

NASD NOTICE TO MEMBERS 98-21

SEC Approves Amendments To Rule On Clearly Erroneous Transactions

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- ☐ Institutional
- ☐ Insurance
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☐ Registered Representatives
- ☐ Registration
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- ☐ Syndicate
- ☒ Systems
- ☒ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

On January 14, 1998, the Securities and Exchange Commission (SEC) approved changes to National Association of Securities Dealers, Inc. (NASD[®]) Rule 11890 regarding the handling of clearly erroneous transactions.¹ The NASD and The Nasdaq Stock MarketSM (Nasdaq[®]) believe that the process for resolving erroneous transaction complaints will become fairer, more efficient, and more timely, thereby promoting the maintenance of fair and orderly markets and exposing the parties to an allegedly erroneous transaction to less market risk. This *Notice* is being issued to alert members to the changes involved, **which will become effective on Monday, February 23, 1998.**

The rule as amended gives designated Nasdaq officials the authority to adjust the price and size of erroneous transactions, where previously Nasdaq officials had authority only to nullify, affirm or decline to act with respect to an allegedly erroneous transaction. Nasdaq officials also will now be able to cancel or adjust erroneous transactions on their own motion rather than merely being able to respond to member complaints as the rule formerly required.

In addition, the amendment shortens the time period to submit erroneous transaction complaints from any time during the trading day to within 30 minutes of the transaction. Furthermore, the time period to appeal an erroneous transaction determination has been shortened from four "market" hours to 30 minutes.

The new rule also clarifies several points, including:

- the procedures by which the parties to an allegedly erroneous transaction may submit written information concerning the transaction;

- the fact that an appeal of an erroneous transaction determination does not operate as a stay of the determination; and
- the requirement that both parties to an erroneous transaction must agree if they wish a complaint to be withdrawn after it has been filed, but before a decision is rendered.

Questions concerning this *Notice* may be directed to Glen Shipway, Senior Vice President, Nasdaq Market Operations, at (203) 385-6250, or Andrew S. Margolin, Senior Attorney, Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8869.

Background

In April 1990, the SEC approved an NASD proposal to add Section 70 to the Uniform Practice Code (now NASD Rule 11890) to permit the NASD to declare clearly erroneous transactions null and void if they arise out of the use or operation of any automated quotation, execution, or communication system owned or operated by the NASD. Previously, the NASD had no authority to cancel a transaction, even if one or more terms of the transaction clearly were in error. For example, one of the catalysts for adopting Rule 11890 was that a member had complained that a trade executed over Nasdaq's SelectNetSM service was 10 points away from the inside quotation, clearly an error, but the contra party refused to cancel the trade. With the adoption of Rule 11890, the NASD now has the ability to resolve disputes involving obvious errors in an expeditious manner.

Experience with Rule 11890, however, revealed shortcomings in the scope of Nasdaq's authority to take certain actions with respect to clearly erroneous transactions. In particular, there have been instances in the

past where it would have been appropriate for Nasdaq to declare a series of transactions erroneous even though the parties to the transactions were immediately unaware of any error. The changes to the rule discussed below are intended to eliminate the current rule's shortcomings and to provide additional capabilities to resolve clearly erroneous transactions.

Prior to these changes, the procedure for canceling a clearly erroneous trade required a member to contact the NASD on trade date and state in writing the basis for his or her complaint. An officer of Nasdaq would then: (1) advise the other party involved in the trade that the transaction was in dispute; (2) obtain additional information concerning the transaction, if necessary; (3) review the trade information; and (4) make a determination as to whether the trade should stand or be revoked. Either party could appeal to the Market Operations Review Committee (MORC or Committee) independently. Although Nasdaq officers had the authority to nullify, affirm or decline to act with respect to an allegedly erroneous transaction, only the MORC had authority to adjust the terms of an erroneous transaction.

Description Of Amendments Authority Of Nasdaq Officers To Adjust The Terms Of Erroneous Transactions

Under the amended rule, Nasdaq officers now have the authority to adjust the price and/or size of a transaction to equitably resolve an error involving a clearly erroneous transaction. This will enhance the efficiency with which erroneous trade disputes are resolved.

Authority Of Nasdaq To Cancel Or Adjust Clearly Erroneous Trades On Its Own Motion

Previously, only members could seek to have an allegedly erroneous transaction nullified. There have been occasions, however, where Nasdaq system malfunctions have caused erroneous trades. Accordingly, the amendment grants Nasdaq officials the authority to cancel or modify the terms of transactions in the event of a disruption or malfunction in the use or operation of any automated quotation, execution, or communication system owned or operated by Nasdaq. These officials would be authorized to cancel or adjust an erroneous transaction on their own motion within 30 minutes of detection of the erroneous transaction, absent extraordinary circumstances, but in no event later than 6:00 p.m. on the next trading day after the date of the trade(s). As with any other erroneous transaction determination, members would have the right to appeal such actions to the MORC.

Time Parameters For The Submission Of Erroneous Transaction Complaints

Rule 11890 previously provided that a member could submit an erroneous transaction complaint "during Nasdaq operating hours on the same business day the transaction occurs...." Because members could file erroneous transaction complaints any time during the trading day, however, the rule had been used by some firms to seek to cancel trades that were not erroneous at the time of execution, but which became unprofitable due to subsequent market movement. For example, when a trade occurred on SelectNet at 10:00 a.m. and a party did not complain of an error until 5:00 p.m., the complainant had the opportunity to watch for positive or negative market move-

ments, prior to requesting NASD action. If the market moved in a direction that was unfavorable to the trade, the member would contact the NASD to cancel the trade after the close of the market, leaving the other side of the transaction at risk, without giving adequate notice of the disputed trade in close proximity to the time of execution.

The amended rule now requires the timely submission of notifications of allegedly erroneous transactions. Because of the pace and volume of trades that occur in the first half-hour of trading each morning, the amendment establishes a separate time frame for reporting clearly erroneous transactions that occur between 9:30 and 10:00 a.m. Thus, notifications would be required according to the following time table:

- (1) for transactions occurring prior to 10:00 a.m., Eastern Time, complaints must be submitted by 10:30 a.m., Eastern Time; and
- (2) for transactions occurring at or after 10:00 a.m., Eastern Time, complaints must be submitted within 30 minutes.

Time Parameter To Appeal Erroneous Transaction Determinations

Previously, members had four "market" hours to appeal an erroneous transaction determination, unduly extending the period of time that both parties to the trade were subject to market risk. Accordingly, the amendment provides that, once a member has received verbal notification of an erroneous transaction determination from the staff, it shall have 30 minutes to appeal the determination. The amendment also clarifies that once a written appeal has been received, the counter-party to the trade will be notified of the appeal and both parties will be able to sub-

mit any additional supporting written information up until the time the appeal is considered by the Committee. In addition, either party to a disputed trade may request the written information provided by the other party during the appeal process.

Procedure For Submission Of Complaints

The amendment clarifies several procedural aspects concerning the submission of erroneous transaction complaints. Specifically, the amendment clarifies that:

- (1) a complaint will not be deemed to have been submitted until Market Operations receives a written complaint, via facsimile or otherwise;
- (2) once a timely complaint is received, a complainant will have up to 30 minutes to submit any supporting written information concerning the complaint, via facsimile or otherwise;
- (3) once a timely complaint is received, the counter-party will be notified by Market Operations of the complaint and afforded a 30-minute period to submit any supporting written information concerning the disputed trade, via facsimile or otherwise;
- (4) either party to a disputed trade may request the written information submitted by the other party;
- (5) notwithstanding the 30-minute period to submit information, once a party to a disputed trade communicates that it has no further information to provide, it may not thereafter provide additional information unless requested to do so by the staff; and
- (6) if both parties to a disputed trade indicate that they have no further

information to provide concerning the complaint before their respective 30-minute information submission period has elapsed, then the matter may be immediately presented to a Nasdaq officer for a determination.

Clarification Of The Appeal Process For Erroneous Transaction Determinations

In order to clarify the current operation of the appeal process for erroneous transaction determinations, the rule now provides that:

- (1) an appeal of an erroneous transaction determination does not operate as a stay of the initial ruling; and
- (2) any decisions by the MORC or the staff are rendered without prejudice as to the rights of the parties to seek arbitration of the disputed transactions.

Withdrawal Of Erroneous Transaction Complaints

Rule 11890 previously permitted a member to unilaterally withdraw an erroneous transaction complaint at any time. Because there are no restrictions on when a complaint can be withdrawn, market participants have in the past withdrawn their complaints when the market moved in their favor subsequent to filing the complaint. This amendment prohibits the withdrawal of a complaint or an appeal of an erroneous transaction determination unless both parties to the trade agree to withdraw the matter.

Text Of Amendments

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

11890. Clearly Erroneous [Trades] Transactions

(a) Authority to [Declare] Review Transactions [Void]

(1) [In circumstances in which the Association deems it necessary to maintain a fair and orderly market and to protect investors and the public interest, the Association may, pursuant to the procedures set forth in paragraph (b) below, declare any transaction arising out of the use or operation of any automated quotation, execution, or communication system owned or operated by the Association or any subsidiary thereof and approved by the Commission, null and void on the grounds that one or more of the terms of the transaction are clearly erroneous.

(2)] For the purposes of this Rule, the terms of a transaction are clearly erroneous when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.

(2) Officers of The Nasdaq Stock Market, Inc. ("Nasdaq") designated by the President of Nasdaq shall, pursuant to the procedures set forth in paragraph (b) below, have the authority to review any transaction arising out of the use or operation of any automated quotation, execution, or communication system owned or operated by Nasdaq and approved by the Commission. A Nasdaq officer shall review transactions with a view toward maintaining a fair and orderly market and the protection of investors and the public interest. Based upon this review, the Officer shall decline to act upon a disputed transaction if the officer believes that the transaction under dispute is not clearly erroneous, or, if the officer

determines the transaction in dispute is clearly erroneous, he or she shall declare that the transaction is null and void or modify one or more terms of the transaction. When adjusting the terms of a transaction, the Nasdaq officer shall seek to adjust the price and/or size of the transaction to achieve an equitable rectification of the error that would place the parties to a transaction in the same position, or as close as possible to the same position, that they would have been in had the error not occurred. Nasdaq shall promptly provide oral notification of a determination to the parties involved in a disputed transaction and thereafter issue a written confirmation of the determination.

(b) Procedures for Reviewing [Declaring a] Transactions [Void]

(1) Any member or person associated with a member that seeks to have a transaction reviewed [declared null and void] pursuant to paragraph (a) hereof, shall submit a written complaint, via facsimile or otherwise, to Nasdaq Market Operations in accordance with the following time parameters:

(A) for transactions occurring prior to 10:00 a.m., Eastern Time, complaints must be submitted by 10:30 a.m., Eastern Time; and

(B) for transactions occurring on or after 10:00 a.m., Eastern Time, complaints must be submitted within thirty minutes.

[notify an officer of the Association designated by the President of the transaction during Nasdaq operating hours on the same business day the transaction occurs, and shall provide such official all facts and information necessary for a determination under paragraph (a). Information communicated orally shall be confirmed promptly in writing.]

(2) Once a complaint has been received in accord with subparagraph (b)(1) above:

(A) the complainant shall have up to thirty (30) minutes, or such longer period as specified by Nasdaq staff, to submit any supporting written information concerning the complaint necessary for a determination under paragraph (a)(2), via facsimile or otherwise;

(B) the counterparty to the trade shall be verbally notified of the complaint by Nasdaq staff and shall have up to thirty (30) minutes, or such longer period as specified by Nasdaq staff, to submit any supporting written information concerning the complaint necessary for a determination under paragraph (a)(2), via facsimile or otherwise; and

(C) either party to a disputed trade may request the written information provided by the other party pursuant to this subparagraph.

(3) Notwithstanding paragraph (b)(2) above, once a party to a disputed trade communicates that it does not intend to submit any further information concerning a complaint, the party may not thereafter provide additional information unless requested to do so by Nasdaq staff. If both parties to a disputed trade indicate that they have no further information to provide concerning the complaint before their respective thirty-minute information submission period has elapsed, then the matter may be immediately presented to a Nasdaq officer for a determination pursuant to paragraph (a)(2) above.

(4) Each member and/or person associated with a member involved in the transaction shall provide Nasdaq with any information that it requests in order to resolve the matter on a timely basis notwithstanding

the time parameters set forth in paragraph (b)(2) above.

(5) Once a party has applied to Nasdaq for review, the transaction shall be reviewed and a determination rendered, unless both parties to the transaction agree to withdraw the application for review prior to the time a decision is rendered pursuant to paragraph (a)(2).

[(2) An officer of the Association designated by the President shall review the information submitted and determine whether the transaction in dispute is clearly erroneous and detrimental to the maintenance of a fair and orderly market and the protection of investors and the public interest and may declare that the transaction be null and void. The official may decline to act upon a disputed transaction if he or she believes that action is unnecessary or inappropriate. The Association shall immediately issue a written determination of the matter, setting forth the actions taken and the reasons therefor.]

(c) Procedures for Reviewing Transactions Executed During System Disruptions or Malfunctions

In the event of a disruption or malfunction in the use or operation of any automated quotation, execution, or communication system owned or operated by Nasdaq and approved by the Commission, Nasdaq, acting through an officer designated by the President of Nasdaq pursuant to paragraph (a)(2), may, on its own motion pursuant to the standards set forth in paragraph (a), declare transactions arising out of the use or operation of such systems during the period of such disruption or malfunction null and void or modify the terms of these transactions; provided that, in the absence of extraordinary circumstances, a Nasdaq officer must take action pursuant to this para-

graph within thirty (30) minutes of detection of the erroneous transaction(s), but in no event later than 6:00 p.m., Eastern Time, on the next trading day following the date of the trade at issue. When Nasdaq takes action pursuant to this subparagraph, the member firms involved in the transaction shall be notified as soon as is practicable and shall have a right to appeal such action in accordance with paragraph (d)(1) below.

(d) [(3)] Review by the Market Operations Review Committee ("MORC")

(1) A member or person associated with a member may appeal a determination made under paragraphs (a)(2) or (c) [the determination under subparagraph (2)] to the MORC [Market Operations Review Committee] provided such appeal is made in writing, via facsimile or otherwise, within [four market hours of] thirty (30) minutes after the member or person associated with a member receives verbal notification of such determination, except that if Nasdaq notifies the parties of action taken

pursuant to paragraph (c) after 4:00 p.m., either party has until 9:30 a.m. the next trading day to appeal. [For the purposes of this Rule, "market" hours shall mean those hours the Nasdaq market is open in the United States, Eastern Time.] Once a written appeal has been received, the counterparty to the trade will be notified of the appeal and both parties shall be able to submit any additional supporting written information, via facsimile or otherwise, up until the time the appeal is considered by the Committee. Either party to a disputed trade may request the written information provided by the other party during the appeal process. An appeal to the Committee shall not operate as a stay of the determination made pursuant to paragraph (a)(2) or (c) above. Once a party has appealed a determination to the Committee, the determination shall be reviewed and a decision rendered, unless both parties to the transaction agree to withdraw the appeal prior to the time a decision is rendered by the Committee. Upon consideration of the record, and after

such hearings as it may in its discretion order, the Committee, pursuant to the standards set forth in paragraph (a), shall affirm, modify, reverse, [dismiss,] or remand the determination made under [sub]paragraph (a)(2) or (c) above.

(2) [(4)] The decision of the Committee shall be final and binding upon any member or person associated with a member and shall constitute final Association action on the matter in issue. Any adverse determination by a Nasdaq officer pursuant to paragraph (a)(2) or (c) or any adverse decision by the Committee pursuant to paragraph (d)(1) shall be rendered without prejudice as to the rights of the parties to the transaction to submit their dispute to arbitration.

Endnote

¹ See Exchange Act Release No. 39550 (January 14, 1998), 63 FR 4333 (January 28, 1998).

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