NASD Notice to Members 99-12

NASD Regulation Issues Guidance Concerning The Operation Of Automated Order Execution Systems During Turbulent Market Conditions

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Executive Summary

In light of the recent dramatic intraday volatility and significant surges in trading volume with respect to certain issues traded on The Nasdaq Stock Market, Inc. (Nasdaq®), particularly Internet-based issues, NASD Regulation, Inc. (NASD Regulation℠) is issuing this *Notice to Members* to provide members guidance concerning the operation of their order execution systems and procedures during extreme market conditions. In sum, while National Association of Securities Dealers, Inc. (NASD®) and Securities and Exchange Commission (SEC) rules and regulations do not specify or mandate a particular order execution algorithm or procedure for the execution of customer orders (aside from requirements imposed by the NASD's limit order protection interpretation), NASD Regulation believes that members' best execution obligations require that such algorithms and procedures treat customer orders in a fair, consistent, and reasonable manner. In addition, to the extent that members (particularly wholesale firms) deviate from or alter their execution algorithms or procedures during turbulent market conditions, NASD Regulation believes that firms should consider disclosing such altered procedures and the basis for activating such altered procedures to their customers and firms sending them order flow.[1]

Questions or comments concerning this *Notice* may be directed to the Legal Section of NASD Regulation's Market Regulation Department, at (301) 590-6410.

Discussion

The recent extraordinary volatility and volume in particular stocks, particularly Internet-based stocks, has led to questions as to whether customer orders in these stocks are handled properly, and requests for guidance on best execution under these circumstances. In a companion *Notice to Members* issued today, *Notice to Members 99-11*, NASD Regulation is providing guidance to firms that deal directly with customers with respect to disclosure firms should consider making to inform investors of the increased risks associated with trading during turbulent market conditions. *Notice to Members 99-11* also lists some of the steps on-line firms have taken to respond to volatility. With this *Notice*, NASD Regulation is providing guidance as to the factors Market Makers should consider in evaluating whether modifications to their order execution algorithms or procedures during turbulent market conditions are consistent with the best execution of customer orders.

Given the high trade volume and share volume of the Nasdaq market, as well as competitive pressures to provide swift executions, wholesale firms (*i.e.*, those firms that principally execute orders routed to them from other firms) and integrated firms (*i.e.*, firms with a large retail business that also engage in market making and other activities) have developed their own automated order execution systems for smaller customer orders, generally 3,000 shares or less. During non-turbulent market conditions, these systems, which are by no means uniform, typically execute orders on a first-in-first-out basis and afford priced orders priority on a price/time basis, in addition to complying with applicable SEC and NASD rules, such as the SEC's limit order display rule and the NASD's limit order protection rule. As a general matter, these systems should be designed to process and execute orders during non-turbulent market conditions in a fair, consistent, and reasonable manner and have a capacity that is adequate to handle reasonably anticipated trading volume in an efficient manner.

During extreme market conditions, where there are large order imbalances and/or significant price volatility, however, many firms implement procedures that are designed to preserve the continuous execution of customers' orders while also lessening the exposure of the firm to extraordinary market risk. For example, some firms switch from an automated order execution mode to a manual execution mode in which orders are generally routed through SelectNet℠ to execute against another Market Maker, passing on those prices to the customer. Other firms provide partial executions up to a certain size and, if applicable, place the remainder of the order in a queue that is then processed on a first-in-first-out basis.[2] These are but two examples of the procedures firms have adopted during extreme market conditions and are not intended to reflect preferred procedures.

Some firms have asked NASD Regulation whether their procedures during extreme market conditions are consistent with the best execution of customer orders. Accordingly, NASD Regulation is issuing this *Notice* to provide guidance in this area. Specifically, NASD Regulation believes firms should consider the following guidelines when evaluating whether their order execution algorithms or procedures are appropriate during turbulent market conditions. Nothing in the following guidelines is intended to suggest that firms are restricted from revising their execution algorithms for business reasons unrelated to market turbulence.

1. The treatment of customer orders under any order execution algorithm or procedure must remain fair, consistent, and reasonable.

2. To the extent that a firm's order execution algorithm or procedures are different during turbulent market conditions, the firm should disclose to its order entry firms (and customers if applicable) the differences in the procedures from normal market conditions and the circumstances in which the firm may generally activate these procedures. In this connection, however, NASD Regulation notes that the disclosure of alternative order handling procedures that are unfair or otherwise inconsistent with the firm's best execution obligations would neither correct the deficiencies with such procedures nor absolve the firm of potential best execution violations.

3. Modifications to order execution algorithms or procedures designed to respond to turbulent market conditions may be implemented only when warranted by market conditions. Excessive activation of modified procedures on the grounds of turbulent market conditions could raise best execution concerns. Accordingly, firms should document the basis for activation of their modified procedures.

4. As noted above, and as the SEC has stated, "[b]roker-dealers therefore need to take steps to prevent their operational systems from being overwhelmed by periodic spikes in systems message traffic due to high volume. In particular, broker-dealers should not merely have sufficient systems capacity to handle average-to-heavy loads."[3] Frequent activation of modified order execution algorithms or procedures because a firm has failed to maintain adequate system capacity to handle exceptional loads may raise best execution concerns.

5. To the extent firms execute orders manually during extreme market conditions, NASD Regulation reminds firms that NASD Rule 2320(d) provides that "[f]ailure to maintain or adequately staff an over-the-counter order room or other department assigned to execute customers' orders cannot be considered justification for executing away from the best available market . . . ."

Ultimately, it necessarily involves a facts and circumstances analysis to determine whether actions taken by a firm during turbulent market conditions are consistent with the duty of best execution. Accordingly, NASD Regulation cannot provide specific guidance that a particular order execution algorithm or order handling procedure during turbulent market conditions is always consistent with best execution. Nevertheless, NASD Regulation believes the guidelines set forth above provide useful direction for firms.

Endnotes

[1]Firms that direct order flow likewise have a best execution obligation to conduct regular and rigorous review of the quality of executions of orders sent to correspondent Market Makers.

[2]Firms also have reduced their size guarantee on individual stocks or groups of stocks (*i.e.*, Internet stocks) on a going-forward basis, irrespective of market conditions at any given time.

[3]See SEC Staff Legal Bulletin No. 8 (September 9, 1998).