

NASD Notice to Members 98-85

SEC Approves Rule Changes Regarding Electronic Communication Networks, Locked And Crossed Markets, And Members' Obligation To Provide Nasdaq With Certain Information

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- Insurance
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registered Representatives
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training
- Variable Contracts

Executive Summary

On September 22, 1998, the Securities and Exchange Commission (SEC) approved amendments to the National Association of Securities Dealers, Inc. (NASD[®] or Association) rules regarding Electronic Communications Networks (ECNs) and locked and crossed markets. The SEC also approved a new rule regarding information requests made by Nasdaq[®] to NASD members. Specifically, the rule changes: (1) amend NASD Rule 4623 to specify the manner in which ECN orders that have a reserved size must interact with incoming SelectNetSM messages; (2) amend Rule 4613(e) to specify the manner in which quotations that are entered into Nasdaq at or after 9:25 a.m. and that lock or cross the market on the opening, must be resolved at the market's opening; and (3) add Rule 4625, which will require members that participate in The Nasdaq Stock Market[®] to provide information to Nasdaq departments and staff when information is so requested. The rule changes are effective November 1, 1998.

Questions concerning this *Notice* may be directed to John Malitzis, Senior Attorney, Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8245.

Background

With the implementation of the SEC's Order Handling Rules in early 1997, a number of ECNs have been integrated into the Nasdaq market. Under SEC Rule 11Ac1-1(c)(5) (the ECN Rule) which was adopted as part of the SEC's Order Handling Rules, a Nasdaq Market Maker must reflect in its public quotes any superior prices that the Market Maker privately quotes in an ECN. The ECN Rule provides an alternative to this public quote display requirement, under which a Market Maker may comply with the ECN Rule if the ECN in which the Market Maker is privately quoting has:

- established a link to Nasdaq by displaying the best ECN prices in Nasdaq's quote montage; and
- provided access through Nasdaq to such publicly displayed prices.

To accommodate this alternative, Nasdaq created the "SelectNet Linkage" that allows: 1) ECNs to display their best prices from Market Makers and other ECN subscribers in the Nasdaq quote montage, including the inside market display; and 2) market participants to access those prices by sending orders to an ECN through SelectNet. The NASD is adopting the following rule changes in light of Nasdaq's experience with the integration of ECNs into the market.

Reserved Size

The NASD is adopting amendments to NASD Rule 4623 to establish the manner in which orders that have a reserved size and that are entered into an ECN must interact with SelectNet orders that are sent to an ECN.

Subsequent to the inclusion of ECNs into the market, Nasdaq has observed locked and crossed markets¹ occurring in connection with the use of "reserved" size orders in ECNs. Specifically, an ECN may display a portion of a customer order (*e.g.*, 1,000 shares) while maintaining a significantly larger portion of the order in reserve (*e.g.*, 10,000 shares). It is Nasdaq's experience that often a Market Maker will send a large SelectNet order (*e.g.*, 20,000 shares) to the ECN to take out the displayed and reserved portion of the ECN order so that the Market Maker may move its quote without locking/crossing the market. The ECN's system may be programmed, however, so that the incoming SelectNet order interacts only with the displayed portion of the ECN order, not the reserved and displayed portions of such order (*i.e.*, the 20,000 share SelectNet message will

execute against the displayed 1,000 shares only, not the full 11,000 shares). Thus, a Market Maker often is unable to take out the entire ECN order -- except in pieces and through multiple executions. After using reasonable means to avoid locking/crossing the market by—for example—sending SelectNet messages to the ECN to take out the quotation, the Market Maker often will enter a quotation that locks/crosses the market. These locked/crossed markets may last for a significant period and disrupt the marketplace.

The NASD is amending NASD Rule 4623 to address this issue. Under the amendment, if an ECN displays in Nasdaq a customer order having a reserved size and a market participant attempts to access the ECN's Nasdaq-displayed order by sending (via a Nasdaq-provided means) an order that is larger than the ECN's Nasdaq-displayed size, the ECN must execute the Nasdaq-delivered order: 1) up to the size of the Nasdaq-delivered order, if the ECN order (including the reserved size and displayed portions) is the same size or larger than the Nasdaq-delivered order; or 2) up to the size of the ECN order (including the reserved size and displayed portions), if the Nasdaq-delivered order is the same size or larger than the ECN order (including the reserved size and displayed portions). Thus, in the above example where the ECN is displaying 1,000 shares and holding 10,000 shares in reserve and the Market Maker sends the ECN a SelectNet order for 20,000 shares, the ECN would be required to execute 11,000 shares—the full size of the order in the ECN.

Locked/Crossed Markets

Nasdaq has observed instances of Market Makers and ECNs entering orders at 9:29 a.m. (when quotations

are not firm) that lock/cross the market and then leaving these orders in place at 9:30 a.m. when the quotations become firm and the market opens. Often times the Market Maker or ECN will not take action to attempt to resolve the lock/cross when the market opens. This effectively locks/crosses the market on the opening and disrupts the opening process.

In light of this situation, the NASD is amending Rule 4613(e). Amended Rule 4613(e) provides that if a Market Maker or ECN enters a quotation at or after 9:25:00 a.m. Eastern Time and the quotation locks or crosses the market on the opening, it is the obligation of that Market Maker or ECN to take action immediately when the market opens to avoid the lock or cross. The rule specifies that the Market Maker or ECN must take such take action (*e.g.*, by sending a SelectNet order to the quotation it will lock/cross, or by taking down its quotation, if appropriate) when the market opens at 9:30:00 a.m., but in no case later than 30 seconds thereafter (*i.e.*, 9:30:30 a.m.). The 30-second period is intended to give a Market Maker or ECN an opportunity to send a SelectNet message to the party that it will lock/cross at a point in time when quotations are firm (*i.e.*, at or after 9:30:00 a.m.).

For example, at 9:28:35 a.m., the market in Stock QRST is 20 x 20 3/16, and MMAB is displaying an offer of 20 3/16. At 9:29:45 a.m., MMCD enters a bid of 20 3/16 thereby locking the market. MMCD is obligated to attempt to resolve the lock as soon as the market opens (but no later than by 9:30:30 a.m.) by, for example, sending a SelectNet message to MMAB.

Although market participants should always monitor their pre-opening quotations to ensure that they do not lock/cross the market on the open-

ing, the amended rule: (1) provides a benchmark of 9:25:00 a.m., at which time market participants must start monitoring their quotations to determine whether they are entering locking/crossing quotations; (2) delineates which party must take action to resolve the lock/cross when the market opens; and (3) provides a benchmark of 9:30:30 a.m., by which time the market participant must take action to resolve the locked/crossed market situation.

Nasdaq Information Requests

Finally, the NASD is adopting Rule 4625 regarding members' obligation to supply Nasdaq with certain information when so requested. Nasdaq's MarketWatch and Market Operations departments have day-to-day responsibilities for administering various NASD and SEC rules, as well as carrying out duties delegated to them by the Association. For example, Nasdaq's MarketWatch Department is responsible for initiating trading halts and monitoring locked and crossed market situations, while Nasdaq's Market Operations Department is responsible for reviewing ITS trade-through complaints, clearly erroneous transactions, and requests for excused withdrawals or reinstatements from unexcused withdrawals. In order to properly administer a particular rule or to carry out a departmental function, Nasdaq staff often must obtain information on a real-time basis from market participants. For example, when monitoring for locked and crossed markets, Nasdaq MarketWatch routinely will contact the parties to the lock or cross (*e.g.*, a Market Maker and/or ECN) to request relevant information.² Staff then will review this information on a real-time basis and assist in resolving the locked or crossed market situation.³

Currently there is no explicit authority in the NASD's rules that allow Nas-

daq staff to request information from members, although members generally have voluntarily complied with such requests in the past. Thus, the NASD is adopting Rule 4625, which authorizes Nasdaq staff to request information in specific circumstances and obligates members to comply with such requests. Under Rule 4625, Nasdaq staff may request from a member information directly related to: a SEC or NASD rule that the Nasdaq department is responsible for administering; or to other duties/responsibilities imposed on the Nasdaq department by the "Plan of Allocation and Delegation of Function by the NASD to Subsidiaries" or otherwise delegated by the Association to such department. Members should note that, under Rule 4625, a failure to provide information in a timely, truthful, and/or complete manner, could subject the member to disciplinary action.

Text Of Amendments

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

Rule 4623. Electronic Communications Networks

(a) The Association may provide a means to permit electronic communications networks ("ECN"), as such term is defined in SEC Rule 11Ac1-1(a)(8), to meet the terms of the [electronic communications network] ECN display alternative provided for in SEC Rule 11Ac1-1(c)(5)(ii)(A) and (B) ("ECN display alternative"). In providing any such means, the Association shall establish a mechanism that permits the [electronic communications network] ECN to display the best prices and sizes of orders entered by Nasdaq market makers (and other entities, if the [electronic communications network] ECN so chooses) into the [electronic communications network] ECN, and allows any NASD member the electronic

ability to effect a transaction with such priced orders that is equivalent to the ability to effect a transaction with a Nasdaq market maker quotation in Nasdaq operated systems.

(b) An [electronic communications network] ECN that seeks to utilize the Nasdaq-provided means to comply with the [electronic communications network] ECN display alternative shall:

(1) demonstrate to the Association that it qualifies as an [electronic communications network] ECN meeting the definition in the SEC Rule;

(2) be registered as a[n] NASD member;

(3) enter into and comply with the terms of a Nasdaq WorkStation Subscriber Agreement, as amended for ECNs;

(4) agree to provide for Nasdaq's dissemination in the quotation data made available to quotation vendors the prices and sizes of Nasdaq market maker orders (and other entities, if the [electronic communications network] ECN so chooses) at the highest buy price and the lowest sell price for each Nasdaq security entered in and widely disseminated by the [electronic communications network] ECN, and prior to entering such prices and sizes, register with Nasdaq Market Operations as an ECN; and

(5) provide an automated execution, or if the price is no longer available, an automated rejection of any order routed to the [electronic communications network] ECN through the Nasdaq-provided display alternative.

(c) When a NASD member attempts to electronically access through a Nasdaq-provided system an ECN-displayed order by sending an order that is larger than the ECN's Nasdaq-

displayed size and the ECN is displaying the order in Nasdaq on a reserved size basis, the NASD member that operates the ECN shall execute such Nasdaq-delivered order:

(1) up to the size of the Nasdaq-delivered order, if the ECN order (including the reserved size and displayed portions) is the same size or larger than the Nasdaq-delivered order; or

(2) up to the size of the ECN order (including the reserved size and displayed portions), if the Nasdaq-delivered order is the same size or larger than the ECN order (including the reserved size and displayed portions).

No ECN operating in Nasdaq pursuant to this rule is permitted to provide a reserved-size function unless the size of the order displayed in Nasdaq is 100 shares or greater. For purposes of this rule, the term "reserved size" shall mean that a customer entering an order into an ECN has authorized the ECN to display publicly part of the full size of the customer's order with the remainder held in reserve on an undisplayed basis to be displayed in whole or in part as the displayed part is executed.

Rule 4613. Character of Quotations

(a) - (d) No Change

(e) Locked and Crossed Markets

(1) A market maker shall not, except under extraordinary circumstances, enter or maintain quotations in Nasdaq during normal business hours if:

(A) the bid quotation entered is equal to or greater than the asked quotation of another market maker entering quotations in the same security; or

(B) the asked quotation is equal to or less than the bid quotation of another market maker entering quotations in the same security.

The prohibitions of this rule include the entry of a locking or crossing quotation at or after 9:25:00 a.m. Eastern Time if such quotation continues to lock or cross the market at the market's opening, and requires a market maker or ECN that enters a locking or crossing quotation at or after 9:25:00 a.m. Eastern Time to take action to avoid the lock or cross at the market's open or immediately thereafter, but in no case more than 30 seconds after 9:30:00 a.m.

(2) A market maker shall, prior to entering a quotation that locks or crosses another quotation, make reasonable efforts to avoid such locked or crossed market by executing transactions with all market makers whose quotations would be locked or crossed. Pursuant to the provisions of paragraph (b) of this Rule 4613, a market maker whose quotations are causing a locked or crossed market is required to execute transactions at its quotations as displayed through Nasdaq at the time of receipt of any order.

(3) For purposes of this [paragraph] rule, the term "market maker" shall include:

(i) any NASD member that enters into an [electronic communications network] ECN, as defined in SEC Rule 11Ac1-1(a)(8), a priced order that is displayed in The Nasdaq Stock Market; and

(ii) [Such term also shall include] any NASD member that operates the [electronic communication network] ECN when the priced order being displayed has been entered by a person or entity that is not a[n] NASD member.

Rule 4625. Obligation to Provide Information

(1) A NASD member operating in or participating in the third market, The Nasdaq Stock Market, or other Nasdaq-operated system, shall provide information orally, in writing, or electronically (if such information is, or is required to be, maintained in electronic form) to the staff of Nasdaq when:

(a) Nasdaq MarketWatch staff makes an oral, written, or electronically communicated request for information relating to a specific NASD rule, SEC rule, or provision of a joint industry plan (e.g., ITS, UTP, CTA, and CQA) (as promulgated and amended from time-to-time) that Nasdaq MarketWatch is responsible for administering or to other duties and/or obligations imposed on Nasdaq MarketWatch by the Association under the Plan of Allocation and Delegation of Function by the NASD to Subsidiaries or otherwise; this shall include, but not be limited to, information relating to:

(i) a locked or crossed market;

(ii) a trade reported by a member or ECN to the Automated Transaction Confirmation Service ("ACT"); or

(iii) trading activity, rumors, or information that a member may possess that may assist in determining whether there is a basis to initiate a trading halt, pursuant to NASD Rule 4120 and IM-4120-1; or

(iv) a quotation that appears not to be reasonably related to the prevailing market.

(b) Nasdaq Market Operations staff makes an oral, written, or electronically communicated request for information relating to a specific NASD rule, SEC rule, provision of a joint industry plan (e.g., ITS, UTP, CTA,

and CQA) (as promulgated and amended from time-to-time) that Nasdaq Market Operations is responsible for administering or to other duties and/or obligations imposed on Nasdaq Market Operations by the Association under the Plan of Allocation and Delegation of Function by the NASD to Subsidiaries or otherwise; this shall include, but not be limited to, information relating to:

(i) a clearly erroneous transaction, pursuant to NASD Rule 11890;

(ii) a request to reconsider a determination to withhold a primary market maker designation, pursuant to NASD Rule 4612;

(iii) a request for an excused withdrawal or reinstatement, pursuant to NASD Rules 4619, 4620, 4730, 5106 and 6350;

(iv) the resolution of a trade-through complaint, pursuant to NASD Rules 5262, 5265, and 11890;

(v) an ACT input error;

(vi) an equipment failure; or

(vii) a request to submit a stabilizing bid, pursuant to NASD Rules 4614 and 5106, or a request to have a quotation identified as a penalty bid on Nasdaq, pursuant to NASD Rule 4624.

(2) A failure to comply in a timely, truthful, and/or complete manner with a request for information made pursuant to this rule may be deemed conduct inconsistent with just and equitable principles of trade.

Endnotes

¹A locked market occurs when the quoted bid price is the same as the quoted ask price. A crossed market occurs when the quoted bid price is greater than the quoted ask price.

²Staff may request information on the identity of the customers, trade information, the reason for the lock or cross (e.g., system

error), and other information related to the locked or crossed market situation.

³In addition to the locks and crosses, there are other instances when staff must gather information from Market Makers and ECNs on a real-time basis. For example, Nasdaq MarketWatch may need to contact a Market Maker or ECN to determine quickly if a trade, quotation, or series of trades appear-

ing to be aberrations, were caused by a malfunction of a computer system (which could pose a threat to the integrity of Nasdaq from a technological perspective) or by some other source.

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