NASD Notice to Members 98-78

NASD Clarifies Operation Of The Limit Order Protection Rule During Unusual Market Conditions

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Executive Summary

The National Association of Securities Dealers, Inc. (NASD® or Association) is issuing this *Notice* to clarify the application of the Association's Limit Order Protection Rule (Conduct Rule IM-2110-2) in instances where the market for a given security is experiencing "abnormal" market conditions. Specifically, consistent with pronouncements by the Securities and Exchange Commission (SEC) concerning the obligations of Market Makers to display customer limit orders during unusual market conditions, the NASD is modifying its interpretation of the Limit Order Protection Rule that was previously set forth in *Notice to Members 95-67*, to provide that, under appropriate circumstances, limit orders need not be filled within one minute if activated during unusual market conditions and if all reasonable steps are taken to execute the transaction as soon as possible following activation. In such instances, which often occur at the opening or upon the commencement of trading following a trading halt or an initial public offering (IPO), members are required to execute customer limit orders as soon as possible under the circumstances.

Questions concerning this *Notice* may be directed to the Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8294, or the Market Regulation Department Legal Section, at (301) 590-6410.

Discussion

The Limit Order Protection Interpretation, IM-2110-2, provides that:

> A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or the customer of another member firm) in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110[.]

In *Notice to Members 95-67*, the Association provided guidance as to the obligation of member firms that execute a transaction at a price that would satisfy a customer's limit order (*i.e.*, at a price equal to or better than that of the customer limit order). Specifically, in Question 5, the Association stated the following:

> Q5: Once a member is obligated to execute a limit order, how quickly must it execute the limit order?
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> A: If a member trades through a limit order that it has accepted, the Interpretation provides that it must contemporaneously execute such limit order. To meet this obligation, a member must execute the limit order as quickly as possible. Absent reasonable justification that is adequately documented by the member firm, a limit order must at least be executed within a general time parameter of one minute after it has been activated.

Subsequent to the issuance of this one-minute requirement to fill activated limit orders, the SEC adopted its Order Handling Rules in August 1996. Specifically, among other things, the SEC amended the Firm Quote Rule (SEC Rule 11Ac1-1) and adopted a new rule governing the public display of customer limit orders, the Display Rule (SEC Rule 11Ac1-4). The Display Rule requires Market Makers to display the full price and size of qualifying customer limit orders in their quotes, subject to certain enumerated exceptions. Once a customer limit order is obligated to be publicly displayed in accordance with the Display Rule, the Display Rule requires that such customer limit order be displayed "immediately," unless a specific exception to the rule applies. In the release accompanying the adoption of the Order Handling Rules, the SEC gave the following guidance as to what it meant by "immediately display":

> Assuming that a specialist or OTC market maker does not rely on one of the exceptions to the Display Rule, . . . such specialist or OTC market maker must display the order as soon as practicable after receipt which, under normal market conditions, would require display no later than 30 seconds after receipt.

Subsequent to the adoption of the Order Handling Rules, the SEC's Division of Market Regulation (the Division) clarified in two letters to the NASD, dated November 22, 1996, and January 3, 1997, what the SEC meant by "30 seconds after receipt" and "normal market conditions." In the November 22, 1996 letter, the Division stated that the "30 second time period [for the display of a customer limit order] begins when the order is received by the specialist or trader that will display the order (or the firm's automated display system)." As for when market conditions are not "normal," such that OTC Market Makers would not be required to display limit orders within 30 seconds of receipt, the Division also stated in the November 22 letter that "OTC market openings should not currently be viewed as 'normal market conditions' for purposes of the Limit Order Display Rule." In such cases, during OTC market openings, the Division stated that "limit orders held at the opening must be displayed as soon as practicable under the circumstances."

In its January 3, 1997 letter to the NASD, the Division stated that "normal market conditions" do not exist for the purposes of strict compliance with the Display Rule's "30 seconds after receipt" requirement in an additional two situations: reopening of trading after a trading halt; and the commencement of trading in an IPO. In this letter, the Division also gave guidance on how a Market Maker is to determine when market conditions have returned to "normal," such that customer limit orders are required to be publicly displayed within 30 seconds: "The Division believes that market makers must make an independent assessment, based on the trading conditions of the stock, as to when trading and quoting in the stock has returned to normal market conditions. This time frame could be one minute for some stocks and longer for others; moreover, the time frame for a stock to return to normal market conditions could vary from day to day."

In light of the Division's statements regarding the application of the Display Rule in the circumstance where there are not normal market conditions, the NASD has likewise determined to apply this same rationale to the application of the one-minute reasonableness parameter in the context of obligations under the Limit Order Protection Interpretation. Accordingly, to the extent that unusual market conditions exist for a particular Nasdaq® security (*i.e.*, "not normal") and a member executes a transaction that activates a limit order during this time period, such member would not be presumptively deemed in violation of the Limit Order Protection Rule if it failed to execute the limit order within a one-minute period, provided the member executed the order as soon as possible under the circumstances. In this connection, as fully consistent with the SEC's interpretation of the Display Rule, "normal market conditions" potentially do not include OTC market openings for specific securities, the resumption of trading after a trading halt, and the commencement of trading after an IPO. In every case where normal market conditions do not exist, Market Makers must make an independent assessment, based on the trading conditions of the specific security, as to when trading and quoting in the stock has returned to normal market conditions. This time frame could be one minute for some stocks and longer for others; moreover, the time frame for a stock to return to normal market conditions could vary from day to day.