

INFORMATIONAL

Locked/Crossed Markets

SEC Approves Changes To Nasdaq Locked/Crossed Markets Rule; **Effective Date: June 5, 2000**

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KEY TOPICS

- Locked/Crossed Markets
- NASD Rule 4613

Executive Summary

On February 7, 2000, the Securities and Exchange Commission (SEC) approved changes to National Association of Securities Dealers, Inc. (NASD[®]) Rule 4613(e), which relates to the entering of locking and crossing quotes by Nasdaq[®] market participants (Market Makers and electronic communications networks (ECNs)). The rule change alters market participants' obligations regarding the entry of locking/crossing quotes prior to the opening of the Nasdaq market at 9:30 a.m. Eastern Time (ET), and sets out specific obligations for parties to a lock/cross, which are determined based on the time the locked/crossed market occurs.

Attachment A includes a question and answer section which explains the major points of the rule changes. Attachment B includes the text of the amended rule.

The rule amendments will go into effect on June 5, 2000.

Questions/Further Information

Questions regarding this *Notice* should be addressed to John Malitzis, Assistant General Counsel, Office of General Counsel, The Nasdaq Stock Market, Inc. (The Nasdaq Stock Market[®]), at (202) 728-8245; or Thomas Moran, Assistant General Counsel, Office of General Counsel, The Nasdaq Stock Market, at (202) 728-8401; or the Legal Section, Market Regulation Department, NASD Regulation, Inc. (NASD RegulationSM), at (301) 590-6410.

Discussion

To address ongoing concerns with locked/crossed markets on the open, Nasdaq proposed and the SEC approved changes (on

February 7, 2000) to NASD Rule 4613(e). The rule change alters market participants' obligations regarding the entry of locking/crossing quotes prior to the opening of Nasdaq, and sets out specific obligations for parties to a lock/cross. The rule amendments generally allow market participants that enter a locking/crossing quote to send a special message to the party being locked/crossed, and the party being locked/crossed must respond to the message within 30 seconds by trading in full with it or moving its quotation out of the way (*i.e.*, to a price level that resolves the locked/crossed market). As noted below, the **obligations** of the parties to a lock/cross will vary slightly depending on whether the lock/cross occurs prior to or after 9:20 a.m., ET.

Market Participants' Obligations***Locks/Crosses Occurring At Or After 9:20 And Before 9:30 a.m., ET***

If a market participant enters a locking/crossing quotation between 9:20:00 a.m. and 9:29:59 a.m. ET, the market participant **must** send to the Market Maker(s) or ECN(s) being locked/crossed a SelectNet[®] message with a "Trade-or-Move" administrative Message (Trade-or-Move Message). (Nasdaq is requiring market participants to append this administrative message to the SelectNet message so that the receiving market participant knows that it owes an obligation to respond to the incoming order.)¹ The Trade-or-Move Message must be sent immediately after entering a locking/crossing quotation, and must be priced at (or better than) the quote of the market participant(s) being locked/crossed. Additionally, the market participant initiating the lock/cross must send

Trade-or-Move Message(s) whose aggregate size is 5,000 shares (*i.e.*, the total number of shares the market participant must send is 5,000 shares). This means that if the market participant is locking/crossing a single Market Maker or a single ECN, it must send one Trade-or-Move Message for 5,000 shares. If the market participant is locking/crossing multiple market participants, it must send each Market Maker or ECN a Trade-or-Move Message and the aggregate size of all of these messages being sent must be 5,000 shares.²

Locks/Crosses Prior To 9:20 a.m., ET

For locks/crosses that occur prior to 9:20 a.m. ET, any party to a lock/cross would have the right, but not the obligation, to send, **beginning at 9:20 a.m.**, a Trade-or-Move Message of any size to any party to the lock/cross. Unlike locks/crosses that occur at or after 9:20 a.m., however, there is no requirement that the market participant initiating the lock/cross send a specific number of shares to those being locked/crossed.

Obligations Regarding "Trade-or-Move Messages"

A market participant that receives a Trade-or-Move Message between 9:20:00 a.m. and 9:29:59 a.m., must within 30 seconds (of receipt of the message) trade in full with the incoming message or must move its quote to a price level that unlocks/uncrosses the market.

A market participant may partially execute the incoming Trade-or-Move Message, but it then must move its quote out of the way within 30 seconds of receiving the Trade-or-Move Message because it has not executed the full size of the order.

In addition, if the receiving market participant trades in full with the message, the market participant may maintain its quote at the locking/crossing price (*i.e.*, not move) if it wishes to trade more shares. Thereafter, any party to the lock/cross has the right, but not the obligation, to send a subsequent Trade-or-Move Message of any size to any other party to the lock/cross. As always, any party to the lock/cross that receives a Trade-or-Move Message must trade in full or move within 30 seconds.

If a party receives a Trade-or-Move Message and stays at its quote without trading in full, this will be considered a violation of NASD Rule 4613(e). In addition, it could be inconsistent with just and equitable principles of trade for a market participant to send a Trade-or-Move Message when not required to by the rule (*e.g.*, before 9:20 a.m. or after 9:30 a.m.) and/or to send a Trade-or-Move Message that does not meet the requirements of the rule (*e.g.*, at a price that is inferior to the receiving market participant's quote). NASD Regulation will surveil for violations of Rule 4613(e) and will bring disciplinary action when appropriate.

The following are examples of how the rule will work.

Example 1. At 9:21 a.m., MMA locks four market participants—MMB, MMC, MMD, and MME—each quoting 1,000 shares. Since the lock has occurred **after 9:20 a.m.**, MMA must send a total of 5,000 shares to these four Market Makers, and must send a Trade-or-Move Message to each party to the lock. Accordingly, MMA sends a Trade-or-Move Message for 1,100 shares to MMB, which declines and moves. MMC receives a 1,500 message, fills it partially (1,000 shares), and as required, moves its quote out of the way. MMD receives a message for 400 shares, and within 30 seconds fills it in full and elects to move down 1/8th to unlock the market. MME receives a 2,000 share message, and fills it completely within 30 seconds; MME is permitted to maintain its quote at the lock price (or it may move its quote to unlock the market). MME also may send a Trade-or-Move Message of any size to MMA, which must trade in full or move, or MMA may send another Trade-or-Move Message of any size to MME, which then would have to trade in full or move.

Example 2. At 9:18 a.m., MMW and MMX are bidding \$74, and MMY and MMZ enter offer prices of \$73, thus crossing the market. At 9:20 a.m., all four market participants would have the right to send a Trade-or-Move Message of any size to either of the two market participants crossing them. Any party receiving a Trade-or-Move Message after 9:20 would be required to trade in full or move its quote out of the way within 30 seconds.

ATTACHMENT A

Questions And Answers

1. When will the rule amendments be implemented?

A. The rule amendments will go into effect on June 5, 2000.

2. What is the relationship between the new rule and the rule that currently governs pre-opening locks/crosses, which requires a market participant that enters a locking/crossing quote between 9:25 a.m. and 9:29:59, to take action to unlock/uncross the market within 30 seconds of open?

A. The 9:25 Lock/Cross Rule is being rescinded and it will be replaced completely by the new rule described in this *Notice*. As is the case today, if a market participant wishes to enter a quote at or after 9:30 a.m. that locks/crosses the market, the market participant must take reasonable action to avoid locking/crossing the market by, for example, sending a Nasdaq-system order (via SelectNet or Nasdaq National Market[®] Execution System) to the participant(s) that would be locked/crossed. Additionally, if a market participant is party to a lock/cross that is created prior to the open and that is not resolved by 9:30:00 a.m., the parties to the lock/cross still must take reasonable action to resolve the lock/cross when the market opens.

For example, at 9:25:00 a.m., MMA locks MMB at a price of \$20, and consistent with Rule 4613(e), MMA sends MMB a 5,000 share Trade-or-Move Message. At 9:25:20 MMB trades in full with MMA's message, and consistent with Rule 4613(e), MMA opts to stay at \$20 and not unlock the market. Since the lock/cross remains in place at

9:30:00, both parties to the lock/cross must take reasonable action at the open to resolve the locked/crossed markets.

The only exception to this general rule is situations where the Trade-or-Move Message remains "live" when the market opens (*i.e.*, the 30 seconds to respond the Trade-or-Move Message carries over into the market's opening) because the lock/cross was created (and the message was sent) in the last 29 seconds before the market opens. **See** Question 6 below for further explanation.

3. How will Market Makers and ECNs denote that a SelectNet message is a Trade-or-Move Message?

A. Nasdaq has added a new "canned" administrative message to SelectNet, which is denoted as "TRD OR MOV." The "TRD OR MOV" administrative message is generated by typing in the text message area of a SelectNet order "TRD OR MOV" or by entering a "6" which will enter the text "TRD OR MOV."

4. If a market participant receives a SelectNet message between 9:20:00 and 9:29:59 a.m. that does not contain the "TRD OR MOV" administrative message, does the recipient owe an obligation to trade or move under NASD Rule 4613(e)?

A. No. If the SelectNet message is sent between 9:20:00 and 9:29:59 a.m. and it does not contain the "TRD OR MOV" administrative message, the recipient owes no obligation to it under NASD Rule 4613(e). It would be a violation of Rule 4613(e) for a market participant to initiate a lock/cross during this period without sending a SelectNet message(s) for at least

5,000 shares with the "TRD OR MOV" administrative message.

5. If a Market Maker or ECN sends a Trade-or-Move Message prior to 9:20 a.m., is the recipient required to trade in full or move under Rule 4613(e)?

A. No. Under Rule 4613(e), the obligation to trade in full or move only attaches if the message is sent between 9:20:00 a.m. and 9:29:59. Thus, if a Market Maker or ECN receives a Trade-or-Move Message prior to 9:20 a.m., the market participant owes no obligation to the message under Rule 4613(e).

6. If a Market Maker receives a Trade-or-Move Message within the last 30 seconds before the opening (*i.e.*, at or after 9:29:30 a.m.), does the Market Maker still have the obligation to trade or move within 30 seconds?

A. Yes. The Market Maker would still have an obligation to trade or move within 30 seconds even if the end of that 30 seconds occurs after the market's open. In this narrow circumstance, the parties to the lock/cross will not have an obligation under Rule 4613(e) to take further action after the 30 seconds has elapsed to resolve the lock/cross that was created prior to the open. Rather, because the Trade-or-Move Message remained "live" when the market opened (*i.e.*, the 30 seconds to respond to the Trade-or-Move Message carried over into the market's opening), the parties to the lock/cross may be deemed to have taken reasonable action to resolve the lock/cross. This, of course, assumes that the parties have fully complied with their obligations under the rule by timely sending Trade-or-Move Messages and properly responding to Trade-or-Move Messages when received.

7. If a market participant receives a Trade-or-Move Message between 9:20:00 a.m. and 9:29:59 a.m. and moves out of the way within 30 seconds, does the member violate the firm quote rule?

A. No, assuming the market participant's quote is closed when the order was presented, as is normal practice in the period prior to 9:30:00 a.m.

8. If a market participant receives a Trade-or-Move Message before the opening and the 30 seconds to act falls after the opening, would it be consistent with the firm quote rule if the market participant moved out of the way when the market opened at 9:30:00 a.m.?

A. Yes. If a market participant receives a Trade-or-Move Message prior to 9:30:00 a.m. that is at or better than its quoted price and is at or less than its quoted size, it would be consistent with the firm quote rule if after the market opens the market participant declined to trade with the message and moved its quote out of the way. (This assumes that the market participant moves out of the way within 30 seconds of receiving the Trade-or-Move Message.) This is because the market participant was presented with the order prior to the market's open when the market participant's quote was closed.

For example, MMA is bidding \$20 for 1,000 shares when at 9:29:50 it receives from MMB a Trade-or-Move Message to sell 1,000 shares for \$20. It would be consistent with the locked/crossed and firm quote rules if at 9:30:15 MMA moved its bid out of the way without filling MMB's Trade-or-Move Message.

9. If a market participant receives a Trade-or-Move Message between 9:20:00 and 9:29:59 a.m. and does

not fill the order or move out of the way within 30 seconds, does the member violate the firm quote rule?

A. It is Nasdaq's and NASD Regulation's view that if a party receives a Trade-or-Move Message and stays at its quote without trading at all or without trading in full, this generally would be considered a violation of NASD Rule 4613(e) regarding locked/crossed markets, and not a violation of the firm quote rule.

10. If a market participant receives a Trade-or-Move Message and in a manner consistent with the rule, moves its quote out of the way, does the market participant have to actually decline the message?

A. No. The rule only requires the recipient of a Trade-or-Move Message to move out of the way within 30 seconds of receipt of such message. In these situations, market participants do not have to (and for capacity reasons should not) decline a Trade-or-Move Message.

11. If a Market Maker or ECN enters a locking/crossing quote between 9:20:00 and 9:29:59 a.m., when must the Market Maker or ECN send the Trade-or-Move Message?

A. The rule requires the market participant to send the Trade-or-Move Message **immediately** after entering the locking/crossing quote. It would be considered a violation of NASD Rule 4613(e) if a market participant that initiates the lock/cross delays sending a Trade-or-Move Message to the party or parties it is locking/crossing. NASD Regulation will surveil for these types of delays and will take disciplinary action when appropriate.

12. If a Market Maker or ECN enters a locking/crossing quote between 9:20:00 and 9:29:59 a.m., is the Market Maker or ECN required to send a single 5,000-share Trade-or-Move Message or multiple 5,000-share messages?

A. The market participant initiating the lock/cross must send a Trade-or-Move Message to each market participant that it will lock or cross. The rule states that the **total size** of all Trade-or-Move Messages must be at least 5,000 shares. This 5,000-share requirement applies to Market Makers and ECNs alike. Accordingly, a Market Maker or ECN may not lock/cross the market in the period between 9:20:00 and 9:29:00 a.m., unless the Market Maker or ECN sends a Trade-or-Move Message for at least an aggregate of 5,000 shares.

For example, if MMA will lock/cross MMC and MMD which are each displaying 1,000 shares in their quotes, MMA must send two Trade-or-Move Messages and the total size of these two messages must be 5,000 shares. While the rule does not specify the size of the individual message that a market participant initiating the lock/cross must send, it must be for at least one normal unit of trading (100 shares).

Additionally, a market participant should (when possible) attempt to match the quote sizes of the market participant(s) being locked/crossed. Thus, if MMA were locking MMC for 2,000 shares, MMD for 2,000 shares, and MME for 100 shares, it would not be consistent with the spirit of the rule for MMA to send MMC and MMD 100 shares each, and MME the remaining 4,800.

13. If a Market Maker or ECN enters a locking/crossing quote between 9:20:00 and 9:29:59 a.m.

and is only locking/crossing one Market Maker or ECN which is displaying less than 5,000 shares, is the market participant initiating the lock/cross still subject to the 5,000-share requirement?

A. Yes. The Market Maker or ECN initiating the lock/cross must send the single market participant being locked/crossed a Trade-or-Move Message for 5,000 shares.

14. What are an ECN's options for handling an order received between 9:20:00 a.m. and 9:29:59 a.m., that is less than 5,000 shares and that would lock/cross the market if displayed in Nasdaq during that period?

A. During the 9:20:00 to 9:29:59 a.m. time period, an ECN may not display in Nasdaq an order for less than 5,000 shares that would lock/cross the market. Instead, the ECN may: (1) attempt to match off the order internally with the order of another subscriber; (2) attempt to fill the order by sending a "regular" SelectNet message to the market participant(s) it would lock/cross; or (3) wait to accumulate at least 5,000 shares and then send the appropriate Trade-or-Move Message(s). When the market opens at 9:30 a.m., the ECN would be obligated to handle the order in a manner consistent with the SEC's Order Handling Rules and NASD rules.

However, in response to concerns that certain agency interest may not be represented in the pre-opening, Nasdaq recently submitted a

proposed rule change to the SEC, which would allow a market participant to lock/cross the market for less than 5,000 shares if it is representing only agency orders. Under the amendment, if between 9:20 a.m. and 9:29 a.m., a market participant receives an agency order that would lock/cross the market, the market participant would be able to lock/cross the market and send a Trade-or-Move Message for the "actual size" of the agency order, instead of 5,000 shares. In essence, agency orders would be "exempt" from the 5,000-share requirement. **Note: This rule change has not been approved by the SEC. We will inform the membership of the progress of this proposed rule change.**

15. If a market participant enters a locking/crossing quote before 9:20 a.m. and the market remains locked/crossed after 9:20 a.m., what are that market participant's obligations?

A. Prior to 9:20 a.m., the market participant can send any party a "regular" SelectNet message, which the recipient is free to trade with, decline, or ignore. At and after 9:20:00 a.m., if the market is still locked or crossed, any party to a lock/cross has the right, but not the obligation, to send a Trade-or-Move Message to any party to the lock/cross. The message may be of any size (assuming at least one minimum unit of trading). The recipient of a Trade-or-Move Message then is required to trade in full or move out of the way within 30 seconds.

16. MMA and MMB lock each other at 9:18 a.m. At 9:25, while MMA and MMB are still locked, MMC joins the locked market. Is MMC obligated to send a Trade-or-Move Message (for a total of 5,000 shares) to the parties it is locking/crossing even though the security was already locked/crossed?

A. Yes. A market participant's obligations under Rule 4613(e) are determined by the time it locks/crosses the market or joins an existing locked/crossed market. In the scenario described above, MMC must send a Trade-or-Move Message(s) for a total of 5,000 shares because MMC joined the lock at 9:25 a.m.

17. After the SOES/SelectNet integration occurs and the Nasdaq National Market Execution System begins operation, will market participants still use SelectNet to deliver Trade-or-Move Messages during the 9:20 to 9:29:59 a.m. period?

A. Yes. Market participants will use the SelectNet system to deliver Trade-or-Move Messages. The automatic execution features of the Nasdaq National Market Execution System will not be available during pre-opening hours, but SelectNet will be available during the pre- and post-market hours as is the case today. Unlike normal market hours, there will be no "over-sized" order requirement for Trade-or-Move and regular SelectNet messages during pre- and post-market hours.³

ATTACHMENT B

(Note: New text is underlined; deletions are bracketed.)

4613. Character of Quotations**(a) - (d) No Changes****(e) Locked and Crossed Markets**

(1) A market maker shall not, except under extraordinary circumstances, enter or maintain quotations in Nasdaq during normal business hours if:

(A) the bid quotation entered is equal to (“lock”) or greater than (“cross”) the asked quotation of another market maker entering quotations in the same security; or

(B) the asked quotation is equal to (“lock”) or less than (“cross”) the bid quotation of another market maker entering quotations in the same security.

[The prohibitions of this rule include the entry of a locking or crossing quotation at or after 9:25:00 a.m. Eastern Time if such quotation continues to lock or cross the market at the market’s opening, and requires a market maker or ECN that enters a locking or crossing quotation at or after 9:25:00 a.m. Eastern Time to take action to avoid the lock or cross at the market’s open or immediately thereafter, but in no case more than 30 seconds after 9:30:00 a.m.]

(C) Obligations Regarding Locked/Crossed Market Conditions Prior to Market Opening

(i) Locked/Crossed Market Prior to 9:20 a.m. — For locks/crosses that occur prior to 9:20 a.m. Eastern Time, a market maker that is a party to a lock/cross because the market maker either has entered a bid(ask) quotation that locks/crosses another market maker’s quotation(s) or has had its quotation(s) locked/crossed by another market maker (“party to a lock/cross”) may, beginning at 9:20 a.m. Eastern Time, send through Nasdaq’s SelectNet system (or its successor system) a Message of any size that is at the receiving market maker’s quoted price (“Trade-or-Move Message”). Any market maker that receives a Trade-or-Move Message at or after 9:20 a.m. Eastern Time, and that is a party to a lock/cross, must within 30 seconds of receiving such Message either: fill the incoming Trade-or-Move Message for the full size of the Message; or move its bid down (offer up) by a quotation increment that unlocks/uncrosses the market.

(ii) Locked/Crossed Market Between 9:20 and 9:29:59 a.m. — If a market maker locks or crosses the market

between 9:20 and 9:29:59 a.m. Eastern Time, the market maker must immediately send through SelectNet to the market maker whose quotes it is locking or crossing a Trade-or-Move Message that is at the receiving market maker’s quoted price and that is for at least 5,000 shares (in instances where there are multiple market makers to a lock/cross, the locking/crossing market maker must send a Message to each party to the lock/cross and the aggregate size of all such Messages must be at least 5,000 shares). A market maker that receives a Trade-or-Move Message during this period and that is a party to a lock/cross, must within 30 seconds of receiving such Message either: fill the incoming Trade-or-Move Message for the full size of the Message; or move its bid down (offer up) by a quotation increment that unlocks/uncrosses the market.

(iii) A market maker that sends a Trade-or-Move Message pursuant to subparagraphs (e)(1)(C)(i) or (e)(1)(C)(ii) of this rule must append to the message a Nasdaq-provided symbol indicating that it is a Trade-or-Move Message.

(2) - (3) No Changes**Endnotes**

¹This will allow market participants to distinguish Trade-or-Move Messages (to which it has an obligation to respond under the rule proposed herein) from other pre-opening Messages that a market participant may receive.

²Thus, a market participant would be prohibited from locking/crossing the market in the 10-minute period prior to the open unless the actively locking/crossing market participant is willing to trade at least 5,000 shares.

³See NASD Rule 4720(c).

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