
Securities Law Developments

SUPERMONTAGE: SEC APPROVES A NEW TRADING PLATFORM FOR NASDAQ

On January 10, 2001, following extensive comments and negotiations, the SEC approved at an open meeting, by a 4-0 vote, the Nasdaq proposal for a central order collector, display facility, and trading platform commonly referred to as "SuperMontage" (the "System").¹ It was noted at the open meeting that, in all probability, the System would not be fully operational until late 2001 or early 2002.² According to Chairman Levitt, the proposal for SuperMontage was the most "time-consuming, controversial, and divisive proposal" taken up during his tenure.³ Notwithstanding concerns raised about potential anti-competitive and conflict-of-interest aspects of having Nasdaq, a subsidiary of the NASD, operate the System, the Commission concluded that the System would offer greater transparency and more efficiency in order execution.⁴ As part of the approval order, however, the Commission called for a study to be conducted as to the "success" of the System once it has become operational.

¹ *Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and Amendment Nos. 1,2,3,4,5,6,7, and 8 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 9 Relating to the Establishment of the Nasdaq Order Display Facility and Order Collector Facility and Modifications of the Nasdaq Trading Platform*, Exchange Act Release No. 43863, 66 Fed. Reg. 8020 (Jan. 26, 2001) ("Adopting Release").

² Nasdaq intends that the System be operational as soon as practicable after decimal pricing is fully implemented. In the Adopting Release, Nasdaq said that participants would be provided advance notice of specific testing dates and of the availability of a testing environment. Nasdaq will also conduct at least two full-day mock trading sessions, on a weekend, to allow participants to train their personnel on the System and participate in a real-time trading environment. *See* Adopting Release at 8030.

³ Arthur Levitt, *Opening Statement on NASD's Proposed SuperMontage and Streamlining the SEC's Review Process For SRO Filings*, available at <http://www.sec.gov/news/speeches/spch458a.htm> (Jan. 10, 2001).

⁴ The Commission received over 100 comment letters regarding the proposal.

This letter is for general informational purposes only and does not represent our legal advice as to any particular set of facts, nor does this letter represent any undertaking to keep recipients advised as to all relevant legal developments.

I. Introduction

The System will be available to trade all Nasdaq securities, including SmallCap securities.⁵ Nasdaq designed SuperMontage to enhance Nasdaq's quotation montage and current trading platforms by adding a new facility for displaying trading interest called the Nasdaq Order Display Facility ("NODF"), by adding a new facility for collecting the quotes/orders called the Order Collection Facility ("OCF"), and by modifying the primary Nasdaq trading platform, the Nasdaq National Market System ("NNMS").⁶ SuperMontage will alter Nasdaq's current trading systems in three principal areas: (1) quote/order collection; (2) quote/order display; and (3) execution services. The NASD believes that SuperMontage will create a more modern trading infrastructure, which will help Nasdaq better compete with both domestic and foreign markets.

II. Quote/Order Collection

SuperMontage will allow participants (market makers, ECNs, and UTP Exchanges) to choose either to enter a single quotation or multiple quotes/orders, at the same or different price levels, into the OCF.⁷ Participants will be able to send Nasdaq only their best quotes or "top of the book." They also will be able to enter non-attributable (anonymous) quotes /orders, although market makers must enter a two-sided attributable quote/order. If a participant enters multiple quotes or orders, the System will aggregate the best priced attributable quotes or orders on each side of the market to create the participant's displayed quote, while maintaining the separate aspects of each quote such as identity, price, and time of entry. As discussed below, accessing participants (*e.g.*, Order Entry Firms) will be able to enter either a directed or non-directed (including preferenced) order into the System to access quotes or orders through the OCF.

III. Quote/Order Display

The System will aggregate and then display on the Nasdaq quotation montage the best-priced non-attributable quotes/orders from all participants as one buy and one sell price (under "SIZE MMID"), as well as the best-priced attributable quotes/orders of each quoting participant. SuperMontage also will aggregate all quotes/orders at each price level and display in the NODF the three best prices on both the bid and offer side of the market, along with the aggregate size of displayed interest at each price level. Nasdaq will also make available a new data feed called "NQDS Prime," which will provide, on a real time basis, all individual attributable quotes/orders at the three best price levels displayed in the NODF. In approving the NASD rule filing, the Commission stated that NODF would be beneficial to the participants and investors because it would enable participants to "... transmit multiple orders at multiple price levels for display at their discretion."⁸ SuperMontage

⁵ SuperMontage will eliminate the current trading rules for the Small Order Execution System ("SOES"), which exclude SmallCap securities from the Nasdaq National Market Execution System ("NNMS").

⁶ The proposed filing to establish SuperMontage was first filed by the NASD, through its subsidiary Nasdaq, on October 1, 1999. *See* Exchange Act Release No. 42166, 64 Fed. Reg. 68125 (Dec. 6, 1999).

⁷ UTP Exchanges will only be able to submit a single principal quote/order, but will be able to enter multiple non-attributable quotes/orders representing agency interest. *See* Adopting Release at 8035.

⁸ *See* Adopting release at 8033.

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will display more quotes and orders than are currently displayed on other systems and thus offer greater transparency to the market.

IV. Execution Services

SuperMontage will replace the SOES and SelectNet services with two new processes: (1) a directed order process; and (2) a non-directed order process (including preferenced orders).⁹ Accessing participants will not be required to use either process, but instead can choose to continue to use alternative methods, such as telephone access or direct connections to other participants, or can develop their own competing execution services.¹⁰

A. Non-Directed Orders

A non-directed order is an order that an accessing participant does not route to a specific participant (or a preferenced order, as discussed below). The non-directed order process will be the standard default method of execution for marketable orders in SuperMontage. A non-directed marketable order (that is not a preferenced order) entered into the non-directed order process will be matched with the highest ranked quote or order on the opposite side of the market and either will be automatically executed by, or delivered on a liability basis to, the quoting participant.

As originally proposed, SuperMontage would have automatically executed non-directed orders based on general price/time priority. In response to commentator and SEC concerns relating to best execution, the NASD proposed changes to the Order Execution Algorithm in several different amendments.¹¹ As adopted, SuperMontage will give accessing participants that enter non-directed orders three options as to how their order will interact with other quotes and orders in Nasdaq. Orders

⁹ Currently, Nasdaq operates two systems for executing orders, SOES and SelectNet. SOES allows participants automatically to execute orders against the quotation of a market maker at the best bid or offer ("BBO"). SelectNet, on the other hand, allows participants to route orders to a particular market maker or ECN. Although SelectNet is an order delivery service, a SelectNet order obligates the market maker or ECN to execute the order at its displayed price and size consistent with the Commission's Firm Quote Rule. On January 14, 2000, the SEC approved an NASD proposal to integrate these two systems, but the NASD has not yet implemented the changes. Those changes would transform SelectNet into a non-liability order delivery and negotiation system and enhance the functionality of SOES, in part by increasing the maximum order size and allowing market participants to enter proprietary orders. *See* Exchange Act Release No. 42344, 65 Fed. Reg. 3987 (Jan. 25, 2000) and NASD Notice to Members 00-30 (Jul. 10, 2000).

¹⁰ In this regard, the NASD will be required to set up an alternative quotation and transaction reporting facility to allow non-participants to satisfy their obligations under the Order Handling Rules, Rules 11Ac1-1 and 11Ac1-4 under the Securities Exchange Act of 1934 ("Exchange Act"), and Regulation ATS. *See* Adopting Release at 8022.

¹¹ The NASD originally proposed that non-directed orders would be executed against ECNs, market makers, and UTP Exchange agency interest, in strict time priority, unless an ECN charged a separate quote-access fee. Thus, charging ECNs would be executed after market makers, non-charging ECNs, and UTP Exchanges. The logic was that an ECN fee represents an increase in the cost of trading and thus the quote of the charging ECN represents an inferior price when compared to same priced quotes of participants that do not charge a fee. In response to commentators claiming that this separation of charging versus non-charging ECNs was unfair, the NASD proposed another change to the rule to allow charging ECNs to include a separate quote access fee in their quote, and would then give charging ECNs equal priority to same priced orders as non-charging ECNs, market makers, and UTP Exchanges. Some charging ECNs then argued that including the fee in the quote would not completely resolve their concerns because of possible price improvement above the quote. The NASD again amended the proposal to take price improvement into account.

will be automatically executed using one of three algorithms: (1) strict price/time priority that does not take into account ECN quote access fees; (2) price/time priority that accounts for ECN quote access fees; and (3) price/size/time priority.¹²

SuperMontage will be programmed to a default Order Execution Algorithm based upon price/time priority without ECN fees, but will allow accessing participants to choose which algorithm to use when submitting an order. Accessing participants will thus be able to make their own determinations as to what weight, if any, should be given to ECN access fees and to size of a quote/order. The proposal, as adopted, also eliminates consideration of ECN access fees by allowing an ECN that charges a separate quote access fee to indicate on an order-by-order basis whether the price improvement offered by the order is equal to or exceeds the access fee charged. If the price improvement is equal to or exceeds the access fee charged, Nasdaq will give equal priority to the charging ECN's order as among same priced orders of non-charging ECNs, market makers, and UTP exchanges' agency interest.

1. Preferred Orders

Although not discussed in depth at the open meeting, a new type of non-directed order, a preferred order, will be allowed under the System. Preferred orders are considered Liability Orders. For an accessing participant to preference an order, that participant will have to identify the preferred quoting participant against which the order is to be executed. Preferred orders will be entered into the non-directed order process and will be processed in the same queue as non-directed orders. Preferred orders, however, will be executed against the displayed and reserve side of the preferred participant only if that participant is at the BBO when the order comes up for execution.¹³ Preferred orders will not be processed pursuant to one of the three algorithms, discussed above, for non-directed orders. Any unexecuted portion will be returned to the sender.

2. Quote Decrementation of Non-Directed Orders

For participants who accept auto-executions, SuperMontage will deliver an execution up to the size displayed by that participant, then to other displayed orders at that price, and then to the participant's reserve size. The System will reduce the aggregate quote in the NODF by the size of the delivered execution and reduce the size of the participant's quote/order in the quotation montage if the quote/order is attributable. If participants have a reserve size, their displayed size in the System will be replenished from the reserve size once their displayed size has been reduced to zero. For those participants that choose not to accept auto-executions, the System will deliver a Liability Order. The System will then automatically reduce the participant's quote by the size of the delivered order.

¹² It is important to note that if a quoting participant enters an order, it is first matched against its own quote/order if that quote/order is at the BBO.

¹³ The System will allow participants to use reserve size, although the reserve size will not be displayed on the System or NODF. The reserve size and the displayed size will be accessible through the System. The reserve size will replenish the displayed size by at least 1,000 shares once the displayed size is reduced to zero.

B. Directed Orders

The directed order process will allow an accessing participant to send an order to a designated participant and will operate in a manner very similar to the current SelectNet system. A directed order will be either a Liability order or a non-liability order, but the receiving participant will not be required to receive Liability Orders through the OCF. If a participant chooses to accept a Liability Order, the system will indicate this choice to other participants. The orders will be delivered on a response basis only (*e.g.* accept or decline), as opposed to the standard auto-execution of SuperMontage.

V. Locked/Crossed Markets

A locked market occurs when one participant's bid equals another participant's lowest offer. A crossed market occurs when one participant's bid is higher than another participant's lowest offer. Under SuperMontage, if a participant enters a quote/order that will lock or cross the market, the System will not display the quote/order. Instead, the System will notify the sender, who will have to override the System to process the order. SuperMontage will then reformat the quote/order as a marketable limit order and enter it into the System as a non-directed order for execution. The reformatted quote/order will then be distributed to the next displayed quote/order in the queue that will be locked or crossed, and executed at the price of the displayed quote/order. Once the locked or crossed order is cleared, if the participant's quote/order that would have locked or crossed the market has not been completely filled, the System will reformat the quote/order again and display it as a quote/order on behalf of the entering participant.

VI. Odd-Lot Processing

SuperMontage will provide a separate system for processing odd-lot orders.¹⁴ Under the proposal, the System will hold all odd-lot orders, which must be non-directed orders, in a separate file and then automatically execute the orders against all participating market makers in a "round robin rotation" as the order becomes marketable. All odd-lot orders will be executed at the BBO, even if the market maker is not at the BBO. A market maker can set its exposure limit, on a security-to-security basis, from 0 to 999,999 shares. The System will not execute an odd-lot order against a participant unless the participant has a sufficient exposure limit to fill the odd-lot order. Once a market maker's odd-lot exposure limit is reduced to zero, it will be removed from the rotation until the market maker sets a new exposure limit.

VII. Conclusion

In approving the NASD rule filing to establish SuperMontage, the Commission appears to have set in motion larger structural changes to be implemented by the NASD and Nasdaq in the future.¹⁵ It

¹⁴ Any purchase or sale of less than 100 shares will be considered an odd-lot, although inactive stocks generally trade in round lots of 10 shares. Typically, an investor buying or selling an odd-lot will pay a higher commission rate than orders for round lots, usually 1/8th of a point.

¹⁵ The NASD's ownership in Nasdaq was reduced to 60% on a fully diluted basis by a private placement sale of shares and warrants on June 28, 2000, and was further reduced to approximately 40% by a second private placement on January 18, 2001. The two phases of the private placement raised approximately \$326 million for Nasdaq, which should help it fund its plan to become a registered national securities exchange, as well as pursue closer ties with non-US

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was specifically noted during the open meeting that SuperMontage would not be unduly anti-competitive, in light of Nasdaq's decision to become an exchange.¹⁶ In addition, the Adopting Release discusses the need to amend the OTC-UTP Plan¹⁷ in the near future, inviting Nasdaq and other market centers to consider changes to the plan that would establish a new exclusive securities information processor ("SIP") to assume the role currently performed by Nasdaq.¹⁸ Finally, the Commission emphasized the ongoing review of SIP and market information arrangement issues by the Market Data Advisory Committee and noted that the rapid evolution of the securities industry may necessitate "fundamental structural change" in how market data is collected and disseminated.¹⁹ In short, SuperMontage is the first of many such changes expected to come in the future, which ultimately may transform the U.S. equity markets in ways that are impossible to predict today.

If you would like a copy of the Adopting Release, or if you have any questions, please contact Brandon Becker (202.663.6979 or bbecker@wilmer.com); Soo J. Yim (202.663.6958 or syim@wilmer.com); Heather Seidel (202.663.6256 or hseidel@wilmer.com); or E. Stuart Parker (202.663.6317 or sparker@wilmer.com).

exchanges. In addition, the Nasdaq board is considering the possibility of an initial public offering. *See* Adopting Release at 8021; John Labate, *Nasdaq Completes Private Placement*, FT.com (Jan. 25, 2001); and *Nasdaq Completes Private Offering, Moving Towards Independence from NASD, BNA, Inc.* Securities Law Daily (January 26, 2001). The NASD board subsequently adopted a resolution stating its intent to divest itself of all remaining shares of Nasdaq by June 30, 2002. *See* Letter from Joan C. Conley, Corporate Secretary, NASD, to Robert Colby, Deputy Director, Division of Market Regulation, (Jan. 18, 2001).

¹⁶ On November 9, 2000, Nasdaq filed a Form 1 application to register as a national securities exchange under Exchange Act Rule 6a-1, 17 C.F.R. § 240.6a-1 (2000).

¹⁷ The OTC-UTP plan is the Joint Self Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Exchange-Listed Nasdaq/National Market Systems Securities Traded on Exchanges on an Unlisted Trading Privileges Basis. Nasdaq currently acts as the exclusive SIP under the plan. *See* Adopting Release at 8024 & n.36.

¹⁸ *See* Adopting Release at 8052.

¹⁹ *Id.* at 8054.

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