

NASD Notice to Members 99-61

SEC Approves Changes
To Rule 4613—Firm
Quotation Requirements;
**Effective Date:
August 2, 1999**

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☐ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
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- ☐ Registration
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- ☒ Systems
- ☒ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

On June 22, 1999, the Securities and Exchange Commission (SEC) approved changes to National Association of Securities Dealers, Inc. (NASD®) Rule 4613(b) regarding quotation updates following execution of an order.

NASD Rule 4613(b), as now amended, will require a Market Maker to disseminate an inferior quote whenever the Market Maker fails to execute the full size of an incoming order that is at least one normal unit of trading greater than the Market Maker's published quotation size. The rule change will also modify IM-4613 to prohibit the use of automatic quote updating in violation of Rule 4613(b).

The NASD and The Nasdaq Stock Market, Inc. (The Nasdaq Stock Market®) believe that this change will improve market efficiency by requiring Market Makers to display their true and intended quote size, thereby increasing market transparency and price discovery. This *Notice* is being issued to alert members to the changes involved, which will become effective on August 2, 1999.

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

Background And Summary

NASD Rule 4613(b) (Rule) sets forth the requirement that a Market Maker execute an order for at least the number of shares displayed in its quotation at the displayed price. The Rule is being modified to address situations where a Market Maker displays the minimum quotation size required, receives an incoming order larger than its displayed size, fills the

order only up to its displayed size, and remains at the inside quote prepared to accept another order at the minimum size. Although the Market Maker has complied with the current NASD Rule 4613(b) and other applicable quotation requirements (NASD Rule 3320, "Offers at Stated Prices," IM-3320, "Firmness of Quotations," and Exchange Act Rule 11Ac1-1), its continued display of the same price and size indicates that it was actually willing to buy more than the number of shares displayed. This practice creates opportunities for "gaming," hinders price discovery, leads to locked/crossed markets, and increases transactions costs.

To remedy this inefficient trading scenario, subsection (2) is being added to the Rule which will mandate that a Market Maker disseminate an inferior quote whenever it fails to execute the full size of an incoming order that is at least one normal unit of trading greater than its published quotation size. The following scenario best describes the behavior to be mandated under Rule 4613(b)(2):

Market Maker #1 (MM1) is bidding \$10 for 100 shares of ABCD. Order Entry Firm #1 (OE1) sends a preferenced SelectNetSM order to MM1 to sell 1,000 shares of ABCD at \$10. MM1 partially executes OE1's 1,000-share order by buying 100 shares of ABCD.

Prior to implementation of these amendments, it would be permissible for MM1 to continue quoting 100 shares at \$10, thereby forcing OE1 to potentially execute an additional nine transactions to sell the 1,000 shares it offered in the original order. Under the amended Rule, however, MM1 must immediately move its quotation to an inferior price for failing to execute the entire 1,000-share order. However, if OE1's 1,000

shares had been offered as an all-or-none order, MM1 would be permitted to decline the order and remain at its current quotation.¹

IM-4613 is also being modified to prohibit a Market Maker from using an automatic quote updating system in any manner that would violate the Rule, as amended.

The modified text of the Rule and IM-4613, which will become effective on Monday, August 2, 1999, is as follows.

Text Of Amendments

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

4613. Character of Quotations

(a) No changes

(b) Firm Quotations

(1) A market maker that receives an offer to buy or sell from another member of the Association shall execute a transaction for at least a normal unit of trading at its displayed quotations as disseminated in The Nasdaq Stock Market at the time of receipt of any such offer. If a market maker displays

a quotation for a size greater than a normal unit of trading, it shall, upon receipt of an offer to buy or sell from another member of the Association, execute a transaction at least at the size displayed.

(2) If a market maker, upon receipt of an offer to buy or sell from another member of the Association in any amount that is at least one normal unit of trading greater than its published quotation size as disseminated in The Nasdaq Stock Market at the time of receipt of any such offer, executes a transaction in an amount of shares less than the size of the offer, then such market maker shall, immediately after such execution, display a revised quotation at a price that is inferior to its previous published quotation. The failure of a market maker to execute the offer in an amount greater than its published quotation size shall not constitute a violation of subparagraph (b)(1) of this rule.

(c) - (e) No changes

IM-4613. Autoquote Policy

(a) No changes

(b) Exceptions to the General Prohibition - Automated updating of quotations is permitted when: (1) the update is in response to an execution in the security by that firm (such as execution of an order that partially fills a market maker's quotation size), and is in compliance with Rule 4613(b)(2); (2) it requires a physical entry (such as a manual entry to the market maker's internal system which then automatically forwards the update to Nasdaq); (3) the update is to reflect the receipt, execution, or cancellation of a customer limit order; or (4) an electronic communications network as defined in SEC Rule 11Ac1-1(a)(8) is required to maintain a two-sided quotation in Nasdaq for the purpose of meeting Nasdaq system design requirements.

Endnote

¹Please note that while NASD Regulation will fully investigate reports of alleged violations of Rule 4613(b)(2) for future disciplinary action, NASD Regulation will not attempt to obtain contemporaneous trade executions based on such claims.

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