

**INFORMATIONAL**

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## Trading Obligations

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NASD Regulation, Inc. Reiterates The Obligation Of Member Firms To Comply With Trading Rules, Particularly Immediately Prior To The Close On Expiration Fridays And Index Rebalancing Days

**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.*

- Legal & Compliance
- Senior Management
- Trading & Market Making

**KEY TOPICS**

- Best Execution
- Firm Quote Compliance
- Locked/Crossed Markets

**Executive Summary**

As more derivative instruments overlay securities listed on The Nasdaq Stock Market ("Nasdaq") and more Nasdaq-listed securities are included in broad-based and narrow-based stock indexes, the amount of trading activity on Nasdaq attributable to and associated with derivative trading strategies and indexation strategies has likewise increased. For example, it is not uncommon for Nasdaq market makers to experience large buy and sell imbalances in particular Nasdaq stocks at the close of trading on Expiration Fridays and index rebalancing days, such as the upcoming rebalancing of the Russell Indexes at the end of June. In addition, it is not uncommon for one market maker to experience a large buy imbalance while another market maker in the same stock simultaneously experiences a large sell imbalance. Accordingly, because these "order surges" may cause market makers to act in a manner that contributes to short-term price volatility, it is critically important that NASD members adhere to all trading rules that are designed to keep Nasdaq securities at their equilibrium price levels. Specifically, during times of heavy volume, it is essential that member firms comply with the NASD's locked and crossed market rule, respond to liability SelectNet orders in conformance with the Securities and Exchange Commission's ("SEC's") firm quote rule, and report their trades in a timely and accurate manner. In addition, while this *Notice* focuses primarily on regulatory requirements at the close of trading on Expiration Fridays and index rebalancing days, these same regulatory requirements apply equally throughout the entire trading day.

As discussed in more detail below, *failure to adhere to the locked and crossed market rule, coupled with failure to respond to SelectNet liability orders and other trading activity, could constitute manipulative conduct in violation of SEC and NASD anti-fraud provisions (SEC Rule 10b-5 and NASD Rule 2120), as well as a violation of the locked and crossed markets rule, firm quote rule, and just and equitable principles of trade. In addition to subjecting member firms to potential disciplinary action, such activity could also subject individual traders to potential disciplinary action.*

**Questions/Further Information**

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>), at (301) 590-6410; or the Office of General Counsel, The Nasdaq Stock Market, at (202) 728-8294.

**Discussion*****Locked/Crossed Markets***

NASD Rule 4613(e) provides that a market participant shall not, except as provided below, enter or maintain a quotation in Nasdaq during normal market hours if the bid (ask) quotation entered is equal to or greater (less) than the ask (bid) quotation of another market participant entering quotations in the same security. First, a market participant may lock or cross the market if, prior to entering the quotation that locks or crosses the market, the market participant first makes reasonable efforts to avoid such locked or crossed market by attempting to execute transactions with all market participants whose quotations would be locked or

crossed. While the rule does not define what constitutes a reasonable effort to avoid a locked or crossed market, Nasdaq and NASD Regulation staff have previously stated that sending a preferenced SelectNet message for a duration of at least 30 seconds constitutes a reasonable attempt to trade.<sup>1</sup> Second, in the event that extraordinary circumstances exist, a market participant may lock or cross the market regardless of whether it has first made reasonable efforts to trade with those market participants whose quotes would be locked or crossed. While the rule does not define "extraordinary circumstances," Nasdaq and NASD Regulation believe such circumstances generally could exist when there are systemic, market-wide failures in the operation of Nasdaq quotation, execution, or trade reporting and dissemination systems that render Nasdaq quotations virtually inaccessible and/or wholly unrelated to current market activity.

Accordingly, just as is the case during the entire normal trading day, if a market participant locks the market immediately prior to the close on an Expiration Friday or index rebalancing day, that market participant is obligated to have first made a reasonable attempt to trade with all market participants whose quotes would be locked or crossed.<sup>2</sup> NASD Regulation also reiterates that member firms that are party to a locked or crossed market have an obligation to not maintain the locked or crossed market, regardless of whether the member initiated the lock or cross. These obligations to avoid a locked or crossed market exist regardless of any order imbalance that a market maker may have. In addition, given the importance of assuring accurate prices at and

around the close, NASD Regulation will closely review all locked and crossed activity during this time period. Disciplinary action will be considered with respect to even single instances of violative activity.

#### ***Firm Quote Compliance***

Members also are reminded of their obligation to honor their quotes pursuant to the SEC and NASD firm quote rules throughout the trading day and particularly during times of peak volume.<sup>3</sup> Failure to honor quotes has an adverse impact on price discovery and undermines the integrity and fairness of the Nasdaq market. NASD Regulation is particularly concerned that members not back away from liability SelectNet orders in an attempt improperly to establish closing prices. Accordingly, depending on the circumstances, disciplinary action will be considered for even a single firm quote violation occurring at the close of trading on Expiration Fridays and index rebalancing days.

#### ***Best Execution***

Member firms should also be aware of the best execution issues that may arise in the context of locked and crossed markets. Members are reminded that they must use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. A member firm's obligation to provide best execution to any customer order includes the execution of guaranteed market-on-open and market-on-close customer orders. It is important to note that the application of best execution concepts necessarily involves a "facts and circumstances" analysis. In determining whether it is

providing best execution, a member firm should consider the market impact of its trading and quotation activity prior to the open and close and the effect it may have on the ultimate execution of its customer orders. This determination is necessary in all cases, including those where the member firm exposes itself to significant risk by accepting large, guaranteed market-on-open or market-on-close orders.

Members are also reminded that under certain facts and circumstances locking and crossing the market and backing away from SelectNet liability orders can constitute manipulative conduct in violation of SEC Rule 10b-5 and NASD Conduct Rule 2120. For example, when handling a large market-on-close order to buy, it would raise serious regulatory concerns if a market maker were to lock or cross the market by raising its bid without first making an attempt to trade with those market participants whose ask quotations would be locked or crossed, fail to honor its quote on the bid side of the market, and thereafter execute an order at its bid price either internally or through SOES on a riskless principal basis pursuant to NASD Marketplace Rule 4730(b)(4). NASD Regulation could view such activity as a manipulative attempt to set the last sale price in the issue. In addition, even though a market maker does not necessarily have control over whether it receives an execution from another firm through SOES when it has locked or crossed the market, if a market maker were to exhibit a pattern of locking or crossing the market at the close in a manner that ensures SOES executions while handling a market-on-close order, NASD Regulation would closely examine whether such a pattern constituted

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## Special NASD Notice to Members 00-42

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manipulation. In sum, while NASD Regulation recognizes that market activity during some Expiration Fridays and index rebalancing days may increase certain risks, NASD Regulation nevertheless reiterates that assuming such additional risks for business and competitive purposes does not excuse a member from complying with NASD rules.

### Endnotes

<sup>1</sup>Nasdaq and NASD Regulation note that implementation of SuperSOES, with its expanded automatic execution capabilities, will enable market participants to trade more readily with each other to avoid locked or crossed markets.

<sup>2</sup>Members are also reminded of their obligation to comply with the NASD's new rule governing locked and crossed markets during the pre-opening that went into effect on June 5, 2000. For a detailed discussion of the new pre-opening locked and crossed

market rule, see *Notice to Members 00-29* (May 2000). NASD Regulation and Nasdaq believe that adherence to this new rule will facilitate more orderly openings on Nasdaq.

<sup>3</sup>For a more detailed discussion of members' firm quote obligations, see *Notice to Members 97-67* (October 1997).

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