

Notice to Members

JUNE 2003

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management
Technology
Trading And Market Making

KEY TOPICS

Market Making
OTC Securities
Recording And Reporting Quotation Data

INFORMATIONAL

Quotation Reporting

SEC Approves NASD Rule Proposal Requiring Quotation
Recording and Reporting for OTC Equity Securities;

Effective Date: June 27, 2003

Executive Summary

On March 27, 2003, the Securities and Exchange Commission (SEC) approved proposed rule changes by NASD that require members to record and maintain their proprietary quotations in over-the-counter (OTC) Equity Securities displayed in certain automated inter-dealer quotations systems, such as the Electronic Pink Sheets (EPS), and to report such data to NASD upon request.¹ The new rule text is contained in Attachment A and becomes effective on June 27, 2003.

At this time, NASD is requiring that the quotation data described herein be submitted to NASD on a **weekly** basis. NASD may alter the frequency of the reporting of this data to NASD based on regulatory need. NASD will notify members of any changes in reporting frequency in a *Notice to Members* and will provide adequate time for members to adjust their systems or reporting arrangements accordingly.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, NASD, at (240) 386-5126; or to Office of General Counsel, Regulatory Policy and Oversight, NASD, at 202-728-8071.

03-28

Background

In September 1999, the EPS began displaying real-time, online stock quotations for approximately 5,000 OTC Equity Securities.² Prior to the availability of EPS, the “pink sheets” consisted of printed weekly lists of quotes in each security. These non-binding quotations were updated by means of a daily facsimile to subscribers. Market participants could learn of changes to intra-day quotations only by telephone or similar means of communication to market makers in the security.

Because the EPS now displays quotations in OTC Equity Securities on a real-time basis, NASD staff requires access to this quotation data to assess member compliance with applicable rules and regulations and, when necessary, to reconstruct market activity. For example, member quotation activities in the EPS are subject to NASD Rule 3320, “Offers at Stated Prices,” which requires that a member’s priced quotations be “firm,” *i.e.*, the member is expected to buy or sell at least a normal unit of trading in the quoted stock at its then-prevailing quotations, unless clearly designated otherwise. In addition, NASD Rule 6750 provides that every member firm that functions as a market maker in OTC Equity Securities on an inter-dealer quotation system that permits quotation updates on a real-time basis honor those quotations for the minimum size applicable to the market maker’s firm bid or ask.

Recording and Reporting Requirements

The new rule requires that members record and maintain their quotations displayed on an inter-dealer quotation system³ that permits quotation updates on a real-time basis. Specifically, the rule change requires all members that publish quotations on the EPS or any other inter-dealer quotation system that meets the requirements under the rule to record and maintain their priced quotations and unpriced indications of interest data and to report such quotation data to NASD. Specifically, members must record and report the following items for all updates in quotations or quotation size:

- Submitting Firm Market Participant Identifier;
- Identification of the inter-dealer quotation system;
- Trade date;
- Time of the quotation display, expressed in hours, minutes and seconds;
- Bid and bid quotation size;
- Offer and offer quotation size; and
- Prevailing inside bid and offer in the inter-dealer quotation system at the time of the quotation.⁴

This information must be recorded for any trade date on which a member displays quotes, even if no quotation updates or changes are entered on that particular day. Members are required to record such information on a daily basis and maintain such records in accordance with Rule 17a-4(a) under the Exchange Act for a period of not less than six years, the first two years in an accessible place.

In addition, members must report such information to NASD on a weekly basis.

The new requirements do not apply to quotations displayed on an inter-dealer quotation system that is operated by a registered securities association or national securities exchange because such quotation information will be available from and/or regulated by the system operator directly. This includes, for example, the OTC Bulletin Board, which is sponsored and regulated by NASD. In addition, the new requirements do not apply to an inter-dealer quotation system that is operated by an NASD member because NASD can obtain quotation data (or in some cases, the display of limit orders) directly from the member that operates the system.

Under the rule, members are permitted to use a Reporting Agent to provide the quotation data to NASD.⁵ NASD believes that most, if not all, members will use the services of a Reporting Agent, which would likely be the operator of the system. The member must enter into a written agreement with the Reporting Agent to have the Reporting Agent fulfill the member's obligations under the rule. The member, however, remains ultimately responsible for compliance with all regulatory requirements, notwithstanding the use of a Reporting Agent.

If a member knows or has reason to believe that it or its Reporting Agent is not complying with the requirements of the rule, the member is required to withdraw its priced quotations or unpriced indications of interest until such time that the member is satisfied that the quotation data is being properly maintained and reported. In this regard, NASD would expect a member periodically to review or monitor a Reporting Agent's activities to ensure continued compliance.

Impact of the New Reporting Requirements on the Three Quote Rule Recordkeeping Requirements

Rule 2320(g), the "Three Quote Rule," requires that a member or person associated with a member contact and obtain quotations from three dealers (or all dealers if three or less) to determine the best inter-dealer market for an OTC Equity Security, unless two or more priced quotations are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis. Rule 3110(b)(2) currently requires that members indicate on the order ticket for each transaction in an OTC Equity Security the name of each dealer contacted and the quotations received to determine the best inter-dealer market. Rule 3110(b)(2), however, does not require members to note such information on the order ticket if two or more priced quotations are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis and NASD has access to historical quotation data from the system. As a result, members have been relieved of certain recordkeeping burdens relating to the Three Quote Rule in those instances where NASD can validate and confirm compliance with applicable requirements directly through its internal historical data.

Upon the implementation of the new requirements described herein, NASD will have access to historical quotation data with respect to the EPS and other inter-dealer quotation systems, as applicable. Therefore, members will not be required to annotate on the order ticket the names of the dealers and the quotations displayed when two or more priced quotations are displayed on the EPS or

another inter-dealer quotation system that permits quotation updates on a real-time basis and for which NASD has access to historical quotation data.

Endnotes

- 1 Exchange Act Release No. 47587 (March 27, 2003) (File No. SR-NASD-2000-42), 68 Federal Register 16328 (April 3, 2003).
- 2 Rule 6610(d) defines "OTC Equity Security" as "any equity security not classified as a 'designated security,' for purposes of the Rule 4630 and 4640 Series. This term also includes certain exchange-listed securities that do not otherwise qualify for real-time trade reporting because they are not 'eligible securities' as defined in Rule 6410(d). The term 'OTC Equity Security' shall not include 'restricted securities,' as defined by SEC Rule 144(a)(3) under the Securities Act of 1933, nor any securities designated in the PORTAL Market, the Rule 5300 Series."
- 3 Rule 15c2-11(e) under the Exchange Act defines "inter-dealer quotation system" as "any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers."
- 4 Members should not consolidate quotation information from other systems or markets that are quoting the same security in calculating the prevailing inside bid or offer.
- 5 Under Rule 6630(e), "Reporting Agent" means a third party that enters into a written agreement with a member pursuant to which such third party agrees to fulfill the member's obligations under the Rule. The written agreement must specify the respective functions and responsibilities of each party to the agreement that are required to effect full compliance with the requirements of the rule.

© 2003. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

New language is underlined; deletions are in brackets.

6600. [REPORTING TRANSACTIONS IN] OVER-THE-COUNTER EQUITY SECURITIES

This Rule 6600 Series sets forth recording and reporting requirements for certain quotations and unpriced indications of interest displayed on inter-dealer quotation systems and the trade reporting requirements applicable to members' transactions in equity securities for which real-time trade reporting is not otherwise required (hereinafter referred to as "OTC Equity Securities"). Members shall utilize the Automated Confirmation Transaction Service (ACT) for trade reporting in OTC Equity Securities.

Rules 6610 and 6620 No Change.

Rule 6630. Recording of Quotation Information

(a) Quotation Recording Requirements

(1) Subject to the terms and conditions contained herein, each OTC Market Maker that displays priced quotations (bid and/or offer) or unpriced indications of interest in OTC Equity Securities in an inter-dealer quotation system that permits quotation updates on a real-time basis shall record each item of information described in paragraph (b) of this Rule. This quote activity record must reflect all changes in an OTC Market Maker's priced quotation or quotation size displayed or unpriced indication of interest, and the time any such change was effected.

(2) Members shall record each item of information required to be recorded under this Rule in such form as is prescribed by the Association from time to time.

(3) Maintaining and Preserving Records

(A) Each member shall maintain and preserve records of the information required to be recorded under this Rule for the period of time and accessibility specified in SEC Rule 17a-4(a).

(B) The records required to be maintained and preserved under this Rule may be immediately produced or reproduced on "micrographic media" as defined in SEC Rule 17a-4(f)(1)(i) or by means of "electronic storage media" as defined in SEC Rule 17a-

4(f)(1)(ii) that meet the conditions set forth in SEC Rule 17a-4(f) and may be maintained and preserved for the required time in that form.

(b) Information to be Recorded

The quotation activity record required pursuant to paragraph (a) of this Rule shall contain, at a minimum, the following information for every priced quotation (bid and/or offer) or unpriced indication of interest displayed by the member during the trading day:

- (1) Submitting firm;
- (2) Inter-dealer quotation system or medium;
- (3) Trade date;
- (4) Time quotation displayed (expressed in hours, minutes and seconds);
- (5) Security name and symbol;
- (6) Bid and bid quotation size (if applicable);
- (7) Offer and offer quotation size (if applicable);
- (8) Prevailing Inside Bid; and
- (9) Prevailing Inside Offer

If no updates were entered to an OTC Market Maker's quotation or quotation size for any given trading day, the member must record the information in subparagraphs (b)(1) through (7).

(c) Quotations Not Required To Be Recorded

The recording requirements contained in paragraphs (a) and (b) of this Rule shall not apply to quotations of OTC Equity Securities that are displayed on an inter-dealer quotation system that is:

- (1) operated by a registered securities association or a national securities exchange; or
- (2) operated by a member of the Association.

(d) Reporting Requirements

(1) General Requirement

Members shall report information required to be recorded under this Rule to the Association upon its request.

(2) Method of Transmitting Data

Members shall transmit this information in such form prescribed by the Association.

(e) Reporting Agent Agreements

(1) "Reporting Agent" shall mean a third party that enters into any agreement with a member pursuant to which such third party agrees to fulfill such member's obligations under this Rule.

(2) Any member may enter into an agreement with a Reporting Agent pursuant to which the Reporting Agent agrees to fulfill the obligations of such member under this Rule. Any such agreement shall be evidenced in writing, which shall specify the respective functions and responsibilities of each party to the agreement that are required to effect full compliance with the requirements of this Rule.

(3) All written documents evidencing an agreement described in paragraph (e)(2) shall be maintained by each party to the agreement.

(4) Each member remains responsible for compliance with the requirements of this Rule, notwithstanding the existence of an agreement described in this paragraph.

(f) Withdrawal of Quotations or Unpriced Indications of Interest

If a member knows or has reason to believe that it or its Reporting Agent is not complying with the requirements of this Rule, the member must withdraw its quotations or unpriced indications of interest until such time that the member is satisfied that its quotation data is being properly recorded and reported.