

Notice to Members

FEBRUARY 2003

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

SEC Approves Changes to Rule on Clearly Erroneous Transactions; Changes Effective Immediately

KEY TOPICS

NASD Rule 11890

Executive Summary

On January 22, 2003, the Securities and Exchange Commission (SEC) approved changes to NASD Rule 11890 regarding the handling of clearly erroneous transactions. The changes, which take effect immediately, are intended primarily to clarify the rule's scope and language rather than to modify the application of the rule to particular transactions. Important clarifications made by the rule change include the following:

- ◆ NASDAQ will adjudicate erroneous transaction complaints only if they concern transactions executed through NASDAQ systems and only if the parties to the transactions are readily identifiable.
- ◆ On its own motion, NASDAQ may nullify or modify any transaction that is executed or reported through a NASDAQ system, if NASDAQ determines that action is necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest.

Questions regarding this *Notice* may be directed to Richard Bush, Director, NASDAQ Market Operations, at (203) 385-6242; or John Yetter, Assistant General Counsel, Office of General Counsel, The NASDAQ Stock Market, Inc., at (202) 912-3039.

03-11

Background

NASD Rule 11890 sets forth the process through which NASDAQ may review certain transactions and declare them null and void or otherwise modify their terms. Under the first part of the Rule, NASDAQ has authority to receive petitions from market participants requesting that designated officers of NASDAQ review the terms of a transaction and nullify or modify it if the transaction is found to be clearly erroneous.

The changes to this part of the Rule approved by the SEC:

- ◆ Clarify that market participants may petition for review of transactions executed through NASDAQ execution and communications systems – *i.e.*, SuperMontage, Primex, Liquidity Tracker, and CAES – but may not petition for review of transactions that are executed exclusively through non-NASDAQ systems, such as transactions that are internalized within an electronic communications network (ECN) or a market maker's internal execution system.
- ◆ Clarify that the Rule covers transactions executed through SuperMontage by a member of an exchange that trades NASDAQ securities pursuant to unlisted trading privileges (UTP Exchange). Thus, the rule covers transactions entered into with members of the Chicago Stock Exchange through SuperMontage, but does not cover transactions of UTP Exchanges that are not linked to SuperMontage.
- ◆ Clarify that the parties to reviewable transactions must be readily identifiable through NASDAQ's systems. To ensure that this

requirement is satisfied, parties filing complaints under the rule should provide clear information about the transaction(s) at issue, including the name of the security, the number of shares, the price, the contra broker, and the executing NASDAQ system.

- ◆ Clarify that information submitted by parties to NASDAQ must be received by NASDAQ within the time frames specified by the Rule. Specifically, a market participant may seek review by submitting a written complaint to NASDAQ Market Operations that is received by 10:30 a.m. for transactions occurring within the first half hour of the regular trading day, and within 30 minutes of the time of the transaction for all other transactions.

Under the second part of Rule 11890, NASDAQ has authority to nullify or modify transactions on its own motion. The changes to this part of the Rule approved by the SEC:

- ◆ Clarify that NASDAQ may exercise its authority in the event of (i) a disruption or malfunction in any of NASDAQ's systems, or (ii) extraordinary market conditions or other circumstances in which the nullification or modification of transactions may be necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest.
- ◆ Clarify that NASDAQ's authority extends to any transaction arising out of or reported through a NASDAQ quotation, execution, communication, or trade reporting system. In contrast to the first part of the Rule, which focuses on errors made by the parties to a specific trade, the focus of the second part of the Rule is on errors

that may affect numerous trades throughout the market. Accordingly, the amended Rule expressly authorizes NASDAQ to break not only trades executed through its systems, but also trades executed through the systems of members that are reported to NASDAQ. In recognition of the authority of other self-regulatory organizations, however, the Rule does not cover trades entered into exclusively through, or reported to, a UTP Exchange, nor does it cover ADF trades reported to NASD's TRACS system. However, NASDAQ will endeavor to coordinate its actions with other market centers in an attempt to achieve consistent treatment of trades executed outside of NASDAQ's jurisdiction.

- ▶ Provide that the authority conferred by the second part of the Rule may be exercised only by NASDAQ's President or an Executive Vice President designated by the President, who must act, except in extraordinary circumstances, within 30 minutes of detection of the transaction or transactions at issue, but in no event later than 3:00 p.m. on the next trading day.

The third part of Rule 11890 governs review of decisions under the Rule by the Market Operations Review Committee (MORC), a standing committee composed of representatives of member firms as well as "non-industry" representatives. The changes to this part of the Rule approved by the SEC:

- ▶ Provide that NASDAQ's President or a designated Executive Vice President may limit review by the MORC if he or she determines that the number of transactions affected by a decision to break or modify trades on NASDAQ's

own motion is such that the decision must be accorded immediate finality in order to maintain a fair and orderly market and to protect investors and the public interest. Although NASDAQ expects that it would use this authority only on rare occasions, NASDAQ believes that there will be circumstances in which review by the MORC of a large number of trades would be impractical and could expose market participants to unacceptable levels of risk.

- ▶ Clarify that determinations of NASDAQ officers that are not appealed are final and binding and constitute final action by NASD on the matter.
- ▶ Provide that it shall be considered conduct inconsistent with just and equitable principles of trade for a member to refuse to take action that is necessary to effectuate a final decision of a NASDAQ officer or the MORC.

Finally, the SEC approved a new section of the Rule to:

- ▶ Clarify that materials submitted to NASDAQ or the MORC must be submitted via facsimile machine and must be received within the time parameters specified by the rule (although, if requested, NASDAQ staff may authorize submission of materials via electronic mail on a case-by-case basis).¹ Materials shall be deemed received at the time indicated by a facsimile machine or computer that receives the materials. NASDAQ reserves the right to reject or accept material that is not received within the time parameters specified by the Rule.

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- ▶ Clarify that NASDAQ may provide notice of determinations under the rule via facsimile machine, electronic mail, or telephone (including voice mail). However, in cases where an officer nullifies or modifies a large number of transactions pursuant to NASDAQ's authority to act on its own motion, individual notice may not be practicable. In that case, NASDAQ may provide notice to market participants via the NASDAQ Workstation II Service, a press release, or any other method reasonably expected to provide rapid notice to many market participants.

Endnote

- 1 For example, if a party wishes to submit, pursuant to subparagraph (a)(2)(A) of the amended rule, a large document containing supporting information, it may be preferable to submit the document via electronic mail. Electronic mail may be used only when specifically authorized by NASDAQ staff, however, because it is impossible to control the delivery time of electronic mail.

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TEXT OF AMENDMENTS

New text is underlined; deletions are bracketed.

11890. Clearly Erroneous Transactions

(a) Authority to Review Transactions Pursuant to Complaint of Market Participant

(1) Scope of Authority. [For the purposes of this Rule, the terms of a transaction are clearly erroneous when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.]

[2)] Officers of [The] Nasdaq [Stock Market, Inc. (“Nasdaq”)] designated by [the] its President [of Nasdaq] shall, pursuant to the procedures set forth in paragraph [(b)] (a)(2) below, have the authority to review any transaction arising out of the use or operation of any [automated quotation,] execution[, or,] or communication system owned or operated by Nasdaq and approved by the Commission, including transactions entered into by a member of a national securities exchange with unlisted trading privileges in Nasdaq-listed securities (a “UTP Exchange”) through such a system; provided, however, that the parties to the transaction must be readily identifiable by Nasdaq through its systems [excluding transactions arising from use of the Nasdaq Application of OptiMark]. A Nasdaq officer shall review transactions with a view toward maintaining a fair and orderly market and the protection of investors and the public interest. Based upon this review, the officer shall decline to act upon a disputed transaction if the officer believes that the transaction under dispute is not clearly erroneous[, or,]. [i)] If the officer determines the transaction in dispute is clearly erroneous, however, he or she shall declare that the transaction is null and void or modify one or more terms of the transaction. When adjusting the terms of a transaction, the Nasdaq officer shall seek to adjust the price and/or size of the transaction to achieve an equitable rectification of the error that would place the parties to a transaction in the same position, or as close as possible to the same position, as [that] they would have been in had the error not occurred. [Nasdaq shall promptly provide oral notification of a determination to the parties involved in a disputed transaction and thereafter issue a written confirmation of the determination.] For the purposes of this Rule, the terms of a transaction are clearly erroneous when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.

[(b) Procedures for Reviewing Transactions]

[(1)] (2) Procedures for Reviewing Transactions

(A) Any member, member of a UTP Exchange, or person associated with [a] any such member that seeks to have a transaction reviewed pursuant to paragraph (a)(1) hereof[,] shall submit a written complaint[, via facsimile or otherwise,] to Nasdaq Market Operations in accordance with the following time parameters:

[(A)] (i) for transactions occurring at or after 9:30 a.m., Eastern Time, but prior to 10:00 a.m., Eastern Time, complaints must be [submitted] received by Nasdaq by 10:30 a.m., Eastern Time; and

[(B)] (ii) for transactions occurring prior to 9:30 a.m., Eastern Time and at or after 10:00 a.m., Eastern Time, complaints must be [submitted] received by Nasdaq within thirty minutes.

[(2)] (B) Once a complaint has been received in accord with subparagraph [(b)(1)] (a)(2)(A) above:

[(A)] (i) the complainant shall have up to thirty (30) minutes, or such longer period as specified by Nasdaq staff, to submit any supporting written information concerning the complaint necessary for a determination under paragraph [(a)(2)] (a)(1)[, via facsimile or otherwise];

[(B)] (ii) the counterparty to the trade shall be [verbally] notified of the complaint via telephone by Nasdaq staff and shall have up to thirty (30) minutes, or such longer period as specified by Nasdaq staff, to submit any supporting written information concerning the complaint necessary for a determination under paragraph [(a)(2)] (a)(1)[, via facsimile or otherwise]; and

[(C)] (iii) either party to a disputed trade may request the written information provided by the other party pursuant to this subparagraph.

[(3)] (C) Notwithstanding subparagraph [(b)(2)] (a)(2)(B) above, once a party to a disputed trade communicates that it does not intend to submit any further information concerning a complaint, the party may not thereafter provide additional information unless requested to do so by Nasdaq staff. If both parties to a disputed trade indicate that they have no further information to provide concerning the complaint before their respective

thirty-minute information submission period has elapsed, then the matter may be immediately presented to a Nasdaq officer for a determination pursuant to paragraph [(a)(2)] (a)(1) above.

[(4)] (D) Each member, member of a UTP Exchange, or person associated with any such member [and/or person associated with a member] involved in the transaction shall provide Nasdaq with any information that it requests in order to resolve the matter on a timely basis notwithstanding the time parameters set forth in subparagraph [(b)(2)] (a)(2)(B) above.

[(5)] (E) Once a party has applied to Nasdaq for review, the transaction shall be reviewed and a determination rendered, unless both parties to the transaction agree to withdraw the application for review prior to the time a decision is rendered pursuant to paragraph [(a)(2)] (a)(1).

[(c)] (b) Procedures for Reviewing Transactions [Executed During System Disruptions or Malfunctions] on Nasdaq's Own Motion

In the event of (i) a disruption or malfunction in the use or operation of any [automated] quotation, execution, [or] communication, or trade reporting system owned or operated by Nasdaq and approved by the Commission, or (ii) extraordinary market conditions or other circumstances in which the nullification or modification of transactions may be necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest, the President of Nasdaq or any Executive Vice President designated by the President], acting through an officer designated by the President of Nasdaq pursuant to paragraph (a)(2)], may, on [its] his or her own motion, [pursuant to the standards set forth in paragraph (a), declare] review any transaction[s] arising out of or reported through [the use or operation of such systems during the period of such disruption or malfunction] any such quotation, execution, communication, or trade reporting system, including transactions entered into by a member of a UTP Exchange through the use or operation of such a system, but excluding transactions that are entered into through, or reported to, a UTP Exchange. A Nasdaq officer acting pursuant to this subsection may declare any such transaction null and void or modify the terms of [these] any such transaction[s] if the officer determines that (i) the transaction is clearly erroneous, or (ii) such actions are necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest; provided, however, that, in the absence of extraordinary circumstances, [a] the [Nasdaq] officer must take action pursuant to this [paragraph] subsection within thirty (30) minutes of detection of the [erroneous] transaction[s], but in no event later than [6]3:00 p.m., Eastern Time, on the next trading

day following the date of the trade at issue. [When Nasdaq takes action pursuant to this subparagraph, the member firms involved in the transaction shall be notified as soon as is practicable and shall have a right to appeal such action in accordance with paragraph (d)(1) below.]

[(d)] (c) Review by the Market Operations Review Committee (“MORC”)

(1) A member, member of a UTP Exchange, or person associated with [a] any such member may appeal a determination made under [paragraphs] subsection (a)(2) or (c) to the MORC. A member, member of a UTP Exchange, or person associated with any such member may appeal a determination made under subsection (b) to the MORC unless the officer making the determination also determines that the number of the affected transactions is such that immediate finality is necessary to maintain a fair and orderly market and to protect investors and the public interest. [provided such] An appeal must be [is] made in writing[, via facsimile or otherwise], and must be received by Nasdaq within thirty (30) minutes after the [member or person associated with a member receives verbal] person making the appeal is given notification of [such] the determination being appealed, except that if Nasdaq notifies the parties of action taken pursuant to paragraph [(c)] (b) after 4:00 p.m., [either party has until] the appeal must be received by Nasdaq by 9:30 a.m. the next trading day [to appeal]. Once a written appeal has been received, the counterparty to the trade will be notified of the appeal and both parties shall be able to submit any additional supporting written information[, via facsimile or otherwise,] up until the time the appeal is considered by the Committee. Either party to a disputed trade may request the written information provided by the other party during the appeal process. An appeal to the Committee shall not operate as a stay of the determination [made pursuant to paragraph (a)(2) or (c) above] being appealed. Once a party has appealed a determination to the Committee, the determination shall be reviewed and a decision rendered, unless both parties to the transaction agree to withdraw the appeal prior to the time a decision is rendered by the Committee. Upon consideration of the record, and after such hearings as it may in its discretion order, the Committee, pursuant to the standards set forth in [paragraph (a)] this section, shall affirm, modify, reverse, or remand the determination [made under paragraph (a)(2) or (c) above].

(2) The decision of the Committee pursuant to an appeal, or a determination by a Nasdaq officer that is not appealed, shall be final and binding upon all [any member or person associated with a member] parties and shall constitute final Association action on the matter in issue. Any [adverse] determination by a Nasdaq officer pursuant to paragraph (a)[(2)] or [(c)] (b) or any [adverse] decision by the Committee pursuant to paragraph [(d)] (c)(1) shall be rendered without prejudice as to the rights of the parties to the transaction to submit their dispute to arbitration.

(d) Communications

(1) All materials submitted to Nasdaq or the MORC pursuant to this Rule shall be submitted via facsimile machine and within the time parameters specified herein; provided, however, that if requested, Nasdaq staff may authorize submission of material via electronic mail on a case-by-case basis. Materials shall be deemed received at the time indicated by the equipment (i.e., facsimile machine or computer) receiving the materials. Nasdaq, in its sole and absolute discretion, reserves the right to reject or accept any material that is not received within the time parameters specified herein.

(2) Nasdaq shall provide affected parties with prompt notice of determinations under this Rule via facsimile machine, electronic mail, or telephone (including voicemail); provided, however, that if an officer nullifies or modifies a large number of transactions pursuant to subsection (b), Nasdaq may instead provide notice to parties via the Nasdaq Workstation II Service, a press release, or any other method reasonably expected to provide rapid notice to many market participants.

IM-11890. Refusal to Abide by Rulings of a Nasdaq Officer or the MORC

It shall be considered conduct inconsistent with just and equitable principles of trade for any member to refuse to take any action that is necessary to effectuate a final decision of a Nasdaq officer or the MORC under Rule 11890.