NASD Notice to Members 99-66

SEC Approves Prior Reference Price Trade Modifier, Changes To Bunching Rules, And Riskless Principal Trade-Reporting Rules For The Third Market

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Executive Summary

On July 8, 1999, the Securities and Exchange Commission (SEC or Commission) approved a rule change to:

1) implement a new trade report modifier to identify trades effected at a prior reference price (.PRP modifier);

2) eliminate the 10,000-share limitation on individual trades that may be "bunched" for trade-reporting purposes for trades that are effected on the first day of secondary market trading; and

3) require Market Makers in the Third Market to report trades under the current riskless principal rules that apply to non-Market Makers in the Third Market.

Additionally, on July 23, 1999, the SEC approved a rule change to eliminate an unnecessary provision in National Association of Securities Dealers, Inc. (NASD®) Rule 6420 relating to the reporting of transactions in exchange-listed securities traded in the Third Market.

This *Notice* includes questions and answers regarding the rule changes (Attachment A); and the text of the rule changes (Attachment B). The rule changes go into effect on September 30, 1999.

Questions/Further Information

Questions concerning this *Notice* may be directed to the Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8294 or the Legal Section, Market Regulation, NASD Regulation, Inc., (NASD Regulation®) at (301) 590-6410.

Discussion

1. Prior Reference Price Modifier

Nasdaq® is implementing a new modifier to report late executions (as distinguished from late trade reports), which will be used for trade reports in Nasdaq securities (both Nasdaq National Market® (NNM) and SmallCap℠ securities) and non-Nasdaq over-the-counter equity securities (*e.g.*, OTC Bulletin Board® and pink sheets).

Recently there have been situations in which members execute certain transactions that, although reported timely, actually relate to an obligation to trade that arose at an earlier point in the day or that refer to a prior reference price. These situations include:

1) obligations to trade arising from a preferenced SelectNet℠ order that was not executed timely;

2) orders that are owed the opening or closing price ("market on open" and "market on close") but that are not executed within 90 seconds of the open or close of the market, respectively; and

3) orders that may have been lost or misplaced and later filled.

In effect, these trades are late executions, not late reports of executions.

To enable market participants to more accurately report late executions (which many firms today report as .SLD trades), Nasdaq is implementing a new trade report modifier, called the ".PRP" modifier. This modifier must be appended to trade reports that reflect a price that is different from the current market because the execution is based on a prior reference point in time. Additionally, when using the .PRP modifier, members are required to input the prior reference time (*i.e.*, the time the obligation to trade arose), which shall be placed in the execution time field on the Automated Confirmation Transaction Service[SM] (ACT[SM]) report.

The following principles and requirements apply to members when using the .PRP modifier:

- Members must use the .PRP modifier for trade reports in Nasdaq securities (both NNM and SmallCap securities), and non-Nasdaq over-the-counter equity securities (*e.g.*, OTC Bulletin Board and pink sheets). Members may not use the .PRP modifier for trades in exchange-listed stocks that are effected in the Third Market.

- Members may not use the .PRP modifier in “stop” stock situations.

- The .PRP modifier will not be required to be used if the report is made within 90 seconds of the prior reference time.

- It will no longer be appropriate for firms to use the .SLD modifier to report late executions; the .SLD modifier may only be used to report late reports of execution.

- Use of the .PRP modifier does not absolve the member of its obligation to provide best execution, in terms of both price and timely execution.

The following are some specific examples of when the .PRP modifier would be used:

Example 1. A member receives a preferenced SelectNet order at the member’s quote (“liability order”) at 11:00 a.m. The member fails to execute the trade. Thirty minutes later, at 11:30 a.m., this is brought to the attention of the receiving member, which agrees that the trade should have taken place at 11:00 and at the price existing at 11:00. The receiving member then executes a trade at the 11:00 price. Under the rule change, the member must append a .PRP to the trade report and must input the time “11:00.”

Example 2. A member receives a large number of customer orders prior to the open, which are to be executed at the opening print. Once that price can be identified, the member’s system begins executing each trade at that price. Any such trade that is executed at the opening but due to heavy volume is not printed until after 9:31:30 should be identified with the .SLD identifier. If, however, at 9:45 the member discovers that a customer’s order that should have been executed at the open has not yet been executed, it would be appropriate to execute that customer’s order and append the .PRP modifier with the time “9:30.” This tells market participants that the execution price represents a price that relates to an earlier point in time (in this case, the open), and thus may not bear any relation to the current market, which may have moved in the interim.

2. Partial Elimination of the 10,000 Share Limitation on Bunching of Trades

NASD trade-reporting rules for NNM and SmallCap securities currently permit members to aggregate transactions into a “bunched” trade report in a variety of situations. In particular, the rules permit a member to aggregate transactions done at the same price when it would be impractical to report the trades individually. The rule provides, however, that when reporting bunched trades no individual order of 10,000 shares or more may be aggregated and reported. The rule further provides that bunched trades must be reported within 90 seconds of the initial transaction and the report must include a “.B” modifier.

Under the rule change approved by the SEC, Nasdaq is removing the 10,000-share limitation for bunching *but only for trades effected on the first day of secondary market trading following an initial public offering (IPO).* The 10,000-share cap will continue to apply for trades effected after the first day of secondary market trading of an IPO (*i.e.,* day two onward of secondary-market trading). The lifting of the cap for first-day secondary market trading will facilitate more efficient and timely reporting of large numbers of trades in the immediate aftermarket. As is the case today, bunching is optional and a member may continue to report trades individually.

3. Trade-Reporting Rules for Riskless Principal Trades in the Third Market

Under current trade-reporting rules for the Third Market, non-Market Makers generally do not report the offsetting trade with a customer when a “riskless principal” transaction is involved (*i.e.*, a transaction that involves a trade with another member, usually a Market Maker, which is used to offset a trade with a customer). This “riskless principal exception” results in one trade report even though the non-Market Maker firm is involved in two separate trades against its principal account.

Due to recent growth and changes in Third Market trading, including significant advances in technology and the implementation of the SEC’s order handling rules, Nasdaq sees no significant reason to continue the distinction between Market Makers and non-Market Makers in the context of the Third Market, and thus is extending this riskless principal exception described above to Market Makers in the Third Market. Under the rule change, only one trade report will result for transactions where the Market Maker has encountered no risk and, although there are two trades effected, the economic reality is that the trades can be viewed as one trade. For example, if a Market Maker in an exchange-listed security does not assume a risk position on an Intermarket Trading System (ITS) commitment sent to another market center, the Market Maker will not reprint the trade in the Third Market when it receives confirmation of an execution on the commitment. This analysis applies to transactions that result from orders sent to the floor even when sent outside of the ITS linkage (*e.g.*, through a floor broker or other automated execution system of the exchange) as well as other Market Makers in the Third Market.

The rule defines "riskless principal" as a trade in which a member, after having received an order to buy (sell), purchases (sells) the security as a principal in order to satisfy the order to buy (sell). Thus, a riskless principal trade generally is one that involves a conditional order rather than one immediately executable by the firm as principal. Such condition may involve a customer order for which execution is dependent upon finding the other side, or a transaction dependent upon the execution of a part of the order placed with another firm or market. For example, after receiving a customer's market order to buy 500 shares, a Market Maker in the Third Market sends an order to an exchange for 1,000 shares, where it is immediately executed. The Market Maker then satisfies the 500-share order for its customer. The 1,000-share execution is reported by the exchange; under the new rules, the 500-share execution by the Market Maker will not be printed again in the Third Market. The remaining 500 shares that the Market Maker bought on the floor of the exchange, however, is deemed to be "at risk." Accordingly, if the Market Maker sells those 500 shares in a later transaction, the Market Maker will print the 500 shares in the Third Market.

Under the rule, there may be situations where only a portion of a transaction may be riskless and reported as such. That is, to the extent that the customer's order is greater than the first leg that is executed on an exchange or in the Third Market, only the portion of the second leg *(i.e.,* the offsetting transaction with the customer) that is offset by the first leg will be deemed riskless; any balance would be "at risk" and reported as a separate trade. Thus, if a portion of a larger transaction is being filled from a Market Maker's inventory, that portion of the trade filled from inventory must be reported as principal. For example, after having received an order to buy 1,000 shares, a Market Maker in the Third Market fills 500 shares from inventory and sends an order for 500 shares to an exchange. The exchange reports back to the Market Maker an execution of 500 shares. The Market Maker then fills the 1,000-share customer order. The Market Maker would only report 500 shares in the Third Market (the amount filled from inventory) and would not report the 500-share execution received on the floor of the exchange because that portion of the trade is deemed riskless.

Marker Order Exception. Nasdaq also considered the extent to which the riskless principal definition would apply in situations where the first leg is a "marker" order. These orders, usually of nominal size, are used to trigger obligations to other orders the firm may be holding. Marker orders serve as a mechanism to notify the Market Maker that the market has traded at that price and that a conditional order the Market Maker is holding has now become executable in accord with the firm's understanding with its customer. Marker orders generally are not intended to offset, to any significant degree, other executions by the Market Maker.

Nasdaq has determined to add an exception to the riskless principal trade-reporting rule for marker orders that are 10 percent or less than the full size of the order or group of orders being marked. That is, the execution of a marker order would appear to merit riskless principal treatment and would not be printed in the Third Market to the extent of the size of the marker order. However, given the purpose for which marker orders are used, a member should not be required to break up the order it is holding into two separate components to distinguish between a risk and riskless portion, if the marker order is no larger than 10 percent of the size of an execution or group of executions that it would trigger. This is because the nominal size of the marker order does not, to any material extent, change the overall risk profile of the order. (**See** Questions 16 and 17 in Attachment A for examples on handling marker orders.)

10b-10 Obligations. In the order approving the Third Market riskless principal rules, the SEC stated that Rule 10b-10 under the Act requires a broker/dealer acting as Market Maker in a riskless principal transaction in an exchange-listed security to confirm to its customer:

1) the reported trade price;

2) the price to the customer in the transaction; and

3) the difference, if any, between the reported trade price and the price to the customer (*i.e.,* any markup or markdown, commission equivalent, or other fee on top of the reported price).

The SEC further stated that under Rule 10b-10, the broker/dealer is required to report, as the "reported trade price", the price at which the security was reported to the tape (Consolidated Tape Authority (CTA)) by the exchange or Market Maker in the Third Market when the member purchased the security for, or sold the security on behalf of, its customer. The Commission stated that this requirement remains in effect regardless of the fact that there is no corresponding requirement in the NASD rules to report the second leg of a riskless principal transaction to the tape.

4. Elimination of "Reasonably Related to the Market" Provision in NASD Rule 6420

In addition to the changes to Third Market trade-reporting rules described above, the SEC approved on July 23, 1999, a rule change that eliminates unnecessary provisions of NASD Rule 6420.

NASD Rule 6420(d)(3)(A), which is the general rule requiring NASD members to report all principal transactions in exchange-listed securities in the Third Market, contains language requiring members to report transactions in a manner "reasonably related to the prevailing market taking into consideration all relevant circumstances..." (Reasonably Related to the Market Provision). The Reasonably Related to the Market Provision was added as part of broader changes in 1980 to the Third Market trade-reporting rules, which at the time required Market Makers in the Third Market to report to the tape transaction prices inclusive of any markup, markdown, commission equivalent, or other fee to the customer (collectively, charges).[1] In contrast, exchange rules at the time required their members to report to the tape transaction prices exclusive of any charges to the customer. The 1980 changes to the Third Market trade-reporting rules were intended to make comparable the reporting of Third Market trades with exchange transactions by requiring Market Makers in the Third Market to report trades exclusive of any charges.

Since the 1980 rule changes, Nasdaq has come to the conclusion that the Reasonably Related to the Market Provision is superfluous in the context of Third Market trading and does not serve any meaningful purpose with respect to the trade reporting for these securities. Indeed, this provision has served only to promote the misinterpretation that the rule provides flexibility in the manner in which NASD members may report Third Market transactions, which has led some to believe there is inaccurate trade reporting in the Third Market. To be certain, NASD rules do not permit such discretion or latitude — Market Makers in the Third Market must report to the tape transaction prices **exclusive** of any charges. Additionally, under Exchange Act Rule 10b-10 Market Makers in the Third Market must confirm to the customer the price reported to the tape and any difference between the price reported to the tape and the price to the customer.

Additionally, as the SEC recently stated in the context of a proposal to extend the NASD's ITS/CAES linkage to all exchange-listed securities, while the Commission appears to concur that the rules could be clarified, the rules are nonetheless the same for the reporting of both 19c-3 securities and non-19c-3 securities. Nasdaq believes that NASD rules and procedures, along with a member's best execution obligations, provide the necessary protections to ensure accurate and appropriate trade reporting in exchange-listed securities. As the Commission has indicated on several occasions, an effective surveillance program along with the requirements of Exchange Act Rule 10b-10, ensure compliance with trade-reporting obligations and the proper disclosure of any markup or markdown.[2] Accordingly, Nasdaq is removing this less-than-clear language from the rule to ensure there are no continuing ambiguities or misinterpretations.

Attachment A — Questions And Answers

General Questions

1. When do the new riskless principal rules for the Third Market go into effect?

The rules go into effect on September 30, 1999, at which time NASD members which effect transactions in the Third Market will be required to report transactions according to the new rules.

2. Do the riskless principal rules described in this *Notice* apply only to transactions in exchange-listed securities effected in the Third Market?

Yes. The new riskless principal rules apply only to transactions in exchange-listed securities effected in the Third Market by NASD members. The rules described in this *Notice* are separate and different from the riskless principal rules that were recently adopted for Nasdaq and over-the-counter securities, which are described in more detail in NASD *Notice to Members 99-65.*

3. Do the new rules define what is a "riskless principal" transaction?

Existing NASD trade-reporting rules for the Third Market define "riskless principal" transactions effected by non-Market Makers, and require non-Market Makers that execute riskless principal transactions to not report the offsetting transaction with the non-Market Maker's customer to the NASD. The new rules simply extend the existing riskless principal trade-reporting rules to cover transactions effected in the Third Market by Market Makers.

Under the new rules, a Market Maker reports a "riskless" principal transaction once if the Market Maker receives an order to buy (sell) a security, and then purchases (sells) the security as principal to satisfy the order to buy (sell). Generally, a riskless principal trade involves two orders, the execution of one being dependent upon the receipt or execution of the other; hence, there is no "risk" in the interdependent transactions when completed. Only when the condition or dependency is satisfied is the offsetting trade effected, the transaction completed, and only a single trade report required. Such condition may involve an institutional customer order, the execution of which is dependent upon finding the other side, in whole or in part, or a transaction dependent upon the execution of all or a part of the order placed with another firm or market. To the extent that any of the order is offset with another principal execution, that portion is deemed riskless and should be reported only once**.** If a portion of the order is not offset with another principal transaction, that portion would represent risk and should be reported to the tape to the extent it is riskless. (As noted in Question 4, there is an exception to the general rule for marker orders.) **See** Question 14 below for an example.

Thus, for example, if a Market Maker receives a customer market or marketable limit order and the Market Maker sends the order to the floor of an exchange for execution, the exchange will print the trade. When the specialist reports the trade back to the Market Maker and the Market Maker subsequently effects the offsetting transaction with its customer, the Market Maker will not report the offsetting transaction to the tape.

Finally, the NASD wishes to clarify that orders received from other broker/dealers and non-customers qualify for riskless principal treatment, although the rule only specifically refers to "customer" orders.

4. Do "marker" orders that are sent to an exchange as part of a larger order qualify for riskless principal treatment?

If a marker order is 10 percent or less than the full size of the order or group of orders it is marking, then the marker order is not considered "riskless" and would be reported as part of the larger order(s) when the offsetting trade is effected in the Third Market. For an example, see Questions 16 and 17.

5. Do riskless principal transactions *only* apply to retail customer orders and limit orders?

No. The rules apply to orders held by a member that are from a customer, another member, the customer of another member, or any other entity including non-member broker/dealers. Further, the rule covers both market and limit orders.

6. How should a member mark a trade report for riskless principal trades?

Members should mark the trade report with the capacity indicator for riskless principal (*i.e.*, click on the "Riskless" button under the P/A field on the ACT report).

7. If one leg of the transaction is executed through Nasdaq's Computer Assisted Execution System℠ (CAES℠), the system automatically reports the trade for the market participants and appends a principal capacity indicator to the trade report when a Market Maker is involved. When this occurs and the trade is part of a riskless principal transaction, is the Market Maker required to go back into ACT and change the system-generated trade report to indicate the trade was riskless principal?

Generally, no. If a trade is executed through CAES where the trade is automatically reported to ACT and sent to the tape, ACT will default to a capacity indicator of "principal" when a Market Maker is involved. When this occurs, a Market Maker will **not** be required to go back into ACT and change the Nasdaq system-generated report to indicate the trade was effected on a riskless principal basis. If, however, the Market Maker does not clear for the customer for which it executed the riskless principal trade, the Market Maker will be required to submit a "clearing-only" record to ACT and to the National Securities Clearing Corporation (NSCC). In these instances, the Market Maker is required to indicate on the "clearing-only" record that the trade was done on a riskless principal basis.

For example, Market Maker A (MMA) receives a customer limit order to buy at $20, and displays that order in its quote. Another Market Maker or market center sends an order through CAES, which executes against MMA's quote and takes out the $20 buy order. CAES then reports the trade to the tape at $20 as principal for MMA. If MMA does not clear for the customer from which it received the customer limit order, MMA will be required to enter a "clearing-only" record into ACT to reflect the offsetting sale to the customer at $20, and will be required to indicate on the clearing record that the trade was done on a riskless principal basis.

For riskless principal transactions that occur over the phone in the Third Market or via a Market Maker's internal execution system, the Market Maker must report the initial leg to the tape and mark the trade report as riskless principal. Additionally, depending on whether the Market Maker clears for the customer, the Market Maker may also have to submit a "clearing-only" record to ACT, which also must indicate the trade was done as riskless principal. Since trades which are executed on the floor of an exchange are reported by such exchange, NASD Market Makers need not report the trade to the tape or otherwise indicate the trade was done on a riskless principal basis.

8. Aren't Market Makers always at risk? For example, if a Market Maker is holding an order and is accumulating a position in an attempt to fill the order, isn't the Market Maker at risk because the customer may cancel the order before the Market Maker finds the other side and fills it? How will a firm know if a trade is riskless?

Market Makers are not necessarily **always** at risk for purposes of trade reporting. A Market Maker generally is not at risk if the Market Maker has two orders in hand that it is crossing or if the Market Maker has one order whose execution is contingent upon finding the other side at the same price.

As a rule of thumb, a Market Maker's responsibility to report to the tape the second leg of the transaction with the customer is determined after the Market Maker has accumulated a position and/or found the other side, and the Market Maker wishes to effect an offsetting transaction with the customer. Generally, if after accumulating a position to fill a customer order the Market Maker actually fills such order, the Market Maker is not at risk on the second leg of the transaction and will not report the customer fill to the tape. Conversely, if the customer cancels the order while the Market Maker is accumulating a position, the Market Maker becomes "at risk" for the amount it has accumulated and is holding in inventory. Accordingly, when the Market Maker attempts to liquidate that position, the Market Maker must report the associated trade(s) to the tape.

9. If a customer cancels an order while a Market Maker is in the process of accumulating a position to fill the customer's order, the trade report will show a riskless principal modifier when these trades are really "at risk." Will this be a violation of NASD rules?

There may be times when a Market Maker has accumulated a portion or all of a position to satisfy a customer order in hand and reported those transactions to the tape as riskless principal, but the customer cancels the order prior to the Market Maker filling it. The member will not be in violation of riskless principal rules provided that the member properly documents that the trade(s) was reported to the tape as riskless principal while the member was holding a customer order and that the customer canceled the order. The member should keep accurate records reflecting the time the customer order was received and subsequently canceled, as well as the execution time(s) of the trade(s) reported as riskless principal.

10. Are the new rules for riskless principal trade reporting mandatory?

Yes. If a transaction meets the definition of "riskless principal" in the new trade-reporting rules, market participants must report once and as riskless principal.

Trade-Reporting Requirements

11. CQS Inside Market: $20 - 20 1/4, 10 X 20

MMA, which is a Market Maker in the Third Market, is at the inside offer displaying its customer's limit order to sell 2,000 shares at

$20 1/4 when Market Maker B (MMB—another Market Maker in the Third Market) lifts the offer using the phone. What are MMA's trade-reporting obligations?

MMA must report to the tape the sale of 2,000 shares to MMB and mark the report with a riskless principal capacity indicator. MMA will not report to the tape the offsetting buy at $20 1/4 from the customer.

12. CQS Inside Market: $20 - 20 1/4, 10 X 20

MMA receives a 500-share market order to buy and sends the order to the floor of an exchange via the ITS linkage or other means (*e.g.*, through a floor broker or other automated routing or execution system of the exchange). The specialist on the exchange floor executes the trade at $20 1/4, and reports that price back to MMA. What are MMA's trade-reporting obligations?

MMA should not report the offsetting trade with its customer to the tape, since this is a riskless principal transaction and the exchange has already reported the trade to the tape.

13. If I am a Market Maker in the Third Market and I am engaging in a riskless principal trade consistent with the new trade-reporting rules, how do I confirm the transaction to my customer under SEC Rule 10b-10? For example, what would I have to confirm in the transaction described in the previous question?

As noted above in the text of this *Notice*, the SEC stated in its approval order of the rule that Exchange Act Rule 10b-10 requires a broker/dealer acting as Market Maker in a riskless principal transaction in an exchange-listed security to confirm to its customer:

1) the reported trade price;

2) the price to the customer in the transaction; and

3) and the difference, if any, between the reported trade price and the price to the customer (*i.e.*, any markup or markdown, commission equivalent, or other fee on top of the reported price).

The SEC further stated that under Rule 10b-10, the broker/dealer is required to report, as the reported trade price, the price at which the security was reported to the CTA when the member purchased the security for, or sold the security on behalf of, its customer. The Commission stated that this requirement remains in effect regardless of the fact that there is no corresponding requirement in the NASD rules to report the second leg of a riskless principal transaction to the tape.

For example, when a Market Maker receives an execution report from an exchange in a listed security through ITS and completes a riskless principal transaction by filling a customer order, the Market Maker must report on the confirmation to its customer the price of the transaction that was reported to the tape by the exchange (*i.e.*, the reported price). (The same would hold true if the transaction occurred in the Third Market between two Market Makers.) The Market Maker must also report the price to the customer and any markup or markdown or other fee charged by the Market Maker to the customer (*i.e.,* any difference between the price reported by the exchange and the price to the customer).

With regard to Question 12, where MMA sent a buy market order to the floor of an exchange and received a report back from the specialist of $20 1/4, first assume that MMA charges the customer no markup, commission equivalent, or other fee. In that case, MMA would confirm to the customer:

1) a reported trade price of $20 1/4 (the price reported by the exchange to CTA);

2) a price to the customer of $20 1/4; and

3) a no differential.

If MMA had added a commission equivalent of 1/4, MMA would have confirmed:

1) a trade price of $20 1/4 ;

2) a price to the customer of $20 1/2; and

3) a differential of 1/4.

Finally, for riskless principal trades effected by non-Market Makers trading as principal in the Third Market, SEC Rule 10b-10 confirmation requirements remain the same as they are today.

14. CQS Inside Market: $10 - 10 1/4, 10 X 10

MMA receives from an institutional customer an order to sell 100,000 shares with instructions to work the order with a price limit (or "bottom") of $10 1/16. MMA discloses that it will charge a commission equivalent of 1/16 on the trade. MMA sends a total of 25,000 shares (either through a single trade or multiple orders) to the floor of an exchange for execution, and MMA receives a report(s) back from the exchange of $10 1/8 per share. Instead of attempting to find the remaining

75,000 shares, MMA fills the entire customer order for 100,000 shares, for a price of $10 1/8 per share, by trading the 75,000-share balance out of inventory. How is this trade reported?

Only a portion of the 100,000 share transaction is deemed to be riskless – the 25,000 shares. The remaining 75,000 shares that were executed from MMA's inventory are considered to be "at risk," and must be reported to the tape. Thus, MMA reports only a buy of 75,000, and not a buy of 100,000 shares, from its institutional customer because the 75,000 is deemed to be "at risk" and the remaining 25,000 is deemed riskless and previously reported by the exchange. The confirmation to the customer would show a reported price of $10 1/8 (the price printed on the exchange and in the Third Market), a price to the customer of $10 1/16, and a differential (commission equivalent) of 1/16.

15. In the above example, it may not be easy for MMA to definitively say that 25,000 shares were riskless, because MMA may have accumulated these shares in multiple transactions that were reported back to MMA throughout the entire day. Can MMA still report these as riskless principal?

No. In order for a Market Maker to report trades as riskless principal, the Market Maker must be able to identify a specific trade or a group of trades (which may be effected at one price level or multiple price levels if the customer is receiving a volume weighted average price (VWAP)) as being those utilized to fill a customer order. If a member cannot identify which trade or series of trades were effected to offset a customer order, the Market Maker is at risk and cannot report as riskless principal.

Thus, in the previous question where MMA was claiming 25,000 shares were riskless principal, MMA must be able to tie a specific trade or trades to the 25,000 shares. If MMA were reporting a VWAP of $10 1/8 because MMA received multiple executions on a number of trades sent to the floor of an exchange, MMA would have to point to a series of transactions which had a volume weighted average price of $10 1/8 and which totaled 25,000 shares.

16. CQS Inside Market: $10 - 10 1/8, 10 X 10

After receiving a 5,000-share order to buy at $10, MMA places a marker order to buy 500 shares at $10 on an exchange. The marker order is executed and triggers the 5,000-share customer order. MMA then fills the 5,000-share customer order. What are MMA's trade-reporting obligations?

MMA would report the 5,000 shares in its entirety (not merely 4,500 shares) and would not exclude the 500 shares executed on and reported by the exchange, since the marker order represents only 10 percent of the 5,000-share order. As a variation of this example, assume the marker order triggers 10 different orders each to buy 500 shares at $10, for a total of 5,000 shares. Similarly, the Market Maker would report each of these 500-share (*i.e.*, a total of 10) trades with its customers.

17. CQS Inside Market: $10 - 10 1/8, 10 X 10

After receiving an order to buy 10,000 shares at $10, MMA places a marker order to buy 2,500 shares at $10 on an exchange. The marker order is executed and triggers the 10,000-share order. MMA then fills the 10,000-share customer order. What are MMA's trade-reporting obligations?

The Market Maker would report the 7,500 shares in the Third Market, and would not report the remaining 2,500-marker order executed on the exchange because that order is greater than 10 percent of the 10,000-share customer order and is otherwise riskless.

18. CQS Inside Market: $10 - 10 3/8, 10 X 10

MMA receives a not-held order from an institutional customer to sell 6,000 shares, with instructions to obtain the best price available with a "bottom" of $10 1/8. MMA sells in the Third Market 4,000 shares at $10 3/8 to MMB and 2,000 shares at $10 to MMC. MMA then buys 6,000 shares at $10 1/4 from its customer. What are MMA's trade-reporting obligations?

MMA must report to the tape the sell to MMB of 4,000 shares at $10 3/8 and the sell to MMC of 2,000 shares at $10. (Note that the VWAP for this trade is $10 1/4). MMA would not report the offsetting purchase from its customer. The NASD believes that it would be consistent with an SEC No-Action Letter regarding SEC Rule 10b-10 for MMA to disclose on the confirmation a reported price of $10 1/4 — the VWAP — instead of a reported price for each individual transaction.[3] The confirmation must contain a notation that the disclosed price is an average price, and must note that details regarding the actual prices are available to the customer upon request.[4] If the Market Maker charged a markdown, commission-equivalent, or other fee on top of the $10 1/4, it also would be permissible for the confirmation to disclose the fee as a single amount.

19. CQS Inside 10 - 10 1/4, 10 x 10

MMA receives a limit order from its customer to sell 5,000 shares at $10 1/16. Through its internal execution system, MMA immediately buys 5,000 shares from its customer at a price of $10 1/16. To reduce its inventory position, MMA subsequently sends a limit order to sell 3,000 shares at $10 1/16 (as principal) to the floor of an exchange or another Market Maker in the Third Market, where the order is filled. What are the reporting obligations here?

MMA would report to the tape that it bought from its customer 5,000 shares at $10 1/16. Additionally, MMA's sell limit order of 3,000 at $10 1/16 that was executed on the floor of the exchange would be reported by the exchange. (Note, if MMA had executed the sell limit order in the Third Market (instead of on the exchange) by, for example, hitting the bid of another Market Maker, MMA would report the sell to the tape.) Note that no part of this transaction constitutes a riskless principal trade because MMA did not have the other side (or a portion thereof) of the customer's buy limit order in hand when it provided the internal execution. Thus, MMA incurred the risk that the market would move against it before MMA could send the offsetting order to the floor of the exchange to reliquify.

20. CQS Inside Market: $10 - 10 1/4, 10 X 10

MMA receives an order to buy 10,000 shares at a limit price of $10 1/8 from Institutional Customer 1, and simultaneously receives an order to sell 10,000 shares at a limit price of $10 1/8 from Institutional Customer 2. MMA buys 10,000 shares from Institutional Customer 2 and sells 10,000 to Institutional Customer 1, both at $10 1/8. How is this reported?

MMA reports the sale to Institutional Customer 1 as riskless principal for 10,000 shares at $10 1/8, assuming that the trades were effected from MMA's market-making account. There will be no trade report for the buy from Institutional Customer 2. MMA will confirm the respective transactions to both customers consistent with SEC Rule 10b-10.

If transaction had been effected as a pure agency cross and the trades were not run through MMA's market-making or proprietary account, MMA would report the transaction as an agency cross, not as riskless principal.

21. CQS Inside Market: $10 - 10 1/4, 10 X 10

MMA receives an order to buy 100,000 shares at a limit price of $10 1/8 from Institutional Customer 1, and simultaneously receives an order to sell 75,000 shares at a limit price of $10 1/8 from Institutional Customer 2. MMA crosses 75,000 shares, and in order to fill the remainder of Institutional Customer 1, sells 25,000 shares at $10 1/8 to the customer. How is this trade reported?

MMA would submit a trade report indicating an agency cross of 75,000 shares since the trade was effected as agent and not through MMA's market-making account. MMA would submit a separate trade report that would indicate a sale of 25,000 shares at $10 1/8 as principal. Note that the confirmation to Institutional Customer 1 would indicate that the firm acted both as principal and agent, consistent with the SEC No-Action Letter.[5]

Attachment B – Text Of Rule Changes

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

4632. Transaction Reporting

(a)(1) through (a)(8) No Change

(9) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

(b) through (f)(1)(C) No Change

(D) Orders received or initiated by the reporting member which are impractical to report individually and are executed at the same price within 60 seconds of execution of the initial transaction; provided however, that no individual order of 10,000 shares or more may be aggregated in a transaction report and that the aggregated transaction report shall be made within 90 seconds of the initial execution reported therein. Furthermore, it is not permissible for a member to withhold reporting a trade in anticipation of aggregating the transaction with other transactions. The limitation on aggregating individual orders of 10,000 shares or more for a particular security shall not apply on the first day of secondary market trading of an IPO for that security.

4642. Transaction Reporting

(a)(1) through (a)(8) No Change

(9) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

(b) through (f)(1)(C) No Change

(D) Orders received or initiated by the reporting member which are impractical to report individually and are executed at the same price within 60 seconds of execution of the initial transaction; provided however, that no individual order of 10,000 shares or more may be aggregated in a transaction report and that the aggregated transaction report shall be made within 90 seconds of the initial execution reported therein. Furthermore, it is not permissible for a member to withhold reporting a trade in anticipation of aggregating the transaction with other transactions. The limitation on aggregating individual orders of 10,000 shares or more for a particular security shall not apply on the first day of secondary market trading of an IPO for that security.

4652. Transaction Reporting

(a)(1) through (a)(7) No Change

(8) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

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 eligible securities in the following manner:

(1) through (2) No Change

(3) (A) For principal transactions, except as provided below, report each purchase and sale transaction separately and report the number of shares and the price. For principal transactions which are executed at a price which includes a markup, markdown or service charge, the prices reported shall exclude the markup, markdown or service charge. [Such reported price shall be reasonably related to the prevailing market, taking into consideration all relevant circumstances including, but not limited to, market conditions with respect to the security, the number of shares involved in the transaction, the published bids and offers with size at the time of the execution (including the reporting firm's own quotation), accessibility to market centers publishing bids and offers with size, the cost of execution and the expenses involved in clearing the transaction.]

(B) Exception: A "riskless" principal transaction in which a member [that is not a market maker in the security] after having received from a customer an order to buy, purchases the security as principal from another member or customer 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 or customer to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the markup or markdown. 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.

6620. Transaction Reporting

(a)(1) through (a)(5) No Change

(6) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

Endnotes

[1] *See* Exchange Act Release No.16960, 45 FR 47291 (July 7, 1980) (approving SR-NASD-80-3).

[2] *See e.g.*, Exchange Act Release No. 40260, n. 63 and 67 (July 24, 1998), 63 FR 40748 (July 30, 1998) (proposed amendments to National Market System plan); Exchange Act Release No. 18713 (May 6, 1982) 47 FR 20413, n.13 (May 12, 1982) (adoption of final amendments to National Market System plan).

[3] *See, e.g.*, SEC No-Action Letter from Catherine McGuire, SEC, to Eugene Lopez, The Nasdaq Stock Market, dated May 6, 1997 (permitting the issuance of a single confirmation at an average price and with multiple capacities for a single customer order effected with multiple executions).

[4] *See id*.

[5] *See id*.