

# Notice to Members

AUGUST 2002

## SUGGESTED ROUTING

Senior Management  
Legal and Compliance  
Operations  
Trading  
Market Making

## KEY TOPICS

## Alternative Display Facility

Alternative Display Facility (ADF) Nine-Month Pilot  
Approved for Trading in Nasdaq Securities

### Executive Summary

On July 24, 2002, the Securities and Exchange Commission (SEC) approved amendments to NASD rules that establish, implement, and operate NASD's Alternative Display Facility (ADF) on a pilot basis for nine months.<sup>1</sup> As described in more detail herein, members that choose to participate in the ADF during the pilot may quote and trade Nasdaq-listed securities on or through the ADF, commencing on July 29, 2002. NASD has proposed the permanent establishment and operation of the ADF in a separate rule filing, which would provide market participants the ability to quote and trade Nasdaq and exchange-listed securities.<sup>2</sup> However, several regulatory issues relating to the trading of exchange-listed securities on the ADF have not been resolved. Because these open issues do not relate to trading Nasdaq securities, NASD has received approval to operate the ADF on a pilot basis with respect to Nasdaq securities only.

The SEC Approval Order, which includes the text of the amendments, is available at <http://www.sec.gov/rules/sro/34-46249.html>. This *Notice* is intended to provide an overview of how the ADF will operate and member requirements in this regard. For additional information regarding ADF, members should review the SEC Approval Order and other ADF documentation available at [http://www.nasdaq.com/mkt\\_sys/adf\\_info.asp](http://www.nasdaq.com/mkt_sys/adf_info.asp).

Questions concerning this *Notice* related to the rules should be directed to either the Division of Regulatory Policy and Oversight, Office of General Counsel, at (202) 728-8071, or Market Regulation Department, at (240) 386-5126. Questions related to the operation of the ADF or becoming an ADF participant should be directed to the Division of Regulatory Services and Operations, Market Operations and Information Services, at (866) 776-0800 or (212) 858-5178.

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## Background

The ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the SEC's SuperMontage Approval Order<sup>3</sup> and in conjunction with The Nasdaq Stock Market, Inc.'s (Nasdaq) anticipated registration as a national securities exchange.<sup>4</sup> Initially, the ADF will be operated on a pilot basis for nine months. During the pilot, ADF market participants (market makers and ECNs) will be able to post quotations in Nasdaq securities and all members that participate in the ADF will be able to view quotations and report transactions in Nasdaq securities. The facility also will provide for trade reporting and comparison through the Trade Reporting and Comparison Service ("TRACS"), which is described in detail below.

Because the ADF pilot will be operating prior to the approval of Nasdaq's registration as an exchange, NASD will operate both Nasdaq and the ADF during the pilot period. Accordingly, the new rules applicable to quotation and trading requirements for activities through the ADF are separate from the quotation and trading rules relating to Nasdaq. Certain rules applicable to trading on Nasdaq have been amended, but only to reflect that members that choose to participate in both Nasdaq and the ADF may elect to trade report to either facility, except as specifically described herein. Otherwise, rules applicable to trading on Nasdaq have not changed.

The ADF trade reporting rules are consistent with current requirements applicable to Nasdaq market participants and are not intended to require new or different trade reporting responsibilities for parties to transactions. As described

in more detail herein, the new Rule 5400 Series details which party to a transaction has the trade reporting responsibility and where (ADF or Nasdaq) the party with the trade reporting responsibility is required, or has the choice, to trade report.

## Market Maker and ECN Registration

Similar to the existing rules applicable to Nasdaq market makers, ADF participants must register as market makers or ECNs to make a market or display orders on the ADF. Market makers will receive approval for registration upon demonstration that they are members in good standing and comply with the net capital and other financial responsibility requirements of the Exchange Act. To ease the administrative burden on NASD members, the pilot ADF rules initially will allow registration as a market maker in the ADF upon proof that a member is a registered Nasdaq market maker.

The ADF rules track Nasdaq requirements that market makers maintain continuous two-sided firm quotations and prescribes market maker obligations when a bid or offer locks or crosses the market. ECNs, however, may post one-sided quotes in the ADF. If an ADF Market Maker that also is a Nasdaq Market Maker is seeking excused withdrawal status, it must obtain such excused withdrawal status in both facilities for the same time period.

The ADF rules also provide that registration as an ADF market maker in a security is voluntarily terminated when the market maker: (1) withdraws its quotations from the ADF and does not re-enter quotations in the security for five minutes; or (2) fails to re-enter quotations within 30 minutes after the end of a trading halt. In either

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circumstance, a market maker would be prohibited from participating as an ADF market maker in that security for twenty (20) business days.

## Order Access Rule

NASD will not provide an order routing capability. Instead, the pilot ADF Rule 4300A (“order access rule”) requires NASD “market participants” to provide “direct electronic access” to other “market participants” and to provide to all other NASD members “direct electronic access” or allow for “indirect electronic access” to the individual market participant’s quote (“order access rule”). The rule defines “market participants” as either an ADF Registered Market Maker, or an ADF Registered ECN or ATS. In other words, “market participants” are those members that post quotations in the ADF.

As stated above, the order access rule requires market participants to provide other market participants with direct electronic access to their quotes. “Direct electronic access” is defined in the rule as the ability to deliver an order for execution directly against an individual NASD market participant’s best bid or offer without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to NASD market participants’ own customers. Therefore, while the linkage must be electronic — telephone access is insufficient — the rule allows market participants flexibility to determine the type and method of linkage. For example, market participants are permitted to link directly among themselves bilaterally using their own technology or to use a provider with multilateral order routing facilities to satisfy the linkage requirements. The rule

requires that a market participant be equally accessible to all other market participants via this electronic link.

The rule also requires market participants to provide all other NASD broker/dealer members (*i.e.*, those members that do not quote in ADF but want to access ADF quotes) with direct electronic access or allow for “indirect electronic access” through their customer broker/dealers. “Indirect electronic access” is defined as the ability to route an order through a market participant’s customer broker/dealer for execution against the market participant’s best bid and offer, without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to the market participant’s customer broker/dealer providing access to the market participant’s quotes.

A market participant may not deny indirect access to its quotes by requiring that all broker/dealers link directly to it. The requirement to allow for indirect access also does not permit market participants to refuse direct access to members that would prefer direct connectivity; rather, it creates an additional means for non-market participant broker/dealers to access market participants’ quotes.

The order access rule applies only to a market participant’s top of book, *i.e.*, the best bid and offer that is displayed in the ADF. Therefore, market participants retain substantial flexibility to negotiate the terms of many other services, such as full book access, placing orders, and use of reserve sizes. ECNs are permitted to charge more for “hit or take” access only — purely a liquidity taking function — than for full subscriber services, provided that the fee is reasonable, based on objective criteria, and not imposed discriminatorily.

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### Costs of Providing Order Access

Market participants must share equally the costs of providing to each other the direct electronic access required by the rule, unless those market participants agree upon another cost-sharing arrangement. For example, assume the ADF consisted of five market participants and a sixth broker/dealer registered as an ADF market participant. Under this scenario, each of the five existing market participants would be required to split with the new market participant the costs to establish their respective bilateral links with the new market participant, unless the parties agreed upon a different cost allocation.

Market participants also must pay the costs to enable direct electronic access to their quotes by non-market participant broker/dealers seeking access. Thus, a market participant must bear the costs to build, upgrade, or otherwise reconfigure its technology to allow other broker/dealers to connect to it, including the costs to accommodate additional volume resulting from indirect electronic access order flow through customer broker/dealers. Similarly, those non-market participant broker/dealers seeking access to a market participant's quote must bear the line or other costs necessary to connect with a market participant's network.

A customer broker/dealer may charge its customers a fee to provide indirect access to a market participant's quotes. A market participant may not influence or prescribe what a customer broker/dealer may charge its customers for indirect access to the market participant.<sup>5</sup> Further, a market participant may not preclude or discourage a specific customer broker/dealer from providing indirect access, either through discriminatory pricing or

by degrading its quality of service to its customer broker/dealer. A market participant may, however, offer to provide direct electronic access at a competitive price as part of the services it provides to customers.

Connectivity costs should be distinguished from fees for various other services provided by market participants. NASD recognizes that market participants have a variety of existing business relationships with broker/dealers for which they charge fees for services rendered, e.g., the handling of limit orders, price improvement opportunities, and liquidity enhancement. Market participants may continue to assess fees for these types of services, as permissible under current rules and regulations.

While ECNs may charge to execute against their best bid and offer, the fee must be based on reasonable and objective criteria. And while ECNs are permitted under the proposal to charge more for hit-or-take access than for full service access, they may not impose hit-or-take fees in a way that discriminates against a particular broker/dealer or class of broker/dealers. Thus, in setting its fee schedule, an ECN may not look through its order flow to identify and discriminate against the source of the order flow, e.g., a competitor or a broker/dealer that is accessing the quote indirectly. Rather, an ECN may set a reasonable fee for order flow that takes liquidity – a fee that may be higher than for order flow that provides liquidity — and apply that fee to all such order flow, irrespective of its origin. Similarly, an ECN that offers a volume discount must offer the same terms to all broker/dealers accessing its quote via direct or indirect access, without regard to the identity of the broker/dealer or the source of its order flow.

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### **Minimum Performance Standards**

To ensure that ADF quotes are reliable and accessible, order access linkages must meet specified minimum performance standards. Specifically, the pilot ADF rules impose a technological requirement on market participants, mandating that their order linkage system provide them the capability to respond to an order – *i.e.* accept or decline it – from another market participant or customer broker/dealer, within two seconds of receipt. Additionally, market participants are required to have in place a system that can accomplish a “round trip” of an order from another market participant in three or fewer seconds, measured from the time an order is released by a market participant until the time notification of action taken on the order is received back by the market participant that sent the order.

Market participants will be required to certify that their systems can meet these standards at peak capacity, based on reasonable forecasts, before they are authorized to post quotes on the ADF. On an ongoing basis, market participants will be required to re-certify that they can meet these performance standards when volumes exceed those on which the initial certification was based. NASD will review test data to confirm the accuracy of such certifications.

It is important to note that these performance standards are independent of existing firm quote requirements in Exchange Act Rule 11Ac1-1, NASD Rule 3320, and new NASD Rule 4613A(b), which require prompt execution of an order up to the quotation size displayed by the market participant upon receipt of an order to buy or sell. The performance standards ensure that all market participants have adequate technology that will not degrade the

overall accessibility of ADF quotes. By comparison, the firm quote rule addresses market participants’ obligation to honor their quotes when they receive an order. Accordingly, the performance standards do not require market makers to fill orders in two seconds; however, due to their structure, broker/dealers whose business models rely primarily upon electronic executions systems, for example, ECNs, would be expected to fill orders in less than two seconds.

### **Market Participant Inaccessibility**

To further ensure the reliability of linkages and the integrity of the ADF, NASD will have the authority to suspend from quoting or displaying orders for 20 business days any market participant that experiences three unexcused, confirmed system outages during any period of five business days. System outages are defined as an inability to quote or an inability to respond to orders. A review and appeal process is available, whereby the burden will rest with the market participant to establish that a confirmed system outage was attributable to another party. NASD will have discretion to excuse certain outages where the market participant voluntarily brings the matter to the attention of NASD. NASD also will receive and investigate complaints related to failure to provide direct or indirect access. Complaints of this nature can be reported to NASD, Market Operations at (866) 776-0800 or (212) 858-5178.

### **Reporting of Order Access Data to NASD**

To allow NASD to monitor compliance with certain trading rules, such as the firm quote rule and “trade or move” rules, all market participants that display quotations or orders in the ADF must record specified items of information

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pertaining to orders they receive from broker/dealers via direct or indirect electronic access and report this information to NASD on a real-time basis. This information must be provided to NASD within 10 seconds of the receipt of an order and, if applicable, when an order is acted upon or responded to.

### Trade Reporting and Trade Comparison Service

As described above, TRACS is a trade reporting and comparison service that will operate as part of the ADF pilot. TRACS will collect trade reports for NASD registered market participants, as well as any NASD member that chooses to or is required to report transactions through the ADF. The service will transmit the reports automatically to the Exclusive Securities Information Processor (ESIP), if required, for dissemination to the public and the industry.

TRACS operates similarly to the trade reporting functions of Nasdaq's Automated Confirmation Transaction Service (ACT)<sup>6</sup> but contains one notable distinguishing feature. TRACS supports a "three party trade report" that will make it easier for ECNs to submit trade reports involving their subscribers and for market makers to submit riskless principal trade reports. A three party trade report is a single last sale trade report that will denote one reporting member – *i.e.*, the party with the trade reporting responsibility as defined in the Rule 4630A Series – and two contra parties. The ADF will split the three party trade report into two separate reports that will then be processed independently in accordance with existing trade reporting rules. Each of these reports will contain its own identifier and a reference to the original three party trade report, so that

the separate reports can be mapped to the same transaction. Therefore, the ADF trade reporting system streamlines the reporting process by reducing from three or two to one the number of trade reports for most ECN and riskless principal transactions.

The TRAC's trade comparison service: (1) compares trade information entered by TRACS participants and submits "locked-in" trades to clearance and settlement; (2) transmits reports of the transactions automatically to the ESIP, if required, for dissemination to the public and the industry; and (3) provides participants with monitoring capabilities to facilitate participation in a "locked-in" trading environment. The trade comparison rules are found in the new Rule 6100A Series.

For those trades where one party is a TRACS subscriber and the other party is an ACT subscriber, both TRACS and ACT will accept one-sided trade reports and submit those trades to the National Securities Clearing Corporation (NSCC). In such cases, NSCC will compare the trade.

### Transaction Reporting

The pilot rules adopt the current Nasdaq approach to trade reporting for Nasdaq securities, regardless of whether the member is reporting through TRACS or ACT. The pilot rules adopt a new Rule 5430(b), which designates which party to a transaction has the trade reporting responsibility and where, TRACS or ACT, the party with the trade reporting responsibility is required, or has the choice, to trade report.

Specifically, Rule 5430(b) requires that the seller report trades between two market makers or two non-market makers, the market maker report trades between it and a customer, and an NASD member

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report trades between it and a customer. NASD members that are market makers in both the ADF and Nasdaq and have a trade reporting obligation under the rule, have a choice to trade report to ADF or Nasdaq, except for those transactions that are executed or facilitated by a Nasdaq system. If a member is a market maker in either Nasdaq or the ADF, but not the other facility, and has a trade reporting obligation under the rule, the member must report to the facility in which it is a market maker.

For example, if a member is an ADF market maker, but not a Nasdaq market maker, in a security, the member, if it has a trade reporting obligation, must report the transaction in that security to TRACS, unless the trade is executed using ACES, the Nasdaq National Market Execution System (NNMS), the SelectNet Service, the SmallCap Small Order Execution System (SOES), or the Primex Auction System (Primex). A trade executed using ACES must be reported using ACT, and trades executed using NNMS, SelectNet, SOES, or Primex will be reported to ACT automatically. A member that is not a market maker in either facility but is a participant in both facilities and has a trade reporting obligation may trade report to either facility, unless the trade is executed using ACES, NNMS, SelectNet, SOES, or Primex.

With respect to trade reporting by ECNs, ECNs that currently display quotes in Nasdaq have developed different methods of reporting trades. ECNs may continue to report to Nasdaq and/or the ADF in this same manner.

## Short Sale Rule

The short sale rule and its accompanying interpretation have been amended for the purposes of the pilot to provide that the current Nasdaq short rule applies to trading in Nasdaq-listed issues on the ADF. Specifically, members trading on the ADF must comply with the short sale rule based on the national best bid, as currently required under Rule 3350, and also includes the current exemption for registered market makers engaged in bona fide market making activity. The short sale rule will continue to apply as it does today to short sale activities on Nasdaq.

## Trading Halts

Rule 4120A provides NASD with authority to halt trading through the ADF in Nasdaq securities. ADF will halt trading when another market halts trading in a security for regulatory reasons. If another market halts trading for operational reasons, market participants may continue to trade in the ADF and would be required to meet all applicable trade reporting requirements. In addition, the ADF has the authority to close ADF to quotation activity when the ADF is unable to transmit real-time quotation and trade reporting data to the ESIP. Under such circumstances where the ADF closes due to an inability to transmit quotation or trade reporting data under Rule 4120A(a)(2), members would not be prohibited from trading through, another market, such as Nasdaq, that has not halted trading, or within their own systems.

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Any trading halt initiated by NASD would become effective simultaneously with notification via an administrative message sent through the ADF terminal or interface. Trading similarly would resume after an administrative notice has been issued.

### **Obligations When Quoting in Multiple Market Centers**

Existing Rule 2320(g)(2) requires members that display quotations for non-Nasdaq securities in two or more quotation mediums to post the same priced quotations in each medium. Similar to this obligation, new Rule 4613A(e)(1) requires members that display quotations for Nasdaq securities in two or more market centers, including the ADF, to display the same priced quotations in each medium. It does not, however, prohibit displaying different size quotations in two or more mediums or market centers, provided that the price displayed is the same.

### **Obligation to Have Quotations From Other Market Centers in Close Proximity**

New Rule 4613A(e)(2) requires a registered NASD market maker to have in close proximity to the ADF terminal or interface at which it makes a market in a Nasdaq security a quotation service that disseminates quotations in that security from other market centers. A similar rule, Rule 6330(c), currently exists with respect to Consolidated Quotation Service (CQS) market makers. As with the CQS rule, it is NASD's intention for the quotations displayed in the ADF terminals or interfaces to function as a verification mechanism whereby ADF market

participants can monitor their current ADF quotations and ensure that NASD is timely updating and disseminating their quotations. NASD will not disseminate to ADF market participants any consolidated quotation or trade data in a security from securities exchanges and market centers. To ensure that ADF participants have the data necessary to make proper order routing decisions and to satisfy the Vendor Display Rule,<sup>7</sup> NASD requires ADF market participants to obtain from vendors dynamic quotations and last-sale information on the securities they trade through the ADF, and to display this data in close proximity to the ADF data displayed on their terminals, just as is currently required of CQS market makers in Rule 6330(c).

### **OATS Requirements**

OATS requirements will remain substantially the same as current requirements, with one exception. All NASD members must complete an additional field on the OATS execution report indicating where the order was reported. This requirement will enable NASD to clearly identify which execution reports are associated with ADF trade reports and which are associated with Nasdaq trade reports and, thereby, keep this data separate and confidential, as necessary. This requirement will not be effective until September 27, 2002, to allow time for necessary system changes.

All NASD members must continue to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed ("reportable events") by NASD members relating to equity securities traded on Nasdaq. When the



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ADF and Nasdaq are both operating, NASD members, in many cases, will have at least two options as to where they may choose to report their transactions in Nasdaq securities. As such, NASD must “match” OATS execution reports to either TRACS data or ACT data, depending upon where the transaction was reported. By having a field in the OATS execution report indicating where the order was reported, NASD systems will be able to more efficiently compare the execution report to the appropriate trade report.

### **Fees and Assessments**

The fees and assessments applicable to activities through the ADF are contained in the new Rule 7000A Series. The following are fees that will be charged relating to transactions on the ADF: Comparison — \$0.014/side per 100 shares (minimum 400 shares; maximum 7,500 shares); Automated Give-Up — \$0.029/side; Late Report - T+N — \$0.30/side; Browse/query — \$0.28/query; Trade Reporting — \$.029/side (applicable only to reportable transaction not subject to trade comparison through TRACS); and Corrective Transaction Charge —\$0.25.

Members choosing to participate in the ADF will be charged a minimum of \$5,000 for installation costs associated with connecting to the ADF. Additional reimbursement from members will be required for charges incurred by NASD above \$5,000 due to the installation, removal, relocation, or maintenance of terminal and related equipment. However, the ADF will provide members with a credit of up to \$5,000 toward their trade reporting and comparison charges. Members also will be charged an ADF workstation fee of \$275 per month for

each ADF terminal software license and \$550 per month for each ADF server license.

ADF market participants will be charged a quotation update fee of \$.01 per quotation update in the ADF quotation montage. This quotation update fee, however, will apply only to those quotation updates by the member in the ADF that exceed three times the number of transactions reported by the member through the ADF. This quotation update fee will be determined on a monthly basis. By imposing this fee only where the quotation updates significantly exceed the number of transactions reported, this fee structure fairly imposes costs on those members whose quotation activity creates system capacity demands and, therefore, costs not covered by trade reporting fees.

### **Fee Waiver and Discount**

ADF participants will not be charged for transaction and quotation update fees (Rules 7010A(a) and (b), respectively) for a period of up to three months during the initial six months of operation of the ADF. As a result, during this six-month period, for up to three months starting from the initial transaction by an ADF participant, a participant will not be charged transaction or quotation fees. However, the time period for which the three-month “fee waiver” is available concludes at the end of the six-month period, irrespective of whether the member has participated in the ADF for three months. For example, if the ADF has been operational for four months and a market participant begins trading at that time, it only would be eligible for the “fee waiver” for two months.

Also during the initial six months of operation of the ADF, NASD will adjust its fees imposed on trade reporting and quotation activities through the ADF to provide for volume discounts subsequent to the three month "fee waiver" period, as applicable. Specifically, discounted fees will apply to those members that have greater than 2,000 trades per month and for those members that have greater than 8,000 chargeable quotes per month. The volume discounts would apply to all transaction fees incurred under Rule 7010A(a), except the browse/query fee, and all quotation update fees incurred under Rule 7010A(b). The discounts would apply in the increments per the chart below.

For example, if a member had 5,000 trades and 16,000 quotation updates during a month, the discounted fee structure would apply as follows: no discount would apply to the first 2,000 trades; the fees imposed on trades 2,001 through 4,000 would be discounted by 10%; and the fees imposed on trades 4,001 through 5,000 would be discounted by 25%. The quotation update charge on 1,000 quotations (those quotations that exceed three times the number of trades) would not be discounted because it is less than 8,001.

For additional information regarding requirements related to quoting and/or trading through the ADF, members should review the rule text, SEC Approval Order, and other additional ADF documentation available at [http://www.nasd.com/mkt\\_sys/adf\\_info.asp](http://www.nasd.com/mkt_sys/adf_info.asp).

Trades per Month	Chargeable Quote Updates per Month	Discount
Up to 2,000	Up to 8,000	0%
2,001 to 4,000	8,001 to 15,000	10%
4,001 to 6,000	15,001 to 25,000	25%
6,001 to 8,000	25,001 to 35,000	35%
8,001 or greater	35,001 or greater	50%

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## Endnotes

- 1 See Securities Exchange Act Release No. 46249 (July 24, 2002), (File No. SR-NASD-2002-97) (“SEC Approval Order”).
  - 2 See SR-NASD-2001-90. It is possible that the SEC may take action prior the expiration of the pilot period on the proposed rule change to make permanent the ADF for trading both Nasdaq and exchange-listed securities. Fees and assessments applicable to the ADF on a permanent basis are proposed in SR-NASD-2002-28.
  - 3 Securities Exchange Act Release No. 43863 (January 19, 2001), 66 Fed. Reg. 8020 (January 26, 2001) (File No. SR-NASD-99-53).
  - 4 Securities Exchange Act Release No. 44396 (June 7, 2001), 66 Fed. Reg. 31952 (June 13, 2001) (File No. 10-131).
  - 5 The fact that a market participant has an ownership interest in a customer broker/dealer or multilateral linkage provider does not, in itself, constitute influence for the purposes of this rule.
  - 6 TRACS will not perform risk management services that are provided by Nasdaq’s ACT service.
  - 7 Exchange Act Rule 11Ac1-2.
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