NASD Notice to Members 99-65

SEC Approves Rule Changes To NASD Trade-Reporting Rules For Riskless Principal Transaction In Nasdaq And OTC Securities

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Executive Summary

On March 24, 1999, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD® or Association) rules regarding trade reporting of riskless principal transactions by Market Makers. The rule change will permit Market Makers in Nasdaq® and other over-the-counter securities to report trades under the current riskless principal rules that exist for non-Market Makers. The effect of the change is that instead of reporting both "legs" of a riskless principal transaction, Market Makers (like non-Market Makers currently) now will only report one portion of the transaction if it meets the definition of riskless principal. The rule defines riskless principal as a trade in which a member, after having received an order to buy (sell) a security, buys (sells) the security at the same price, as principal, in order to satisfy the order to buy (sell).

This *Notice* includes questions and answers regarding the rule changes (Attachment A); and the text of the rule changes (Attachment B). These changes are effective as of 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 Market Regulation Legal Section, NASD Regulation, Inc. (NASD Regulation®), at (301) 590-6410.

Background

The rules for reporting trades in Nasdaq securities have long existed in their current form. The rules were broadly designed to capture all trading activity by broker/dealers, both dealer-to-dealer trades and trades with customers. These rules, and the trade reports that result, serve several important purposes. They form the basis for public dissemination of "last sale" transaction prices to the tape, thus providing transparency. Trade reports also are an integral part of the audit trail used by the NASD in its regulatory efforts to surveil and regulate firms' activities. Given the historical structure of the dealer markets and the need to provide a comprehensive view of all trading, and because Market Makers were always deemed to be "at risk" when trading from their principal accounts, NASD trade-reporting rules have required the reporting of all principal trades by Market Makers.

Non-Market Makers, however, generally do not report all principal trades under current rules, to the extent the trades are defined as "riskless" — that is, they involve a trade with another member, usually a Market Maker, which is used to offset a trade with a customer. This riskless principal exception to the general rule of reporting all principal trades results in one trade report even though the non-Market Maker firm is involved in two separate trades against its principal account.

In light of the growth and evolution of the structure of Nasdaq and the over-the-counter (OTC) market, the NASD is now extending the riskless principal exception to Market Makers in Nasdaq-listed securities (including Nasdaq convertible debt securities) as well as other securities traded over-the-counter (*e.g.*, OTCBB and pink sheets). Thus, certain matching principal trades involving a Market Maker are now explicitly included within the riskless definition, and reported to the public tape only once. For example, under the SEC Order Handling Rules, Nasdaq Market Makers now display customer limit orders in their public quotes. Those orders are often filled by the Market Maker when that quote is accessed by another market participant.[1] Because Market Makers generally trade exclusively from a principal account, it is necessary to engage in two separate principal trades: one with the other market participant, and then another directly with the customer. Both of these trades are reported by Market Makers under current rules. In effect, however, these two trades can be viewed as one event – the execution of a customer order upon the execution of an offsetting transaction obtained by the Market Maker. Under the proposed rule change, these two trades are reported only once. One of the expected benefits of the extension of riskless principal trade reporting to Nasdaq and OTC Market Makers is the reduction of SEC transaction fees, which generally are assessed to the seller in a transaction that is trade reported.

The new rules define "riskless principal" as a trade in which a member, after having received an order to buy (sell) a security, buys (sells) the security at the same price, as principal, in order to satisfy the order to buy (sell). In order to qualify for riskless principal trade reporting, the rule requires that the trades be executed at the "same price" (exclusive of a markup or markdown, commission equivalent, or other fee). Additionally, under the rules a portion of a transaction may be deemed riskless. That is, to the extent that any of the order is offset with another principal execution at the same price, that portion is deemed riskless and should be reported only once.

In addition, the NASD has made certain technical changes to the existing rule. Specifically, while the current rule refers to orders received from a "customer", the new rule simply refers to "an order." This change ensures consistent application of the riskless principal trade-reporting rules to any order received by a member, regardless of the person or entity from whom it was received. Furthermore, the NASD has amended the rules to more clearly provide that riskless principal trades are reported exclusive of any fee, not just markups and markdowns.

Attachment A – Questions And Answers

General Questions

1. When do the new riskless principal trade-reporting rules go into effect?

The rules go into effect on September 30, 1999, at which time market participants will be required to report transactions according to the new rules.

2. Do the new riskless principal rules apply to Nasdaq securities, as well as all other securities traded in the over-the-counter market?

The new riskless principal rules apply to Nasdaq National Market® Securities (NNM), Nasdaq SmallCap℠ Securities (SmallCap), Over-the-Counter Bulletin Board securities (OTCBB), Nasdaq convertible debt securities, and all other securities traded in the over-the-counter market (*e.g.*, pink sheet securities). The riskless principal rules described in this *Notice to Members* do **not** apply to Third-Market transactions in exchange-listed securities. Rather, a separate rule proposal that specifically covers transactions in the Third Market was recently approved by the SEC, which is separately described in *Notice to Members 99-66.*

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

Existing NASD trade-reporting rules 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 tape. The new rules simply extend the existing riskless principal trade-reporting rules to cover transactions effected by Market Makers, provided that the transactions are done at the same price.

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 at the same price as the order in hand 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. **See** Question 16 for an example. Additionally, as set forth in more detail in Question 4, if a member finds the other side of an institutional order and matches off the orders, the presumption will be that the trade is riskless principal.

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

In order for a transaction to be reported as riskless under the new rules, the price of the initial transaction and the offsetting transaction with the customer must be the same when the markup or markdown, commission equivalent, or other fee is excluded from the transaction prices. To determine whether two transactions are at the same price, members generally must compare the price reported to the Automated Confirmation Transaction Service℠ (ACT℠) pursuant to NASD trade-reporting rules (which require members to exclude any markup or markdown, commission equivalent, or other fee when trade reporting) and the "net price" of the offsetting trade with the customer (*i.e.*, the price to the customer, exclusive of any markup or markdown, commission equivalent, or other fee). If the tape price and the net price to the customer are the same, then the transaction must be reported as riskless principal to ACT and the offsetting leg with the customer should not be reported to ACT.

Additionally, if a Market Maker is executing a large order through a series of trades and has an arrangement to charge the customer an average price based on the various executions received, the net price to the customer and the volume weighted average price (VWAP) of the trades must be the same for the transaction to receive riskless principal treatment. **See** Question 20 for an example. To this end, when a Market Maker is attempting to fill a large order through a series of trades during the trading day, the Market Maker must be able to identify which trades were effected from inventory to fill the customer order if the Market Maker is claiming riskless principal treatment for a transaction or a portion thereof; otherwise, the Market Maker is at risk and cannot report as riskless principal. **See** Question 17 for an example.

Finally, if a member is working an order for an institutional account (as defined in NASD Rule 3110(c)(4)) or of a block size (10,000 shares or greater and at least $200,000) 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.

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. Do the rules prohibit "net" trading? In other words, do the rules require Market Makers to trade at one price when executing two offsetting institutional orders or when filling an institutional order out of a position the Market Maker accumulated to fill that order in hand?

The rules do not prohibit Market Makers from trading on a net basis. Nor do the rules mandate the prices at which Market Makers must execute the various legs of "riskless principal" transactions. Thus, a Market Maker is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price (with no markup, markdown, commission equivalent, or other fee), provided that such arrangement satisfies the member's best execution obligations and is consistent with SEC and NASD statements regarding the matching of limit and market orders.[2] The rules establish, however, the requirements of how transactions should be reported if they are riskless and meet the requirements/definition of riskless principal (*i.e.*, both legs of the transaction are effected at the same price).

The NASD recognizes that there are times when a Market Maker will, while holding a customer's order, effect a buy (sell) at one price and an offsetting sell (buy) with the customer at another price, such as when a Market Maker is trading "net" with an institution. If what otherwise would appear to be a riskless principal trade is effected at two different net prices, a Market Maker would be required to report both legs of the transaction to the tape. However, if a member is working an order for an institutional account or 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.

The NASD believes that Market Makers should endeavor to trade at one price when executing riskless principal transactions because this will provide greater transactional integrity and will have the corollary benefit of reducing SEC transaction fees (commonly know as "Section 31 fees"). This is particularly true for customer limit orders as well as other limit orders that are not of a block size or for an institutional account.

As indicated above, the new rules do not change current trade-reporting requirements for non-Market Makers that effect riskless principal transactions.

7. Do the new rules preclude Market Makers from effecting and separately reporting riskless principal trades at different prices?

NASD rules do not prohibit Market Makers from reporting trades at two different prices of what essentially is a riskless principal trade, assuming of course the Market Maker is complying with best execution obligations. As noted above, however, if a member is working an order for an institutional account and the member finds the other side of the order, the presumption will be that the orders will be crossed 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.

8. How should I mark my ACT trade report for riskless principal trades?

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

9. If one leg of the transaction is executed through Nasdaq's Small Order Execution System℠ (SOES℠) or SelectNet℠ system, 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 SOES or SelectNet, the trade is automatically reported to ACT and sent to the tape. When a trade involves a Market Maker, ACT defaults to a capacity indicator of "principal" on the trade report. For SOES and SelectNet trades, a Market Maker will **not** be required to go back into ACT and change the Nasdaq system-generated ACT 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 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, MMA receives a customer limit order to buy at $20 from another member, and displays that order in its quote. SOES executes against MMA's quote thus taking out the $20 buy order, and SOES reports the trade to the tape at $20 as principal for MMA. If MMA does not clear for the member from which it received the customer limit order, MMA would be required to enter a clearing-only record into ACT to reflect the offsetting sale to the member at $20, and would be required to indicate on the clearing record that the trade was done on a riskless principal basis.

For riskless principal transactions that occur outside Nasdaq systems (*e.g.*, phone orders or internal executions) the Market Maker must report the initial leg to ACT and mark the ACT 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.

10. If a Market Maker does not report a trade with a customer to ACT because the trade qualifies for riskless principal treatment, is the Market Maker still required to input that information into the Order Audit Trail System (OATS℠)?

Yes. If Market Maker A (MMA), for example, represents in its quote a limit order to buy 100 shares at $20, and Market Maker B (MMB) hits MMA's bid, MMA will not be required to report to ACT the offsetting sale of 100 shares at $20 to the customer. MMA will, however, be required to report this information to OATS. Specifically, MMA should report the receipt of the order via a "New Order Report" and the execution of the customer order via an "OATS Execution Report." On the OATS Execution Report, MMA should supply a Reporting Exception Code of "M" (M = Market Maker side of Nasdaq execution system execution). The Reporting Exception Code indicates that there is no corresponding trade report in ACT.

11. 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 at the same price or if the Market Maker has one order for which 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 ACT 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 ACT. 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.

12. 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 ACT 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, has reported those transactions to the tape as riskless principal, and 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 ACT 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 canceled, as well as the execution time(s) of the trade(s) reported as riskless principal.

13. 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 (*i.e.*, two orders that offset one another that are executed at the same price), market participants must report once and as riskless principal.

Trade-Reporting Requirements

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

MMA is at the inside offer displaying its customer's limit order to sell 2,000 shares at $20 1/4 when MMB lifts the offer using the phone. What are MMA's trade-reporting obligations?

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

15. If I am a Market Maker in a Nasdaq-listed security and I am engaging in a riskless principal trade consistent with the new trade-reporting rule, 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 Question 14?

SEC Rule 10b-10(a)(2)(ii)(B) requires a Nasdaq Market Maker that trades as principal to disclose on the confirmation:

1) the "reported trade price" for the trade between the Market Maker and the customer (net price or reported trade price);

2) the price to the customer (gross price); and

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

Under the riskless principal trade-reporting rules, if a Market Maker executes a riskless principal transaction where the tape price and the net price to the customer are the same, the Market Maker would not report the offsetting transaction with the customer to the tape. Thus, there technically would be no "reported trade price" (Item #1 above) for the purpose of Rule 10b-10 confirmation requirements, since the transaction with the customer would not be reported to the tape. After consultation with the SEC, it appears warranted that in these instances, the Market Maker would disclose on the confirmation:

A) the price that was reported to the tape for the first leg of the transaction, as the "reported trade price" (Item #1, above);

B) the price to the customer (*i.e.*, the gross price of the buy/sale to the customer); and

C) the difference (if any) between the reported trade price and the gross price to the customer (*i.e.*, Item A and Item B).

With regard to Question 14, assume that MMA, which was reflecting a limit order to sell at 20 1/4, tacked on no markdown or other fee. In that case, MMA would confirm to the customer:

A) a trade price of $20 1/4 (the first leg of the transaction that was reported to ACT by MMA);

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

C) a no differential.

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

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

B) a price to the customer of $20; and

C) a differential of 1/4.

Members should note that while the disclosure requirements of SEC Rule 10b-10(a)(2)(ii)(B) do not apply to Market Makers in non-Nasdaq OTC securities (pink sheet and OTCBB securities), the NASD currently is considering adopting a parallel disclosure requirement for non-Nasdaq OTC Market Makers.

Finally, for riskless principal trades effected by non-Market Makers trading as principal in Nasdaq and OTC securities, SEC Rule 10b-10 confirmation requirements remain the same as they are today.[3]

16. Nasdaq 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 1/8. The customer tells MMA that it is willing to pay a markdown, commission equivalent, or other fee of 1/8 below the $10 1/8 price. Using the phone, MMA sells 75,000 shares to MMB at a price of $10 1/8 per share. Instead of attempting to find the remaining 25,000 shares, MMA fills the entire customer order for 100,000 shares, for a price of $10 1/8 per share (exclusive of any markdown, commission equivalent, or other fee), by

trading the 25,000-share balance out of inventory. How is this trade reported? Is part of the order deemed to be "at risk" and part of the order considered to be riskless?

Only a portion of the 100,000-share transaction is deemed to be riskless – the 75,000 shares. The remaining 25,000 shares that were executed from MMA's inventory are considered to be "at risk," and must be reported to the tape. Thus, MMA will report the sale to MMB of 75,000 shares at $10 1/8 in one ACT report, and separately report the offsetting buy of 25,000 at $10 1/8 from its institutional customer. MMA reports only a buy of 25,000 and not a buy of 100,000 shares from its institutional customer because the 25,000 is deemed to be "at risk." The confirmation to the customer would show a reported price of $10 1/8, a price to the customer of $10, and a differential (markdown) of 1/8.

17. In the above example, it may not be easy for MMA to definitively say that 75,000 shares were riskless, because MMA may have accumulated these shares in multiple transactions 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 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 question above where MMA was claiming 75,000 shares were riskless principal, MMA must be able to tie a specific trade or trades to the 75,000. If MMA were reporting an average price of $10, MMA would have to point to a series of transactions which had an average price of $10 (exclusive of markups or markdowns, commission equivalents, or other fees) and which totaled 75,000 shares.

18. Nasdaq Inside Market: $10 - 10 1/4, 10 X 10

MMA is at the inside bid displaying a customer limit order to buy 1,000 shares at $10, when MMA receives a market order to sell 500 shares over SOES, which is automatically executed against MMA's quote and reported to the tape. What are MMA's trade-reporting obligations?

Under NASD Rule 2110 and IM-2110-2 (commonly know as "Manning"), MMA is obligated to execute at least 500 shares of the limit order it is holding. Thus, MMA can sell 500 shares on a riskless principal basis to the customer at $10, not report the transactions to the tape, and display the remaining 500 shares in its quote. Alternatively, MMA can sell 1,000 shares to the customer limit order at $10, and report 500 shares to the tape as the 500 are deemed to be at risk.

19. Nasdaq Inside Market: $25 - 25 1/8, 10 X 10

MMA receives a not-held order from an institutional customer to buy 5,000 shares, with instructions to work the order with a price limit (or "top") of $25 1/16. MMA's customer tells it that he wishes to trade net and does not wish to pay a markup, markdown, commission equivalent, or other fee over and above the $25 1/16 top price. Using SelectNet, MMA buys 5,000 shares from MMB at $25, and SelectNet reports the transaction to the tape. What are MMA's reporting obligations?

Assuming that MMA sells the 5,000 shares to its customer at $25 1/16 net, MMA must report this sale to the tape because the reported price via SelectNet and the offsetting sell to its customer were done at different prices.

If MMA were not trading net and, for example, sold to its customer at $25, plus a 1/16 mark-up or sales credit, MMA would not report the sale to the customer to ACT since the two trades were done at the same price. Under SEC Rule 10b-10, the confirmation to the customer would show a reported price of $25, a price to the customer of $25 1/16, and a differential of 1/16. This answer is consistent with statements made by the NASD in *Notices to Members 95-67* and *96-10*, as well as the letter from Richard Lindsey, SEC, to Richard Ketchum, NASD, dated January 3, 1997.

20. Nasdaq 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. Using the phone, MMA sells 4,000 shares at $10 3/8 to MMB and 2,000 shares at $10 to MMC. What are MMA's trade-reporting obligations?

MMA must report to ACT 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). If MMA buys 6,000 shares from its customer at a VWAP of $10 1/4, it will not be required to report to the tape the offsetting buy with the 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.[4] 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.[5] If MMA 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.

Alternatively, if MMA trades on a net basis and buys 6,000 shares from its customer at $10 1/8 (or any other price different from the VWAP of $10 1/4), MMA would report the buy with its customer to the tape because VWAP and the buy from the customer were different prices. The confirmation would disclose a reported price of $10 1/8, a price to the customer of $10 1/8, and no differential.

21. Nasdaq 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 of 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 the 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.

22. Nasdaq 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?

One ACT report would indicate an agency cross of 75,000 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.[6]

Attachment B – Text Of Rule Changes

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

4630. Reporting Transactions in Nasdaq National Market Securities

4632. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price and Volume

(1) through (3)(A) No Change

(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 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 or customer] 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 mark-down, commission-equivalent, or other fee.

(e) through (f) No Change

4640. Reporting Transactions in Nasdaq SmallCap Market Securities

4642. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price and Volume

(1) through (3)(A) No Change

(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 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 or customer] 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 mark-down, commission-equivalent, or other fee.

(e) through (f) No Change

4650. Reporting Transactions in Nasdaq Convertible Debt Securities

4652. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price and Volume

(1) through (3)(A) No Change

(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 a security, purchases the bond 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 bond as principal [to another member or customer] 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 mark-down, commission-equivalent, or other fee.

(e) through (f) No Change

6600. Reporting Transactions In Over-The-Counter Equity Securities

6620. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price and Volume

(1) through (3)(A) No Change

(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 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 or customer] 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 mark-down, commission-equivalent, or other fee.

(e) No Change

Endnotes

[1]In fact, NASD Rule IM-2110-2 (Limit Order Protection Rule) requires Market Makers to execute customer limit orders (regardless of whether the customer is theirs or that of another member) when trading as principal at prices that would satisfy the customer's limit order. In addition, pursuant to best execution obligations articulated by the SEC under the SEC Order Handling Rules, Market Makers generally must pass along any price improvement obtained when executing an incoming order at its published quote while holding an undisplayed limit order priced better than that quote. *See Notice to Members 97-57*.

[2]*See* Exchange Act. Release No. 34-37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (Order Handling Rules Adopting Release); NASD *Notice to Members 96-65* (October 1996); NASD *Notice to Members 97-57* (September 1997).

[3]*See* SEC Rule 10b-10(a)(2)(ii)(A).

[4]*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).

[5]*See id*.

[6]*See id*.