

NASD NOTICE TO MEMBERS 97-49

Compliance With SEC Order Handling Rules And Nasdaq Trading Rules

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Executive Summary

The National Association of Securities Dealers, Inc. (NASD®) has been reviewing member firm compliance with the Securities and Exchange Commission (SEC) Order Handling Rules and with Nasdaq® trading rules. We are taking this opportunity to reemphasize the application of several rules and system changes and to remind members of their responsibilities in the following areas. Several of these topics have been addressed in the more than 50 faxes that have been sent to head traders and others at member firms since January 1997. Responsible Nasdaq departments are listed below, with appropriate contacts and telephone numbers.

Discussion

Members Must Comply With ECN Rules

In the stocks covered by the SEC Order Handling Rules (the SEC Rules), a market maker is required to reflect all orders (customer and proprietary) placed in an electronic communications network (ECN) in its quote unless the ECN's display is included in the Nasdaq system and there is access to that ECN. SelectNetSM is not a linked or eligible ECN under the SEC Rules because SelectNet orders are not reflected in the Nasdaq quote montage and, accordingly, market makers may not use SelectNet Broadcast to reflect orders priced better than their own displayed quotes, without also adjusting their quotes.

ECN Rules

1) A market maker that broadcasts a SelectNet order must reflect that order in its own quote if the order is priced better than its quote, whether the market maker is at the inside or not. For example, if a market maker broadcasts a SelectNet order to buy 1,000 shares at 20, the market maker

must change its Nasdaq bid to 20 for 1,000 shares.

2) Further, if the market maker is at the inside and places a customer order into SelectNet Broadcast that represents a size greater than 10 percent of its quote size, the market maker must increase its displayed size in its quote. For example, if a market maker broadcasts a customer order in SelectNet to buy 5,000 shares at 20, the market maker must change its Nasdaq bid to 6,000 shares. (It is not necessary to change a market maker's quote size to reflect a proprietary order.)

3) Before Nasdaq moved to display quotes in 1/16's, a market maker could broadcast an order in SelectNet priced 1/16 better than its displayed quote without changing its quote in Nasdaq, but since the change on June 2, 1997, this is no longer permissible. Market makers may continue to preference orders to other market makers or ECNs via the SelectNet preference service without changing their quotes.

4) A market maker that broadcasts an all-or-none (AON) SelectNet order priced superior to its quote must still update its quote to reflect the better-priced SelectNet order.

Market Makers Must Reflect Customer Limit Orders In Quotes

In all stocks covered by the SEC Rules, customers are not required to request that their limit orders be displayed in a market maker's quote. All customer orders that are priced better than a market maker's quote or that add size to the market maker's quote at the inside price are required to be displayed, unless an exception applies. Exceptions include: block size orders (e.g., 10,000 shares or \$200,000 market value); odd-lots; all-or-none orders; those executed immediately upon receipt, sent to

another market maker or a linked ECN; or those requested by the customer not to be displayed. Customers do not have to ask for their limit orders to be displayed — it is the obligation of the market maker to display the orders, unless instructed otherwise by the customer.

Market Makers Must Display Customer Orders

The SEC Rules require members to display customer limit orders as soon as possible, within 30 seconds of receipt in normal market conditions. The 30-second rule does not apply at market openings or shortly thereafter, when trading reopens after a trading halt, or when an Initial Public Offering (IPO) first begins trading, but it does apply at all other times. Members are reminded of their obligation to comply with the 30-second time frame.

Members Must Comply With Limit Order Protection Rules

Whether or not a stock is subject to the SEC Rules, a member's obligation to protect a customer limit order does not cease when the order is sent to an ECN or a market maker for execution. The limit order protection obligations (Manning Rules) apply to all customer limit orders sent to an ECN or a market maker, and the member sending or receiving the order cannot trade ahead of that order. Members must monitor the status of the order and not trade ahead of it until the order has been executed within the ECN or by the market maker.

For example, in an instance where a member receives a customer limit order, sends it to an ECN for execution, and subsequently receives a market order, the SEC has stated that the market order must be given the improved price of the limit order. A member's obligation to protect the

limit order and to improve the price of an incoming market order does not end when the limit order is sent to another entity for execution.

Market Makers Should Review "No Dec" Feature

Nasdaq has given market makers the option to prevent their displayed quote size from being decremented following an execution in the Small Order Execution System (SOESSM) (no dec), provided that their published quote size is equal to or greater than the SOES tier size. This qualification on the use of no dec has been put into place to ensure that market makers who do not want their quote size diminished will continue to provide liquidity of at least the SOES tier size. Accordingly, while it is permissible under the rules to quote the first 50 pilot stocks in proprietary sizes less than the SOES tier size, it is not permissible to do this while using the no dec feature.

The NASD recognizes a very limited exception to the use of the no dec feature when a market maker uses no dec while quoting smaller size in conjunction with the operation of the market maker's own auto-quote system. Specifically, market makers may reflect customer limit orders in sizes lower than SOES tier size while using the no dec feature, but they must immediately reinstate the SOES tier size using their own automated quote update systems following the execution of the customer limit order.

Market makers are not permitted to continue to quote at less than the SOES tier size in any stock while using no dec.

Members Must Maintain Appropriate Size Quotes

With the implementation of the SEC Rules, market makers began reflecting customer limit orders in their

quotes, regardless of the minimum quote sizes required by Nasdaq. The SEC allowed the first 50 pilot stocks to be quoted in actual size, as low as 100 shares, and Nasdaq began decrementing the size of market makers' quotes following unpreferenced SOES executions. Accordingly, market makers for the first time have been required to actively monitor their posted size to make sure that they are complying with the various new rules and system features.

Size Obligations

1) Market makers are permitted to quote actual size in the first 50 pilot stocks, unless they are using the no dec feature.

2) For stocks that are phased in under the SEC Rules, market makers are required to reflect better priced customer limit orders in their quotes, and to increase their size if they are at the inside and the customer order represents at least 10 percent of the market maker's quote size. Market makers may voluntarily choose to reflect customer limit orders in their quotes for stocks that have not yet been phased in under the SEC Rules.

3) Market makers who have their size decremented following a SOES execution may remain at that size until other SOES executions reduce their size to zero. When a quote is decremented to zero size, the Nasdaq automated quote refresh feature will refresh the market maker's quote to tier size if the market maker has chosen this feature. A market maker may also use its own manual or automated update system to refresh its quote to tier size or customer limit order size. If none of these alternatives is used, the market maker will be placed in a SOES closed status and would be deemed to have withdrawn from the stock if it has not refreshed its quote after five minutes.

4) Market makers who have had their size decremented by a SOES execution and who voluntarily update their price must also update their size to the SOES tier size at that time. Market makers may not update their price and leave less than the SOES tier size displayed. The new Quick Quote Update feature, available on June 24, 1997 with the Workstation 4/5 release, now permits market makers to update the size of their quotes quickly for this purpose.

Aggregated Size Of Customer Limit Orders

Anytime a market maker is at the inside, or the inside market moves to the market maker's quote, the market maker's displayed price and size must reflect the aggregated size of all of its customers' limit orders.

For example, if a market maker receives three customer limit orders priced at 20 for 1,000, 2,000, and 1,000 shares, the SEC Rules require these orders to be displayed. If 20 becomes the inside bid and the market maker is quoting 20, the market maker must update its quote size to at least 4,000 shares, reflecting the aggregation of the limit order sizes.

Market Makers May Not Lock Or Cross The Market

Market makers are reminded of their obligations to use reasonable means

not to lock or cross the market, whether through their own quote or by sending an order into an ECN. "Reasonable means" has been interpreted to include a SelectNet order preferenced to the firm(s) at the bid or offer. This is especially important at the opening, and it is important that members monitor their quotes as well as any orders placed in ECNs to avoid locking or crossing the market during the opening. If these orders in the ECN are market maker orders, it is the obligation of the market maker to attempt to contact the other side prior to sending the order into the ECN and locking or crossing the market. ECNs are also required to use reasonable means to avoid locking or crossing the market, especially when the orders sent into Nasdaq emanate from a non-market maker or non-member.

Members Must Mark ACT Reports

Since all market makers are now primary market makers and exempt from the short sale rule for Nasdaq National Market securities, when market makers effect a short sale using their primary market maker exemption, they must mark their Automated Confirmation Transaction Service (ACTSM) reports with "short sale exempt."

Requests For Excused Withdrawal Status

Market makers that call Nasdaq Market Operations for an excused withdrawal should maintain, as a part of their recordkeeping requirements, supporting documentation for the reason they have requested the withdrawal. NASD Regulation examiners will request and review such documentation for excused withdrawal requests.

Questions regarding this *Notice* or marketplace rules in general may be directed to:

Nasdaq MarketWatch at (800) 211-4953;

Nasdaq Office of General Counsel at (202) 728-8294; or

NASD Regulation, Market Regulation at (301) 590-6410.

For questions regarding system operations, please call:

Nasdaq Market Operations at (800) 481-2732; or

Nasdaq Trading and Market Services at (202) 728-8805.

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