

NAqcess file so as to permit customer orders to interact directly with each other without the participation of a market maker. The interaction of customer orders offers such orders an opportunity for price improvement over the dealer quotation and increases the likelihood that public limit orders will be executed on a more timely basis.

The companion rules and Interpretations regarding price protection in Nasdaq will also significantly enhance the protection of customer limit orders whether they are held in NAqcess or stored in a member firm's limit order file. Under a newly proposed rule, NASD member firms, whether acting as principal or agent, will not be permitted to execute an order at a price inferior to any limit order(s) in the NAqcess limit order file that the member firm is able to view, without satisfying the viewable limit order(s). An "inferior price" means an execution price that is lower than a buy limit order or higher than a sell limit order. In addition, if a member firm holds a customer limit order outside of NAqcess, a new Interpretation to Article III, Section 1 of the Rules of Fair Practice would require the member firm that holds the limit order to provide the customer with price protection that is equivalent to that which the limit order would have received if it had been entered into the NAqcess file. The concept of equivalent price protection is further explained below.

Aside from these major regulatory enhancements that provide for major changes in order handling and protection in The Nasdaq Stock Market, the NAqcess system itself represents a significant improvement over the current methodology for the handling of small investor orders. NAqcess, as noted, will permit interaction of small customer limit and market orders within the dealer spread and thus permit such orders to obtain significant opportunities for price improvement over the dealer quotation.

This new order delivery and execution system will replace SOES, the NASD's current system for the handling of small customer orders. Because SOES is an automated, quote-based execution system, it does not offer the opportunity for price improvement over the dealer quotation of small customer orders. Moreover, the proposed NAqcess system addresses the queuing concerns that were raised in connection with the previously proposed N-Prove system. NAqcess will distribute non-directed market orders that can not be immediately matched against NAqcess limit orders to available market makers at the inside market as the orders are

presented. A market maker will provide such order an automated execution at the inside if the market maker presented with the order does not manually decline the order within a 20-second period because the market maker (consistent with SEC Rule 11Ac1-1)<sup>3</sup> has already effected, or is in the process of effecting an execution in the security and is in the process of updating its quotation. This approach eliminates the single-threaded distribution mechanism proposed in Notice To Members 95-20 and permits rapid distribution of orders to market makers as the orders are received.<sup>4</sup>

<sup>3</sup> 17 CFR 240.11Ac1-1 (1995).

<sup>4</sup> The NASD believes that significant queues in excess of those currently experienced under SOES today will not occur under the new proposal. First, if the limit order file for a security has depth, market orders will immediately execute against limit orders without any delay. Because each order when received is immediately distributed to the next available market maker, the large majority of orders will be executed within 20 seconds of distribution. Even if an order is declined by a market maker at one price level, an event that the NASD believes will not be frequent, the declined order will be automatically executed without the possibility of rejection immediately upon presentation at the next price level. All of these techniques mean that it will be rare for an order not to be executed within a 20 to 40-second period after processing.

For example, assume that five market orders are entered into NAqcess at one second apart from each other and there are five market makers in the stock at the inside. Each order when received will be immediately distributed to the next market maker. Thus, order one at second one is distributed immediately to market maker one, while order two at second two is sent to market maker two immediately, and so on through order five. In most circumstances, each market maker will not decline the order within 20 seconds, and thus, each order would be executed within 20 seconds of processing. If any one of these orders were declined, the order would wait for the next available market maker for re-presentation. If that market maker remained at the same price level as that when the order was originally presented, the order would be subject to a further 20-second reaction period. In the unlikely event it was declined again, the order would be presented again for execution. If that presentation occurred at a new price level, it would be immediately executed at the new price level.

If order entry firms enter more orders than there are market makers at the inside, the queue for such orders would be the same as today in SOES when orders must be queued while waiting for a market maker to update its quotation after a SOES execution. Consequently, the NASD believes that queuing under this proposal does not represent a significant threat to prompt market order execution much different from current queuing. It should be noted as well, that market orders of eligible size entered into NAqcess are guaranteed an execution. Such execution may be effected against a customer order or a dealer's quote. Thus, in response to concerns raised in some comment letters the NASD received in response to Notice to Members 95-20 and 95-60, NAqcess will provide guaranteed executions to investors entering eligible market orders. Accordingly, the NASD believes that those comment letters from individual investors that allege that NAqcess will deprive them of an automatic execution are mistaken. Of course, it should be noted that not even in SOES is a market order guaranteed an execution at the price observed

NAqcess and its companion rules represent a significant enhancement to the treatment of investor orders in The Nasdaq Stock Market. The entire proposal, when taken together with other recent enhancements to the Nasdaq trading environment, such as the Limit Order Protection Interpretation<sup>5</sup> and the Short Sale Rule,<sup>6</sup> demonstrates the significant strides that the NASD and The Nasdaq Stock Market have taken to provide increased protection of investors while continuing to preserve the benefits that its competitive dealer market structure currently provides. Individual investors seeking price improvement over the dealer quotation will be afforded a transparent mechanism to obtain greater opportunities for price improvement over the dealer quotation without market maker interaction. Moreover, through the accompanying rules, NAqcess will provide such limit orders with increased market-wide price protection. Individual investors seeking rapid execution of small market orders at the best available price will continue to be able to obtain executions promptly, while Nasdaq market makers will be permitted the opportunity to interact with such orders in a manner consistent with SEC rules and in a manner similar to market order handling in exchange markets. By permitting market makers to continue the operation of their own internal execution systems, the NASD will maintain the ability of dealers to provide liquidity and competitive mechanisms to handle customer orders.

## 2. NAqcess Operations

The proposed NAqcess system will provide the following:

**A. Scope of System.** NAqcess will be available for all Nasdaq issues. It will completely replace SOES which will operate until the effective date for operation of NAqcess and will be discontinued as of that date. NAqcess participation will be mandatory for market makers in all National Market securities. NAqcess participation for SmallCap market makers will be voluntary, as is SOES participation today for such market makers.

**B. Order Entry Requirements.** Agency orders may be entered into NAqcess only by member firms on behalf of customers. "Customers" are defined to

at the time the order was entered. Similarly, under NAqcess no such guarantee is extended to an investor.

<sup>5</sup> Securities Exchange Act Release Nos. 35751 (May 22, 1995), 60 FR 27997 (May 26, 1995) and 34279 (June 29, 1994), 59 FR 34883 (July 7, 1994).

<sup>6</sup> Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).