

Notice to Members

SEPTEMBER 2004

SUGGESTED ROUTING

Institutional
Internal Audit
Legal & Compliance
Operations
Senior Management
Syndicate
Systems
Trading

KEY TOPICS

Operations
Order-Routing and Execution Systems
Rule 3010
Rule 3310 and IM-3310
Supervision
Trading and Market Making Systems

GUIDANCE

Order-Routing and Execution Systems

NASD Reminds Member Firms of Their Obligations to Ensure the Accuracy and Integrity of Information Entered into Order-Routing and Execution Systems

Executive Summary

In recent months, there have been several instances where member firms inadvertently have entered, or permitted customers or non-members to enter, the incorrect quantity of shares or prices into the handling, routing, and execution services of a vendor, automated trading system, electronic communications network, or other market center (collectively, "trading systems"). NASD is issuing this *Notice* to remind firms of their obligations under Rule 3010 (Supervision) to have in place a supervisory system and written supervisory procedures reasonably designed to ensure that such orders placed into trading systems are not entered in error or in a manner inconsistent with NASD rules, including Rule 3310 (Publication of Transactions and Quotations) and IM-3310 (Manipulative and Deceptive Quotations). NASD is also reminding firms that their supervisory systems should promote compliance with the subscriber agreements of such trading systems to the extent necessary to ensure compliance with NASD rules.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126; or Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071.

Discussion

NASD is reminding firms that enter, or permit customers or non-members to enter, orders into trading systems to take steps to ensure that such orders are free of errors and representative of bona fide transaction and quotation activity. NASD notes that there have been several instances where firms inadvertently have entered the incorrect quantity of shares or price into a trading system for execution, primarily as a result of mistakes in data entry or defective or malfunctioning software operated by either a firm or its vendor. An NASD firm is ultimately responsible for all orders entered, whether entered by the firm or by a sponsored customer or non-member, even if such firm is using the services of a vendor to facilitate the entry of such orders.¹

Firms have an obligation to act in accordance with NASD rules and to ensure that all trading systems are used properly and in accordance with the terms and conditions specific to those systems to the extent necessary to ensure compliance with NASD rules. These rules include, but are not limited to, Rule 3310 and IM-3310, concerning bona fide transaction and quotation activity. Consequently, firms must have in place a supervisory system and written supervisory procedures reasonably designed to ensure that orders are not entered in error or in a manner inconsistent with NASD rules. Such supervisory systems and procedures should comply with the subscriber and operating agreements of such trading systems for the purpose of avoiding erroneous orders and transactions.²

NASD recognizes that trading systems enhance the ability to route and execute orders and enable firms to execute multiple orders as quickly and efficiently as possible. However, speed and efficiency must be balanced against the safeguards needed to protect against errors or mistakes that can result in increased market volatility and confusion, as well as significant financial risk and exposure to firms and the investing public.

When developing supervisory systems and written supervisory procedures in this area, firms should consult NASD's supervision rule, Rule 3010, and guidance provided in *Notices to Members 88-84* (November 1988), *89-34* (April 1989), *98-96* (December 1998), and *99-45* (June 1999). Additionally, firms should consider the following factors when developing a supervisory system and written supervisory procedures:

1. Firm trading systems should include controls that limit the use of such systems to authorized persons, check for order accuracy, prevent orders that exceed preset credit- and order-size parameters from being transmitted to a trading system, and prevent the unwanted generation, cancellation, repricing, resizing, duplication, or re-transmission of orders.
2. Safeguards should be in place to ensure that the operation, testing, or maintenance of a firm's trading system does not result in the inadvertent disabling of the applicable trading system, mistaken executions, errors, or other trading problems.

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3. Firms should ensure that they do not test their systems' connectivity to the applicable trading system by sending orders that are not executable, such as by sending orders during normal market hours that are priced far outside a security's current price. Firms must test pursuant to established protocols and test messages should be clearly denoted as such.
 4. Before permitting or sponsoring customer or non-member access to a firm's trading system, a firm must have a supervisory system and written supervisory procedures in place reasonably designed to ensure that such orders are not entered in error or in a manner inconsistent with NASD rules (including, but not limited to, Rule 3310 and IM-3310) or with the subscriber agreements of such trading systems to the extent necessary to ensure compliance with NASD rules. *See Notice to Members 98-66.*
 5. Procedures that are available to adjudicate clearly erroneous transactions are to be used only in cases of clear or obvious errors and should not be used as a proxy for proper system use or trading procedures. Other errors, whether as a result of a system problem or human error, will not be dealt with through the rules applicable to clearly erroneous transactions.

Firms are reminded that NASD will examine closely firms' supervisory systems and written supervisory procedures with respect to the review and detection of potential order-entry errors, and, where appropriate, initiate disciplinary action against firms and their supervisory personnel for failure to adopt, implement, and enforce appropriate supervisory procedures. NASD also may impose more significant sanctions if it finds that a firm has inadequate supervisory systems and procedures in place and such deficiencies have resulted in a pattern or practice of erroneous information being distributed to the marketplace.

Endnotes

- 1 See *Notice to Members 98-66* (August 1998).
- 2 See NASD Rules 2110 and 3010.

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