Exposure Limit Rule''); and (2) implementation of an automated function for updating market maker quotations when the market maker's exposure limit has been exhausted (''SOES Automated Quotation Update Feature''). These rules are part of a set of SOES rules approved by the SEC on a pilot basis known as the Interim SOES Rules.[4]

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

On December 23, 1993, the SEC issued an order approving the Interim SOES Rules on a one-year pilot basis effective January 7, 1994. In response to two applications requesting a stay of the Interim SOES Rules Approval Order, however, the SEC granted a partial stay of the effective date of the order through January 25, 1994. Thus, absent further Commission action, the Interim SOES Rules initially were effective from January 26, 1994 through January 25, 1995.[5] On January 25, 1995, the SEC approval an NASD proposal to extend the effectiveness of the Interim SOES Rules through March 27, 1995.[6]

As described in more detail below, because the NASD believes implementation of the SOES Minimum Exposure Limit rule and the SOES Automated Quotation Update Feature have been associated with positive developments in the markets for Nasdaq securities and clearly have not had any negative effect on market quality, the NASD believes it is appropriate and consistent with the maintenance of fair and orderly markets and the protection of investors to extend the effectiveness of these rules. In addition, consistent with the termination of the Interim SOES Rule that prohibited the entry of short sales into SOES, the NASD believes its instant proposal to continue the effectiveness of some but not all of the original components of the Interim SOES Rules is appropriate and consistent with the Act. While the NASD believes the Interim SOES Rules collectively have had a beneficial impact on the market, the NASD also believes that each of the Interim SOES Rules has individually had a benefit on the market. Thus, each one of the Interim SOES Rules can be evaluated for consistency with the Act independent of the others. The SOES Minimum Exposure Limit rule and the SOES Automated Quotation Update Feature reflect a reasoned approach by the NASD to address the adverse effects on market liquidity attributable to active intra-day trading activity through SOES, while at the same time not compromising the ability of small, retail investors to receive immediate executions through SOES. Specifically, these rules are designed to address concerns that concentrated, aggressive use of SOES by a growing number of order entry firms has resulted in increased volatility in quotations and transaction prices, wide spreads, and the loss of liquidity for individual and institutional investor orders.

The NASD believes that the same arguments and justifications made by the NASD in support of approval of the SOES Minimum Exposure Limit rule and the SOES Automated Quotation Update Feature are just as compelling today as they were when the SEC relied on them to initially approve the rules. In sum, the NASD continues to believe that concentrated bursts of SOES activity by active order-entry firms contributed to increased short-term volatility, wider spreads, and less market liquidity on Nasdaq and that the SOES Minimum Exposure Limit rule and the SOES Automated Quotation Update Feature are an effective means to minimize these adverse market impacts.

The NASD also notes that the SEC made specific findings in the Interim SOES Rules Approval Order that the SOES Minimum Exposure Limit rule and the SOES Automated Quotation Update Feature were consistent with the Act. In particular, the SEC stated in its approval order that:

a. Because the benefits for market quality of restricting SOES usage outweigh any potential decrease in pricing efficiency, the Commission concludes that the net effect of the proposal is to remove impediments to the mechanism of a free and open market and a national market system, and to protect investors and the public interest, and that the proposed rule changes are designed to produce accurate quotations, consistent with Section 15A(b)(6) and 16A(b)(11) of the Act. In addition, the Commission concludes that the benefits of the proposal in terms of preserving market quality and preserving the operational efficiencies of SOES for the processing of small size retail orders outweigh any potential burden on competition or costs to customers or broker-dealers affected adversely by the proposal. Thus, the Commission concludes that the proposal is consistent with Section 15A(b)(9) of the Act in that it does not impose a burden on competition which is not necessary or appropriate in furtherance of the purposes of the Act.[7]

b. The Commission also concludes that the proposal advances the objectives of Section 11A of the Act. Section 11A provides that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure economically efficient execution of securities transactions, fair competition among market participants, and the practicality of brokers executing orders in the best market. The Commission concludes that the proposal furthers these objectives by preserving the operational efficiencies of SOES for the processing of small orders from retail investors.[8]

c. The Commission believes that it is appropriate to restrict trading practices through SOES that impose excessive risks and costs on market makers and jeopardize market quality, and which do not provide significant contributions to liquidity or pricing efficiency. * * * The Commission believes that it is more important to ensure that investors seeking to establish or liquidate an inventory position have ready access to a liquid Nasdaq market and SOES than to protect the ability of customers to use SOES for intra-day trading strategies.[9]

d. The Commission believes that there are increased costs associated with active intra-day trading activity through SOES that undermine Nasdaq market quality * * * Active intra-day trading activity through SOES can also contribute to instability in the market. * * *[10]

e. In addition, these waves of executions can make it difficult to maintain orderly markets. Given the increased volatility

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[4] As first approved by the Commission on December 23, 1993, the Interim SOES Rules had four components: (1) The SOES minimum Exposure Limit; (2) the Automated Quotation Update; (3) a reduction in the maximum size order eligible for execution through SOES from 1,000 shares to 500 shares (''SOES Maximum Order Size''); and (4) the prohibition of short sales through SOES. In light of the SEC's approval of the NASD's short sale rule in June 1994, the NASD did not seek to extend the prohibition against the entry of short sales into SOES. Absent SEC approval of an extension of the effectiveness of the SOES Maximum Order Size rule, the rule will lapse effective March 28, 1995.

[5] Securities Exchange Act Release No. 33377 (Dec. 23, 1993), 58 FR 69419 (Dec. 30, 1993) (approving the Interim SOES Rules on a one-year pilot basis effective January 7, 1994). See also Securities Exchange Act Release No. 33424 (Jan. 5, 1994) (order denying stay and granting interim stay through January 25, 1994) and Securities Exchange Act Release No. 33635 (Feb. 17, 1994) (order denying renewed application for stay).

[6] See SOES Interim Rules Extension Order, *supra* note 3.

[7] Interim SOES Rules Approval Order, supra note 2, 58 FR at 69423 (footnote omitted).

[8] *Id.* (footnote omitted).

[9] *Id.* at 69424–25.

[10] *Id.* (footnote omitted).