

NASD NOTICE TO MEMBERS 98-6

SEC Approves Changes To Rules On Market Maker Withdrawals And Reinstatements

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Executive Summary

On December 10, 1997, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD[®]) rules governing market maker withdrawals and reinstatements.¹ Specifically, the rule changes: (1) establish objective standards for the reinstatement of market makers who have been "SOESed out of the Box" or accidentally withdraw from a stock; (2) broaden the bases for excused withdrawal and require that requests based on religious holidays or vacation be made only one day in advance; and (3) transfer jurisdiction concerning appeals of staff determinations to the Market Operations Review Committee. The rule changes are effective immediately.

Questions concerning this *Notice* may be directed to Richard H. Bush, Assistant Director, Nasdaq[®] Market Operations, at (203) 385-6242, or Andrew S. Margolin, Senior Attorney, Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8869.

Background

In order to ensure that market makers are complying with their obligation to make continuous, firm, two-sided markets, NASD Rule 4620 provides that market makers who voluntarily withdraw from an issue cannot re-register in that issue for 20 business days (the 20-Day Rule). A corollary rule to the 20-Day Rule is NASD Rule 4730(b)(6), a Small Order Execution SystemSM (SOESSM) rule that provides that a market maker in a Nasdaq National Market[®] (NNM) security will be deemed to have voluntarily withdrawn from a stock, and therefore subject to the 20-Day Rule, if it has failed to restore a two-sided quotation within five minutes after its bid or offer has been completely decremented due to an SOES execution. When a market maker is dereg-

istered from a stock because it failed to restore its quotation, it is referred to as being "SOESed out of the Box." To avoid being "SOESed out of the Box," members can do one of several things. They can elect to not have their quote size decremented upon the execution of SOES orders, provided the market maker's quote size is equal to or greater than the applicable SOES tier size; set a supplemental exposure size; or utilize Nasdaq's auto-refresh feature that automatically updates a market maker's quote after its quote size has been decremented.

Notwithstanding the 20-Day Rule, NASD Rule 4619 affords market makers the ability to obtain an "excused" market maker withdrawal in certain limited circumstances, as described below in Section 2. Market makers receiving "excused" withdrawals are not subject to the 20-Day Rule and can re-enter their quotes once the circumstances justifying the withdrawal no longer exist.

The NASD believes that amendments are necessary to establish objective standards for the reinstatement of market makers while ensuring that market makers are not able to avoid or circumvent their market making obligations through inappropriate excused market maker withdrawals or inappropriate market maker reinstatements, and to otherwise align the rules with the realities of the market place. Accordingly, the NASD is adopting the following rule changes.

Summary Of Rule Changes

1. Reinstatement Of Market Makers Upon Being "SOESed Out Of The Box" And For Accidental Withdrawals

A. Reinstatements Upon Being "SOESed Out Of The Box"

The rule changes are designed to ensure that market maker reinstatement

ments will only be made when it is clear that a market maker was not attempting to avoid its market making obligations. Specifically, the changes to Rule 4730 provide that a market maker can be reinstated only upon satisfaction of all of the following:

(1) the market maker notifies Market Operations to request reinstatement as soon as practicable, but within one hour of being "SOESed out of the Box," and immediately thereafter provides written notification of the request;

(2) it was a Primary Market Maker at the time it was SOESed out of the Box;

(3) a designated Nasdaq officer determines that the withdrawal was not an attempt by the market maker to avoid its obligations to make a continuous two-sided market, taking into account factors including market conditions at the time, the frequency with which the firm has been SOESed out of the Box, procedures adopted by the firm to avoid doing so inadvertently, and the length of time before the firm sought reinstatement; and

(4) the reinstatement will not result in the market maker's firm exceeding certain limitations on the number of reinstatements per year. In particular, under the rule change, firms that simultaneously made markets in less than 250 stocks during the previous calendar year could receive no more than four (4) reinstatements per year; firms that simultaneously made markets in 250 or more, but less than 500, stocks during the previous calendar year could receive no more than six (6) reinstatements per year; and firms that simultaneously made markets in 500 or more stocks during the previous calendar year could receive no more than twelve (12) reinstatements per year.

Decisions to reinstate a market maker will be made by Nasdaq Market Operations staff and appeals of such decisions will be considered by the Market Operations Review Committee (MORC).

Notwithstanding the numerical limitations and requirements set forth above, the NASD staff has the authority to reinstate a market maker that has been "SOESed out of the Box" if such reinstatement is necessary to protect investors or the integrity of the market in instances where:

(1) a member firm experiences a documented technological constraint or failure involving either its own automated system (other than chronic failures within the firm's control) or an automated system operated by Nasdaq;

(2) the market maker is a manager or co-manager of a secondary offering from the time the secondary offering is announced until ten (10) days after the offering is complete; or

(3) there has been a significant decline in the number of market makers in a particular issue, as defined in Rule 4730.

Before any such reinstatement could occur, Nasdaq staff will have to make a finding that the reinstatement is necessary for the protection of investors or the maintenance of fair and orderly markets and determine that the withdrawal was not an attempt by the market maker to avoid its obligation to make a continuous two-sided market.

B. Reinstatements For Accidental Withdrawals

There have been instances in the past where market makers have accidentally withdrawn from a stock because they inadvertently typed the wrong

stock symbol. Because the rules currently do not provide that market makers can be reinstated in these instances, the NASD has amended Rule 4620 to permit such reinstatements, provided the withdrawal was clearly accidental and did not reflect an attempt by the market maker to avoid its market making obligations.

Specifically, under the rule change, a market maker that accidentally withdraws as a market maker may be reinstated if all of the following requirements are met:

(1) the market maker notifies Market Operations of the accidental withdrawal within one hour of such withdrawal, and immediately thereafter provides written notification of the withdrawal and request;

(2) it is clear that the withdrawal was inadvertent and the market maker was not attempting to avoid its market making obligations; and

(3) the market maker's firm will not exceed specific reinstatement limitations per year. In particular, firms that simultaneously made markets in less than 250 stocks during the previous calendar year could receive no more than two (2) reinstatements per year; firms that simultaneously made markets in 250 or more, but less than 500, stocks could receive no more than three (3) reinstatements per year; firms that simultaneously made markets in 500 or more stocks could receive no more than six (6) reinstatements per year.

In addition, factors that will be considered in granting a reinstatement include:

(1) the number of accidental withdrawals by the market maker in the past as compared to other market makers making markets in a comparable number of stocks;

(2) the similarity between the symbol of the stock intended to be withdrawn and the symbol of the stock actually withdrawn;

(3) market conditions;

(4) whether the withdrawal served to reduce the market maker's exposure to market risk; and

(5) the timeliness with which the market maker notified Nasdaq Market Operations of the error.

Determinations initially will be made by Nasdaq Market Operations staff and be subject to review by the MORC.

2. Bases For Excused Withdrawals

Rule 4619(b) presently provides that excused withdrawal status may be granted for a variety of reasons provided that certain conditions are satisfied. Specifically, as noted above, excused withdrawal status may be granted for: (1) the duration of "cooling off" periods mandated by Regulation M; (2) physical circumstances beyond the market maker's control; (3) religious holidays (provided the request is submitted five business days in advance of the holiday); (4) vacations (provided the request is received 20 business days in advance of the vacation and is made by a market maker with three or less Nasdaq terminals); (5) involuntary failures to maintain clearing arrangements; and (6) other legal requirements (*e.g.*, the market maker is in possession of material non-public information). While the NASD and Nasdaq continue to believe that it is critical for the maintenance of the integrity of the market for Nasdaq to grant excused withdrawals only when warranted, the NASD nevertheless believes that the present excused withdrawal rule is not drafted broadly enough to encompass all of the legitimate reasons for an

excused withdrawal. The NASD and Nasdaq also believe that the time parameters for advance notice of vacations and religious holidays are unnecessary.

Accordingly, the NASD is amending Rule 4619(b) as follows. First, excused withdrawals may be granted for "circumstances" beyond the market maker's control, not just "physical circumstances" beyond its control. With this amendment, unpredictable events, such as jury duty, bomb threats, the birth of a child, or a sudden illness, could be used as a basis for an excused withdrawal. Second, requests for excused withdrawals based on vacations (for firms with three or less Nasdaq level 3 terminals) and religious holidays may be submitted one business day in advance of the proposed withdrawal. Requests for excused withdrawals based on legal or regulatory requirements will continue to be made in writing, although Nasdaq recognizes that counsel to market makers often do not want to disclose the specific legal basis for their withdrawal request, particularly when the basis for the withdrawal is that the market maker is in possession of material, non-public information. In this connection, Nasdaq will continue its current practice of apprising NASD Regulation, Inc., of all such requests.

3. Jurisdiction Of The MORC Over Excused Market Maker Withdrawals And Market Maker Reinstatements

Presently, appeals of Nasdaq staff determinations concerning excused withdrawal requests and market maker reinstatements are within the purview of the NASD's Qualifications Committee's jurisdiction pursuant to NASD Rule 4730(b)(8). Pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries, however, the

Board of Directors of The Nasdaq Stock MarketSM has delegated the Market Operations Review Committee jurisdiction over such matters. Accordingly, the NASD is amending Rules 4619, 4620, and 4730, to effectuate the transfer of jurisdiction over these matters from the Qualifications Committee to the MORC.

Text Of Amendments

(Note: New text is underlined; deletions are bracketed.)

4619. Withdrawal of Quotations and Passive Market Making

(a) A market maker that wishes to withdraw quotations in a security or have its quotations identified as the quotations of a passive market maker shall contact Nasdaq Market Operations to obtain excused withdrawal status prior to withdrawing its quotations or identification as a passive market maker. Withdrawals of quotations or identifications of quotations as those of a passive market maker shall be granted by Nasdaq Market Operations only upon satisfying one of the conditions specified in this Rule.

(b) Excused withdrawal status based on [physical] circumstances beyond the market maker's control may be granted for up to five (5) business days, unless extended by Nasdaq Market Operations. Excused withdrawal status [or passive market maker status] based on demonstrated legal or regulatory requirements, supported by appropriate documentation and accompanied by a representation that the condition necessitating the withdrawal of quotations is not permanent in nature, may, upon written request, be granted for not more than sixty (60) days (unless such request is required to be made pursuant to paragraph (d) below). Excused withdrawal status based on religious holidays may be granted

only if written notice is received by the Association [five] one business day[s] in advance and is approved by the Association. Excused withdrawal status based on vacation may be granted only if:

(1) the written request for withdrawal is received by the Association [twenty (20)] one business day[s] in advance, and is approved by the Association;

(2) the request includes a list of the securities for which withdrawal is requested; and

(3) the request is made by a market maker with three (3) or fewer Nasdaq level 3 terminals. Excused withdrawal status may be granted to a market maker that has withdrawn from an issue prior to the public announcement of a merger or acquisition and wishes to re-register in the issue pursuant to the same-day registration procedures contained in Rule 4611, above, provided the market maker has remained registered in one of the affected issues. The withdrawal of quotations because of pending news, a sudden influx of orders or price changes, or to effect transactions with competitors shall not constitute acceptable reasons for granting excused withdrawal status.

(c) - (d) No changes.

(e) The Market Operations Review Committee shall have jurisdiction over proceedings brought by Market Makers seeking review of the denial of an excused withdrawal pursuant to this Rule 4619, or the conditions imposed on their reentry.

4620. Voluntary Termination of Registration

(a) A market maker may voluntarily terminate its registration in a security by withdrawing its quotations from The Nasdaq Stock Market. A market

maker that voluntarily terminates its registration in a security may not re-register as a market maker in that security for twenty (20) business days. Withdrawal from SOES participation as a market maker in a Nasdaq National Market security shall constitute termination of registration as a market maker in that security for purposes of this Rule; provided, however, that a market maker that fails to maintain a clearing arrangement with a registered clearing agency or with a member of such an agency and is withdrawn from participation in the Automated Confirmation Transaction System and thereby terminates its registration as a market maker in Nasdaq National Market issues may register as a market maker at any time after a clearing arrangement has been reestablished and the market maker has complied with ACT participant requirements contained in Rule 6100.

(b) Notwithstanding the above, a market maker that accidentally withdraws as a market maker may be reinstated if:

(1) the market maker notified Market Operations of the accidental withdrawal as soon as practicable under the circumstances, but within at least one hour of such withdrawal, and immediately thereafter provided written notification of the withdrawal and reinstatement request;

(2) it is clear that the withdrawal was inadvertent and the market maker was not attempting to avoid its market making obligations; and

(3) the market maker's firm would not exceed the following reinstatement limitations:

(A) for firms that simultaneously made markets in less than 250 stocks during the previous calendar year, the firm can receive no more than

two (2) reinstatements per year;

(B) for firms that simultaneously made markets in 250 or more but less than 500 stocks during the previous calendar year, the firm can receive no more than three (3) reinstatements per year; and

(C) for firms that simultaneously made markets in 500 or more stocks during the previous calendar year, the firm can receive no more than six (6) reinstatements per year.

(c) Factors that the Association will consider in granting a reinstatement under paragraph (b) of this rule include, but are not be limited to:

(1) the number of accidental withdrawals by the market maker in the past, as compared with market makers making markets in a comparable number of stocks;

(2) the similarity between the symbol of the stock that the market maker intended to withdraw from and the symbol of the stock that the market maker actually withdrew from;

(3) market conditions at the time of the withdrawal;

(4) whether, given the market conditions at the time of the withdrawal, the withdrawal served to reduce the exposure of the member's position in the security at the time of the withdrawal to market risk; and

(5) the timeliness with which the market maker notified Market Operations of the error.

(d) The Market Operations Review Committee shall have jurisdiction over proceedings brought by Market Makers seeking review of their denial of a reinstatement pursuant to paragraph (b) above.

4730. Participant Obligations in SOES

(b)(6) In the case of an NNM security, a Market Maker will be suspended from SOES if its bid or offer has been decremented to zero due to SOES executions and will be permitted a standard grace period, the duration of which will be established and published by the Association, within which to take action to restore a two-sided quotation in the security for at least one normal unit of trading. A Market Maker that fails to re-enter a two-sided quotation in a NNM security within the allotted time will be deemed to have withdrawn as a Market Maker (“SOESed out of the Box”). Except as provided below in this subparagraph and in subparagraph (7) [below], a Market Maker that withdraws in an NNM security may not reenter SOES as a Market Maker in that security for twenty (20) business days.

(A) Notwithstanding the above, a market maker can be reinstated if:

(i) the market maker makes a request for reinstatement to Market Operations as soon as practicable under the circumstances, but within at least one hour of having been SOESed out of the Box, and immediately thereafter provides written notification of the reinstatement request;

(ii) it was a Primary Market Maker at the time it was SOESed out of the Box;

(iii) the market maker’s firm would not exceed the following reinstatement limitations:

a. for firms that simultaneously made markets in less than 250 stocks during the previous calendar year, the firm can receive no more than four (4) reinstatements per year;

b. for firms that simultaneously made markets in 250 or more but less than 500 stocks during the previous calendar year, the firm can receive no more than six (6) reinstatements per year;

c. for firms that simultaneously made markets in 500 or more stocks during the previous calendar year, the firm can receive no more than twelve (12) reinstatements per year; and

(iv) the designated Nasdaq officer makes a determination that the withdrawal was not an attempt by the market maker to avoid its obligation to make a continuous two-sided market. In making this determination, the designated Nasdaq officer will consider, among other things:

a. whether the market conditions in the issue included unusual volatility or other unusual activity, and/or the market conditions in other issues in which the market maker made a market at the time of the SOES exposure limit exhaustion;

b. the frequency with which the firm has been SOESed out of the Box in the past;

c. procedures the firm has adopted to avoid being inadvertently SOESed out of the Box; and

d. the length of time before the market maker sought reinstatement.

(B) If a market maker has exhausted the reinstatement limitations in subparagraph (b)(6)(A)(iii) above, the designated Nasdaq officer may grant a reinstatement request if he or she finds that such reinstatement is necessary for the protection of investors or the maintenance of fair and orderly markets and determines that the withdrawal was not an attempt by the market maker to avoid its obligation to make a continuous two-sided market in instances where:

(i) a member firm experiences a documented problem or failure impacting the operation or utilization of any automated system operated by or on behalf of the firm (chronic system failures within the control of the member will not constitute a problem or failure impacting a firm’s automated system) or involving an automated system operated by Nasdaq;

(ii) the market maker is a manager or co-manager of a secondary offering from the time the secondary offering is announced until ten days after the offering is complete; or

(iii) absent the reinstatement, the number of market makers in a particular issue is equal to two (2) or less or has otherwise declined by 50% or more from the number that existed at the end of the prior calendar quarter, except that if a market maker has a regular pattern of being frequently SOESed out of the Box, it may not be reinstated notwithstanding the number of market makers in the issue.

(b)(8) [The Rule 9700 Series of the Code of Procedure] The Market Operations Review Committee shall [apply to] have jurisdiction over proceedings brought by Market Makers seeking review of [(A)] their removal from SOES pursuant to subparagraphs (6) or (7) above [, (B) the denial of an excused withdrawal pursuant to Rule 4619, or (C) the conditions imposed on their reentry].

Endnote

¹ See Exchange Act Release No. 39423 (December 10, 1997), 62 FR 66160 (December 17, 1997).

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