I. Introduction

Nasdaq7 is a screen-based market, operating in an efficient, highly competitive electronic trading environment. In contrast to traditional floor-based, auction markets, Nasdaq has no single specialist through which transactions pass. At the core of Nasdaq are trading services that use computer technology to provide market participants access to the market. Most of these trading services reside on the Nasdaq Workstation II7, and are designed to create an efficient, flexible, trading environment. Nasdaq's market structure allows multiple market participants to trade stock through a sophisticated computer network linking geographically dispersed buyers and sellers. Together, these participants help ensure transparency and liquidity for a company's stock while maintaining an orderly market.

Set forth below are descriptions of the market participants that provide liquidity in the Nasdaq market, as well as the manner in which they enter and access quotes and orders. This is followed by a description of the trading services that Nasdaq provides market participants to facilitate trading, including order entry, order routing, trade reporting, settlement, and clearance. Finally, there is a description of certain system enhancements that the Commission has approved and that will be implemented shortly, as well as other system changes that have been proposed but not yet approved.

II. Market Participants

There are two types of entities that trade securities through the Nasdaq system – market makers and Order Entry Firms. Market makers are individual dealers who commit capital and openly compete with one another for investors' buy and sell orders. Order Entry Firms (including electronic communications networks ("ECNs")) are brokers, dealers, or trading systems that bring additional customer orders into Nasdaq, but that do so without ordinarily taking proprietary positions.

A market maker is a Nasdaq member firm that buys and sells securities at prices it displays in Nasdaq for its own account (principal trades) and for customer accounts (agency trades). Market makers actively compete for investor orders by displaying quotations representing their buy and sell interest—plus customer limit orders—in Nasdaq-listed stocks. Each market maker has equal access to Nasdaq's trading system, which broadcasts their quotations simultaneously to all market participants. By standing ready to buy and sell shares of a company's stock, market makers provide to Nasdaq-listed companies a unique service. The result of their combined sponsorship helps meet investor demand and creates an environment of immediate and continuous trading. In fact, Nasdaq's system is so finely calibrated that market makers located 25, 250, and 2,500 miles from Nasdaq's technology center each receive quotation updates at precisely the same time. Currently, more than 500 market making firms provide capital support for Nasdaq-listed stocks.

The primary types of market-making firms are retail, institutional, wholesale, regional, and those that trade pursuant to unlisted trading privileges ("UTP"). The retail market-making firm has a retail brokerage network serving individual investors that provides a continuous flow of orders or sales opportunities. This order flow helps facilitate liquidity for the company's stock and stability in the marketplace. The institutional market-making firm specializes in executing large block orders for pension funds, mutual funds, insurance companies, and asset management companies, among others. The regional market-making firm focuses on both the companies and the investors of a particular region. The regional market maker gives the company the advantage of specialized, in-depth knowledge of the stocks and investors of a particular area of the country, providing more extensive coverage than might be available elsewhere. The wholesale market-making firm trades shares for institutional clients as well as for other broker-dealers that are not registered market makers in a company's stock, but need to execute orders in that stock for customers. They help create liquidity for a company's stock by being an important source of shares for retail, institutional and regional firms. Firms that trade Nasdaq stocks via unlisted trading privileges may route their customer or proprietary orders through another exchange, if a quote on that exchange represents the inside market.

Regardless of their business model or location, all Nasdaq market makers have similar obligations and rights. Market makers are required to (1) display two-sided quotes in all stocks in which they choose to make a market; (2) display both quotes and orders in Nasdaq, in compliance with the Commission's Order Handling Rules; (3) honor their quoted prices; and (4) report trading in a timely manner. Failure to do so can lead to disciplinary action. In return for undertaking these obligations, market makers gain the right to enter, retrieve, monitor, and adjust quotations and to enter and execute orders in all of Nasdaq's automated services (e.g. Small Order Execution SystemĶ ("SOES")and SelectNet7); report trades in Nasdaq National Market7 ("NNM"), Nasdaq SmallCapĶ, and other listed stocks within 90 seconds of execution; and compare and clear trades through automated services, such as the Automated Confirmation Transaction SystemĶ ("ACT").

ECNs are the newest market participants in Nasdaq's inclusive marketplace. These private trading systems were incorporated into the Nasdaq market structure in 1997, when Nasdaq implemented the SEC's Order Handling Rules. To trade on Nasdaq, ECNs must be certified with the SEC and registered with Nasdaq. When a market maker uses an ECN to represent an order, the order is first routed through the ECN to check for matches, and is then posted electronically in Nasdaq as an ECN quote. The forwarded order can then be executed on Nasdaq or matched with a new order through the ECN.

Buy and sell orders that are represented in Nasdaq through ECN quotes are either public orders forwarded to the ECN by subscribing broker/dealers, or orders from institutions subscribing to an ECN. Additionally, ECNs provide institutions and market makers with an anonymous way to enter orders for stock into the marketplace.

III.   System Access

Market participants gain access to the Nasdaq market via a direct or indirect electronic link to Nasdaq's computer facilities. The primary device for accessing the market is the Nasdaq Workstation II ("NWII"). NWII consists of two components: (1) the actual connection to the Nasdaq trading network and (2) Nasdaq software that allows market participants to access the various trade negotiation, execution, and reporting services Nasdaq offers. The NWII software can be installed on a market participant's personal computer and can be customized to address a market participant's individual requirements.

Introduced in 1995, NWII is the primary device for trading Nasdaq stocks. This network of workstations gives securities traders a centralized quotation service and automated trade executions, trade reporting, trade negotiation, and clearing. Nasdaq keeps NWII cutting-edge through frequent software and hardware upgrades. In 1999, Nasdaq replaced the network upon which NWII is run with a new network that will effectively meet the future technological needs of the marketplace by more than doubling the speed and capacity of its predecessor. Each NWII trading device connects to a server, which links directly to Nasdaq's computer facility through dual T1 telecommunication lines.

NWII subscribers have three service-level options. Level I service allows the user to view inside quote information only; no orders can be entered or trades made. Nasdaq Level II users can query market maker quotes and enter orders and trade reports. Level III service provides the functionality of Levels I and II plus the ability to enter quotations for individual securities.

NWII runs on Windows NT 4.0x, as well as Sun Solaris 2.5x and can be integrated with most in-house systems. NWII employs advanced Windows technology to create a fast, flexible, and convenient trading environment. Each terminal receives immediate connection to a Nasdaq server, which links directly to the main Nasdaq computer facility in Trumbull, CT. A back-up facility is located in Rockville, MD. Quick response times required by the marketplace are fully maintained by the NWII telecommunications network and mainframe.

Market participants can also access the Nasdaq market through a Computer-to-Computer Interface ("CTCI"). CTCI is a two-way communications link over point-to-point circuits that permits market participants to transmit transactions from their computer systems to Nasdaq's computer systems. CTCI also is designed to permit a firm acting as Service Bureau to interface with Nasdaq on behalf of multiple firms.

IV.   Order Entry, Routing, and Handling Systems

The services that are currently available through NWII and CTCI are: the Order Confirmation Transaction Service ("SelectNet"); the Small Order Execution System ("SOES"); the Advanced Computerized Execution SystemΚ ("ACES"); Computer-Assisted Execution System/Intermarket Trading SystemΚ ("CAES/ITS"), and the OptiMark facility of Nasdaq.

A.   SelectNet

SelectNet offers market participants the ability to automate the negotiation and execution of trades, eliminating the need for verbal contact between trading desks. Orders of any size within six digits can be traded on SelectNet. SelectNet allows order-entry firms and market makers to direct orders to specified market makers or ECNs/ATSs, or to broadcast orders to all market makers and ECNs/ATSs. SelectNet also identifies incoming and outgoing orders and allows traders to see subsequent messages and negotiation results. SelectNet is the exclusive Nasdaq-operated, automated system for communicating with, sending orders to, and receiving executions from ECNs/ATSs.

SelectNet's flexibility begins with the ability to set up a "watch list" to control what information comes to a trading screen. Traders can specify those securities for which they will receive SelectNet messages—buy or sell orders. Market makers can assign SelectNet orders in specific securities to the responsible traders. Traders can enter "directed" orders in SelectNet, which are displayed to a specific market maker.

Market participants follow a few easy steps to enter, negotiate, and accept orders. To enter an order the market participant must choose buy or sell or sell short; enter the share size; enter the security ID; designate a price; indicate whether price and/or size are negotiable; leave the order open from three to 99 minutes, make it a day order, or leave it open until after-hours trading has ended. Market participants can respond to an order in several ways: accept the order; price improve it; decline it; counter the order or accept a portion of an order; or allow order to expire or time out. When an order is countered, negotiations begin and the parties exchange messages until they produce a full or partial execution, decline the transaction, or the transaction times out.

After an order is executed, SelectNet automatically confirms it on the workstation displays of the order-entry firms, market makers, and ECNs/ATSs, sends the trade report through Nasdaq for public dissemination, and compares, matches, and sends the locked-in trade to a clearing corporation. All Nasdaq order-entry or market maker subscribers are eligible to participate in SelectNet, provided that have a clearing arrangement with an approved clearing agent.

B.   SOES

SOESK is an execution system that automatically executes small agency orders, reports trades for public dissemination, and sends trades to clearing for comparison and settlement. By automatically executing small agency orders at the best quoted price, SOES helps traders manage investors' small orders and allows more time for trades that require negotiation. Participation in SOES is mandatory for market makers in Nasdaq NMS securities and voluntary for market makers in Nasdaq SmallCap securities. A Nasdaq member firm may participate in SOES if it has a clearing arrangement with an approved clearing agent.

SOES accepts market orders and marketable limit orders in both Nasdaq National Market System and SmallCap Market securities. Orders entered into SOES can be either preferenced or unpreferenced. A preferenced order is executed, at the inside market price, against the market maker to which the order is directed. Market makers can choose the order-entry firms from whom they will accept preferenced orders. An unpreferenced order is executed, at the inside market, against market makers in a rotation. ECN/ATS and unlisted trading privilege ("UTP") participant quotes are not accessible through SOES.

C. ACES

ACES7 routes orders between order-entry firms and market makers that have established relationships, providing the benefits of an advanced order routing tool without the start-up costs of a stand-alone system. ACES streamlines routine order entry by routing orders directly into the market maker's internal system for execution and routing the executed message back to the order-entry firm. ACES eliminates a considerable amount of routine paperwork and nonessential telephone negotiations

ACES is a voluntary service for which market makers must register to be authorized subscribers. To use ACES, market makers elect to provide order-entry firms with access to their internal trading systems through ACES using the NWII. Once authorized, order-entry firms can route orders directly to specified market makers through their NWIIs or their own proprietary systems. These orders are executed within the market makers' internal trading systems and execution reports are routed back to the order-entry firms. Market makers have the ability to add, delete, or restore one or all of the designated order-entry firms routing their orders.

D. OptiMark

Nasdaq operates the OptiMark Trading System as a trading facility of The Nasdaq Stock Market7 in conjunction with OptiMark Technologies, Inc. This screen-based trading facility provides a computerized, optimal matching cycle designed to satisfy the trading interests of market participants. The facility adds a "third" dimension to trading criteria by allowing participants to anonymously represent their trading interest across a full spectrum of prices and sizes, rather than a single price and size.

OptiMark users submit customized expressions of trading interest called Profiles. Profiles give users the ability to visually depict complex trading strategies by reflecting an investor's willingness to trade at a variety of prices and sizes, and by enabling an investor to add a third dimension to his or her trading strategy. This third dimension is the level of preference, on a sliding scale, of trading at a given price and size. The preference levels are expressed as a number between zero and one for each coordinate on a price/size grid. In addition to Profiles submitted directly by users, the facility includes certain system-generated Profiles known as the "Nasdaq Quote Montage Profiles," reflecting the Inside Bid and Offer quotes from Nasdaq market makers, ECNs, and UTP exchange specialists as displayed in the Nasdaq Quote Montage at the start of a matching cycle.

The OptiMark Matching Module measures and ranks all relevant trading interests for a particular stock in matching cycles of no longer than three seconds. There are two separate stages in each matching cycle. In the first stage, aggregation, the Matching Module will process only buy and sell coordinates with a full satisfaction value of one. Smaller-sized coordinates may be aggregated to build sufficient size to be matched with larger-sized coordinates. Upon completion of the aggregation stage, the Matching Module will consider potential matches between buy and sell coordinates where one or both parties have less than one, but greater than zero, satisfaction values.

Just prior to the start of a Matching Cycle, OptiMark reads all quotes being displayed in Nasdaq for the particular security to be matched. Those quotations (price and displayed size) are converted to OptiMark Profiles and are eligible for matching as described below:

- Two Profiles are generated for each quote, one each for the Bid and Offer.
- If a match would trade through the quotes, a SelectNet order will be generated to the affected market maker(s).
- When the SelectNet order is generated, the member that entered the OptiMark Profile receives a Fill Pending message in their Book View window.
- The order is generated at the Aggregation price of the Match and could afford the Nasdaq market maker or ECN price improvement over his/her quote.
- The market maker or ECN has the ability to accept the order at which time a Fill Notice is generated to the OptiMark Profile.
- If the market maker or ECN has met its Firm Quote Obligation, the order may be declined, at which time the member that entered the OptiMark Profile would receive a Nothing Done message.

After each matching cycle, the OptiMark Trading System sends all fill results to ACTK for trade reporting and clearing. A public trade report--not distinguished from any other trade reported through Nasdaq--is immediately disseminated by Nasdaq for any executions resulting from a match. Final locked-in trades will be forwarded to NSCC and will clear and settle regular way just as any other Nasdaq transaction.

Nasdaq market makers and order-entry subscribers can access OptiMark through the NWII as well as other software interfaces and systems. To become an authorized user of the OptiMark Trading System, firms must sign an OptiMark subscriber agreement.

E. CAES/ITS

The Computer Assisted Execution System (CAES) is an automatic execution system for exchange-listed securities. ITS is a trading link between Nasdaq's system and U.S. stock exchanges. CAESK allows Nasdaq member firms to direct orders in exchange-listed securities to market makers for automatic execution. The Intermarket Trading System (ITS) features in the system provide an interface between the ITS (operated by the Securities Industry Automation Corporation) and Nasdaq market makers authorized as CAES/ITS market makers.

Although CAES is linked to ITS, CAES is itself a self-standing linkage that can accommodate various market participants and competing market centers. On March 16, 2000, the SEC approved a proposal that allows ECNs to participate in CAES on an equal basis as market makers, and therefore, to link to ITS. CAES will be open to all Nasdaq member ECNs that are able to demonstrate compliance with the CAES rules and system requirements. To date, several ECNs have expressed interest in CAES participation and were recently provided with the modified CAES system specifications that will allow them to assess any internal system modifications necessary for participation in CAES.

Nasdaq order-entry firms and market makers enter market and limit orders in exchange-listed securities to be executed against other Nasdaq market makers quoting at the best bid or offer in those securities. Orders in CAES can be delivered as preferenced to a specific market maker or can be unpreferenced and sent in a principal or agency capacity.

Nasdaq market makers and order-entry firms may participate in CAES. Only Nasdaq market makers currently participate in ITS. Nasdaq member firms that quote in eligible exchange-listed securities must participate in CAES/ITS, allowing the firm to be exposed for execution at its quoted price for a fixed number of shares through CAES from other Nasdaq member firms or the exchanges. Exchange specialists at the following exchanges may also participate:

American Stock Exchange
Boston Stock Exchange
Chicago Stock Exchange
Cincinnati Stock Exchange
New York Stock Exchange
Pacific Stock Exchange (Los Angeles and San Francisco)
Philadelphia Stock Exchange

CAES/ITS trading is available through the NWII or through CTCI.

V. Trade Reporting

The ACT service provides market participants with the ability to perform three important post-execution functions: trade reporting, trade comparison, and risk management. Participation in ACT is mandatory for all Nasdaq members that are members of a clearing agency registered with the SEC pursuant to Section 17A of the Act and for all Nasdaq members that have a clearing relationship with a member of a clearing agency.

Once a trade is executed on Nasdaq, the details of the trade (*e.g.*, trade price and number of shares) must be reported within 90 seconds of the time of execution. ACT is the service market participants use to report these trade details. In addition, ACT calculates last sale information and disseminates it to the Nasdaq last sale tape as well as to the media through the Nasdaq Trade Dissemination Service.

The ACT service is also integral to the timely settlement of trades. ACT provides several different methods for parties to a trade to confirm the details of a trade. For example, in a trade by trade match, both parties to the trade submit transaction data and the ACT system performs an on-line match. Another method of matching permits one party to enter its version of the trade and the other party (the contra party) can accept or reject the trade. Once the trade details are confirmed, by either ACT performing a match or the contra party accepting the trade, the trade is considered locked-in and is forwarded to the NSCC for settlement. Trades that are rejected are purged from the system each day. Open trades (*i.e.*, unmatched or unaccepted trades) are not purged at the end of day, but are carried over until the next business day for continued comparison and reconciliation. ACT will automatically lock in and transmit to NSCC any carried-over, open trade if it remains open as of 2:30 p.m. on the next business day. In addition, ACT provides an on-line facility that permits members to monitor the status of their trades (*e.g.*, accepted, matched, or open).

Once an ACT participant is reported by ACT as a party to a trade that is locked-in and sent to NSCC, notwithstanding any other agreement to the contrary, that party is obligated to act as a principal to the trade and must honor the trade on the scheduled settlement date.

ACT also provides risk management functions to clearing firms that enable these firms to monitor the trading activity of their correspondents. Clearing firms can establish gross dollar thresholds for purchases and sales by their correspondent executing brokers, and ACT will alert the clearing firm and its correspondent if the correspondent's trading activity equals or exceeds either threshold. ACT will also alert the clearing firm and its correspondent when the correspondent's trading activity equals or exceeds 70% of either gross dollar threshold. The thresholds can be set on a intra or inter day basis.

Clearing firms can also set a Super Cap on a correspondent's trading activity. The Super Cap is set at two times the gross dollar thresholds for purchases and sales, but in no event less than $1 million. When a correspondent's Super Cap is exceeded, notice will be furnished to ACT participants and no trade in excess of $200,000 will be accepted for ACT processing unless the clearing firm accepts the trade within 15 minutes of execution.

ACT also permits clearing firms to set single trade limits for their correspondents. For any trade that equals or exceeds $1 million, clearing firms have 15 minutes from the time the trade report is entered in ACT to decide whether it will clear the trade. If, however, the clearing firm does not affirmatively accept or decline the trade, at the end of 15 minutes the trade will be subject to normal ACT processing and the clearing firm will be obligated to act as principal to clear the trade.

Finally, clearing firms that access ACT through the CTCI linkage have additional functions to monitor their correspondents' trading. These clearing firms can monitor the intra-day activity of their correspondents as it is reported and can receive an end of day recap of all trade detail information of their correspondents. These additional functions are not available to clearing firms that access ACT through NWII.

VI.   Fees and Hours of Operation

The Rule 7000 Series of the Nasdaq Manual (attached hereto as Exhibit A) describe the fees currently assessed for each service offered by The Nasdaq Stock Market.

Similarly, Nasdaq will maintain its current trading schedule after it becomes an Exchange. The trading schedule is as follows:

The Nasdaq Stock Market Trading Sessions
Pre-Open Trading Hours from 8:00 to 9:30 a.m. eastern time.
Regular Trading Hours from 9:30 a.m. to 4:00 p.m. eastern time.
After Hours from 4:00 p.m. to 6:30 p.m. eastern time.

The Nasdaq International Market Session
From 3:30 a.m. to 9 a.m. eastern time

In addition, OptiMark conducts Profile matching cycles on a periodic basis from 9:45 a.m. to 3:45 p.m., Profiles that are active at the end of the day are placed in a "dormant" state. All "dormant" Profiles from the prior day must be reactivated by the user the following day prior to 9:20 a.m., in order to retain their time stamp and to be included in subsequent match cycles.

Finally, ACES orders can be entered as early as 7 a.m. Orders entered between 7 a.m. and 8 a.m. will not be delivered until 8 a.m..

VII.   Market Surveillance

Nasdaq maintains a real-time surveillance department, MarketWatch comprised of two units -- StockWatch and TradeWatch -- that constantly monitor trading activity in Nasdaq.

A.   StockWatch

The StockWatch section provides real-time surveillance of issuer activity in The Nasdaq Stock Market. To accomplish this task, StockWatch continually reviews press releases issued by Nasdaq-listed companies for material news and monitors price and volume activity in Nasdaq securities on a real-time basis using automated surveillance systems. These combined functions allow StockWatch to maintain an orderly market to protect investors as well as Nasdaq-listed companies.

Nasdaq Stock Market Rules IM-4120-1, 4310(c)16 and 4320(d)(14) require that, except in unusual circumstances, Nasdaq-listed companies promptly notify the public through the news media of any material information. These rules also require issuers to give StockWatch advance notice of news events. This requirement permits StockWatch to assess press releases for materiality and in certain circumstances, implement temporary trading halts to allow for even-handed dissemination of material news.

Trading Halts provide an opportunity for investors to gain equal access to information until the material news is disseminated. Such a pause benefits existing and potential shareholders by ensuring that material news is distributed equally among all market participants and by ensuring trading is based on publicly-held facts. Although trading halts may vary in length, trading normally resumes in about 30 minutes following the coverage of the news by one of the following: *Dow Jones, Reuters, BusinessWire, PR Newswire, the Wall Street Journal, Bloomberg, Bridge News, Barron's or The New York Times.* For the purposes of trading halt evaluations, Nasdaq market hours are 9 a.m. to 6:30 p.m., Eastern Time, Monday through Friday. This includes the morning and afternoon SelectNet trading sessions.

An automated detection system monitors the trading activity in each issue and generates price and volume alerts. StockWatch analysts review these alerts and use news gathering resources and telephone contacts with the company and market makers to determine if there is a reasonable explanation for the activity. StockWatch immediately refers all noted suspicious activity for further review and investigation   StockWatch can receive notification of press releases 24 hours a day. Nasdaq companies may speak with a StockWatch Analyst from 8 a.m. to 7 p.m., Eastern Time, Monday through Friday. Outside of normal business hours, issuers are still obligated to give prior notification to StockWatch of material press releases. The prior notification may be given by phone, fax or voice mail.

B.   TradeWatch

TradeWatch provides real-time monitoring of trading activity on The Nasdaq Stock Market and is responsible for the immediate resolution of real-time trade reporting issues. It is the responsibility of the TradeWatch analysts to monitor automated detection systems and review alerts to make certain the price and volume information reported by market participants is accurate, thereby ensuring integrity in the marketplace.

Specifically, TradeWatch resolves pre-market and intraday locked/crossed markets in accordance with the applicable Nasdaq rules. In addition, the TradeWatch section is responsible for immediate resolution of real-time issues related to the trade reporting of Nasdaq, OTCBB, and Nasdaq Intermarket transactions.

TradeWatch is also a resource for NASD market participants requesting information regarding general trade reporting rules and various NASD and SEC rules and regulations such as the SEC order handling rules, short sale rules, limit order protection and best execution.

The TradeWatch section coordinates and executes the Initial Public Offering (IPO) release process. The analysts actively monitor the IPO during the opening quote period and make the decision to open trading or extend the quote period in accordance with SR NASD 98-98.

TradeWatch is responsible for monitoring the opening and closing trading activity for securities in the Nasdaq 100on a daily basis and S&P 400 and S&P 500 indices on monthly expirations. On a daily basis, TradeWatch facilitates immediate resolution of index calculation problems caused by trade reporting errors. TradeWatch also monitors quotes posted by market makers to ensure compliance with the Reasonably Related Quotations Rule 4613(c).

C.   NASD Regulation

In addition to surveillance by Nasdaq, Nasdaq has contracted with NASD Regulation for NASD Regulation to surveil Nasdaq in the same manner that it does today. NASD Regulation's Market Regulation Department operates a highly automated process of investigating and preventing abusive, manipulative, or illegal trading practices in The Nasdaq Stock Market.   NASD Regulation carries out its regulatory responsibilities through education, examinations, market surveillance, registration of securities personnel, advertising and underwriting reviews, disciplinary actions that violate rules, investigation of customer complaints, and forums to resolve disputes.

To ensure effective regulation, investor confidence, and to protect market participants, Market Regulation has put in place regulatory programs and has established specialized units focused on determining compliance with specific Nasdaq rules and regulations and federal securities laws. Market Regulation is comprised of 16 investigative, examination, and operational units comprised of over 180 analysts, attorneys, and examiners based in Rockville, Maryland, Chicago and New York. The

Market Regulation Department utilizes state-of-the-art technology to carry out its regulatory responsibilities. This technology provides the ability to reconstruct market transactions utilizing trading data and quote information that is captured second-by-second throughout the trading day, and alert staff to potential violative activity.

The Market Regulation Department also conducts onsite inspections of the largest Nasdaq market-making and trading firms to assess compliance with Nasdaq market-making and trading rules and regulations and federal securities laws. The regulatory information gathered from online surveillance, customer and broker/dealer complaints, and on-site examinations of trading activity is shared and analyzed by experts in the Market Regulation Department to determine whether violative activity has occurred and disciplinary action is warranted. The staff's mission is to serve investors and all market participants by being a fair, efficient, and effective regulator.

VIII. Pending System Changes

On January 14, 2000 the SEC approved modifications to Nasdaq's negotiation and automatic execution systems to deal with the problem of dual liability. As a general matter, SelectNet, through rule and system changes, will be re-established as a non-liability, order delivery and negotiation system for NNM securities. The current automatic execution system for small orders from public customers will be substantially enhanced and recast for the trading of NNM securities through the following changes: (1) increasing the maximum order size for NNM securities to 9,900 shares; (2) allowing market participants (including market makers) to enter proprietary orders into the new system and to obtain automatic execution for their proprietary and agency orders in NNM securities; (3) reducing the current 17-second delay between executions against the same market maker to 5 seconds; and (4) enabling NNM orders to interact on an automatic basis with market markers' displayed size and reserve size. These rule changes will reduce dual liability, improve the speed of executions, and increase access to the full depth of a security's trading interest by all market participants.

A.   Changes to SelectNet

SelectNet will be transformed to an order delivery and negotiation system through rule changes prohibiting the use of SelectNet for the entry of any preferred orders directed to market makers in NNM securities unless such orders are at least 100 shares in excess of the displayed amount of the market maker's quote to which they are directed ("over-sized order requirement"). In addition, such orders must also be designated as either: 1) "All - or - None" ("AON") of a size that is at least 100 shares greater than the displayed amount of the market maker's quote to which the order is directed; or 2) a "Minimum Acceptable Quantity" order ("MAQ") with an MAQ value of at least 100 shares greater than the displayed amount of the market maker's quote to which the order is directed. SelectNet will automatically reject preferred messages that fail to meet these requirements. The over-sized order requirement will also apply to orders directed to ECNs that take automatic execution against their quotes in NNMS. These changes will

ensure that market makers and ECNs that take automatic execution are not subject to potential dual liability arising under the Firm Quote rule as the result of receiving orders from different systems. Recipients of over-sized NNM SelectNet orders will have the option to execute, or initiate electronic negotiation in response to the message.

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

B. Nasdaq National Market Execution System ("NNMS")

NNMSK will be the Nasdaq market's primary trading and execution medium. The NNMS system transforms the currently-operating execution systems for small orders from public customers into a more efficient, automated facility for the handling of all NNM orders of less than 9,900 shares. NNMS will execute automatically against market makers' quotes -- displayed and reserve size -- as more fully described below.

1. **Order Entry Parameters**. First, the maximum order size for NNM securities entered into NNMS will be 9,900 shares. Second, Nasdaq members (including market makers) will be allowed to use NNMS on a proprietary basis, including being able to obtain automatic execution for orders sent to other NNMS participants, when trading NNM securities. Third, the interval delay between automatic executions against the same market maker will be 5 seconds. Fourth, the system will have a reserve size feature for quotes. NNMS will permit interaction of orders against a market maker's "reserve size" after yielding priority to displayed quotes at the same price. Additionally, market makers will have the option of having their quote automatically refreshed from that reserve to a size level of their choosing. If no particular size is designated by the market maker, the quote will automatically be refreshed by NNMS at a 1000 share displayed-size level.

2. **Reserve Size** Participants in the NNMS will be able to indicate a reserve size amount, which will not be displayed in Nasdaq. Rather, reserve size will refresh quotes that have been decremented to zero, and will be accessed automatically if all displayed interest is exhausted. The reserve size feature of NNMS will yield priority to all displayed quotes at the same price level, so that the system will execute against displayed size in time priority and then against the reserve size in time priority. NNMS will require those using the NNMS reserve-size feature to display at least 1000 shares in its quote. Moreover, quotes at the inside of the market that are to be refreshed at the same price level must be refreshed to at least 1000 share in order for a market maker to continue using reserve size.

Failure to update a fully exhausted quote will result in the system placing the market maker's quote in a "closed" state that, if not updated within 5 minutes, will be cause for suspension of the market maker's quote for 20 business days. Market makers will still have the ability, through Nasdaq's automatic quote update facility, to pre-select a tick value and size, and have Nasdaq refresh their proprietary quote away from the inside market. If a market maker's quote is refreshed to a different price or size level, another order will not be delivered to that market maker for 5 seconds after that quote is refreshed at the new price or size level.

3. **"No Decrementation" Eliminated** NNMS will not offer the "NO DEC" feature for NNM securities. NO DEC, which currently allows continuous executions against a market maker's quote at the same price, is unnecessary in an environment where market makers can manage their quote by displaying their actual size and refresh their quote at a size they determine.

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

5. **ECN and UTP Exchange Participation** ECNs will have two options for participation in NNMS, and the manner in which they choose to participate shall be governed by an addendum to the Nasdaq Workstation II Subscriber Agreement for ECNs. Specifically, ECNs can choose to be Order-Entry ECNs or Full-Participant ECNs.

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

Second, Full-Participant ECNs will agree to provide automatic execution against their quotes for orders entered into the NNMS, similar to market makers. Like OE ECNs, Full-Participant ECNs will use the NNMS system to obtain automatic execution of orders they send to market makers or other Full-Participant ECNs. Full Participant ECNs will use SelectNet to deliver liability orders to OE ECNs.

National securities trading pursuant to grants of unlisted trading privilege ("UTP") will continue to have access to the full range of SelectNet's capabilities as their primary linkage with Nasdaq. UTP Exchanges will continue to receive, and be obligated to execute, preferred SelectNet liability orders. Additionally, UTP Exchanges will retain their ability to send SelectNet preferred liability orders to market makers. Thus, a market maker will face dual liability on the sporadic occasions when its quote is accessed simultaneously by a UTP Exchange via SelectNet and also by an NNMS market maker or order entry firm via the NNMS system.

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

C.   Nasdaq SmallCap

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

IX.   Pending Rule Filing

In rule filing SR-NASD-99-53, Nasdaq is proposing to enhance the Nasdaq quotation montage and Nasdaq's pending trading platform– the Nasdaq National Market System ("NNMS"). In particular, Nasdaq is proposing: 1) to add a new display to the NWII called the Nasdaq Order Display Facility ("NODF," also called by some the "SuperMontage"), which will show the best bid/best offer in Nasdaq and two price levels away, accompanied by the aggregate size at each price level of the "displayed" trading interest of market makers, electronic communication networks ("ECN"), and UTP Exchanges; 2) to make substantial enhancements to the NNMS, which will improve the efficiency of the current trading platform; 3) allow market makers and ECNs to designate orders for "display" in Nasdaq on either an attributable (i.e., not anonymous) or non-attributable (i.e., anonymous) basis; 4) to establish the Order Collector Facility ("OCF") as part of the NNMS, which will allow Nasdaq market makers and ECNs to give the Nasdaq system multiple quotes/orders at a single as well as multiple price levels, which will be displayed in the Nasdaq Quotation Montage and the NODF, consistent with an order's parameters; 5) to establish the OCF as a single point of order entry and single point of delivery of liability orders and executions; and 6) to create an odd-lot processing

facility in Nasdaq.

The upper portion of the SuperMontageκ will show the best bid/best offer in Nasdaq and two price levels away from the best bid/offer. Each price level will be accompanied by the aggregate size of the trading interest at the price that is in the system from market makers, ECNs, and exchanges granted Unlisted Trading Privileges for Nasdaq securities ("UTP Exchanges"). The display will not identify the orders of any particular market participant; rather, it will represent all displayed interest in the system at the inside and two price levels away on an anonymous basis.

The lower portion of the SuperMontage, like the current quote montage, will display the quotes of market makers, ECNs, and UTP Exchanges, each identified with their four-character trading symbol. However, with the SuperMontage, Nasdaq market participants will be able to designate an order as "non-attributable" (anonymous). The best-priced of these orders will be aggregated and displayed in the quote montage under a non-specific market participant identifier. Attributable orders will be displayed in the current Nasdaq quotation montage next to the Nasdaq market participant's identifier. Both attributable and non-attributable orders will be displayed in the upper part of the SuperMontage as part of the aggregate trading interest at the inside (and two prices away).

Most significantly, Nasdaq market makers and ECNs will be permitted for the first time to give multiple orders and orders at multiple price levels, which the system will manage. That is, if a market participant chooses to give Nasdaq its orders, the system will display those orders in the montage as part of the aggregate trading interest when the order is at the best bid/best offer or two price levels away. As a result, when an investor looks at the Nasdaq Workstation II, the investor will be able to view the entire depth of the market at the inside bid and offer and two price-levels away (to the extent the market participants have given Nasdaq those orders).

Finally, Nasdaq market participants will be able to access orders in SuperMontage almost instantaneously using a substantially enhanced Nasdaq order delivery and execution system, built on an architecture that accommodates the technology needs of all Nasdaq market participants (market makers and ECNs alike).