NASD Notice to Members 98-5

SEC Approves Changes To Third Market Trading Rules

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Executive Summary

On November 26, 1997, the Securities and Exchange Commission (SEC or Commission) approved changes to National Association of Securities Dealers, Inc. (NASD®) rules governing trading in exchange-listed securities in the over-the-counter market (the Third Market). The amendments: (1) codify permissible uses of computer-generated quote systems; (2) eliminate the excess spread rule; (3) reduce the minimum quotation size applicable to Consolidated Quotation System (CQS) market makers to one unit of trading (*i.e.*, 100 shares) regardless of whether the market maker is displaying a customer's limit order or quoting for its own proprietary account; (4) extend pertinent provisions of the NASD's limit order protection rule applicable to securities listed on The Nasdaq Stock Market℠ (the Manning Rule) to exchange-listed securities; and (5) change the Computer Assisted Execution System℠ (CAES℠) to automatically execute at the firm's displayed price and up to the firm's displayed size only. The rule changes are effective December 16, 1997, with the exception of the rules relating to computer-generated quotations, which are effective December 22, 1997.[1]

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Background

The SEC has approved several amendments to NASD rules governing trading in exchange-listed securities by market makers in the Third Market.[2] The NASD proposed these amendments in light of the implementation of the SEC's Order Handling Rules, which enhanced the obligations CQS market makers[3] have with respect to the quotation and trading in exchange-listed securities. Specifically, the SEC adopted a new rule 11Ac1-4 (Limit Order Display Rule) and amendments to SEC Rule 11Ac1-1 (Quote Rule).[4] In particular, an amendment to the Quote Rule expanded the quotation requirements of substantial OTC market makers and exchange specialists to require that they publicly disseminate continuous two-sided quotations for any exchange-listed security for which they account for 1 percent or more of the trading volume (commonly referred to as the 1 Percent Rule).[5] Prior to those rule changes, mandatory quotations were only required from OTC market makers and exchange specialists who transacted more than 1 percent of the volume in a Rule 19c-3 security.[6] Those rule changes are intended to improve transparency and provide the public with information about significant market participants. The NASD rule changes are described below.

Summary Of Rule Changes

1. Codification Of Permissible Uses Of Computer-Generated Quote Updates For Non-Rule 19c-3 Securities

In expanding the 1 Percent Rule, and requiring active market makers to quote in the Third Market, the Commission recognized that it raised issues with respect to the ability of NASD members to employ computer-generated quote systems in light of the constraints imposed by the plan governing the Intermarket Trading System (ITS Plan) and the NASD policy on autoquoting. Under the ITS Plan, exchange specialists and CQS market makers can use "automated quotation tracking systems," provided that the quotations generated by such systems are for 100 shares or less (100-Share Autoquoting Limitation). Despite the ITS

Plan's allowance of 100-share autoquotes, CQS market makers were prohibited from using computer-generated quotes under the NASD's autoquoting policy, which prohibited firms from using such systems to effect automated quote updates or track the inside market. In addition, the NASD's rule requiring CQS market makers to quote a minimum quote size of 500 shares when they were not displaying a customer limit order effectively prohibited CQS market makers from autoquoting.

The Commission, however, believes that the existing prohibition on the use of computer-generated quotes is no longer appropriate. Such an approach may excessively limit the use of sophisticated trading strategies that rely on automation in the quotation process for their success. It also may act as a competitive disadvantage to market makers and specialists that would otherwise rely on technology to meet their quotation obligations more efficiently.[7] Given the enhanced quotation obligations imposed on some market participants under the revised Quote Rule, therefore, the Commission urged the NASD, ITS participants, and other interested market participants to develop revised standards that would permit the use of computer-generated quotes, provided that such quotations contribute value to the market.

To this end, the NASD has eliminated certain restrictions on the use of automation to update quotes in exchange-listed securities.[8] These changes do not apply to securities listed on The Nasdaq Stock Market. The rule governing automated quote updates for Nasdaq securities (IM-4613) is being retained in its current form. **Furthermore, it should be noted that these restrictions have been eliminated only for non-Rule 19c-3 securities.** Thus, restrictions will remain for those exchange-listed securities eligible for trading through ITS, because lifting the ban on computer-generated quotations for these securities would still conflict with the ITS Plan in its current form.

As amended, NASD Rule 6330(d) now explicitly permits, for non-Rule 19c-3 securities only, the following uses of computer-generated quote updates:

- an update in response to an execution;
- a manual entry into a firm's system that then routes the update to the Nasdaq system;
- an update to reflect the receipt, execution, or cancellation of a customer limit order;
- exposing an order for price improvement; and
- equaling or improving either or both sides of the national best bid or offer (NBBO), or adding size to the NBBO.

These changes explicitly accommodate computer-generated quotations that add value to the market and do not raise quotation accessibility concerns or compromise the capacity or integrity of Nasdaq. **In this regard, it is important to note that market makers are prohibited from using computer-generated quotes to track away from the inside market ("autoquoting away").** Thus, the new rule will permit computer-generated quotations in exchange-listed securities that generate proprietary quotes for 100 shares or more if such quote systems **equal or improve** either or both sides of the NBBO.

For example, if a CQS market maker utilized a computer-generated quotation program to match the best offer (bid) and the market responsible for the best offer (bid) subsequently increased (decreased) its offer (bid) price, the CQS market maker could not use the program to track such inferior price. Thus, if the best offer is 20 1/4, a CQS market maker could use the program to improve its offer to 20 1/4. If the market responsible for the 20 1/4 offer moved to 20 3/8, however, the CQS market maker **could not** use the program to move its offer to 20 3/8.

2. Elimination Of Excess Spread Rule For All Exchange-Listed Securities

In conjunction with the amendments to permit only certain types of computer-generated quote updates while retaining the ban on autoquoting away as discussed above, the NASD determined to enhance the quotation flexibility of CQS market makers by eliminating the current excess spread rule, Rule 6330(c). That rule, as applied to CQS securities, provided that a CQS market maker could not enter a quotation spread in excess of 125 percent of the average of the three narrowest market maker spreads in such security, which average spread calculation should include quotations from national securities exchanges. In an environment that retains the ban on autoquoting away, the elimination of the excess spread rule will provide CQS market makers with the ability to update their quotes in an efficient and cost-effective manner while minimizing the impact on the operation and capacity of Nasdaq systems that collect, process, and disseminate quotation changes. This should serve to minimize the potential adverse competitive consequences on highly automated CQS market making.

3. Changes To Minimum Quote Size For CQS Market Makers

NASD Rule 6330(b) previously provided that a CQS market maker must display a minimum quotation size of 500 shares, with the exception of displaying a customer limit order, which could be for less than 500 shares. In an environment where CQS market makers were the only market participants who could impact quotes in the Third Market, it was desirable and appropriate to impose a minimum quotation size requirement to ensure an acceptable level of market liquidity and depth.

Now that the SEC's Limit Order Display Rule permits investors to directly impact quoted prices in the Third Market by having their limit orders displayed publicly, however, it is appropriate to treat CQS market makers in a manner equivalent to exchange specialists and not subject them to minimum quote size requirements. Accordingly, Rule 6330(b) now provides that CQS market makers may post quotations commensurate with their own freely-determined trading interest, provided that the quotations are for at least one normal unit of trading.

4. Modifications To CAES

The implementation of the SEC's Limit Order Display Rule exacerbated a shortcoming in the design of the CAES system.[9] Specifically, while in the past CAES volume was minimal, it permitted other CQS market makers to send preferenced orders of up to 1,000 shares to another CQS market maker for automatic execution at the best bid or offer among CQS market makers. CAES would execute such orders regardless of whether the CQS market maker was at the best bid or offer, the quote driving the BBO was for less than 1,000 shares, or the CQS market maker wanted to accept preferenced orders from the order entry firm or market maker.

Now, because the Order Handling Rules require market makers to display customer limit orders, CQS market makers are not only obligated to execute trades up to 1,000 shares at another market maker's quote, they must also execute trades at superior-priced limit orders displayed by any other CQS market maker, even if such limit orders are only for 100 shares.

Accordingly, CAES has been modified in order to facilitate the best execution of customer orders and not subject CQS market makers to automatic executions at prices other than their posted quotes. Specifically, CAES will now automatically execute at the firm's price and up to the firm's displayed size.

5. Modifications To The Limit Order Protection Rule Applicable To CQS Securities

NASD Rule 6440 provides that no member shall trade ahead of a customer limit order. Unlike the limit order protection rule applicable to Nasdaq securities (the Manning Rule), however, the limit order protection rule applicable to exchange-listed securities does not explicitly permit a member to negotiate special terms and conditions with a customer. Specifically, under the Manning Rule, member firms may attach terms and conditions with respect to the handling of limit orders that are either: (1) for institutional accounts;[10] or (2) limit orders that are for 10,000 shares or greater, regardless of whether they are for institutional accounts, provided that the order is $100,000 or more in value.

The NASD believes there is no basis to differentiate between limit orders in Nasdaq securities and limit orders in exchange-listed securities with respect to the protections afforded under NASD rules. Accordingly, the NASD is extending the "terms and conditions" language of the Manning Rule to the CQS limit order protection rule.

Text Of Amendments

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

6330. Obligations of CQS Market Makers

(a) No Change

(b) [CQS market makers shall be required to input a minimum quotation size of 200 or 500 shares in each reported security (as established and published from time to time by the Association) depending on trading characteristics of the security; provided that a CQS market maker may input a quotation size less than such minimum quotation size to display a limit order in compliance with SEC Rule 11Ac1-4. A limit order displayed in a] <u>A</u> CQS market maker's quotation [pursuant to SEC Rule 11Ac1-4] must be for at least one normal unit of trading [or a multiple thereof].

[(c) Excess Spreads.

A market maker shall not enter quotations in CQS securities that exceed the parameters for maximum allowable spreads as approved by the Association's Board of Governors and that may be published from time to time by the Association. The maximum allowable spreads for CQS securities shall be 125 percent of the average of the three (3) narrowest market maker spreads in each security, which average spread calculations shall include quotations from national securities exchanges (if the number of CQS market makers in a security plus the number of national securities exchanges trading that security is less than three (3), the maximum allowable spread will be 125 percent of the average spread); provided, however, that the maximum allowable spread shall never be less than 1/4 of a point.]

(d) redesignated as paragraph (c)

(d) Computer-Generated Quotations.

(1) General Prohibition - Except as provided below, this rule prohibits the automatic updating or tracking of inside quotations in CQS by computer-generated quote systems. This ban is necessary to offset the negative impact on the capacity and operation of Nasdaq systems regarding certain systems that track changes to the inside quotation and automatically react by generating another quote to keep the market maker's quote away from the best market, without any cognizable human intervention.

(2) 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); (2) it requires a physical, cognizable entry (such as a manual entry to the market maker's internal system which then automatically forwards the update to a Nasdaq system); (3) the update is to reflect the receipt, execution, or cancellation of a customer limit order; (4) it is used to expose a customer's market or marketable limit order for price improvement opportunities; or (5) it is used to equal or improve either or both sides of the national best bid or offer ("NBBO"), or add size to the NBBO.

6440. Trading Practices

(a) – (e) No Change

(f)(1) No Change

(f)(2) No Change

(3) The provisions of this paragraph shall not apply:

(A) No Change

(B) No Change

(C) No Change

(D) to any purchase or sale for which a member has negotiated specific terms and conditions applicable to the acceptance of limit orders that are:

(i) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or

(ii) for 10,000 shares or more, unless such orders are less than $100,000 in value.

Endnotes

[1] A brief announcement of these rule changes was made by fax to members dated December 16, 1997, and posted on the Nasdaq Trader℠ Web Site *(www.nasdaqtrader.com).*

[2] *See* Exchange Act Release No. 39367 (November 26, 1997), 62 FR 64242 (December 4, 1997).

[3] Quotations and quotation sizes in reported securities may be entered into the Consolidated Quotations Service (CQS) through The Nasdaq Stock Market only by an Association member registered with it as a CQS market maker. *See* NASD Rule 6320.

[4] *See* Securities Exchange Act Release No. 37619A (September 6, 1997), 61 FR 48290 (September 12, 1997) ("Adopting Release").

[5] *See* Adopting Release at 48317. An OTC market maker must, within 10 business days of the end of each calendar quarter, compute its trading volume for each subject security, and if the volume exceeds 1 percent, the market maker must begin publishing two-sided quotations.

[6] Exchange Act Rule 19c-3 prohibits the application of off-board trading restrictions to securities that: (1) were not traded on an exchange on or before April 26, 1979; or (2) were traded on an exchange on April 26, 1979, but ceased to be traded on an exchange for any period of time thereafter. Accordingly, exchange-traded securities not subject to off-board trading restrictions are referred to as Rule 19c-3 securities. While the amendments to the Quote Rule extended the quotation requirement to all exchange-listed securities, the Commission, by exemptive order, provided relief from compliance with the 1 Percent Rule with respect to non-Rule 19c-3 securities until September 30, 1997. *See* Exchange Act Release No. 38870 (July 24, 1997), 62 FR 40732 (July 30, 1997).

[7] *See* Adopting Release at Section III.B.3.c.i.

[8] These uses are in addition to three other forms of computer-enhanced quotation maintenance programs referenced in the NASD's existing Autoquote Policy with respect to securities listed on Nasdaq, which are also being incorporated into Rule 6330 with respect to exchange-listed securities. *See* NASD IM-4613. Specifically, these three forms are: (1) quotation updates 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); (2) quotation updates that require a physical entry (such as manual entry to the market maker's internal system which then automatically forwards the update to Nasdaq); and (3) quotation updates that reflect the receipt, execution, or cancellation of a customer limit order. With the exception of these types of computer-generated quotation and maintenance systems, all other types of computer-generated quotations would continue to be prohibited. Thus, market makers could not use computer-generated quotations to track away from the inside market ("autoquoting away").

[9] CAES is an automated system operated by Nasdaq that allows NASD members to direct both agency and principal orders (in stocks in which they make a market) in exchange-listed securities to CAES for automated execution in the third market. All CQS market makers must be CAES market makers.

[10] Institutional limit orders are orders for institutional accounts. NASD Rule 3110(c) defines an institutional account as an account for: (1) banks, savings and loan associations, insurance companies, or registered invest-

ment companies; (2) investment advisors registered under Section 203 of the Investment Advisers Act of 1940; and (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.