NASD Notice to Members 97-57

NASD Interpretations Of SEC Order Handling Rules, NASD Limit Order Protection Rules, And Member Best Execution Responsibilities

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Executive Summary

In the following document, the National Association of Securities Dealers, Inc. (NASD®), after consultation with staff of the Securities and Exchange Commission (SEC), is providing interpretive advice regarding a member's best execution obligations when handling a customer order, especially in light of the SEC's Order Handling Rules and the NASD's Limit Order Protection Rules. The Questions and Answers that follow are an attempt to provide members with answers to compliance questions raised following the implementation of the new Order Handling Rules. If members have additional questions regarding these issues, please contact Eugene A. Lopez, Director, Market Services, The Nasdaq Stock Market, Inc., at (202) 728-6998 or NASD Regulation, Inc.'s Market Regulation Department, at (800) 925-8156. Any requests for legal opinions regarding matters addressed in this *Notice* should be directed to the Nasdaq Office of General Counsel, at (202) 728-8294.

Questions And Answers On New SEC Order Handling Rules And Associated Nasdaq Rules: Best Execution And Other Issues

In its release adopting and amending the new and amended SEC Order Handling Rules, Rule 11Ac1-4 and Rule 11Ac1-1, the SEC made specific statements regarding the best execution of customer orders. Specifically, the SEC stated that when a market maker holds an undisplayed limit order priced better than the quote, and it subsequently receives a market order on the opposite side of the market from the limit order, it is no longer appropriate for the market maker to execute the market order at the published quote and the limit order at its limit price. The market maker must pass along the price improvement of the limit order to the market order. The Nasdaq Stock Market℠ (Nasdaq®) has received a number of questions regarding NASD member firm obligations to obtain best execution of customer orders in light of this statement. Nasdaq and NASD Regulation℠ have discussed various best execution scenarios as detailed below with the SEC.

In using this Q & A as a tool to develop a member's policies regarding its best execution obligations, it is important to note that the application of best execution concepts necessarily involves a "facts and circumstances" analysis. Depending upon the particular set of facts surrounding an execution, actions that in one set of circumstances may meet a firm's best execution obligation, may not meet that standard in another set of circumstances. It should also be noted that the best execution obligation is an obligation that evolves as rules and systems change. Thus, if Nasdaq were to amend its Limit Order Protection Rule, a firm's best execution obligations will likely change as well.

In addition, it should be noted that the discussion that follows relates principally to the handling of orders in Nasdaq securities (National Market and SmallCap) in light of the NASD's Limit Order Protection Rule, IM-2110-2. However, because the NASD Limit Order Protection Rule (Manning) only applies to Nasdaq securities, the limit order protection requirements discussed below do not necessarily apply to over-the-counter equity securities that may trade in the NASD's OTC Bulletin Board®. Of course, members continue to have best execution obligations for these securities. The NASD continues to evaluate best execution and limit order handling obligations for such securities and will provide information regarding a firm's obligations in a separate document at a future date. Separately, we note that limit order protection for over-the-counter executions in exchange-listed securities is governed by NASD Rule 6440 and members continue to have best execution obligations for these securities as well.

I. Treatment Of Orders Received From Another Member

Question 1: Basic Obligation

Nasdaq Inside Market:
10 – 10 1/2   10 x 10

Market Maker A (MMA) holds customer limit to buy 1,500 shares at 10 1/4.

The customer requests that this order not be displayed.

MMA receives a market order to sell 1,000 shares from another customer through its internal order delivery and execution system.

What must MMA do?

Answer 1:

Under best execution principles discussed in the SEC's Adopting Release, market makers holding undisclosed limit orders must execute incoming market orders at the limit order price. Thus, MMA must execute the market order at 10 1/4, the price of the undisplayed limit order. MMA may execute the market order against the limit order or against its own inventory. However, if it fills the market order out of its own inventory, the Manning Rule requires that MMA protect the limit order at its price. Therefore, the limit order would also have to be executed at its price. The remaining 500 shares of the limit order would continue to reside undisplayed on MMA's book.

Question 2: System Orders

Nasdaq Inside Market:
10 –10 1/2   10 x 10

MMA holds a customer limit order to buy at 10 1/4 for 1,500 shares that is not displayed.

MMA receives a customer market order to sell 1,000 shares from another broker/dealer through MMA's automated order delivery and execution system.

At what price should the limit and market orders be executed?

Answer 2:

Even though the order is from another broker/dealer, because the other firm has routed its order with the understanding that MMA will provide automated executions for that broker's customer orders and thereby provide best execution through MMA's system, MMA must match (as principal or as agent, as explained in Answer 1, above) the 1,000-share customer market order against 1,000 shares of the undisclosed customer limit and execute at 10 1/4. The remaining 500 shares of the 10 1/4 limit order remains undisclosed on MMA's files. The same rationale for matching the market order against the limit order would apply if the customer order had been routed to MMA through Nasdaq's Advanced Computerized Execution System (ACES®) facility.

Question 3: Phone Orders — Market Maker And Order Entry Firm Have A Relationship

Nasdaq Inside Market:
10 – 10 1/2   10 x 10

MMA holds an undisclosed customer limit order at 10 1/4 for 1,500 shares.

MMA is quoting publicly 10 bid.

Broker/dealer B (BD-B) telephones MMA to sell 1,000 shares at the market for a customer. MMA has an arrangement with BD-B with the understanding that MMA will provide BD-B's customer orders with best execution, such as part of a payment for order flow, reciprocal, or correspondent arrangement.

What is MMA's obligation to broker/dealer B and to the limit order to buy?

Answer 3:

Even though the order is from another broker/dealer, MMA must match 1,000 shares of BD-B's customer order against the undisclosed limit order of 10 1/4, because MMA has an arrangement under which it has implicitly or explicitly undertaken to provide best execution to BD-B's customer orders. MMA will execute 1,000 shares of the market order and the limit order at 10 1/4.

However, because the Limit Order Display Rule, Rule 11Ac1-4, has not been fully implemented as of the date of this document, limit orders received by a market maker may not yet be reflected in the market maker's quote. Consequently, it may be difficult for a market maker to quickly access information regarding the limit order at a better price that it holds at the time the telephone order is received. Accordingly, until such time that all Nasdaq stocks are subject to Rule 11Ac1-4 and thus are likely to be reasonably accessible to the trader, the NASD will not take regulatory action against market makers that fail to provide the undisplayed limit order price to the execution of telephone orders that they receive in any Nasdaq stocks during the phase-in period. Once all Nasdaq securities are subject to Rule 11Ac1-4, members will be expected to provide telephone orders, except as detailed below, the benefit of superior limit order prices, whether displayed or not.

Question 4: Phone Orders — Market Maker And Order Entry Firm Do Not Have A Relationship

Nasdaq Inside Market:
10 – 10 1/2   10 x 10

MMA holds an undisclosed customer limit order at 10 1/4 for 1,500 shares.

MMA is quoting publicly 10 bid.

Broker/dealer B telephones MMA to sell 1,000 shares at the market for BD-B's own account where MMA has no agreement or understanding to treat BD-B's orders as customer orders or otherwise provide them with best execution.

What is MMA's obligation to broker/dealer B and to the limit order to buy?

Answer 4:

MMA may execute BD-B's market order to sell at MMA's published quote of 10. MMA does not owe a best execution obligation to a non-customer where no understanding or expectation of treatment as a customer has been reached by MMA and BD-B. Broker/dealers are not considered customers for purposes of this obligation.

If MMA executes BD-B's order at 10, MMA, however, has traded through the customer limit order it holds. Under the Manning Rule, therefore, MMA must execute 1,000 shares of the limit order it holds. Under the present interpretation of Manning, MMA must execute 1,000 shares of the customer limit order at 10 1/4 or better, because 10 1/4 is the price at which the limit order was held. MMA, of course, may choose to give the market order customer the price of the limit order, but it is not currently required to do so. The NASD's staff is presently evaluating whether to propose to the Nasdaq Board a change to the Manning Rule that would require a member to provide price improvement to the limit order in this situation.

Question 5: Rounded Orders

Nasdaq Inside Market:
20 – 20 1/2   10 x 10

MMA holds a customer limit order to buy a Nasdaq stock at 20 5/32 for 2,000 shares. MMA changes its quote to 20 1/8 for 2,000 shares to reflect the rounded price of the customer limit order

MMA receives a market order to sell 2,500 shares.

At what price must the market and limit orders be executed?

Answer 5:

MMA must execute the customer limit order and 2,000 shares of the market order at 20 5/32, even though its displayed quote was rounded to 20 1/8. The execution must occur at the actual limit order price that MMA held.

Question 6:

Nasdaq Inside Market:
10 – 10 1/2   10 x 10

MMA holds a customer limit order to buy at 10 1/4 for 1,500 shares that is not displayed.

MMA receives a customer limit order to sell 1,000 shares at 10 1/8.

At what price(s) should the limit orders be executed?

Answer 6:

The SEC's best execution discussion in the Adopting Release did not discuss the crossing of limit orders with each other. However, by analogy to the best execution example used in the SEC's Order Handling Release, Nasdaq believes that the crossing of two limit orders is similar to the interaction of a market order and a limit order. Accordingly, Nasdaq believes that to provide best execution to a customer limit order when that limit order would cross another customer limit order, MMA should execute the sell limit order against the buy limit order at 10 1/4. In essence, the second limit order is a marketable limit order that is the equivalent of a market order and should be treated as such under the best execution principles discussed by the SEC.

Question 7: Minimum Price Improvement To Avoid Manning Violation

Nasdaq Inside Market:
20 – 20 1/4   10 x 10

MMA receives a customer limit order to buy at 20 1/16 for 2,000 shares.

MMA changes its quote to 20 1/16 for 2,000 shares to reflect the price of the customer limit order.

MMA receives a market order to sell 2,500 shares.

May MMA offer the market order price improvement over the 20 1/16th limit order and execute the market order for its own account? If so, what is the minimum amount of price improvement allowable?

Answer 7:

MMA is allowed to execute the market order at a price better than the limit order. Nasdaq, after consultation with the Quality of Market Committee, believes that the minimum amount of price improvement that would permit a market maker to avoid a violation of the Manning Rule is 1/16th, where the actual spread is greater than 1/16th; however, where the actual quotation spread is the minimum quotation increment, the minimum price improvement is one-half of the normal minimum quote increment. In Question 7, since the actual spread is 20 1/16 – 20 1/4, the minimum price improvement is 1/16th. Thus, MMA could trade ahead of the limit order at 20 1/8th. If the actual spread were 20 1/16 – 20 1/8, since the security is priced at more than $10 per share, the minimum quote increment is 1/16th. If the market maker wants to trade with an incoming market order to sell without triggering its Manning obligations to the buy limit order, the market maker must buy from the sell order at 20 3/32nds. Similarly, if the security were priced under $10 and quoted at 5 1/32 – 5 1/16, the minimum price improvement to avoid a violation of the Manning Rule would be 1/64th better than a buy limit order it holds.

This represents a change from previous statements regarding price improvement. In *Notice to Members 95-43*, regarding the Manning Rule, Nasdaq stated that market makers may avoid violating Manning if they execute for their own accounts at 1/64th better than the limit order price. This statement no longer is applicable and is superseded by this *Notice* as of the date of the publication of this *Notice*.

II. Discretionary Or Working Orders

Question 8:

Nasdaq Inside Market:
10 - 10 1/8   10 x 10

MMA quote: 9 7/8 - 10 1/4

MMA receives 100,000 share discretionary (“working”) order to buy in which the institutional customer and the market maker agree to the terms under which the order is to be worked and the compensation that MMA is to receive. The parties to this trade agree that MMA may, if necessary to fill the entire order at an acceptable price, trade ahead of the institutional customer’s order. MMA immediately sells 30,000 shares to the institution and holds the remaining 70,000 shares.

A. MMA executes an undisplayed limit order to sell at 10 1/16 for 1,000 shares.

B. MMA executes a market order to sell for 1,000 shares at 10.

C. MMA executes an order to sell 10,000 shares at 9 7/8.

What are MMA’s responsibilities to the 70,000 share order when it executes any of the orders described in A, B, or C?

Answer 8:

MMA is holding a discretionary market order for which it has agreed to work to obtain an execution satisfactory to the customer. A discretionary order, sometimes called a “not held” or a “working” order, is an order voluntarily categorized by the customer as permitting the member to trade at any price without being required to execute the customer order. A broker/dealer with such an order must use its brokerage judgment in the execution of the order, and if such judgment is properly exercised, the broker is relieved of its normal responsibilities with respect to the time of execution and the price or prices of execution of such an order.

Because MMA has been given discretion by its customer to work the order, MMA does not owe the same best execution obligations to it and to other crossing orders as it would if the order were a non-discretionary market or limit order. Thus, where beneficial to the discretionary order, MMA may trade at 10 1/16 or lower with incoming orders without necessarily triggering a fill for the discretionary order it holds. Because the discretionary order is not a priced order, there are no Manning obligations to the order, nor is there a specific price at which an incoming order can be matched.

MMA, however, must clearly document that it has obtained the authorization of its customer to work the order and must disclose to the customer that such discretion means that the firm may trade at the same price or at a better price than that received by the discretionary order. In addition, it should be noted that, because the customer has granted the market maker the discretion to work the order, the market maker, as agent, has a clear responsibility to work to obtain the best fill considering all of the terms agreed to with the customer and the market conditions surrounding the order. In the absence of a clear understanding between the trader and the customer regarding MMA’s activities in competing with the customer order, MMA could potentially violate its fiduciary duties to its customer in the way it “works” the order.

Question 9:

Nasdaq Inside Market:
10 x 10 1/4   10 x 10

MMA accepts a discretionary order to buy 100,000 shares with a cap of 10 3/16.

MMA receives a market order to sell 1,000 shares from a customer.

Does MMA have to match the market order against the discretionary order that has a cap?

Answer 9:

The discretionary order with a cap is not considered a limit order because the firm is “working” the order and may be able to execute it at prices other than the 10 3/16 cap price. Thus, MMA does not have to match the market order against the discretionary order and MMA is able to buy from the market order at its bid of 10, assuming that this handling benefits the discretionary order.

III. Execution Of Blocks Outside The Inside Market Price

Question 10:

Nasdaq Inside Market:
10 x 10 1/4

MMA accepts a customer limit order to buy 1,000 shares at 10 1/8 that is not displayed.

MMA negotiates with an institution to buy 100,000 shares at 9 7/8.

Does MMA have to execute the 1,000-share limit order at 9 7/8?

Answer 10:

No. While MMA has a Manning obligation to execute the limit order, MMA can execute the limit order at its stated price of 10 1/8. In addition, MMA is not obligated to execute 1,000 shares of the block at 10 1/8, assuming that MMA has clearly disclosed to the institution that it intends to handle the order in this manner, and the institution has agreed to this practice.

IV. Net Trades/Internal Sales Credits

Question 11:

Nasdaq Inside Market:
20 - 20 1/4   10 x 10

MMA holds a limit order to buy at 20 for 1,000 shares.

MMA receives from an institution a limit order to sell 9,000 shares “net” at 20.

What effect does the “net” sell order have on MMA’s Manning or best execution obligations?

Answer 11:

MMA must execute the net sell order at 20 by matching (as principal or as agent) the limit order to buy at 20 against the net sell order first and execute the remainder of the net order against its inventory.

Question 12:

Assuming the same facts as outlined in Question 11 above, does the answer change if MMA discloses to the institutional customer with the sell limit order that the sales representative is to obtain a 1/8th sales credit and thus, MMA will be holding the limit order at a price exclusive of the sales credit?

Answer 12:

If MMA chooses to disclose the internal sales credit to the institutional customer, explains that the 20 net price is to be affected by this sales credit, and the customer agrees to this arrangement, then MMA should hold the limit order to sell at 20 1/8 and display the order in its quote, unless an exception to Rule 11Ac1-4 were available. Thus, the inside market would move to 20 – 20 1/8, 10 x 90. Accordingly, because the net limit order to sell was held at a price (20 1/8) that does not match against the limit order to buy at 20, there is no execution.

Further, if the net limit order to sell were to be executed, it should be executed at a price of 20 1/8 and reported at such price to Nasdaq for trade reporting purposes and to the customer on the confirmation for purposes of Rule 10b-10. In effect, the agreement regarding the compensation to the sales representative converts an internal division of firm profits on a trade into compensation to the firm that must be treated as a markup/markdown or commission and handled as such. This answer is consistent with statements made by the NASD in *Notices to Members 95-67* and *96-10,* as well as the letter from Richard Lindsey, SEC, to Richard Ketchum, NASD, dated January 3, 1997.