NASD NOTICE TO MEMBERS 97-76

Nasdaq Eliminates Excess Spread Rule For Nasdaq Securities

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Executive Summary

The Nasdaq Stock Market, Inc. (Nasdaq®) Board of Directors approved, and the National Association of Securities Dealers, Inc. (NASD®) Board of Governors ratified, a decision to allow NASD Rule 4613(d)—the "excess spread" rule for Nasdaq securities—to lapse as of October 13, 1997. Accordingly, NASD member firms are no longer required to comply with excess spread parameters for Nasdaq securities, as of October 13, 1997.

Questions regarding this rule change should be directed to John F. Malitzis, Senior Attorney, Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8245.

Background And Summary

Prior to January 20, 1997, the NASD's excess spread rule (the Rule or the Excess Spread Rule) provided that registered market makers in Nasdaq securities could not enter quotations that exceeded 125 percent of the average of the three narrowest market maker spreads in that issue, provided, however, that the maximum allowable spread could never be less than 1/4 of a point (125 Percent Rule). The Rule originally was designed to enhance the quality of the Nasdaq market by preventing firms from holding themselves out as market makers without having a meaningful quote in the system. Despite the regulatory objectives underlying the Rule, however, certain market participants believed that the Rule produced a variety of unintended consequences that undermined the integrity of Nasdaq. Most notably, the Securities and Exchange Commission (SEC) found in its 21(a) Report on the NASD and Nasdaq that the then-current Excess Spread Rule posed the potential for discouraging, rather than encouraging, the narrowing of spreads.[1] Accordingly, the SEC requested that the NASD "modify the rule to eliminate its undesirable effects, or to repeal it."[2]

In response to the SEC's 21(a) Report, the NASD submitted a proposal, which was approved by the SEC and which amended the Excess Spread Rule on a pilot basis.[3] Under the revised Excess Spread Rule, a registered market maker in a Nasdaq security was precluded from being a registered market maker in that issue for 20 business days if its average spread in the security over the course of any full calendar month exceeded 150 percent of the average of all dealer spreads in such issue for the month (150 Percent Rule). While the Commission approved the 150 Percent Rule on a pilot basis, in its approval order for the new rule, the SEC stated that "[a]lthough the amended excess spread rule may reduce some of the anticompetitive concerns outlined in the 21(a) Report, the Commission believes that the amendment . . . may not completely satisfy the NASD's obligations under the Commission's Order with regard to the excess spread rule. Specifically, it may not remove completely the anticompetitive incentives for market makers to refrain from narrowing quotes because the market makers' quotation obligation continues to be dependent to some extent upon quotations of other market makers in the stock."[4]

Furthermore, almost simultaneous with the implementation of the Excess Spread Rule, the SEC's Order Handling Rules were implemented in a specified number of Nasdaq securities, and thereafter in the remaining Nasdaq securities on a rolling basis.[5] The rollout schedule for the implementation of these rules was recently amended, so that all Nasdaq securities will be subject to the Order Handling Rules (*i.e.*, the Limit Order Display Rule and the Electronic Communications Network (ECN) Amendments to the Quote Rule) by

October 13, 1997.[6] Under these rules, market maker spreads are affected by both customer limit orders and market maker quotes, adding a new dimension to the Nasdaq market which previously did not exist. In addition, studies by the NASD's Economic Research Department have shown that the Order Handling Rules have narrowed dealer spreads in stock in which these rules have been implemented—a primary aim of the Excess Spread Rule.[7]

In light of the foregoing, the Nasdaq Board of Directors and the NASD Board of Governors determined to allow NASD Rule 4613(d) to lapse as of October 13, 1997. The NASD and Nasdaq determined this appropriate because: (1) the need for the Rule is obviated by the implementation of the Order Handling Rules in all Nasdaq-listed securities as of October 13; and (2) the SEC has continuing concerns with the Excess Spread Rule. Accordingly, NASD member firms are no longer required to comply with excess spread parameters for Nasdaq securities as of October 13, 1997.

Endnotes

[1] *See Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market* at p. 98 (21(a) Report) (SEC, Aug. 8, 1996).

[2] *Id.* at 99.

[3] *See* Exchange Act Rel. No. 38180 (Jan. 16, 1997), 62 FR 3725 (Pilot Program Approval Order). The pilot originally was set to expire on July 1, 1997, but was extended through September 30, 1997, and again through October 13, 1997. *See* Securities Exchange Act Rel. No. 38804 (July 1, 1997); Securities Exchange Act Rel. No. 39120 (Sept. 23, 1997).

[4] Pilot Program Approval Order, *supra* note 4.

[5] *See* Securities Exchange Act Rel. No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (Order Handling Rule Adopting Release). Among other things, the SEC in the Order Handling Rule Adopting Release amended Rule 11Ac1-1 (ECN Amendments to Quote Rule) to the Securities Exchange Act of 1934 (Exchange Act), and adopted new Rule 11Ac1-4 (Limit Order Display Rule).

[6] *See* Securities Exchange Act Rel. No. 38870 (July 24, 1997).

[7] *See Effects of the Removal of Minimum Sizes for Proprietary Quotes in The Nasdaq Stock Market, Inc.*, p. 6, NASD Economic Research Department (June 5, 1997).