INFORMATIONAL

Riskless Principal Trade Reporting

Nasdaq Adopts
Alternative Approach For
Complying With Riskless
Principal Trade-Reporting
Rules And Issues Net
Trading Interpretation;
Riskless Principal TradeReporting Rules Will Be
Implemented On
February 1, 2001

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

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- Operations
- Senior Management
- Systems
- Technology
- Trading & Market Making
- Training

KEY TOPICS

- · Riskless Principal
- Trade Reporting

Executive Summary

The Nasdaq Stock Market, Inc. (Nasdag®) has adopted an alternative approach for reporting riskless principal transactions in Nasdag, over-the-counter (OTC), and exchange-listed securities. Nasdaq also has adopted an interpretation with respect to the use of negative consent letters for net trading of Nasdag and OTC securities. The Riskless Principal Trade-Reporting Rules will be implemented on February 1, 2001. NOTE: This Notice should be read in conjunction with Notices to Members 99-65 and 99-66.

Amendments to the Riskless Principal Trade-Reporting Rules are contained in Attachment A.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Nasdaq Office of General Counsel at (202) 728-8294; Nasdaq MarketWatch at (800) 211-4953; and the Legal Section, Market Regulation Department, NASD Regulation, Inc. (NASD Regulation[™]), at (240) 386-5126.

Background

On March 24, 1999 and July 8, 1999, the Securities and Exchange Commission (SEC) approved proposals to amend the National Association of Securities Dealers. Inc. (NASD®) trade-reporting rules relating to riskless principal transactions (Riskless Principal Trade-Reporting Rules or Rules) in Nasdag National Market®, Nasdag SmallCap Market[™], and Nasdaq convertible debt securities (Nasdag securities); non-Nasdaq OTC equity securities, including OTC Bulletin Board® and pink sheet securities (OTC securities); and exchangelisted securities traded in the

Nasdaq InterMarket[™] (exchangelisted securities).1 Under the new Riskless Principal Trade-Reporting Rules, riskless principal transactions effected by market makers must now be reported as one transaction, as was previously the case for riskless principal transactions effected by non-market makers. Specifically, a "riskless" principal transaction is one in which an NASD member, after having received an order to buy (sell) a security, purchases (sells) the security as principal at the same price to satisfy the order to buy (sell). The Rules require a firm to report a riskless principal trade as one transaction.

Original Approach To Riskless Principal Trade Reporting

Notices to Members 99-65 (discussing the trade-reporting rules for riskless principal transactions effected by market makers in Nasdag and OTC securities) and 99-66 (discussing, among other things, the trade-reporting rules for riskless principal transactions in exchangelisted securities occurring in the Nasdaq InterMarket) were published in August 1999. The Notices provided guidance on compliance with the new Rules, and stated that market makers must report the initial leg of a riskless principal transaction to the Automated Confirmation Transaction Service[™] (ACTSM) and mark the ACT report "riskless principal." The Rules also provide that market makers must not report to ACT the offsetting transaction with the customer. This is the original approach to riskless principal trade reporting by market makers.

After the *Notices* were issued, a number of NASD member firms raised concerns about tradereporting problems presented by the Rules.² The firms represented

that the approach to riskless principal trade reporting by market makers described in *Notices to Members 99-65* and *99-66*, which requires market makers to report the first leg of a riskless principal transaction to ACT and mark the report "riskless principal," would be problematic and would result in inaccurate and/or late reporting of the initial leg of a riskless principal transaction. Specifically, the firms identified the following problems:

- Trades reported by a third party (e.g., an electronic communications network) on behalf of a broker/dealer cannot be properly marked "riskless principal" because market makers do not know whether a particular order will trigger a riskless principal execution at the time the broker/dealer sends the order for execution.
- To the extent Small Order Execution SystemSM (SOESSM) and SelectNet[®] executions trigger a riskless principal execution (for example, as a result of Manning limit order protection), the principal capacity assumed by Nasdaq's systems will be inaccurate.
- Systemic delay would be introduced into the tradereporting process for trades executed within a market maker's own trading system because the system would be required to determine if Manning protection is owed to any orders on the books before the first trade is reported as riskless principal.

The implementation date of the Riskless Principal Trade-Reporting Rules was delayed several times to provide Nasdaq with an opportunity to work with the firms to address these issues.

Alternative Approach To Riskless Principal Trade Reporting

After reviewing concerns raised by the firms, and consultation with the SEC and NASD Regulation, Nasdaq has adopted a different method for reporting riskless principal trades that can be used as an alternative to the original approach set forth in the *Notices*. This new approach can be utilized by both market makers, which for the first time must adhere to Riskless Principal Trade-Reporting Rules, and by non-market makers, which have been subject to the Rules for some time.

Under the alternative approach, member firms may report a riskless principal transaction by submitting either one or two reports to ACT. The first report would be required only if the member is the party with a reporting obligation under the relevant Nasdag trade-reporting rule. The second report, representing the offsetting, "riskless" portion of the transaction with the customer, must be submitted by all members electing to use the alternative method for riskless principal trade reporting. regardless of whether the firm has a reporting obligation, when the firm effects the offsetting trade with its customer. This report will be either a non-tape, non-clearing report (if there is no need to submit clearing information to ACT) or a clearingonly report.4 In either case, the report must be marked with a capacity indicator of "riskless principal." Because this is not a last sale report, it does not have to be submitted within 90 seconds after the transaction is executed, but should be submitted as soon as practicable after the trade is executed but no later than by the time ACT closes for the trading day (currently 6:30 p.m., Eastern Time).

The effect of the new rule can be illustrated by the following examples.

Example 1

A market maker (MM1) holds a customer limit order to sell 1,000 shares of ABCD at \$10 that is displayed in its quote. MM1 sells 1,000 shares to a second market maker (MM2) at \$10. (MM2's bid represents proprietary interest, not a customer order.) When there is a trade between two market makers, the Nasdag trade-reporting rules require the member representing the sell side to report the transaction.5 MM1, the seller in this transaction, reports the sale of 1,000 shares by submitting a last sale report to ACT marked "principal." MM1 then fills its customer order for 1,000 shares. Under the new alternative approach, MM1 would submit either one of the two following reports marked "riskless principal" to ACT for the offsetting, riskless portion of the transaction:

- a clearing-only report if necessary to clear the transaction with the customer; or
- a non-tape, non-clearing report (if a clearing entry is not necessary because, for example, the trade is internalized).

This submission is not entered for reporting purposes and thus there will be no public trade report for this leg of the transaction. Because MM2 did not enter into a riskless principal transaction, MM2 does not have an obligation to submit the second report.

Example 2

Both MM1 and MM2 hold customer limit orders: MM1 holds a marketable customer limit order to

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sell 1.000 shares of ABCD and MM2 holds a customer limit order to buy 1.000 shares of ABCD, both of which are displayed in the market makers' quotes. MM1 sells 1,000 shares to MM2 at \$10. MM1 and MM2 then fill both of their customer orders. MM1 submits two reports to ACT—a last sale report and either a clearing-only report or a non-tape, non-clearing report—as described above. MM2 does not have a reporting obligation under the Nasdag trade-reporting rules because it bought 1,000 shares from MM1. Therefore, it does not submit a last sale report for the transaction with MM1. However, for the offsetting transaction with its customer, MM2 is obligated to submit to ACT either a clearing-only report or a non-tape, non-clearing report marked "riskless principal."

Firm's Discretion On Which Approach To Use

Firms can use either the original approach described in Notices to Members 99-65 and 99-66 or this new alternative approach for reporting riskless principal trades. Also, firms can use either approach for all trades or on a trade-by-trade basis. While the new alternative approach is voluntary, firms that elect not to use this approach must comply with the original approach or they will be in violation of the trade-reporting rules. NOTE: The alternative approach is available for transactions in Nasdag and OTC securities, and for transactions in exchange-listed securities executed off an exchange, but is not available for transactions in exchange-listed securities executed on an exchange, which are reported by the exchange.

All necessary enhancements have been made to ACT to enable firms to report riskless principal trades according to the new Rules.⁶ No ACT fee will be assessed for the non-tape, non-clearing report. An ACT fee will be assessed for the clearing-only report, however, because the firm is receiving clearing services in connection with the report.

Notices to Members 99-65 and 99-66 provide useful guidance on riskless principal trade reporting, including how to determine whether transactions are at the "same price": what constitutes a "riskless" transaction in whole or in part; Order Audit Trail System compliance; and SEC Rule 10b-10 compliance. This guidance is valid whether a firm uses the original approach or the alternative approach to riskless principal trade reporting. Firms should review these Notices in their entirety prior to the implementation of the new Rules.

Net Trading Interpretation— Customer Negative Consent Letters

Nasdaq also has adopted an interpretation regarding a statement from *Notice to Members 99-65* with respect to net trading of Nasdaq and OTC securities. Notice to Members 99-65 announced SEC approval of the Riskless Principal Trade-Reporting Rules and included an attachment containing questions and answers regarding the rule change. A number of the questions and answers in the *Notice* discusses net trading. For example, question and answer 4 states the following:

How does a member determine whether transactions are at the "same price"?

[If] a member is working an order for an institutional account . . . or of a block size

... and the member finds the other side of the order, the presumption will be that the orders will be matched off at the same price (exclusive of any markup or markdown, commission equivalent, or other fee) and reported as riskless principal, unless the customer has specifically requested that the order be traded on a net basis at a different price.

Questions and answers 3, 6, 7, 19, and 20 also address net trading.

After Notice to Members 99-65 was issued, a number of firms raised concerns about the stated presumption that members, which are working an order for an institutional customer and find the other side. will "match off" those orders at the same price. The firms were concerned that the presumption did not reflect the fact that institutional customers have historically expected firms to trade with them on a net basis. The firms also were concerned that such a presumption would place them in the difficult position of having to rebut it on nearly every institutional trade. The firms requested guidance on how to document this understanding, and asked for permission to use "negative consent" letters, citing difficulties with obtaining affirmative consent from customers.

After thorough consideration of this issue, and after consultation with both the SEC and NASD Regulation, Nasdaq has concluded that firms may use negative consent letters to evidence a customer's request to trade on a net basis, as long as the letter meets the following conditions.

 A firm using a negative consent letter to demonstrate a customer request to trade on a

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net basis should send a letter to the customer clearly disclosing the terms and conditions for handling the customer's orders.

- Only one letter must be sent to each customer; a letter is not required for each transaction.
- The customer must be provided with a meaningful opportunity to object to any statements in the letter.
- If no objection is received, the firm may reasonably conclude that the customer has consented to the terms and conditions in the letter and has requested that the firm trade for the customer on a net basis.

Technical Changes To Rules

Nasdaq also has made certain technical changes to the trade-reporting rules. Nasdaq has amended Rule 6130(d)(7) to explicitly include "riskless principal" as a symbol on an ACT trade report, in addition to the principal and agent capacity indicators. The riskless principal symbol already is utilized in Nasdaq systems and in ACT trade reports, so this is not a new requirement; it is merely a technical change that adds this capacity indicator to the current list of symbols in the rule.

Nasdaq also has made technical changes to Rule 6420(d)(3)(B), the trade-reporting rule for exchange-listed securities, to conform the language in that rule to language in Rules 4632(d)(3)(B), 4642(d)(3)(B), 4652(d)(3)(B), and 6620(d)(3)(B),

the trade-reporting rules for Nasdag and OTC securities. In particular, Nasdag proposes to delete language from Rule 6420(d)(3)(B) to ensure consistent application of the Riskless Principal Trade-Reporting Rules to any order received by a member, regardless of the person or entity from which it was received. Specifically, while the current rule refers to orders received from a "customer," the proposed rule simply refers to "an order." Thus, a transaction can be defined as riskless when a market maker is holding an order from a customer, another member, the customer of another member, or any other entity, including nonmember broker/dealers. Furthermore, Nasdag has amended the text of the rule to more clearly provide that riskless principal trades are reported exclusive of any fee, not just markups and markdowns. Identical revisions previously were made to Rules 4632(d)(3)(B), 4642(d)(3)(B), 4652(d)(3)(B), and 6620(d)(3)(B).

Implementation Date

The Riskless Principal Trade-Reporting Rules, both the original and the alternative approach, will be implemented on February 1, 2001. At that time, NASD firms that effect riskless principal transactions in Nasdaq, OTC, and exchange-listed securities must report the transaction in conformance with the new Rules, using either the original approach or the alternative approach, or will be in violation of the trade-reporting rules.

Endnotes

¹ See Securities Exchange Act Release Nos. 41208 (Mar. 24, 1999), 64 Fed. Reg. 15386 (Mar. 31, 1999) (File No. SR-NASD-98-59) and 41606 (July 8, 1999), 64 Fed. Reg. 38226 (July 15, 1999) (File No. SR-NASD-98-08).

²See letter to Belinda Blaine, Associate
Director, SEC, dated February 18, 2000 from
Automated Securities Clearance, Ltd. and
the following NASD member firms: Bernard
L. Madoff Securities; CIBC World Markets;
Credit Suisse First Boston; Deutsche Banc
Alex. Brown; Donaldson, Lufkin & Jenrette;
Goldman Sachs & Co.; Jefferies &
Company, Inc.; Lehman Bros.; Merrill Lynch,
Pierce, Fenner & Smith, Inc.; Morgan
Stanley Dean Witter; and Salomon Smith
Barney Inc.

³The SEC announced the effectiveness of this approach in Securities Exchange Act Release No. 43303 (September 19, 2000), 65 Fed. Reg. 57853 (September 26, 2000) (File No. SR-NASD-00-52).

⁴A non-tape, non-clearing report is a new type of ACT report being introduced in conjunction with the implementation of the alternative approach. As discussed below, there are no fees associated with these reports and they are not reported to the public.

⁵See Rules 4632(b), 4642(b), 4652(b), 6420(b), and 6620(b).

⁶ See Technical Update dated September 6, 2000, available at: http://www.nasdaqtrader.com/Trader/News/technicalupdates/090600.stm.

⁷The SEC announced the effectiveness of this interpretation in Securities Exchange Act Release No. 43103 (August 1, 2000), 65 Fed. Reg. 48774 (August 9, 2000) (File No. SR-NASD-00-44).

ATTACHMENT A

Text Of Rule Changes

Note: New language is underlined; deletions are in brackets.

Rule 4630. Reporting Transactions in Nasdaq National Market Securities

Rule 4632. Transaction Reporting

- (a) through (c) No Change
- (d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

- (1) through (3)(A) No Change
- (3)(B) Exception. A "riskless" principal transaction in which a member, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the markup or mark-down, commissionequivalent, or other fee. Alternatively, a member may report a riskless principal transaction by submitting the following report(s) to ACT:
 - (i) The member with the obligation to report the transaction pursuant to paragraph (b) above must

submit a last sale report for the initial leg of the transaction.

- (ii) Regardless of whether a member has a reporting obligation pursuant to paragraph (b) above, the firm must submit, for the offsetting, "riskless" portion of the transaction, either:
 - a. a clearing-only report with a capacity indicator of "riskless principal," if a clearing report is necessary to clear the transaction; or
 - b. a non-tape, non-clearing report with a capacity indicator of "riskless principal," if a clearing report is not necessary to clear the transaction.

Example:

SELL as a principal 100 shares to another member at 40 to fill an existing order;

BUY as principal 100 shares from a customer at 40 minus a mark-down of \$12.50;

REPORT 100 shares at 40 by submitting to ACT either a single trade report marked with a "riskless principal" capacity indicator or by submitting the following reports:

- (1) where required by this Rule, a tape report marked with a "principal" capacity indicator; and
- (2) either a non-tape, nonclearing report or a clearingonly report marked with a "riskless principal" capacity indicator.
- (e) through (f) No Change

Rule 4640. Reporting Transactions in Nasdaq SmallCap[™] Market Securities

Rule 4642. Transaction Reporting

- (a) through (c) No Change
- (d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

- (1) through (3)(A) No Change
- (3)(B) Exception. A "riskless" principal transaction in which a member, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the markup or mark-down, commissionequivalent, or other fee. Alternatively, a member may report a riskless principal transaction by submitting the following report(s) to ACT:
 - (i) The member with the obligation to report the transaction pursuant to paragraph (b) above must submit a last sale report for the initial leg of the transaction.
 - (ii) Regardless of whether a member has a reporting obligation pursuant to paragraph (b) above, the firm must submit, for the offsetting,

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<u>"riskless" portion of the</u> transaction, either:

a. a clearing-only report with a capacity indicator of "riskless principal," if a clearing report is necessary to clear the transaction; or

b. a non-tape, non-clearing report with a capacity indicator of "riskless principal," if a clearing report is not necessary to clear the transaction.

Example:

SELL as a principal 100 shares to another member at 40 to fill an existing order;

BUY as principal 100 shares from a customer at 40 minus a mark-down of \$12.50;

REPORT 100 shares at 40 by submitting to ACT either a single trade report marked with a "riskless principal" capacity indicator or by submitting the following reports:

- (1) where required by this Rule, a tape report marked with a "principal" capacity indicator; and
- (2) either a non-tape, nonclearing report or a clearingonly report marked with a "riskless principal" capacity indicator.
- (e) through (f) No Change

Rule 4650. Reporting Transactions in Nasdaq Convertible Debt Securities

Rule 4652. Transaction Reporting

- (a) through (c) No Change
- (d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

- (1) through (3)(A) No Change
- (3)(B) Exception. A "riskless" principal transaction in which a member, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the markup or mark-down, commissionequivalent, or other fee. Alternatively, a member may report a riskless principal transaction by submitting the following report(s) to ACT:
 - (i) The member with the obligation to report the transaction pursuant to paragraph (b) above must submit a last sale report for the initial leg of the transaction.
 - (ii) Regardless of whether a member has a reporting

obligation pursuant to paragraph (b) above, the firm must submit, for the offsetting, "riskless" portion of the transaction, either:

a. a clearing-only report with a capacity indicator of "riskless principal," if a clearing report is necessary to clear the transaction; or

b. a non-tape, non-clearing report with a capacity indicator of "riskless principal," if a clearing report is not necessary to clear the transaction.

Example:

SELL as a principal 100 shares to another member at 40 to fill an existing order;

BUY as principal 100 shares from a customer at 40 minus a mark-down of \$12.50;

REPORT 100 shares at 40 by submitting to ACT either a single trade report marked with a "riskless principal" capacity indicator or by submitting the following reports:

- (1) where required by this Rule, a tape report marked with a "principal" capacity indicator; and
- (2) either a non-tape, nonclearing report or a clearingonly report marked with a "riskless principal" capacity indicator.
- (e) through (f) No Change

Rule 6000. NASD SYSTEMS AND PROGRAMS

Rule 6100. AUTOMATED CONFIRMATION TRANSACTION SERVICE (ACT)

Rule 6130. Trade Report Input

- (a) through (c) No Change
- (d) Trade Report To Be Input
 - (7) A symbol indicating whether the trade is as principal, <u>riskless</u> <u>principal</u>, or agent
- (e) No Change

Rule 6400. REPORTING TRANSACTIONS IN LISTED SECURITIES

Rule 6420. Transaction Reporting

- (a) through (c) No Change
- (d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

- (1) through (3)(A) No Change
- (3)(B) Exception. A "riskless" principal transaction in which a member, after having received [from a customer] an order to buy a security, purchases the security as principal [from another

member or customer] at the same price to satisfy the order to buy or, after having received [from a customer] an order to sell, sells the security as principal [to another member] at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction. excluding the mark-up or markdown, commission-equivalent, or other fee. Alternatively, a member may report a riskless principal transaction by submitting the following report(s) to ACT:

- (i) The member with the obligation to report the transaction pursuant to paragraph (b) above must submit a last sale report for the initial leg of the transaction.
- (ii) Regardless of whether a member has a reporting obligation pursuant to paragraph (b) above, the firm must submit, for the offsetting, "riskless" portion of the transaction, either:
 - a. a clearing-only report with a capacity indicator of "riskless principal," if a clearing report is necessary to clear the transaction; or
 - b. a non-tape, non-clearing report with a capacity indicator of "riskless principal," if a clearing report is not necessary to clear the transaction.

A riskless principal transaction in which a member purchases or sells the security on an exchange to satisfy a customer's order will be reported by the exchange and the member shall not report.

Example:

BUY as principal 100 shares from another member at 40 to fill an existing order;

SELL as principal 100 shares to a customer at 40 plus mark-up of \$12.50;

REPORT 100 shares at 40 by submitting to ACT either a single trade report marked with a "riskless principal" capacity indicator or by submitting the following reports:

- (1) where required by this Rule, a tape report marked with a "principal" capacity indicator; and
- (2) either a non-tape, nonclearing report or a clearingonly report marked with a "riskless principal" capacity indicator.

Example:

BUY as principal 100 shares on an exchange at 40 to fill an existing order;

SELL as principal 100 shares to a customer at 40 plus a markup of \$12.50;

DO NOT REPORT (will be reported by exchange).

(e) No Change

Rule 6600. REPORTING TRANSACTIONS IN OVER-THE-COUNTER EQUITY SECURITIES

Rule 6620. Transaction Reporting

- (a) through (c) No Change
- (d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

- (1) through (3)(A) No Change
- (3)(B) Exception, A "riskless" principal transaction in which a member, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the markup or mark-down, commissionequivalent, or other fee.

Alternatively, a member may report a riskless principal transaction by submitting the following report(s) to ACT:

- (i) The member with the obligation to report the transaction pursuant to paragraph (b) above must submit a last sale report for the initial leg of the transaction.
- (ii) Regardless of whether a member has a reporting obligation pursuant to paragraph (b) above, the firm must submit, for the offsetting, "riskless" portion of the transaction, either:
 - a. a clearing-only report with a capacity indicator of "riskless principal," if a clearing report is necessary to clear the transaction; or
 - b. a non-tape, non-clearing report with a capacity indicator of "riskless principal," if a clearing report is not necessary to clear the transaction.

Example:

SELL as a principal 100 shares to another member at 40 to fill an existing order;

BUY as principal 100 shares from a customer at 40 minus a mark-down of \$12.50:

REPORT 100 shares at 40 by submitting to ACT either a single trade report marked with a "riskless principal" capacity indicator or by submitting the following reports:

- (1) where required by this Rule, a tape report marked with a "principal" capacity indicator; and
- (2) either a non-tape, nonclearing report or a clearingonly report marked with a "riskless principal" capacity indicator.
- (e) through (f) No Change

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