these suggestions as part of the Display Rule does not relieve broker-dealers which receive such orders from compliance with their obligation to obtain best execution for those orders.

¹⁵⁴ Section 240.11Ac1-4(b)(1)(ii) and (b)(2)(ii).

¹⁵⁵ Securities listed on regional exchanges that do not substantially meet NYSE or Amex original listing criteria do not satisfy the definition of "covered security." Such securities are not "reported securities" as that term is defined, nor do they meet the other elements of the definition of covered security. OTC Bulletin Board ("OTCBB") securities also do not satisfy the definition of covered security. The Commission has determined not to extend the display requirement to any of those securities at the present time.

The Commission received several comments regarding the application of the rule to Nasdaq securities. Some commenters believe that the rule should not extend to all Nasdaq securities, and that some measure of liquidity should be used to determine which Nasdaq securities should be subject to the rule.¹⁵⁶ For example, one commenter suggests limiting the rule's application to the top 250 Nasdaq National Market securities with the highest average daily trading volume over the previous calendar quarter.¹⁵⁷ In contrast, another commenter favors the inclusion of Nasdaq SmallCap securities within the definition of "covered security."¹⁵⁸ Further, at least one commenter suggests that the rule apply not only to all Nasdaq securities, but also to OTCBB securities.¹⁵⁹

As noted above, the Commission believes that the Display Rule should apply equally to exchange-traded as well as non-exchange-traded securities. In addition, the Commission believes it is appropriate to include all Nasdaq securities within the definition of "covered security." The Commission believes that, regardless of the current trading volume of a particular security, the investors in any security can benefit from the uniform display of customer buying and selling interest if all quotations in that security are required to be firm. As noted previously,¹⁶⁰ data analyzed by the Commission shows that limit orders are used frequently for transactions in NYSE securities with ADTVs under \$100,000. On average, 63% of customer orders in such securities are limit orders. Of those limit orders, 30% narrowed the NYSE quote and 32% matched the quote. This data indicates that the display requirement may lead to increased customer trading interest in securities that are currently thinly traded.¹⁶¹

The Commission reiterates that limit order display is not solely an issue of improved transparency. The Display Rule will improve the handling of customer orders across all markets and increase the probability that a customer limit order will be executed. Therefore, the Commission believes that a uniform limit order display requirement is

¹⁵⁶ See, e.g., Bear Stearns Letter; Lehman Letter; Merrill Letter; NASD Letter; SIA Letter.

¹⁵⁷ SIA Letter.

¹⁵⁸ PSE Letter.

¹⁵⁹ Ricker Letter.

¹⁶⁰ See *supra* notes 50 and 52.

¹⁶¹ As stated previously, because dealers are not required to register as OTC market makers in OTCBB securities and are not required to enter and maintain continuous firm two-sided quotations in OTCBB securities, the Commission does not believe that the Display Rule should be extended to such securities at this time.

closely related to a broker-dealer's ability to obtain best execution for limit orders.

The Commission recognizes, however, that the rule represents a significant change for the OTC market. The Commission, therefore, has determined to provide a phase-in period for application of the rule to customer limit orders in Nasdaq securities.¹⁶² The Commission believes that the phase-in period will allow the Commission to monitor the effects of the rule on the most liquid Nasdaq securities first, while ensuring that customer limit orders in all Nasdaq securities will receive the benefits of the rule within one year of its adoption. This schedule also will provide OTC market makers with time to adjust their systems to comply with the rule's requirements.¹⁶³

Under the rule, a customer limit order includes any order to buy or sell a covered security at a specified price not for the account of a broker or dealer. Customer limit orders transmitted from one broker-dealer to another for execution are included in the definition. Although some commenters believe that the rule should be extended to orders for the account of a broker or dealer, the Commission does not believe such extension is appropriate at this time. The Commission acknowledges that the display of all limit orders, including those of a broker or dealer, would further enhance transparency.¹⁶⁴

Requiring the display of broker-dealer limit orders, however, would be a significant extension of the rule that could change its impact on market maker participation and increase its operational burdens. Therefore, the Commission believes that the effects of the rule should be observed, and additional comment should be solicited, before the rule is expanded.¹⁶⁵

b. Size

As noted above, some commenters expressed concern regarding the requirement that specialists and OTC market makers display the full size of a customer limit order. These commenters suggest that the rule only require the

display of representative size.¹⁶⁶ They argue that the use of representative size would preserve the ability of a specialist or OTC market maker to exercise some discretion in determining the best execution of the order.¹⁶⁷

Other commenters, however, believe that the full size of a customer limit order should be required to be displayed.¹⁶⁸ Such commenters argue that the display of full size is an important element in the Commission's effort to improve transparency and, therefore, no dealer discretion should be permitted unless a customer expressly requests that its order not be displayed, or expressly grants discretion, pursuant to the Display Rule.¹⁶⁹

The Commission continues to believe that the display of full size is important to improved transparency. The display of full size will provide the most accurate picture of the depth of the market at a particular price.¹⁷⁰ The Commission believes that size, as well as price, is a factor in attracting order flow and that the display of full size increases the likelihood that a limit order will be executed. The Commission, however, understands that there may be instances where a customer would not want its order displayed, or does not want the full size of its order displayed. The Display Rule, therefore, still contains an exception for a customer that decides to rely on the

discretion of a broker-dealer rather than to take advantage of the display requirement for its limit order.¹⁷¹ The Display Rule also permits a customer to state explicitly what portion, if any, the customer wants displayed.¹⁷² Furthermore, the Display Rule contains other exceptions to the display requirement that will ease any potential operational burdens associated with the display of full size.¹⁷³

The following example illustrates the application of the Display Rule where a customer limit order improves the price of a specialist's or market maker's quote. Assume that a market maker covered by the rule is quoting 10-10¹/₂ (2,000x2,000) when it receives a customer limit order in a covered security to buy 4,000 shares at 10¹/₄. Under the rule, the market maker must change the price and size associated with its quote to 10¹/₄-10¹/₂ (4,000x2,000). If this new quote represents the NBBO, the Display Rule would require the market maker to increase the size associated with the quote upon the receipt of additional customer limit orders. For example, if the market maker subsequently accepts another customer limit order to buy 4,000 shares at 10¹/₄, the market maker must change its quote to 10¹/₄-10¹/₂ (8,000x2,000).

The rule as adopted contains a *de minimis* standard applicable in situations where a customer limit order equals a specialist's or market maker's displayed price and that price is equal to the NBBO. One commenter states that the use of representative size would eliminate the Commission's need to rely on a *de minimis* standard.¹⁷⁴ Another commenter believes that the rationale underlying the *de minimis* standard demonstrates that the display of size does not benefit public customers.¹⁷⁵ Some commenters also believe that the *de minimis* standard should be clarified or even eliminated.¹⁷⁶

The Commission proposed the *de minimis* standard to strike a balance

¹⁷¹ Section 240.11Ac1-4(c)(2).

¹⁷² *Id.*

¹⁷³ As noted above, a specialist or OTC market maker has the ability to execute a customer limit order upon receipt; transmit the order to another exchange member or OTC market maker that will display the limit order in accordance with the rule; or transmit the order to an exchange or association sponsored system pursuant to the rule.

Additionally, a specialist or OTC market maker may transmit an order to an ECN that provides for public display of limit orders and provides access to these orders. Moreover, the rule contains an exception to the display requirement for certain orders of *de minimis* size.

¹⁷⁴ CSE Letter.

¹⁷⁵ Dean Witter Letter.

¹⁷⁶ See, e.g., Amex Letter; CHX Letter; Schwab Letter.

¹⁶⁶ See, e.g., BSE Letter; CSE Letter; Madoff Letter; NASD Letter; NYSE Letter; PSE Letter; SIA Letter; Specialists Assoc. Letter; see also LJR Letter (questioning whether the display of size, at least with respect to institutional orders, would be consistent with best execution obligations).

¹⁶⁷ See, e.g., Madoff Letter; NASD Letter; NYSE Letter; SIA Letter; Specialists Assoc. Letter.

¹⁶⁸ See, e.g., Amex Letter; CHX Letter; D.E. Shaw Letter.

¹⁶⁹ See, e.g., Amex Letter; CHX Letter; D.E. Shaw Letter; ICI Letter.

¹⁷⁰ A few commenters believe that all customer limit orders should be displayed, including the size of those orders that equal the specialist's or OTC market maker's bid or offer, but are not equal to the NBBO. See, e.g., CHX Letter; Letter from Edward J. Johnsen, Vice President and Counsel, Morgan Stanley & Co., to Jonathan G. Katz, Secretary, SEC, dated January 16, 1996 ("Morgan Stanley Letter"); Peake Letter; Weaver Letter. The Commission believes, however, that the burden associated with the commenters' suggestion would outweigh the corresponding benefit to market transparency. Of course, the rule represents a floor, rather than a ceiling. An exchange, association, or broker-dealer may determine to adopt more stringent display requirements. Requiring display of size when the limit order is away from the NBBO and equals the market maker's or specialist's quote would provide some additional market information but also would require market makers not quoting at the NBBO to change their quote size on an ongoing basis. Although some market makers or specialists may choose to do so to be prepared if their quotation becomes the NBBO, on the whole the Commission believes the increased transparency that would result from this updating would not outweigh the burdens imposed by a display requirement.

¹⁶² See description of the phase-in at section III.A.3.d., *infra*.

¹⁶³ See, e.g., Amex Letter.

¹⁶⁴ The Commission also is sensitive to the fact that providing suitable opportunities for broker-dealers, including options market makers, to lay off risk is an important component of overall market liquidity and efficiency. See Manning II, *supra* note 24.

¹⁶⁵ The Commission notes that other actions recently taken by the Commission address certain anti-competitive behavior in the Nasdaq market that heretofore may have negatively impacted the ability of some broker-dealers, including options market makers, to efficiently perform their market making function. See 21(a) Report, *supra* note 28.

between the benefits of increased transparency and operational burdens that might arise under the display requirement in displaying limit orders irrespective of size. The *de minimis* standard was intended to reduce the burdens of displaying the smallest of limit orders where the frequent updating of the quote for smaller orders would not result in significant improvements in quotation size. The Commission believes that the size of a customer limit order should be considered *de minimis* if it is less than or equal to 10% of the displayed size associated with a specialist's or OTC market maker's bid or offer.¹⁷⁷

The Commission believes that this *de minimis* standard will ease potential operational burdens associated with the display of additional size in a specialist's or OTC market maker's quote. The following example illustrates the application of the *de minimis* standard.

Assume a market maker's quote is 10-10½ (1,000×1,000), and the NBBO is 10-10¼ when the market maker receives a customer limit order to buy 2,000 shares at 10. Under the rule, the market maker is obligated to change the size of its quote immediately to 10-10½ (3,000×1,000).¹⁷⁸ In this case, the 2,000 share order size is more than *de minimis* in relation to the size associated with the market maker's quote. If the limit order was for 100 shares, however, the market maker would not be required to change its quotation size because the order is *de minimis* in relation to its quote.¹⁷⁹ Alternatively, the market

maker could voluntarily display the additional 100 shares.

c. Exceptions

The rule requires the "immediate" display of certain customer limit orders. To satisfy this requirement, a specialist or OTC market maker must display the limit order immediately upon receipt unless there exists an applicable exception to the display requirement. Some commenters have asked for clarification of the "immediate" display requirement.¹⁸⁰ The Commission is mindful that some measure of time is needed for specialists or market makers to display limit orders in the quote. Assuming that a specialist or OTC market maker does not rely on one of the exceptions to the Display Rule, however, such specialist or OTC market maker must display the order as soon as is practicable after receipt which, under normal market conditions, would require display no later than 30 seconds after receipt.¹⁸¹

There are seven exceptions to the general requirements of the rule. The first exception applies to any customer limit order that is executed upon receipt of the order.¹⁸² If the order is executed upon receipt, then no duty arises under the rule.

The second exception applies to any limit order that is placed by a customer who expressly requests that the order not be displayed.¹⁸³ This request may take place on an order-by-order basis, or may be agreed to prospectively. Most commenters that addressed the issue were in favor of the exception.¹⁸⁴ The Commission included this exception because there could be instances in which a customer prefers to exclude its order from public display. For example, a customer with a large limit order could wish to let its broker work the order rather than display the entire order. This exception gives the customer the right to decide if the order should be displayed in its entirety, in part, or not at all.¹⁸⁵ The Commission notes that

¹⁸⁰ See, e.g., Amex Letter; D.E. Shaw Letter; NYSE Letter; PSE Letter.

¹⁸¹ The Commission stresses that specialists and OTC market makers still are under an obligation to protect the customer limit order even during the time the limit order is not displayed. See, e.g., Manning I & II, *supra* note 24 (prohibiting trading ahead of customer limit orders). It should also be noted that this standard would supersede SRO rules that are less stringent with regard to the time in which limit orders are to be displayed. Those rules that impose more stringent standards may continue to apply.

¹⁸² Section 240.11Ac1-4(c)(1).

¹⁸³ Section 240.11Ac1-4(c)(2).

¹⁸⁴ *But see*, e.g., Madoff Letter; Morgan Stanley Letter.

¹⁸⁵ Any portion of a customer limit order that is not displayed pursuant to this exception shall not

under this exception, a customer may leave the decision to display an order to the discretion of a broker-dealer. Therefore, rather than instructing a broker-dealer not to display an order, a customer, consistent with this exception, may instruct the broker-dealer to use its discretion in determining whether to display the order. Although allowing some orders to not be displayed or to be displayed partially in the system reduces transparency, the Commission believes this exception is appropriate to give investors flexibility in deciding how their orders should be handled.

The exception to the rule requires a customer to expressly request that an order *not* be displayed.¹⁸⁶ A customer request that an order be placed in a particular non-public trading system would not, by itself, be deemed to be a non-display request. The Commission expects that most retail customers will want their limit orders displayed pursuant to the rule. Thus, the Commission has written the rule to require specialists and OTC market makers to assume that retail customers wish to have their orders displayed unless the customer specifically requests that the order not be displayed.

The exception also permits any customer to negotiate with its broker-dealer an individual agreement regarding the display of its limit orders either on an order-by-order basis or prospectively. Standardized disclaimers or contractual language in broker-dealer new account agreements, however, would not be deemed to be an individual request by a customer that its order or orders not be displayed.

The third exception applies to odd-lot orders.¹⁸⁷ The rule does not require the display of an order for less than a unit of trading as established by the rules of the exchange or association. In the event that a round-lot limit order represented in the quote is partially filled and, as a result, the remainder of the order would then be deemed an odd-lot order, the remainder of the order may be treated as an odd-lot for purposes of this exception. For example, assume a

be included in the calculation for determining whether any other limit order is *de minimis*. See *supra* note 179.

¹⁸⁶ At least one commenter believes that documentation of such customer requests should be required. CHX Letter. Although the Commission does not believe it necessary to mandate a particular method of record keeping, the Commission expects the compliance departments of individual firms to discharge their responsibilities in such a manner as to allow adequate supervision of compliance with the customer's request not to display or to display pursuant to discretionary authority provided by the customer.

¹⁸⁷ Section 240.11Ac1-4(c)(3).

¹⁷⁷ Any SRO may set more stringent display requirements through its own rules.

¹⁷⁸ If the original 1,000 shares displayed represents the market maker's proprietary quote and, consistent with Rule 11Ac1-1, the market maker no longer wishes to trade for its own account at 10, the market maker may quote at 10-10½ (2,000×1,000).

¹⁷⁹ The Commission stresses that all other orders previously considered *de minimis* and not displayed must be added to the order under consideration for purposes of the *de minimis* calculation. Therefore, in the case of a 100 share limit order to buy at 10, where the market maker had a previous 100 share limit order to buy at 10 that was not displayed pursuant to the *de minimis* standard, both orders must be considered together for purposes of making the *de minimis* calculation. Because 200 shares is more than 10% of the displayed size of 1,000, the market maker must include the 200 shares in its quote.

The Commission notes that if an OTC market maker chooses not to display a *de minimis* limit order, the NASD's interpretation regarding limit orders would prohibit the market maker from trading ahead of the limit order. See Manning I & II, *supra* note 24. In addition, the NASD has indicated that market makers must establish and consistently follow policies regarding the priority in which limit orders received from customers, which would include *de minimis* orders, will be executed. See Special NASD Notice to Members 95-43 (June 5, 1995).

market maker is quoting at the NBBO ($10\frac{1}{4}$ – $10\frac{3}{8}$ (200×1000)) and is representing a 200 share customer limit order to buy when a market order to sell 150 shares is received. Upon execution of 150 shares of the 200 share customer limit order, the market maker is not required to display the remaining 50 shares of the order at $10\frac{1}{4}$.¹⁸⁸

The fourth exception applies to block size orders.¹⁸⁹ Orders of at least 10,000 shares or for a quantity of stock having a market value of at least \$200,000 need not be displayed in accordance with the rule, unless the customer so requests.¹⁹⁰ The Commission recognizes that the display of block size orders would add to market transparency. In practice, however, the handling of block size orders differs from other orders. For example, in the OTC market, market makers often negotiate terms and conditions with respect to the handling of block size orders, and display of block size orders may impact market maker quotations in a security more than would smaller limit orders.¹⁹¹ Further, one of the major objectives in proposing the Display Rule was to improve the handling and execution opportunities afforded to customers that lack the power to negotiate better terms. Because most investors that trade in block size have such power, the Commission has chosen not to mandate the display of block size orders, unless the customer so requests.¹⁹² The Commission is satisfied that the current definition strikes an appropriate regulatory balance by requiring a presumption in favor of display for those orders requiring enhanced

protection, while not extending the presumption to those orders less likely to need such protection. Of course, the Commission may reevaluate its treatment of block size orders at a later date.

As proposed, the fifth exception would have applied to a limit order that is delivered immediately to an exchange or association sponsored system that displays limit orders and complies with the requirements of the rule with respect to that order.¹⁹³ This exception did not relieve a specialist or OTC market maker from its display obligation for orders it received through exchange or association facilities, unless the facility itself displayed the order.¹⁹⁴

In the Proposing Release, the Commission requested comment on whether to extend this exception from display to instances where customer limit orders are sent to ECNs or PTSs by a specialist or OTC market maker.¹⁹⁵ As discussed below in connection with the amendments to the Quote Rule, the Commission is amending the Quote Rule to require specialists and OTC market makers to include priced orders they enter into ECNs in the bids and offers they communicate to their exchange or association for reflection in their published quotations, when such orders improve their published quotations.¹⁹⁶ In recognition of the concerns raised by commenters, the Commission also has included an alternative to the amendment designed to preserve the anonymity of specialists and OTC market makers that is

¹⁹³ Section 240.11Ac1-4(c)(5). A facility would not be deemed to comply with the requirements of the Display Rule if the highest priced buy orders and lowest priced sell orders entered by a specialist or OTC market maker in the facility for a particular security were not included in calculating the best bid and offer for the market and incorporated in the consolidated quote.

¹⁹⁴ One commenter argues that the exception permits specialists and OTC market makers to become "fair weather dealers," effectively allowing them to selectively withdraw from the national market system, which creates a misleading picture of liquidity. Madoff Letter. The Commission believes, however, that the exception provides a specialist or OTC market maker with an appropriate amount of discretion in handling a customer limit order while ensuring that orders at the best price are displayed to the marketplace.

¹⁹⁵ See, e.g., Letter from James Lynch, General Counsel, ITG, Inc., to Jonathan G. Katz, Secretary, SEC, dated, January 15, 1996 ("POSIT Letter") (not supporting the extension of the exception); PSE Letter (extension of exception should be contingent on access provided by ECNs); Whitcomb Letter (doubtful that exception could be extended in today's environment); see also Madoff Letter (market makers and specialists should be able to represent a portion of the size of a customer limit order in other markets or ECNs, but the best price and some size should be reflected in their quote).

¹⁹⁶ See § 240.11Ac1-1(c)(5)(i)(A); see also Amendments to the Quote Rule discussion at section III.B.2.c.ii., *infra*.

currently provided by certain ECNs, while still publicizing in the public quotation stream better prices entered into ECNs. The ECN display alternative in the Quote Rule is available only if the ECN provides for public dissemination of the price and full size of the orders entered by specialists and OTC market makers to an exchange or association and provides access to other broker-dealers to trade at those prices which is equivalent to that provided in the market where the prices are disseminated.¹⁹⁷

The Commission believes that ECNs that provide their best specialist and market maker prices to the public quotation system and provide ready access to their prices can provide an effective means for specialists and OTC market makers to ensure that customer limit orders are handled in a manner consistent with the Display Rule. In view of the ECN display alternative in the Quote Rule, the Commission believes it is appropriate to extend the exception in the Display Rule to orders entered into ECNs that comply with the Quote Rule alternative.¹⁹⁸ Accordingly, a specialist or OTC market maker that delivers a customer limit order to an ECN will be deemed to have satisfied its display obligation with regard to that order if the ECN complies with the requirements of the new alternative in the Quote Rule.¹⁹⁹ The proposed exception for limit orders entered into exchange or association sponsored systems contemplated that such orders would be transparent and accessible. Therefore, expanding the exception to include the use of ECNs that provide for the requisite transparency and accessibility is consistent with the rule as proposed.

The Commission notes that this exception to the Display Rule maintains the benefits, including increased transparency, provided to customer limit orders under the rule. The

¹⁹⁷ As discussed, the Commission expects the SROs to work expeditiously with ECNs that wish to avail themselves of this alternative, and is prepared to act if necessary to ensure the effectiveness of the ECN display alternative, prior to the effective date of the Quote Rule amendments. See Introduction and Summary, *supra*; see also § 240.11Ac1-1(c)(5)(ii); Amendments to the Quote Rule discussion at section III.B.2.c.iii., *infra*.

¹⁹⁸ See Amendments to the Quote Rule discussion at section III.B.2.c.i., *infra*, for a description of the ECN definition; see also § 240.11Ac1-1(a)(8); § 240.11Ac1-4(a)(8).

¹⁹⁹ Section 240.11Ac1-4(c)(5). See also, Amendments to the Quote Rule discussion on accessibility at section III.B.2.c.iii., *infra*. Additionally, a specialist or OTC market maker may be relieved of its display obligation if it delivers the customer limit order to an exchange or association sponsored system that complies with the new alternative in the Quote Rule. Section 240.11Ac1-4(c)(5).

¹⁸⁸ The market maker still will have best execution obligations with respect to the remaining odd-lot portion of the customer limit order.

¹⁸⁹ Section 240.11Ac1-4(c)(4).

¹⁹⁰ This block definition is consistent with the current definition used in NYSE Rule 127.10. Some commenters, however, suggest that the parameters for such orders be increased or made flexible depending on the liquidity of a particular security. See, e.g., D.E. Shaw Letter; PSE Letter; Schwab Letter. Still others believe that there should be no exception for orders of block size. Instead, these commenters want such orders to be included within the scope of the rule so as to add to market transparency. See, e.g., Amex Letter; ICI Letter; Lehman Letter; Peake Letter; Ricker Letter. One commenter suggests the use of a "block indicator" to give a specialist or OTC market maker the option of displaying the full size of the order or using the indicator to identify the quote as representing a block size order. Lehman Letter.

¹⁹¹ See, e.g., Manning II, *supra* note 24.

¹⁹² Customers placing block orders, however, may request that the order be displayed in accordance with the requirements of the rule; a specialist or OTC market maker that accepts the order will be obligated to honor such a request. Section 240.11Ac1-4(c)(4). The Commission expects that adequate procedures will be developed to ensure compliance with a customer request. See *supra* note 186.

exception ensures that customer limit orders will have equivalent public disclosure whether they are sent to an ECN that complies with the alternative or displayed directly in a specialist's or OTC market maker's quote.²⁰⁰

The sixth exception applies to a limit order that is delivered to another exchange member or OTC market maker that complies with the display requirements of the rule with respect to that order.²⁰¹ For example, a market maker that receives a limit order subject to the display requirement under the rule may immediately send the order to another market maker in the security if the other market maker will display the order in accordance with this rule.²⁰²

The seventh exception applies to "all-or-none limit orders." An "all-or-none limit order" is an order accompanied by the customer's instruction that the order is to be executed in its entirety or not at all.²⁰³ Although this exception was not included in the proposed rule, the Commission believes that exempting all-or-none limit orders is necessary to avoid operational difficulties regarding partial executions at the public quote.²⁰⁴ In this regard, all-or-none limit orders typically are not displayed in the exchange markets today.²⁰⁵ The Commission believes, therefore, that this exception is consistent with the goals and objectives of the Display Rule.

Finally, a new provision has been included that enables the Commission to exempt, conditionally or unconditionally, any transactions that may determine are not encompassed within the purposes of the Display Rule. The Commission believes that this exemptive authority provides flexibility in applying the Display Rule.²⁰⁶

d. Effective Date and Phase-In

The Display Rule will become effective on January 10, 1997. As of this

²⁰⁰ An OTC market maker or specialist choosing to enter customer limit orders for display through an ECN must still evaluate whether the customer order is likely to obtain best execution through display in that ECN. See section III.C.2., *infra*.

²⁰¹ Section 240.11Ac1-4(c)(6).

²⁰² One commenter believes that the rule should require a specialist or OTC market maker to obtain assurances that a customer's limit order will be displayed in accordance with the rule before such an order is sent. MJT Letter. *But see* PSE Letter; Salomon Letter. As noted earlier, the Commission believes that it is best left to a firm's compliance department to decide on the necessary assurances that the order will be displayed in conformance with the rule.

²⁰³ See, e.g., NYSE Rule 13.

²⁰⁴ For example, if an all or none order to buy 1,000 shares at 10 $\frac{1}{4}$ were displayed in the quote and represented the NBBO, a subsequent market order to sell 500 shares could not be matched against the all or none order.

²⁰⁵ See, e.g., NYSE Rule 13.

²⁰⁶ Section 240.11Ac1-4(d).

date, the Display Rule will apply to exchange-traded securities. Moreover, this date will mark the beginning of the first phase-in for Nasdaq securities. As of this date, the Display Rule will apply to the 1,000 Nasdaq securities with the highest average daily trading volume in the previous quarter.

The second phase-in date will be on March 28, 1997. From this date forward, the Display Rule will apply to the next 1,500 Nasdaq securities with the highest average daily trading volume over the previous quarter.²⁰⁷

The third phase-in date will be on June 30, 1997. From this date forward, the Display Rule will apply to the next 2,000 Nasdaq securities with the highest average daily trading volume over the previous quarter.

The final phase-in date will be on August 28, 1997. From this date forward, the Display Rule will apply to all remaining Nasdaq securities.

Although the Commission believes that the Display Rule should apply equally to exchange-traded and non-exchange-traded securities, the Commission understands that the Display Rule will more significantly impact current order handling procedures for Nasdaq securities in light of existing practices in that market. The phase-in period will allow the Commission to monitor the effects of the Display Rule on successive groups of Nasdaq securities while ensuring that all covered securities receive the benefits of the display requirement within one year of the Display Rule's adoption.

B. Amendments to the Quote Rule

1. Background

Public quotation reporting for equity securities is governed by the Commission's Quote Rule,²⁰⁸ as well as by exchange and NASD rules. These rules require registered exchanges and securities associations to file quotation reporting plans with the Commission that provide for the collection and transmission of quotation information on a real-time basis for securities

²⁰⁷ Any security already covered by the rule will not be included as part of the calculation of the securities to be included in any subsequent group. Therefore, if a security is included as one of the 1,000 securities in the first group, such security will not be counted as one of the next 1,500 securities in the second group (even if such security's average daily trading volume over the previous calendar quarter would otherwise place it in the second group).

²⁰⁸ 17 CFR 240.11Ac1-1. See also Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978) ("Quote Rule Adopting Release").

covered by the Quote Rule.²⁰⁹ Market makers and exchange specialists communicate their quotes to the NASD or to an exchange pursuant to these plans and the NASD and exchanges in turn make this information available to vendors for dissemination to the public.²¹⁰

The Quote Rule requires the collection and public dissemination of the best bid, best offer, and size for each market quoting any security covered by the Quote Rule, as well as the consolidation of those markets' quotations and public dissemination of the national "consolidated" best bid and offer ("NBBO").²¹¹ These quotations must be firm, and a market maker or specialist generally is obligated to execute an order at a price at least as favorable as its published bid or offer up to the size of its published bid or offer.²¹² Broker-dealers covered by the Quote Rule, including dealers trading listed securities in the OTC market (*i.e.*, third market makers), must supply quotations to their exchange or association for dissemination to quotation vendors.

The 1975 Amendments identified the need for a prompt, accurate and reliable

²⁰⁹ Rule 11Ac1-1(b)(1), 17 CFR 240.11Ac1-1(b)(1) (dissemination requirements for exchanges and associations).

²¹⁰ Rule 11Ac1-2, 17 CFR 240.11Ac1-2 ("Vendor Display Rule") requires vendors of market information to display quotation information in a non-discriminatory manner.

²¹¹ Rule 11Ac1-1(b)(1), 17 CFR 240.11Ac1-1(b)(1). Pursuant to the Quote Rule and the Joint Consolidated Quotation Plan ("CQS Plan"), the inside quotations collected and calculated by the exchanges and Nasdaq for exchange-listed securities are consolidated and disseminated to vendors by SIAC, the exclusive processor for consolidated quotations in listed securities. Similarly, Nasdaq is the exclusive processor for quotations in Nasdaq National Market ("Nasdaq NMS") securities. Nasdaq collects and consolidates inside quotations furnished by OTC market makers and by exchanges pursuant to a Joint Self-Regulatory Organization Plan that provides for exchange trading of Nasdaq securities. Nasdaq then disseminates to vendors the inside bid and offer in Nasdaq NMS securities, and disseminates to various subscribers more specific information concerning the individual market maker and exchange quotes in each Nasdaq security. The terms "consolidated quote" and "publicly available quotation," when used with respect to information disseminated by exchanges and Nasdaq via their exclusive processors, refer to the quotes that SIAC or Nasdaq furnishes to vendors for dissemination to the public. The terms "public quote" or "publicly available quote," when used with respect to a specialist or market maker, refer to the bid and offer that the specialist or market maker has furnished to its exchange or association for inclusion in the consolidated quote. The term "public quotation system" refers to this entire structure through which SROs collect quotations from market participants, and the exclusive processors collect, process, and disseminate those quotations to vendors.

²¹² Rule 11Ac1-1(c)(1), 17 CFR 240.11Ac1-1(c)(1). This is referred to as the broker-dealer's "firmness" requirement.

central quotation reporting system.²¹³ The Quote Rule, in particular, was designed to facilitate the NMS by requiring specialists and market makers publishing quotes to provide these quotes to a central system so they could be made available to the public. Congress considered the public availability of quotation information to be critical to fair and competitive markets because published quotations provide investors, their brokers, and other market participants with essential information about the condition of the market. This information assists investors in making investment decisions and in finding the best market for a security, while making it possible for investors to evaluate the quality of their executions.

Since the 1975 Amendments and the adoption of the Quote Rule, there have been dramatic changes in the markets and the technologies used by market participants. To ensure that the Quote Rule keeps pace with the evolution of the securities markets and continues to ensure the public availability of accurate, reliable, and comprehensive quotation information, the Commission has determined that certain amendments to the Quote Rule are necessary and appropriate in furtherance of the objectives of the Exchange Act.

The Commission proposed an amendment to the Quote Rule to require specialists and market makers to reflect in their public quotes any better priced orders they place in certain systems that are not currently integrated into the NMS. In particular, the ECN amendment is intended to incorporate within the public quotes any better priced orders broadly displayed by market makers and specialists through ECNs. This amendment is being adopted with modifications to address concerns raised by some commenters. Specifically, in order to provide specialists and market makers with an alternative method to meet the ECN display requirement, the Commission is adopting an alternative suggested in the proposing release that deems a specialist or market maker in compliance with the ECN amendment if the ECN provides the best prices entered into the ECN by market makers or specialists for each covered security to an exchange or association for inclusion in the public quotation system and provides access to those prices equivalent to the access currently

²¹³ Senate Report, *supra* note 31. Cf. H.R. Rep. No. 229, 94th Cong., 1st Sess. 29 (1975) ("Conference Report") (noting that the conference committee adopted the Senate's provisions on the NMS with minor revisions).

available to other quotes published by the exchange or association. In addition, the Commission is amending the Quote Rule to expand the categories of securities covered by certain existing Quote Rule provisions. The quotation requirements that previously applied to substantial specialists and market makers in only certain exchange-listed securities now will apply to substantial specialists and market makers in all exchange-listed securities. Further, certain Quote Rule provisions that previously applied to market makers electing to quote particular Nasdaq securities now will apply to market makers electing to quote any Nasdaq security. The Commission is adopting these amendments substantially as proposed, along with minor technical amendments to the Quote Rule that are discussed more fully below.

2. Public Dissemination of Market Maker and Specialist Prices in ECNs

a. Basis for the ECN Amendment

Over 20 years ago, the Commission noted that an essential purpose for the establishment of the NMS was "to make information on prices, volume, and quotes for securities in *all* markets available to *all* investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell, or not sell for less than the highest price a buyer is prepared to offer."²¹⁴ At the time, the lack of consolidated quote information made it difficult to ascertain the different prices that were often available in the various markets for a particular security. This lack of transparency as to the best prices among competing markets was widely recognized as preventing investors and their brokers from ascertaining accurate trading interest for a security and obtaining the best prices for their orders.²¹⁵ To address these concerns, Congress directed the Commission to facilitate the creation of a national market system that would link the various markets trading a security. The price and quotation transparency resulting from the Commission's ensuing NMS initiatives has produced

²¹⁴ Securities and Exchange Commission, *Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets* (February 2, 1972) ("Future Structure Statement") at 9-10, 37 FR 5286, 5287 (February 4, 1972) (emphasis added). See also Securities and Exchange Commission, *Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System* (1973) at 25-28.

²¹⁵ See Senate Report, *supra* note 31.

extremely liquid, successful, and, in most cases, competitive markets.

As discussed in the Proposing Release, the Commission for many years has been concerned that the development of so-called "hidden markets," in which a market maker or specialist publishes quotations at prices superior to the quotation information it disseminates on a general basis, impedes these NMS objectives.²¹⁶ Over the course of the last decade, certain trading systems that allow market makers and specialists to widely disseminate significant trading interest to certain market participants without making this trading interest available to the public market at large have become significant markets in their own right. Although offering benefits to some market participants, widespread participation in these hidden markets has reduced the completeness and value of publicly available quotations contrary to the purposes of the NMS. Because these systems are not registered as exchanges or associations, they are currently not required to integrate into the public quote the prices at which their subscribers, including subscribing market makers and specialists, are willing to trade.²¹⁷ The use of these systems by market makers and specialists to quote prices not incorporated into the NMS has resulted in fragmented and incomplete dissemination of quotation information.

Certain markets, in particular ECNs that allow subscribers²¹⁸ to enter priced orders that are widely disseminated to third parties²¹⁹ and permit such orders to be executed in whole or in part through the system, communicate orders that are closely analogous to quotations. These ECNs, in effect, allow market makers and specialists to display different prices to different market participants.

Although these ECNs can facilitate the execution of their subscribers' orders and allow institutions to participate

²¹⁶ See Proposing Release at 4.

²¹⁷ Certain ECNs may be registered with the Commission as broker-dealers and indeed perform various brokerage functions. Nevertheless, the Commission recognizes that in providing a mechanism by which system subscribers can (1) broadcast prices to other system subscribers and (2) trade with one another at those prices, these systems also function as securities markets.

²¹⁸ ECN subscribers may include institutional investors, broker-dealers, and market makers. ECNs provide their services to subscribers for a fee or commission equivalent. Some ECNs (such as SelectNet) have been available only to broker-dealers and not to investors generally.

²¹⁹ "Third parties" in this context refers to subscribers or any other entities (such as customers of subscribers) that receive information from the ECN concerning any priced order entered into the ECN by another subscriber.

directly in price discovery, the display of better prices privately in ECNs reduces the reliability and completeness of consolidated quotations, the accuracy of which continues to be an essential element of the NMS. These private markets have resulted in fragmented quotations and a reduction in the reliability of public quotations as an accurate indicator of market makers' and specialists' best prices, the identical situation that prompted Congress to adopt the NMS amendments in 1975. The unavailability of full market maker and specialist quotation information prevents investors and their brokers from ascertaining the true trading interest for a security, and obtaining the best price for market orders, and prevents investors from monitoring the efforts of their brokerage firms to obtain best execution for their orders.

The Commission's analysis of the trading activity in these ECNs has produced clear evidence of the existence of a two-tiered market in which market makers routinely trade at one price with retail customers and at better prices with ECN subscribers.²²⁰ For example, analysis of trading activity in the two most significant ECNs in the Nasdaq market, Instinet and SelectNet, reveals that approximately 85% of the bids and offers displayed by market makers in Instinet and 90% of the bids and offers displayed on SelectNet were at better prices than those posted publicly on Nasdaq.²²¹ Furthermore, approximately 77% of the trades executed on Instinet and 60% of the trades executed on SelectNet occurred at prices between the Nasdaq best bid and offer. Market makers participated on at least one side of approximately 90% of the trades in these ECNs. The trading activity in Instinet, which comprised approximately 17% of trades and 15% of the volume in Nasdaq securities, represents a significant portion of the overall market for Nasdaq securities.²²²

²²⁰ For example, a market maker with a public offer constituting the best public offer of 20¾ might offer to sell shares in an ECN at 20½. If the market maker did not change its public offer to reflect this improved selling price, public customers buying from the market maker would pay the higher price of 20¾ for the security because they do not have access to the market maker's price in the ECN.

²²¹ The Commission's analysis is based on Instinet and SelectNet data for the months April through June 1994. See 21(a) Report at notes 48-52 and accompanying text and Appendix at notes 18-28 and accompanying text.

²²² More trading volume now occurs on Instinet than on any of the organized U.S. stock markets other than the NYSE and Nasdaq. In 1994, trading volume on Instinet totalled approximately 10.8 billion shares with an approximate dollar volume of \$282 billion. In comparison, Nasdaq traded approximately 74 billion shares, with an

The Commission's recent investigation into various trading practices in Nasdaq stocks revealed that the existence of this two-tiered market facilitated the maintenance of wide spreads on Nasdaq. As discussed in the 21(a) Report, Nasdaq market makers engaged in a widespread course of conduct that resulted in artificially wide spreads in a large percentage of Nasdaq stocks. The maintenance of wide spreads was made possible at least in part by the fact that ECNs like Instinet and SelectNet did not affect the prices at which market makers traded with the general public, thus allowing market makers to attract trading interest at prices inside the spread without adjusting their Nasdaq quotes. Integrating the better prices market makers quote in ECNs should significantly limit the types of uncompetitive practices identified in the investigation without limiting the usefulness of these systems as efficient alternative mechanisms for negotiating transactions.

The Commission firmly believes that all investors should have an opportunity to have their orders filled at the best prices made available by market makers. Consistent with Congress's goals for a NMS, these opportunities must be made available to all customers, not just those customers who, due to size or sophistication, may avail themselves of prices in ECNs not currently linked with the public quotation system. The vast majority of investors may not be aware of the better prices widely disseminated by market makers or specialists through ECNs and many do not have the ability to route their orders directly or indirectly to such systems. As a result, many customers, both institutional and retail, do not always obtain the benefit of the better prices entered by a market maker or a specialist into an ECN.

Brokers frequently use the consolidated quote as the benchmark for automated execution of customer orders and for the starting point in negotiating execution prices with institutional investors.²²³ Consolidated quotations in

approximate dollar volume of \$1,449 billion. *Id.* at note 50 and accompanying text.

²²³ Some commenters argue that the ECN amendment focuses on expanding the availability of these systems to small investors, and ignores the fact that small investors already benefit from these systems in that institutional subscribers in ECNs primarily represent the collective interests of small investors, e.g., through mutual funds and 401(k) plans. See, e.g., CALpers Letter; Dillon Letter; Instinet Letter; LJR Letter; Northern Trust Letter; SIA Letter; STAIC Letter. The objectives of the ECN amendment, however, are not limited to improving market transparency and accessibility for small investors. Comprehensive and transparent information about market conditions is critical to efficient and competitive markets for all investors,

listed stocks are provided by CQS to vendors, who then provide this information to the public. In approving the CQS as the mechanism to serve this vital function, the Commission stressed that it would expect broker-dealers to take into account pricing information made available through the CQS in fulfilling their best execution obligations.²²⁴ Similarly, for OTC securities, Nasdaq disseminates to market makers, vendors, and investors multiple market maker quotations, and a "best" bid and offer derived from these quotations. As broker-dealers and markets have developed automated order-routing and order execution systems, they have relied on these consolidated quotes in pricing and executing customer orders routed through their systems.²²⁵ Including the prices entered into ECNs by market makers and specialists in the consolidated quotation will help broker-dealers using these automated systems to provide their customers' orders with improved executions, and will improve institutions' ability to ascertain true market prices.

In light of the stated fundamental purposes of the 1975 Amendments and clear evidence of a two-tiered market, the Commission believes it is imperative to amend the Quote Rule to ensure the public dissemination of accurate quotes that represent the best prices that market makers and specialists widely disseminate. Thus, the ECN amendment is intended to integrate into the public quote the prices of market makers and specialists that are now widely disseminated to ECN subscribers but are not available to the rest of the market.²²⁶

whether retail or institutional. Indeed, while large institutional investors often have access to ECNs, the public quotes nevertheless frequently serve as a benchmark for their negotiations with market makers. In any event, while retail investors directly account for a significantly smaller percentage of trading volume than institutional investors, they still account for half of the direct equity investment in U.S. markets. *NYSE 1995 Fact Book* at 57. The Commission recognizes that direct retail participation provides critical liquidity and therefore limited access and transparency to the best prices available undermines the efficiency of our markets and jeopardizes public confidence in their fairness.

²²⁴ See Securities Exchange Act Release No. 15009 (July 28, 1978), 43 FR 34851 (declaring the CQS Plan temporarily effective); Securities Exchange Act Release No. 16518 (Jan. 22, 1980), 45 FR 6521 (permanently approving the CQS Plan).

²²⁵ See discussion of best execution principles, *infra* section III.C.2.

²²⁶ Several commenters characterize ECNs as "wholesale" markets, and argue that the ECN rule would require market makers to trade with retail customers at wholesale prices. See, e.g., Davis Letter; Instinet Letter; LJR Letter; Merrill Letter. The Commission notes that market makers are compensated by the spread between their bid and offer prices, and nothing in the ECN rule prevents

Most commenters support the Commission's goal of improving the quality of quotation information made available to the public, although many raise questions, discussed below, about the proposal. In particular, and as discussed below, some commenters expressed concern about the potential impact of the rule on benefits provided to the market as a whole by ECNs. Upon review of the comments received, the Commission has determined that it is appropriate to adopt the proposed ECN amendment. Furthermore, in response to the concerns noted, and to facilitate compliance with the ECN amendment, the Commission has included the ECN display alternative that permits a market maker or specialist to comply with the amendment through an ECN that meets two conditions. First, the ECN into which the market maker or specialist enters its order must ensure that the best prices market makers and specialists have entered therein are communicated to the public quotation system. Second, the ECN must provide brokers and dealers access to orders entered by market makers and specialists into the ECN, so brokers and dealers that do not subscribe to the ECN can trade with those orders. The ECN display alternative therefore allows a market maker or specialist to comply with the ECN amendment directly by changing its quote, or alternatively by using an ECN that meets the above two conditions.

As discussed above, the Commission expects the SROs to work expeditiously with ECNs that wish to avail themselves of the ECN display alternative to develop rules or understandings of general applicability. The Commission is prepared to act as necessary to ensure implementation of the ECN display alternative prior to the effective date of the Quote Rule.

b. Response to Comments²²⁷

The Commission solicited comment on whether the proposed amendment achieves the goals of deterring fragmented markets and promoting improved quotations. The Commission also invited comment on whether there are any feasible alternatives to the rule, and on possible business or economic justifications for permitting market makers and specialists to publish prices in ECNs that differ from their public quotations. The Commission requested comment on the competitive effects of

market makers from buying at the bid from one customer and selling at the offer to another.

²²⁷ This section includes a discussion of the principal arguments advanced by the commenters. A more detailed discussion of the comments is provided in the Summary of Comments.

the proposal on existing ECNs, subscribers, and users.²²⁸ In addition, the Commission solicited comment on alternatives to the proposal that would minimize any negative effects, yet still achieve the Commission's goals. The Commission specifically asked whether ECNs should, as an alternative, furnish market makers' and specialists' best prices to the applicable exchange or association for further dissemination, and provide access to those prices through some form of linkage.²²⁹

i. General Comments

The Commission received numerous comments on the ECN proposal. Many commenters support the proposal as an important initiative designed to further investor protection by improving publicly available quotation information and assuring best execution of customer orders.²³⁰ Some commenters recognize that a number of brokers and dealers have adopted the practice of placing superior priced orders in ECNs without including these better prices in their public quotes.²³¹ These commenters agree that the Commission should be concerned that some retail investors may have neither knowledge nor access to the best available prices under these circumstances.²³² They voice general support for the rule, and recommend one or more mechanisms²³³ by which the Commission could ensure that public quotes contain the best prices otherwise widely disseminated by market makers and specialists.

ii. Impact on ECNs, Market Makers and Specialists, and Institutions

Some commenters express concern that the amendment could negatively impact services provided by ECNs and caution the Commission not to diminish the benefits provided by ECNs to the market as a whole. Some commenters argue that, under the proposal, market

²²⁸ The Commission also specifically solicited comment on whether exceptions to the rule would be appropriate, particularly if a customer requests that the market maker refrain from publicly disseminating its order. The Commission also solicited comment on whether market makers should be required to disseminate publicly the full size of orders placed in ECNs. The Commission received only minimal response to these questions, which is discussed in the Summary of Comments.

²²⁹ See Proposing Release at 28-29.

²³⁰ See, e.g., DOJ Letter; Lehman Letter; Madoff Letter; Amex Letter; NASD Letter.

²³¹ See, e.g., Amex Letter; DOJ Letter; Madoff Letter; RPM Letter.

²³² See, e.g., Letter from Gerri Detweiler, Policy Director, National Council of Individual Investors, to Jonathan G. Katz, Secretary, SEC, dated January 22, 1996 ("NCII Letter"); Goldman Sachs Letter; PaineWebber Letter; SIA Letter; Madoff Letter; Lehman Letter; DOJ Letter.

²³³ See discussion of alternative approaches, *infra* at section III.B.2.b.iv.

makers and specialists that use ECNs would lose the anonymity that these commenters believe is crucial to successfully execute large trades for institutional investors.²³⁴ Some commenters anticipate the adoption of the ECN amendment prompting a potential decline in the use of certain ECNs.²³⁵ In addition, some commenters contend that this amendment, because of the impact on ECNs and their subscribers, will lead to a loss of liquidity in both ECNs and the public markets²³⁶ and to a decline in the variety of available trading options which could be detrimental to all investors.²³⁷ Other commenters argue that the proposal would effectively double the risk of a specialist or market maker that enters orders into an ECN because the specialist or market maker could be simultaneously responsible for multiple executions based on its disseminated quote as well as its ECN order.²³⁸ Moreover, at least one commenter argues that quotes, bids, offers, and orders have historically had different meanings and that the proposal's treatment of priced orders as quotes confuses the essence of the terms, thereby resulting in inadvertent anti-competitive effects.²³⁹ Some commenters also argue that the better prices frequently available in ECNs reflect the lower costs of doing business in those systems, and therefore, it would be inappropriate to require market

²³⁴ See AZX Letter; Instinet Letter; ICI Letter; Investors Research Letter; NASD Letter; Ruane Letter; STAIC Letter; Letter from Edward G. Shufro, Partner, Shufro, Rose & Ehrman, to Jonathan G. Katz, Secretary, SEC ("Shufro Letter"); Sutro Letter.

²³⁵ See Goldman Sachs Letter; STA Letter; AZX Letter; Instinet Letter; Schwartz and Wood Letter; Ruane Letter.

²³⁶ See DOJ Letter; STA Letter; Alex. Brown Letter; Letter from Jeffrey L. Davis, Economist Incorporated, to Jonathan G. Katz, Secretary, SEC, dated October 25, 1995 ("Davis Letter"); Dillon Letter; Instinet Letter; Merrill Letter. (citing the "deleterious effects concerning liquidating inventory and replacing necessary capital" at pp. 7-8); Schwartz and Wood Letter; Letter from Mary Kay Wright, Second Vice President and Senior Equity Trader, The Northern Trust Company, to Jonathan G. Katz, Secretary, SEC, dated February 28, 1996 ("Northern Trust Letter").

²³⁷ See Letter from Anthony R. Gray, Chairman and CIO, STI Capital Management, to Jonathan G. Katz, Secretary, SEC, dated February 12, 1996 ("STI Capital Letter"); Ruane Letter; DOJ Letter; and LJR Letter.

²³⁸ See, e.g., Merrill Letter.

²³⁹ See Instinet Letter. Instinet also bases much of its arguments on its regulatory identification as a broker-dealer. Instinet argues that the proposal targets its ECN operations for treatment different from other broker-dealers. The Commission notes that Instinet (and similar systems) provides to its customers ECN services that are significantly different from the services provided by other broker-dealers to their customers. Specifically, Instinet, without discretion, publicizes subscriber orders and enables other subscribers to trade with these orders at their stated price.

makers and specialists to match their ECN prices in their public quotes.²⁴⁰

The Commission agrees with commenters that ECNs provide certain valuable benefits to their subscribers. It also recognizes the benefits competing systems bring to the market as a whole, particularly systems that take advantage of new technologies to offer improved trading opportunities. The Commission, therefore, has adopted an alternative method of compliance with the ECN requirement discussed in the proposing release to reduce the amendment's potential impact on existing ECNs and their subscribers, and to maintain incentives and opportunities for new ECNs to enter the marketplace.²⁴¹ The Commission continues to believe it is important that the best prices of orders entered into these markets by market makers and specialists are properly integrated into the public market so that all market participants can benefit from the price discovery taking place within these markets.

In its comment letter, the NASD stated its view that the proposal could

²⁴⁰ See, e.g., Dillon Letter; HHG Letter; LJR Letter; Merrill Letter; STA Letter; Goldman Sachs Letter.

There appear to be counter arguments. For example, there is no reason to suppose that adverse selection costs—that is, the risks of trading with an informed trader—are any lower in ECNs, whose subscribers typically can include market makers, other broker-dealers, institutional money managers, hedge funds, momentum traders, and options market makers. Second, because traders can more easily mask their identities and thus their trading motives in ECNs than in the primary market, informed traders may prefer to trade in ECNs. These higher information asymmetries would be expected to lead to higher, rather than lower, trading costs. Finally, ECNs often impose transactions charges that may not otherwise be incurred by dealers trading in the primary market.

Furthermore, it does not appear that the better prices available in ECNs can be explained by differences in the size of orders and transactions given that the average order size and trade size in one ECN (Instinet) is substantially similar to the average size of quotes and trades in the primary market. In any event, the Commission generally would not expect larger size orders to receive better prices in view of the considerable literature suggesting that in equities markets, larger orders tend to get worse prices because of the risk of trading with an informed trader. See, e.g., David Easley and Maureen O'Hara, 19 J. Fin. Econ. 69, (No. 1, September 1987).

²⁴¹ The Commission believes that although the ECN amendment may marginally reduce the incentive of some subscribers to participate in an ECN, on the whole the effect on ECNs should not be so significant as to affect their viability. Moreover, given the availability of the ECN display alternative, which is designed to minimize any potentially detrimental effects of the rule on ECNs, the Commission believes that the benefits of the amendment to investors of publicizing the better prices entered by market makers and specialists outweigh the limited likely costs to ECNs. Many of the comments received that addressed the ECN proposal raised concern about the importance of preserving the anonymity offered by these systems. See, e.g., Alex. Brown Letter; AZX Letter; Dillon Letter; Estep Letter; ICI Letter; Instinet Letter; NASD Letter.

discourage market makers' use of ECNs because a market maker placing an order in an ECN at a better price would have to simultaneously change its quote, thereby telegraphing its interest. In proposing a solution to this situation, the NASD specifically referred to the ECN alternative noting "'* * * this problem can be addressed without discouraging market maker use of ECNs through the approach suggested by the Commission as a possible alternative, i.e., by reflecting the better ECN prices in the *inside market* display, rather than in individual quotes.'" ²⁴²

In response to the concerns raised by the NASD and other commenters, the ECN display alternative is designed to preserve the benefits associated with the anonymity that some ECNs currently offer to subscribing market makers and specialists and their customers.²⁴³ This alternative will ensure that the best prices of market makers and specialists are publicly disseminated and that non-ECN-subscribing brokers and dealers can trade with the ECN orders represented by those prices. Under the display alternative, the best prices and sizes of orders entered into an ECN by specialists and market makers would be publicly disseminated while the specialists and market makers themselves would remain anonymous. This alternative not only preserves anonymity, but also eliminates the risk that a market maker or specialist could be exposed to multiple executions at the ECN price.²⁴⁴

The ECN amendment, as proposed, sought to minimize the potential impact

²⁴² NASD Letter at 14.

²⁴³ The Commission recognizes that in certain securities, specific market makers or specialists may be viewed as price leaders for those securities. Therefore, if the market knows that one of those firms has changed its quote, other market makers or specialists are likely to follow that price change and frustrate the first's firms ability to obtain an execution at the improved price. The ability to place an anonymous order in an ECN allows the firm to change its price without triggering corresponding price changes from other market makers or specialists and thereby increases its potential to obtain an execution at the improved price.

²⁴⁴ Certain commenters fear that, as originally proposed, the amendment would have an adverse impact on institutional investors which currently subscribe to ECNs. These commenters appeared to believe that the ECN amendment would seriously harm ECNs, and thus harm institutional users. See, e.g., ICI Letter; Ruane Letter. The Commission does not believe that the amendments will significantly interfere with the operations of ECNs. Moreover, the Commission believes that as adopted, particularly with the addition of the ECN display alternative, ECNs will continue to be able to provide services to institutional investors of similar value to those they provide today. The Commission also believes that the benefits of the amendments, including increased market maker competition and decreased fragmentation, will flow to all investors, institutional as well as retail. See 21(a) Report.

on market makers, specialists, and ECNs by requiring a market maker or specialist to display in its public quote only the size required by its exchange or association, rather than the actual size of any order the firm places into an ECN. This part of the amendment is being adopted as proposed for orders for the accounts of market makers and specialists. However, for customers' orders entered into an ECN by a market maker or specialist that are smaller than the quote size required by the market maker's or specialist's exchange or association, the Commission has amended the rule to allow market makers and specialists to display only the customer's order size.²⁴⁵ The requirement to display no more than the required size for market makers' and specialists' own orders should reduce any disincentives to use ECNs that could otherwise result from the ECN amendment, and responds to the concern that disclosure of the full size of the order in the market maker's or specialist's quote could impede its ability to execute the order.²⁴⁶ Moreover, permitting the display of customer orders of less than the minimum quote size should reduce the potential burden on a specialist or market maker of having to publish a public quote for more than the customer's order size when the customer's order is for less than the minimum quotation size required by the specialist's or market maker's exchange or association.

Market makers and specialists who avail themselves of the ECN display alternative will be required to furnish to the public quotation system the full size of the best buy and sell orders they enter into the ECN. The Commission believes that the display of full size by the ECN will help inform the public market of the true trading interest entered by specialists and market makers, without impeding the execution of these orders by disclosing the identity of the specialist or market maker placing the order. Under the ECN display alternative, the market maker or specialist will be able to continue to represent the order on an anonymous basis both in the ECN and in the public

²⁴⁵ As discussed *supra* in footnote 144, SROs may wish to allow market makers or specialists to quote in sizes smaller than the minimum quotation increment when the quote represents a customer limit order.

²⁴⁶ The Commission received several comments that support this aspect of the proposal. See, e.g., Lehman Letter; and Smith Barney Letter. These commenters believe that display of full size in a market maker's quote could impair the quality of an execution obtained for a customer because the display in the public quotation system is broader than the display in the ECN.

quote, substantially reducing any negative impact of the amendment on ECN users.

Where the order entered by the market maker or specialist is on behalf of a customer, the display of full size under the ECN display alternative is consistent with the requirement under the Display Rule, which requires market makers and specialists to display the full size of their customer limit orders. Therefore, the full size of customer limit orders will be displayed whether the specialist or market maker displays the order itself or enters the order into an ECN complying with the ECN display alternative.²⁴⁷

The Commission believes that the concerns expressed by some commenters about a potential loss of liquidity resulting from the proposal have been substantially addressed by the alternative adopted today. Because this alternative preserves the anonymity some ECNs afford to the users of their systems, the proposal maintains incentives for subscribers to continue participating in such systems. In fact, a market maker or specialist, who presumably wants its orders executed at prices it is widely displaying through the ECN, should benefit from attracting greater trading interest by having the prices of its orders displayed to the entire market.

Finally, under the proposal, priced orders of institutions and other non-market makers entered directly into ECNs would not be required to be reflected in the public quote. Some commenters criticized the proposal because it did not require the inclusion of all better priced orders in the public quote. This result, however, is consistent with existing quotation principles. Institutional bids, offers, and orders handled independent of a market

maker historically have been outside the scope of the Quote Rule, and the Commission's proposal was not intended to expand the scope of the Quote Rule in this respect.²⁴⁸ Furthermore, the Commission believes that, although institutional investors' direct orders in ECNs provide valuable liquidity, the amendments will substantially strengthen the public quotation system by publishing orders entered by market makers and specialists without creating new requirements for orders not controlled by market makers or specialists.²⁴⁹ Nevertheless, the Commission will continue to monitor closely issues involving the display of prices published by institutions in light of the Quote Rule and its objectives.

iii. Technology and Innovation

Some commenters predict that the proposal may have a chilling effect on technological innovation, primarily because the proposal applies only to ECNs and not to all available communication technologies that may be used for disseminating interest to buy and sell a particular number of shares at a specified price.²⁵⁰ Some commenters argue that the proposal is anti-competitive and otherwise antithetical to the purposes of the Exchange Act because it will deter future technological advances in automated trading environments by favoring less automated trading methods (e.g., telephone transactions).²⁵¹

The Commission is cognizant of the importance of the continued development of innovative trading systems and services. New technologies have expanded the ways in which investors' buying and selling interest can be brought together and have fostered additional competition in the securities markets. The Commission believes that this competition should be encouraged. Nonetheless, to promote competition, efficiency, and transparency in the securities markets, and insure the integrity of publicly available information, the Commission believes it is appropriate to set minimum standards that apply to the entry of the functional equivalent of

²⁴⁸ The fact that ECNs will continue to contain institutional investors' orders priced better than the public quotes will provide another incentive for market participants to continue to participate in those systems.

²⁴⁹ The Commission notes that, as described in the Commission's 21(a) Report, institutions trading with dealers or others accounted for less than 20% of trades in one ECN (Instinet). See Appendix to the 21(a) Report at A-11.

²⁵⁰ See DOJ Letter; SIA Letter; Instinet Letter; Schwab Letter; STI Capital Letter; Sutro Letter.

²⁵¹ See, e.g., Instinet letter.

quotations by market makers and specialists in trading systems.²⁵² Indeed, consistent with the Commission's experience with previous NMS initiatives,²⁵³ these minimum standards will permit and foster the development of new technologies that improve the public availability of trading information, while discouraging practices that are inconsistent with the purposes of the 1975 Amendments. The Commission believes that the Quote Rule as amended will not unduly diminish the beneficial services provided by existing ECNs, nor will it stifle the development of new trading technologies or new ECNs.

iv. Alternative Approaches

In the Proposing Release, the Commission suggested alternatives to the proposal, and solicited comment on these alternatives. The Commission also invited commenters to suggest possible alternatives. The Commission specifically asked whether it should require ECNs to furnish prices to the applicable exchange or association for public dissemination and to provide some access, such as a linkage, to the prices in the ECN.²⁵⁴ A number of commenters supported this approach.

The NASD recommended, as an alternative to the proposed rule, that the better ECN price be reflected in the inside market, rather than in individual quotes. Under the alternative described by the NASD, an ECN would report its best market maker or specialist inside prices to the SRO that is the primary market in the security. The NASD also recognizes that more assured access to orders in the ECNs would be necessary under this option.²⁵⁵ Similarly, one commenter agreed that the inside market available to the public should reflect the best bid and offer prices whether in a market maker's quote or in a market maker's order on an ECN. The Commenter suggested that this could be accomplished by requiring quotations in ECNs to be made part of the public quotation and by separately identifying the ECN into which the order is entered rather than the market maker that

²⁵² The Commission notes that the focus of the proposal is not on any particular system or systems but, rather, on the types of orders that are the fundamental equivalent of quotations, and the fragmented market that results when the prices of these orders are not integrated into publicly available quotations.

²⁵³ See Simon and Colby, *supra* note 58. The Commission also notes the growth in technologies over the past twenty years, including broker-dealer and exchange automated execution systems, that clearly rely on, and were facilitated by, successful operation of NMS and joint industry initiatives such as the Quote Rule, CTA, and the ITS Plan.

²⁵⁴ See Proposing Release and e.g., NASD Letter.

²⁵⁵ See NASD Letter.

²⁴⁷ The Commission notes that the exceptions under the Display Rule for limit orders of block size and for limit orders that a customer has asked not to be displayed will not apply to customer limit orders entered by a market maker or specialist into an ECN. If entered into an ECN, these orders must either be reflected in the market maker's or specialist's own quote or displayed via the ECN alternative. As discussed previously, the Commission believes that a customer should have discretion to permit a market maker or specialist to handle its limit order without public display, and large limit orders should not be required to be displayed unless the customer makes a request. However, the Commission does not believe these orders should be withheld from public display if they are being displayed in an ECN. The Commission believes that if these orders, when handled by market makers or specialists, are displayed widely through an ECN to the ECN's subscribers, then they should also be displayed to the public generally. Moreover, limiting display to only one market would be inconsistent with Congress's goal for a NMS in which trading interest in disparate markets would be consolidated and publicly disseminated.

placed the order.²⁵⁶ Finally, certain commenters state that expanding ITS to include orders entered into ECNs would be a better alternative to the proposal.²⁵⁷

The Commission believes that the ECN display alternative adopted today is consistent with these suggested alternatives and will minimize many of the asserted negative effects of the rule. The adopted provision provides an alternative to an ECN that disseminates specialists' and market makers' best prices to the public quotation system. Thus, the amendment enables a market maker or specialist to comply with the Quote Rule either directly by sending to its exchange or association the prices of orders it places into ECNs that improve the market maker's or specialist's public quote, or indirectly by using an ECN that transmits the best prices entered therein by market makers and specialists for publication in the public quotation system.

The ECN display alternative is consistent with the alternative recommended by the NASD because the adopted provision enables the specialists' or market makers' best prices in ECNs to be consolidated with the exchange's or association's best prices for dissemination within the consolidated quotes. In addition, the adopted amendment requires the ECNs to provide an equivalent means of access to those best prices.

The Commission recognizes that this alternative may reduce the content of information that is publicly available because under the ECN display alternative, the identity of the market maker or specialist that entered the better priced order in the ECN will be withheld.²⁵⁸ The Commission believes this result is justified because the inside prices and full sizes of orders entered by market makers and specialists will be in the public quotation system to inform the entire market of these prices and ECNs will provide equivalent access to those prices. Moreover, the Commission believes the benefits of facilitating the use of ECNs, by permitting the continued anonymity of market makers and specialists, more than offset the

²⁵⁶ Morgan Stanley Letter. See also, PaineWebber Letter (recommending that priced orders in ECNs be included in the NBBO).

²⁵⁷ See, e.g., STAIC Letter; ICI Letter.

²⁵⁸ The Commission also notes that under the alternative, a specialist or market maker that puts an order into an ECN that is priced better than that specialist's or market maker's public quote, but is not the best priced quote from any specialist or market maker in the ECN, will not have its better priced order reflected in the public quote. The prices will be displayed, however, if the better price in the ECN is executed or withdrawn and the lower specialist's or market maker's priced quote then becomes the best priced quote.

reduced information available on the identity of a particular market maker or specialist.

As an alternative to the ECN amendment, certain commenters suggested that enforcement of best execution principles would be sufficient to protect public investors.²⁵⁹ As discussed in more detail in section III.C.2., the Commission does not believe this is a practical alternative because ECNs do not provide broker-dealers with automated links and thus may not be reasonably available for the handling of retail orders on an automated basis. Furthermore, investors and their brokers cannot efficiently ascertain if they have received the best prices for their orders if publicly available prices do not reflect the best prices at which specialists and market makers are willing to trade. Under these circumstances, providing customers the best executions available can be achieved most effectively by ensuring that the consolidated quotes systematically include the better prices that market makers and specialists have entered into an ECN.

Finally, certain commenters argue that, as an alternative to adopting the ECN proposal, the Commission should defer any action until further study is completed on the use of ECNs because the Proposing Release provides insufficient data regarding whether customers currently get the best available price, or market maker and specialist use of ECNs results in harm to customers.²⁶⁰ The Commission has determined to go forward with the amendments now because of compelling concerns presented by two-tiered markets. Many of the commenters to the proposed rules also recognize these concerns. Furthermore, as part of its recently concluded Nasdaq investigation, the Commission has conducted an extensive analysis since the proposals were published that supports the Commission's proposal and clearly evidences the existence of a "two-tiered" market in which customer orders are executed at publicly available prices inferior to prices contemporaneously available in existing ECNs.²⁶¹ Moreover, Commission data

²⁵⁹ See, e.g., Instinet Letter.

²⁶⁰ See, e.g., Instinet Letter, asserting that the Commission should obtain and study data on this matter and that, absent such data, adoption of the proposed amendment is unwarranted.

²⁶¹ As discussed previously, the Commission believes the data it has reviewed supports the need for prompt adoption of the ECN amendment to the Quote Rule. See *supra* notes 222 and 223, and accompanying text. Given the strong evidence that investors would benefit from public dissemination of the hidden prices that are broadly disseminated to subscribers in these systems, the Commission

shows that the pricing opportunities available in at least two ECNs (Instinet and SelectNet) are not limited to block trades, but extend to smaller orders executed in the system.²⁶² The Commission believes, therefore, that further study is not necessary to address a structural disparity in market information that disadvantages investors who lack access to ECNs.

c. Operation of the Rule Amendment

i. Definition of the Term "Electronic Communications Network"

The proposed amendment did not specifically define the term "electronic communications network." The Commission did state, however, that priced orders that market makers and specialists enter into certain ECNs are bids and offers for the purposes of the Quote Rule.²⁶³ The proposal applied to systems that widely disseminate priced orders to third parties and permit such orders to be executed against in whole or in part. The Commission further explained that the term "electronic communications network" was intended to include continuous auction trading systems, but was not intended to include crossing systems or broker-dealer internal order routing systems.

Several commenters suggested the need for a definition of the term "electronic communications network."²⁶⁴ The Commission agrees that it is appropriate to define the term in the Quote Rule and has decided to adopt a definition that reflects the fundamental characteristics of an ECN as discussed in the Proposing Release.

As discussed earlier, the objective of the ECN amendment is to incorporate within the consolidated public quote firm prices quoted by market makers and specialists in securities markets that widely disseminate those prices but are not registered as exchanges or associations and thus are not integrated

believes that it is appropriate to adopt the amendments to the Quote Rule.

²⁶² As noted above, the Appendix to the 21(a) Report states that average trade size for Nasdaq NMS securities on Instinet was approximately 1,600 shares for the period studied, while the average trade size generally in the securities was approximately 1,900 shares. See Appendix to the 21(a) Report at A-8.

²⁶³ As a result, relevant provisions of the Quote Rule, such as the obligation on exchanges and associations to disseminate quotes, and the firmness requirement placed on a market maker or specialist who furnishes the quotes, become operative with respect to a security when a market maker or specialist enters an order for that security into an ECN. See section III.B.2.c.v., *infra*.

²⁶⁴ See Goldman Sachs Letter; Instinet Letter; Schwab Letter. In addition, one commenter argues that ECNs should include SRO stock crossing systems and all non-market-maker broker-dealers. NYSE Letter.

into the NMS. Therefore, the Commission has defined the term "ECN" as an electronic system that widely disseminates to third parties²⁶⁵ orders entered therein by a market maker or specialist, and permits such orders to be executed against in whole or in part. The definition specifically excludes any system that crosses multiple orders at one or more specified times at a single price set by the system and that does not allow orders to be crossed or executed against directly by participants outside of such times. This exclusion is consistent with statements made in the Proposing Release that it was not the Commission's intention to cover crossing systems because these systems do not communicate to multiple market participants the prices at which system subscribers are willing to trade. Rather, the excluded crossing systems themselves establish an internal trading price for subscribers on an episodic basis.²⁶⁶

The ECN definition also excludes any system operated by, or on behalf of, a market maker or specialist that executes customer orders primarily for its own account as principal, other than as riskless principal. This exclusion is intended to ensure that, as discussed in the Proposing Release, internal broker-dealer order routing systems in which the market maker trades primarily with customer orders on a principal basis are not ECNs within the scope of the amendment. The exclusion would not except from the ECN definition systems that involve multiple market makers or specialists competing as principal in a security or that cross multiple market maker and customer orders.

Furthermore, the Commission believes the definition should be read broadly to include systems that match orders internally and deliver the matched order to some other market for execution. Thus, the term "permits such orders to be executed against" should not be read to exclude systems where a narrow technical reading of "executed" is the only reason that the system would not fall within the ECN definition. For example, if a system puts buy orders and sell orders together for execution, completes all necessary elements of the trade, and then sends the matched pair to an exchange or association merely to print the terms of the trade on the

²⁶⁵ The Commission intends the term "third parties" to refer to subscribers to the ECN, other than the ECN and the market maker or specialist that is entering its priced order into the ECN. The ECN also may disseminate to others, including non-subscribers.

²⁶⁶ The Commission notes that broker-dealers that publish quotes through a vendor are already covered by the rule.

Consolidated Tape, the system would be an ECN.

ii. "Priced Orders" in ECNs

Under this definition, the Commission intends to include in the public quotation system firm prices for securities entered by market makers or specialists, whether such firm prices are labeled as "quotes" or "orders." The Commission believes that priced orders entered by market makers or specialists into ECNs where the orders are widely disseminated and executable are the functional equivalent of market maker or specialist quotations, and like quotations, play a key role in the price discovery process. The Commission thus believes that these "quotation-equivalents" should be made part of the public quote.

Although some commenters argue that priced orders entered into ECNs are more closely parallel to prices communicated over the telephone to other market makers than to market quotes, the Commission recognizes a fundamental distinction between limited communication of price in bilateral telephone negotiations and broad exposure of firm prices to multiple participants in a market.²⁶⁷ Accordingly, prices communicated by telephone are excluded because these prices generally are not widely disseminated to other parties for execution. The rule also would not cover indications of interest that do not constitute firm prices.

In this connection, the Commission intended the term "priced order," which is deemed under the ECN amendment to be a bid or offer, to encompass commitments to buy or sell a security at a particular price for a particular number of shares. The Commission also does not intend the term "priced orders" to include interest to buy or sell a security where price or the number of shares is not specified to system subscribers, unless the price or size is otherwise understood as part of the system's operation.²⁶⁸ The ECN

²⁶⁷ The Commission recognizes that market makers and specialists may be willing to trade with certain customers at better, negotiated prices, such as when market makers negotiate with customers over the telephone. In contrast, however, the prices quoted by market makers and specialists in ECNs are widely disseminated to market participants. In adopting the ECN amendment, the Commission is reaffirming the NMS principle that prices advertised in one market must be integrated into the national market—that is, the consolidated public quote.

²⁶⁸ The definition of an ECN specifically excludes any system that crosses multiple orders at one or more specified times at a single price set by the ECN (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by subscribers outside of such times. See 11Ac1-1(a)(8).

amendment would, however, include priced orders entered into an ECN by a market maker or specialist that are visible only to *some* system subscribers if these orders can be executed against in the ECN. The ECN amendment is intended to require the public display of priced orders entered into ECNs by market makers and specialists where these priced orders are similar to quotations. Accordingly, the Commission does not intend the ECN amendment to apply to a priced order that is entered into an ECN by a market maker or specialist merely in order to execute against an existing order visible in the ECN, and not entered to elicit other buying or selling interest. If, however, the order entered by the market maker or specialist does not in fact execute immediately in full against an existing order but rather is itself disseminated as an open order in the ECN, the market maker or specialist must comply with the requirements of the ECN amendment with respect to the order.

In order to ensure that customers consistently receive the benefit of better prices entered into ECNs, a market maker or specialist entering an all-or-none or minimum size order for its own account into an ECN would be required to include this price in its public quote, or disseminate the price via the ECN display alternative, and thereby publicly display the order for the full number of shares for execution in whole or in part. Although the execution of an all-or-none order is typically conditioned on execution of the entire size of the order, the Commission believes that allowing market makers to avoid public display of an unconditional quote when using this type of order could seriously undermine the purposes of the rule.²⁶⁹ The rule will permit, however, a market maker or specialist to enter an all-or-none customer order into an ECN without requiring public display of the quote for that order where the customer specifically requests that the order be executed on an all-or-none basis. This latter provision accommodates the desire of some customers to trade only at a specific size associated with a specific price.

iii. ECN Display Alternative

Pursuant to the amendment as adopted, a priced order entered by a market maker or specialist into an ECN that widely disseminates the order is deemed to be a bid or offer for the

²⁶⁹ All-or-none and minimum size orders are rarely used by market makers and specialists in ECNs and are prohibited from being included in the public quotes by the registered exchanges and Nasdaq.

purposes of the market maker's or specialist's quotation reporting obligations under the Quote Rule. As a result, specialists and market makers are required to include such orders in the bids and offers they communicate to their exchange or association for inclusion in the published quotations made available by the exchange or association.²⁷⁰

As discussed above, in response to the concerns of some commenters, the adopted amendment includes an alternative to the specialist or market maker itself revising its public quotation to reflect its better priced order entered in an ECN. This alternative allows the ECN to act as an intermediary in communicating to the public quotation system the best price and size of orders for each security that have been entered into the ECN by a specialist or market maker. To communicate the quotations publicly, the ECN must submit the best price entered by a specialist or market maker to an exchange or association, or to a securities information processor acting on behalf of one or more exchanges or associations.

The alternative reduces the impact of the amendment on specialists and market makers because they have a choice regarding how to comply with their obligation. This alternative also reduces the impact of the amendment on ECNs by offering these systems an opportunity to provide additional services to their subscribers, and creating an opportunity to generate additional order flow from non-subscribers. At the same time, more accurate prices are provided through public quotation systems than are currently available.

Under this alternative, consistent with the goals of the initial proposal, the ECN must comply with two conditions. First, the ECN must provide the best prices and sizes that market makers or specialists have entered in the ECN to the public quotation system for inclusion in the consolidated quotation. The market maker or specialist responsible for the price does not have to be identified.²⁷¹ The ECN must, however, at a minimum, publicly identify itself as the originating system for these prices. Accordingly, if a market maker puts an order that improves the

²⁷⁰ An OTC market maker that places priced orders for execution into any ECN will in effect be making an election to communicate quotations to its association bids, offers and quotation sizes in the security. See 11Ac1-1(a)(25)(ii)(B).

²⁷¹ An ECN that does not offer the option of anonymity to its subscribers could choose to include the identity of the market maker or specialist with the prices furnished to the SRO for public dissemination. As discussed below, the ECN also must provide access to these prices.

NBBO into an ECN and the ECN disseminates that price to the public quotation system, the disseminated price must either be identified as originating from the market maker or from the ECN.

Second, the ECN must provide non-subscriber brokers and dealers with a means of access to those prices entered in the ECN by market makers and specialists. This access must be equivalent to the access that would have been available for the relevant security if these prices had been published in the market makers' or specialists' quotation.²⁷² The extent and form of this access will depend on the form(s) of access available in the market to which the ECN supplies the bids and offers for public dissemination.²⁷³

For example, market makers in Nasdaq NMS and SmallCap securities typically can be reached through the telephone and through the NASD's Small Order Execution System. Therefore, an ECN that chooses, pursuant to the alternative, to act as an intermediary for its market maker and specialist subscribers for Nasdaq NMS and Smallcap securities would have to be prepared to receive and execute telephone orders from broker-dealers against those market makers' and specialists' orders entered in the ECN. The ECN will have to execute these orders promptly at the prices the market makers and specialists have entered into the ECN. In addition, because a market maker with the best price in a Nasdaq NMS security is subject to SOES executions, this equivalent access condition would require the ECN to provide broker-dealers who use SOES with equivalent automated access to the best priced market maker orders in the ECN. This could be accomplished either through an electronic linkage to SOES or by other means agreed upon with the NASD. For example, the ECN could supply the NASD with an identifier for the market maker who entered the best priced order, which the NASD could use in assigning SOES executions to that market maker.²⁷⁴

²⁷² For access to be "equivalent", the ECN must enable non-subscribing broker-dealers to execute against the ECN's published best price to the same extent as would be possible had that best price been reflected in the public quote of a specialist or market maker. The ECN, however, may impose charges for access to its system, similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers.

²⁷³ The extent and form of the access will not necessarily be the same as the access available in the market to which the specialist or market maker would otherwise supply its bid and offers.

²⁷⁴ As discussed *supra* section II., the NASD has proposed a new facility, NAqcess, which, as part of its proposed services, would widely disseminate

Similarly, in exchange-listed securities, the degree of access that the ECN must offer would depend on the current access that the market receiving the information from the ECN offers to broker-dealers in the relevant type of security. If the ECN communicates prices for exchange-listed securities to an exchange, the specialist or market maker orders in the ECN must be accessible to broker-dealers in the same manner as quotes on that exchange. This access would include any automated execution features offered to broker-dealers by the exchange. The ECN must provide to the exchange, or to the exchange specialist in each security, access to the market maker or specialist orders in the ECN. Such access must provide broker-dealers with the ability to enter and obtain executions for their orders at least as promptly as that exchange offers to its own members through its order-routing and execution systems. Because the ITS Plan applies to exchange-trading of listed securities, orders received from other markets through ITS must have the same ability to trade with ECN orders whose prices are displayed through the exchange as they have with the exchange's own quotations. For instance, if the exchange specialist typically receives incoming ITS commitments and executes them manually, the ECN must at a minimum enable the incoming ITS commitment to be manually entered into the ECN for execution.

If the ECN instead provides orders in exchange-listed securities to the NASD for inclusion in the public quotation system, the orders must be as accessible to broker-dealers as the quotes published by third market makers in

priced orders for execution in whole or in part. *Supra* note 45. As proposed, NAqcess would publish its best prices in the Nasdaq quotation system stream and would be accessible to all NASD members for order entry and execution against those orders. Thus, NAqcess, as proposed, would appear to make prices entered by market makers into NAqcess available, and provide equivalent access under the alternative. Therefore, a market maker that entered its best priced order into NAqcess would comply with the requirements of the ECN amendment without reflecting the order in the market maker's own quote. Moreover, a market maker that entered an order into another ECN at a price better than its quote could satisfy the requirements of the ECN amendment by entering an order reflecting this price into NAqcess, even if the other ECN does not directly provide the price to the public quotation system, because this use of NAqcess, as proposed, would meet the requirements of the amendment. Similarly, an ECN availing itself of the ECN display alternative could provide prices directly to NAqcess. The ECN and the NASD also could develop mechanisms to ensure public anonymity of market makers that use ECNs, while providing to the NASD the identity of the market makers that are at the inside quote solely for the purpose of direct order-routing between NAqcess and the market maker.

exchange-listed securities. At a minimum, these prices must be included as part of the third market quotation display and identified as originating from a named market maker or from a named ECN. For non-Rule 19c-3 securities, broker-dealers must be able to contact the ECN by telephone and have an order promptly entered into the ECN for execution. For Rule 19c-3 securities, the ECN also must be accessible through the ITS/CAES linkage, operated by the NASD, in the same manner as other third market maker quotes in those securities.²⁷⁵

Under the ECN display alternative, the ECN must furnish to an exchange or association the full size associated with the best priced orders placed in the ECN by market makers and specialists to buy and to sell a security. This full size requirement under the alternative is intended to give the public information about the depth of the market at the ECN prices, while maintaining the anonymity of market makers and specialists. For example, if an ECN is furnishing quotation information to Nasdaq under this alternative, and a market maker enters a 4,000-share order into the ECN at a price that is better than other market maker or specialist prices for that security in the ECN, the ECN will be required to provide Nasdaq that price and size of 4,000 shares as a quotation for public dissemination. If 2,500 shares of this order is executed, the ECN must display the remaining 1,500 shares. If two market makers enter 4,000-share orders for a security at the same price, which is the best price in the ECN for that security, the ECN is required to show all 8,000 shares publicly. In contrast, if a market maker enters a 100-share order for a Nasdaq security at the best price in the ECN for that security, the alternative requires the ECN to furnish the price for only 100 shares, even though NASD rules require Nasdaq market makers to display no less than 1000, 500, or 200 shares in Nasdaq, depending on the characteristics of that security.

The Commission recognizes that the means of providing equivalent access will vary for different markets, and that ECNs operating under the ECN display alternative that currently do not provide access to their systems to non-subscribers will have to develop methods to provide this access. Meeting this requirement may be achieved in a variety of ways, including a linkage between ECNs and one or more of the

²⁷⁵ As discussed below concerning expansion of the ITS/CAES linkage, currently non-Rule 19c-3 securities may not be traded via the ITS/CAES linkage.

SROs. The Commission believes an SRO that accepts the prices provided by an ECN for publication should be authorized to impose reasonable rules related to the public dissemination of those prices upon market makers and specialists who avail themselves of this alternative. The rules an SRO imposes in this regard, however, may not establish standards for the dissemination of these prices that are more burdensome for market makers and specialists using ECNs than the SRO rules that apply to quotations delivered directly to the SRO by specialists and market makers.

The Commission looks forward to working closely with all market participants to effect the necessary market developments to ensure that this alternative method of compliance with the Quote Rule is made possible. In order to ensure prompt implementation of the necessary changes before the effective date of the rule amendments, the Commission requests each SRO, individually or jointly as signatories to the CQS Plan, to notify the Commission in writing by October 28, 1996 regarding its willingness and its plan to afford ECNs the opportunity to communicate, for inclusion in the public quotation system, the prices of market makers and specialists.

In order to implement the changes to the Quote Rule under new subsection (c)(5), the prices sent to an ECN by market makers and specialists will have to be displayed in the public quotations disseminated by SROs, and order routing or access linkages will have to be in place. After hearing from the SROs, the Commission will determine whether it will be necessary to use its authority under Section 11A(a)(3)(B) of the Exchange Act to require the SROs to act jointly to provide means to accomplish these objectives.

iv. Minimum Price Variations

In the Proposing Release the Commission recognized that there may be different minimum price variations in any given security between the SROs providing a market for the security and ECNs through which the security is also traded. Currently most exchange-listed securities tend to be quoted and traded with a minimum price variation of $\frac{1}{8}$ point or $\frac{1}{16}$ point.²⁷⁶ Nasdaq securities can be publicly reported in variations as low as $\frac{1}{64}$, and can be quoted in

²⁷⁶ NYSE Rule 62 provides that bids or offers in stocks selling above one dollar per share may not be made at a variation of less than one-eighth of a dollar or twelve and a half cents; Amex Rule 127 allows for one-sixteenth spreads for stocks priced under ten dollars, and one-eighth spreads for stocks priced ten dollars and over.

minimum variations as low as $\frac{1}{32}$, depending on the price at which the security trades.²⁷⁷ Some ECNs allow priced orders in variations as low as $\frac{1}{256}$; other systems provide for orders priced in decimals as small as one cent.

Most commenters did not address the issue of ECN minimum price variations. Some commenters that did address the issue, however, recommended that the ECN quote be rounded for public dissemination either downward from or upward to better prices in increments of $\frac{1}{16}$ or smaller.²⁷⁸ Other commenters recommended rounding in decimals,²⁷⁹ while still others strongly opposed the use of decimals.²⁸⁰ One commenter asserted that non-standard increments (*i.e.*, increments not approved by the primary market for the relevant security) should be prohibited in non-primary markets.²⁸¹ To address situations where the priced order in an ECN is at a non-standard increment, the Commission has determined that it is appropriate to interpret the ECN amendment to allow market makers and specialists to comply with the amendment (either individually or through the ECN) by rounding up or down to the nearest fraction accepted by the market disseminating the quote provided by the ECN.²⁸² The Commission believes, however, that rounding is appropriate only if the rounded public quotes are accompanied by an identifier that marks the quote as rounded.²⁸³ Market makers, specialists, and ECNs will be permitted to round the prices of ECN buy orders

²⁷⁷ The NASD does not have a minimum variation policy for Nasdaq stocks. Nasdaq, however, is designed to process quotes and trades in particular minimum variations.

²⁷⁸ See, *e.g.*, NASD Letter; Lehman Letter; Instinet Letter.

²⁷⁹ See, *e.g.*, Letter from Leslie M. Marx, Assistant Professor of Economics and Management, and Eugene Kandel, William E. Simon Graduate School of Business Administration, University of Rochester, to Commissioner Steven Wallman, SEC, dated November 27, 1995 ("Marx and Kandel Letter"), concluding that the markets should move toward decimal pricing.

²⁸⁰ See CHX Letter.

²⁸¹ See Madoff Letter.

²⁸² The Commission believes this alternative is preferable to imposing particular trading increments on the markets. At the same time, however, this alternative will provide the markets with an incentive to voluntarily move towards finer trading increments.

²⁸³ In order to facilitate compliance with the rule, it will be necessary for SROs to provide a means for rounded prices to include a "rounded" identifier that makes clear that a better price is available in the ECN. The Commission notes that SROs, and the public quotation system, may not currently have such a field available for identifying quotations as rounded. The Commission, therefore, requests that the SROs work jointly to modify the public quotation system to ensure that specialists, market makers, and ECNs that are disseminating rounded prices have the ability to distinguish those rounded quotes.

down to the nearest quote increment, and round the prices of ECN sell orders up to the nearest increment. For example, under this interpretation, if a market maker or specialist enters a priced buy order into an ECN at $10^{5/16}$ and the market receiving the price from the ECN for dissemination has a minimum quote increment of $1/8$, a bid of $10^{1/4}$ will be displayed in the public market and identified as a rounded price. This result reflects an SRO rule that prohibits dissemination of quotes in $1/16$ variations. If the market maker or specialist already is bidding publicly at $10^{1/4}$ when it enters the $10^{5/16}$ buy order in an ECN, the market maker or specialist publishing a quote must reflect the ECN order by identifying its $10^{1/4}$ bid as rounded.

In addition, market makers and specialists entering orders into ECNs that are reflected at rounded prices in the public quote will be expected to give their customers an execution at the superior non-rounded price. Thus, the market maker or specialist quoting a rounded price of $10^{1/4}$ to reflect a $10^{5/16}$ buy order must give a customer sell order an execution at $10^{5/16}$ up to the published size. Similarly, an ECN providing market maker or specialist prices pursuant to the rounding alternative must execute an incoming order at the non-rounded price. The Commission recognizes that it may not be feasible for market makers or specialists that have not entered the rounded order into an ECN to determine, in an efficient manner, the actual price of the better order in the ECN. This may particularly be true with respect to market makers or specialists operating automated execution systems. The Commission believes that it is appropriate in such instances for such market makers and specialists that did not enter the rounded order to execute orders at the displayed rounded price.²⁸⁴

The Commission recognizes that this interpretation will allow prices in ECNs that are denominated in non-standard quotation increments not to be fully displayed, but believes this interpretation is appropriate to accommodate ECN prices in the existing public quotation system without imposing uniform trading increments.²⁸⁵ The rounding identifier will inform investors that a better price is behind the rounded quote. Thus, even though the actual price cannot be readily

²⁸⁴ See also, section III.C.2. for a discussion of best execution, *infra*.

²⁸⁵ If primary markets in the future allow narrower quotation increments, these ECN prices between the existing quotation increments could be more accurately displayed in the public quote.

displayed, investors will be aware of, and will be able to obtain, the better price in the ECN or from the market maker or specialist.

v. Effect on the Voluntary Aspect of the Quote Rule

If an OTC market maker uses an ECN that does not rely on the alternative of communicating that market maker's best prices to the public quotation system, then the market maker must publish in its own quote that better priced order entered into the ECN. Once a market maker publishes a quote through its association to reflect a priced order it entered into an ECN, pursuant to Rule 11Ac-1(c)(5)(i)(A), it will be deemed to have elected to publish quotations in that security,²⁸⁶ and will therefore be subject to the quotation provisions of the Quote Rule. Moreover, pursuant to certain existing SRO rules,²⁸⁷ withdrawal of that quotation after the ECN order has been executed or withdrawn prevents the market maker from immediately reinstating quotes in that security.²⁸⁸ As a practical matter, once electing to quote, a withdrawal then precludes the market maker from continuing to enter priced orders for the security in an ECN because of the SRO prohibition on re-entering quotes after withdrawal.

The Commission solicited comment on this aspect of the ECN proposal. Although most commenters were silent concerning this issue, certain comments indicate confusion as to the effect on market makers who currently use ECNs but who do not voluntarily quote under the existing Quote Rule.²⁸⁹ The

²⁸⁶ 17 CFR 240.11Ac1-1(b)(5), as amended. See also, 17 CFR 240.11Ac1-1(a)(25), 17 CFR 240.11Ac1-1(c)(4)(ii), and 11Ac1-1(c)(5)(ii), as amended, acting jointly to ensure that OTC market makers publish quotations pursuant to the Quote Rule in securities they trade via ECNs.

²⁸⁷ See *NASD Manual*, Marketplace Rules, Rule 4600 et. seq., Nasdaq Market Maker Requirements (requiring members to maintain continuous two-sided quotations in the Nasdaq securities for which they are registered as market makers). See also, ITS Plan, Section 6(A)(i)(B), Furnishing Quotations (requiring each ITS Participant to furnish the current bid-asked quotation emanating from its floor or, in the case of the NASD, the best bid and offer emanating from ITS/CAES market makers in eligible securities). Unexcused withdrawal of quotations violates these NASD rules and ITS provisions.

²⁸⁸ This will be true even if the market maker traded less than 1% of the share volume in the security in the previous quarter because the 1% threshold of the Quote Rule for mandatory quotes would not exempt the market maker from disseminating quotes once the market maker has "elected" to quote the security by using the ECN.

²⁸⁹ See, e.g., Madoff Letter; Instinet Letter. In its comment letter, Instinet notes that some market makers that make a continuous market in a security, but do not normally publish quotations in that security, will now be required to disseminate quotations for that security if the market maker

Commission, therefore, reiterates that the combined operation of the ECN amendment and SRO rules may require a market maker or specialist who enters an order into an ECN that does not rely on the ECN display alternative, and publishes a quote reflecting that price, to continue to publish quotes in the public market regardless of the number of shares traded by the market maker or specialist in the security during the previous quarter.

In determining whether a market participant will be required to publish quotes after entering orders in an ECN, the Commission notes that, with respect to any given security, the quote rule requirements only apply if the market participant falls within the definition of the term "OTC market maker" for that security. To be an OTC market maker, the participant must hold itself out as willing both to buy and sell on a regular or continuous basis.²⁹⁰

The "OTC market maker" definition is not intended to capture subscribers who enter orders into ECNs on one side of the market to limit or offset their risk, such as options market makers who use ECNs to hedge their positions in the securities underlying the options they trade. They would not be required to publish public quotes in a security simply because they had entered an order for the security into an ECN, unless they regularly or continuously hold themselves out as willing to buy and sell the security. An entity that holds itself out via contract, marketing, or other communications with its customers, as being willing both to buy and sell a specific security on a regular or continuous basis would be an "OTC market maker" for the security. This latter market maker's entry of a superior priced order into an ECN for a security that itself does not publish quotes would compel the market maker to publish a quote and potentially, depending on SRO rules, trigger on-going quotation obligations.

vi. Exemptive Relief

Finally, the Commission is amending Section (d) of the Quote Rule concerning exemptive relief. Under that section, the Commission previously could exempt from the provisions of the Quote Rule, either conditionally or on specified terms and conditions, any responsible broker or dealer (which now will include a specialist or market

places a priced order for that security on an ECN. The Commission recognizes this result, but notes the ECN display alternative of allowing such market makers to continue to place orders in a security into an ECN without having to directly publish quotes in that security.

²⁹⁰ Rule 11Ac1-1(a)(8), as amended.

maker under the ECN amendment), exchange, or association if the Commission determined that such an exemption was consistent with the public interest, the protection of investors and the removal of impediments to and perfection of an NMS. The Commission is adding a provision allowing it to exempt an ECN from the definition in the rule. The Commission did not solicit comment on expanding its authority to grant exemptive relief in this manner. The Commission believes, however, that the added exemptive authority is appropriate because it provides flexibility in applying the ECN amendment.

3. Amendments to the Quote Rule Concerning Definitions

a. Introduction

In the Proposing Release the Commission proposed to expand the Quote Rule's existing requirements to include quotation information from broker-dealers that, while internalizing order flow, hold themselves out as willing to buy and sell on a regular or continuous basis. This expansion of the Quote Rule would be accomplished by amending the definition of OTC market maker. The Proposing Release also recommended that quotation requirements be imposed on substantial broker-dealers in non-Rule 19c-3 securities by amending the definition of subject security, and on broker-dealers in Nasdaq SmallCap securities by amending the definition of covered security.²⁹¹ In putting forward this proposal, the Commission noted that some dealers quote on a selective basis, choosing not to display quotes for securities that they actively trade because these securities are subject only to the voluntary quote provisions of the Quote Rule.

The amendments adopted by the Commission today are substantially the same as those proposed.²⁹² The

²⁹¹ OTC market makers and specialists are not required by the Quote Rule to provide continuous two-sided quotations for any Nasdaq security. As amended, an OTC market maker or specialist may make an election, pursuant to paragraph (b)(5)(i) of the Quote Rule, to collect, process, and make available quotations for Nasdaq NMS or Nasdaq SmallCap securities. The Commission is soliciting comment on a proposed amendment which would require continuous two-sided quotations from OTC market makers and specialists responsible for more than 1% of the aggregate transaction volume for a Nasdaq security. See Companion Release.

²⁹² The only substantive difference between the amendments as adopted today and as proposed is the definition of the term "OTC market maker." The definition as proposed read " * * * sell to a customer * * * " but has been modified to read " * * * sell to its customers * * * ." Rule 11Ac1-1(a)(13), 17 CFR 240.11Ac1-1(a)(13). See *infra* note 308.

Commission believes these amendments will benefit investors by improving price discovery and liquidity, and increasing competition between OTC market makers and specialists. The Commission further believes that these amendments are in keeping with Congress's directive that the Commission use its rulemaking authority to remove impediments to competition.

b. Basis for Amendments to Rule 11Ac1-1(a)

i. Amendment to 11Ac1-1(a)(25) (Definition of a "Subject Security")

The Commission is amending the Quote Rule's definition of subject security to require continuous two-sided quotations from OTC market makers and exchanges that are responsible for more than 1% of the volume in a non-Rule 19c-3 security. The Commission believes that this amendment removes an impediment to competition that exists under the current rule. Broker-dealers that held themselves out as willing to buy and sell non-Rule 19c-3 securities on a regular or continuous basis were not previously required to disseminate quotation information unless they transacted the largest percentage of the aggregate trading volume in a particular security. Consequently, regardless of the volume transacted by other exchanges or OTC market makers, the primary market,

In addition to the amendments discussed in detail herein, the Commission is making technical, non-substantive amendments to the Quote Rule. The terms "association", "revised bid or offer", and "revised quotation size" will be separately defined in the rule. The definition of "exchange-traded security" has been revised to exclude OTC securities traded on an exchange pursuant to unlisted trading privileges. The definition of "plan processor" has been amended to reflect the appropriate cross-reference. The definition of "principal market" has been removed from the Quote Rule because it is no longer applicable. In addition, the definitions have been arranged in alphabetical order.

Paragraph (b)(1)(i) of the rule has been reorganized to separately set forth the exclusions in subparagraphs (A) and (B). Paragraph (b)(1)(iii) has been eliminated and the substance of the provision has been incorporated into paragraphs (b)(1)(i) and (b)(1)(ii).

The Commission is also amending the definition of the term "reported security" as it appears in Rule 11A3-1(a)(4). The amendment alters the form but not the meaning of the term or its application. The amendment will make the term consistent with the definition of "reported security" in the Quote Rule.

The amendments to Rule 11Ac1-1(a) are being adopted prospectively. Outstanding Quote Rule interpretations and no-action letters continue to be operative, to the extent that the positions taken therein are not materially in conflict with the amendments adopted today. Persons seeking clarification regarding the status of outstanding no-action letters should contact the Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission.

which was the market responsible for transacting the largest percentage of the aggregate trading volume, was the only market participant required to disseminate quotations in these securities.²⁹³

As noted in the Proposing Release, third market trading in non-Rule 19c-3 securities has increased considerably since the Quote Rule was last amended.²⁹⁴ Third market trading in Rule 19c-3 securities now accounts for a greater number of stocks and a more substantial percentage of U.S. trading volume than it did when the Commission initially established disparate regulatory treatment under the Quote Rule for Rule 19c-3 securities and non-Rule 19c-3 securities.²⁹⁵ In view of the growth of third market trading volume, the Commission believes that requiring all broker-dealers trading more than 1% of the volume in a listed security to publish quotations will provide more accurate and comprehensive quotation information for non-Rule 19c-3 securities.

The Commission believes that disparate regulatory requirements for Rule 19c-3 and non-Rule 19c-3 securities can no longer be justified by differences in the trading of the two types of securities. Moreover, the Commission finds that differences in regulatory treatment have impaired transparency. Because of the growth of third market trading in non-Rule 19c-3 securities, the absence of quotes revealing the substantial third market makers in a security and the prices they are prepared to publicly quote results in the consolidated quotations in the security being incomplete.²⁹⁶ The Commission therefore believes that significant dealers in non-Rule 19c-3 securities should become subject to the same standards required for trading

²⁹³ An OTC market maker or specialist, although not the principal market for a listed security, could elect to disseminate quotes for the security. Under the amended 11Ac1-1(a)(25) an OTC market maker or specialist may still elect to disseminate quotations if it is responsible for 1% or less of the volume in that security.

²⁹⁴ Third market trading interest is more concentrated in non-Rule 19c-3 securities, as evidenced by the fact that the percentage of third market quotes in non-Rule 19c-3 securities (36%) is greater than that for Rule 19c-3 securities (28%). See *Fragmentation vs. Consolidation of Securities Trading: Evidence of the Operation of Rule 19c-3*, Office of Economic Analysis, SEC, at 5 (March 29, 1995) ("*Fragmentation vs. Consolidation*").

²⁹⁵ Third market trading volume has grown, at least in part, because the universe of securities subject to Rule 19c-3 has increased considerably. For example, nearly 60% of the stocks listed on the NYSE are subject to Rule 19c-3, accounting for approximately 48% of the total NYSE volume. See *Fragmentation vs. Consolidation* at 4-5.

²⁹⁶ See, e.g., *supra* note 294.