

Notice to Members

SEPTEMBER 2004

SUGGESTED ROUTING

Legal & Compliance
Operations
Registered Representatives
Senior Management
Trading

KEY TOPICS

Alternative Display System (ADF)
Electronic Communications Network (ECN)
Rule 4300A
Trade Reporting and Comparison Service (TRACS)

GUIDANCE

Alternative Display Facility (ADF)

SEC Approves Rule Amendment Requiring That ADF Market Participant Provide Advance Written Notice When Denying Access; **Effective Date: October 20, 2004**

Executive Summary

On August 18, 2004, the Securities and Exchange Commission (SEC) approved amendments to Rule 4300A to require Alternative Display Facility (ADF) Market Participants to provide written notice, via facsimile, personal delivery, courier, or overnight mail, at least 14 calendar days in advance to NASD's ADF Market Operations before denying direct electronic access to an NASD member firm.¹ Upon receipt of the notice, ADF Market Operations will post the required notice on the ADF Web page to ensure that member firms have adequate time to make other routing or access arrangements, as necessary. Amended Rule 4300A also provides that only a Market Participant that is an electronic communications network (ECN) may lawfully deny access to its quotes, and may only do so in the limited circumstance where a broker-dealer fails to pay contractually obligated costs for access to the ECN's quotes.

The text of the amendments is set forth in Attachment A and becomes effective on October 20, 2004.

Questions/Further Information

Questions concerning this *Notice* may be directed to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight (202) 728-8026; or Elliot Levine, Chief Counsel, Markets, Services, and Information, at (202) 728-8405.

Background

The ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the SEC's SuperMontage Approval Order.² The ADF currently is operating as a pilot until October 26, 2004,³ and it is anticipated that the ADF will continue to operate on a pilot basis until the SEC approves the operation of the ADF on a permanent basis.

ADF provides Market Participants (e.g., ADF-registered market makers or ECNs) the ability to post quotations in NASDAQ securities and provides all member firms that participate in the ADF the ability to view quotations and report transactions in NASDAQ securities to the Securities Information Processor (SIP) for NASDAQ-listed issues for consolidation and dissemination of data to vendors and ADF Market Participants. The facility also provides for trade comparison through the Trade Reporting and Comparison Service (TRACS). The facility further provides for real-time data delivery to NASD for regulatory purposes, including enforcement of firm quote and related rules.

The ADF does not provide an order-routing capability. Instead, Rule 4300A requires Market Participants to provide direct electronic access to other Market Participants and to provide to all other NASD member firms direct electronic access or allow for indirect electronic access to the individual market participant's quote. This rule provides the means for Market Participants and other broker/dealers to access ADF quotes and, among other things, meet the firm quote and locked and crossed quotation requirements. Rule 4300A prohibits Market Participants from in any way discouraging or discriminating against member firms that wish to reach their quotes.

Last year, NASD became aware that a Market Participant denied access, with no prior notice, to a second ADF Market Participant for allegedly failing to pay contractually obligated costs. This action caused disruption not only for the Market Participant denied access, but also other NASD member firms that typically accessed the first Market Participant's quote through the second ADF Market Participant's routing system. Although there were other means in place by which an NASD member firm could access the first Market Participant's quotes, the absence of any advance notice of the denial of access caused confusion in the marketplace as member firms considered alternative means to access the first Market Participant's quotes.

Accordingly, to maintain market efficiency and prevent such confusion in the future, NASD has amended Rule 4300A to require that Market Participants provide written notice, via facsimile, personal delivery, courier, or overnight mail, at least 14 calendar days in advance to ADF Market Operations before denying access to an NASD member firm. The 14-day period begins on the first business day that ADF Market Operations has receipt of the notice. Upon receipt of the notice, ADF Market Operations will post the notice on the ADF Web page to ensure that member firms have adequate time to make other routing or access arrangements, as necessary. To ensure proper documentation of compliance with Rule 4300A, member firms should maintain evidence of receipt of the notice (*i.e.*, dated facsimile confirmation, receipt from a courier, etc.).

Rule 4300A also codifies existing NASD guidance that a Market Participant may deny access to its quotes only in the limited circumstances where a broker-dealer fails to pay contractually obligated costs for access to its quotes.⁵ Because the SEC has determined that only ECNs may charge a post-transaction fee for execution against their displayed quotation (*i.e.*, access fee),⁵ Rule 4300A clarifies that only Market Participants that are ECNs may deny access to an NASD member firm for failure to pay contractually obligated access fees.

Additionally, any denial of access must be based on a good faith belief that the denial of access is appropriate and does not violate any NASD rules or the securities laws. Amended Rule 4300A further clarifies that the publication of an ADF Market Participant's intent to deny access will have no bearing on the merits of any claim between the Market Participant and any affected broker-dealer, nor will it insulate the Market Participant from liability from violations of NASD rules or the federal securities laws, such as SEC Rule 11Ac1-1. If NASD believes that a Market Participant has improperly denied a broker-dealer access to its quotes, the Market Participant will not have met the terms of Rule 4300A. In that instance, NASD will consider the ADF Market Participant to be in violation of that provision and will not permit the ADF Market Participant to continue quoting on the ADF.

Endnotes

- 1 Exchange Act Rel. No. 50218 (August 18, 2004), 69 F.R. 52055 (August 24, 2004) (File No. SR-NASD-2004-002).
- 2 Exchange Act Rel. No. 43863 (January 19, 2001), 66 F.R. 8020 (January 26, 2001) (File No. SR-NASD-99-53).
- 3 See Exchange Act Rel. No. 49131 (January 27, 2004), 69 F.R. 5229 (February 3, 2004) (File No. SR-NASD-2004-12).
- 4 See Exchange Act Rel. No. 46249 (July 24, 2002), 67 F.R. 49822 (July 31, 2002) (File No. SR-NASD-2002-97).
- 5 See Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to Louis B. Todd, Jr., Head of Equity Trading, J.C. Bradford & Co. (August 6, 1998).

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ATTACHMENT A

New language is underlined; deletions are in brackets

4000A. NASD ALTERNATIVE DISPLAY FACILITY

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4300A. Quote and Order Access Requirements

(a) To ensure that NASD Market Participants comply with their quote and order access obligations as defined below, for each security in which they elect to display a bid and offer (for Registered Reporting ADF Market Makers), or a bid and/or offer (for Registered Reporting ADF ECNs), in the Alternative Display Facility, NASD Market Participants must:

(1) through (2) No change.

(3) Provide at least 14 calendar days advance written notice, via facsimile, personal delivery, courier or overnight mail, to NASD Alternative Display Facility Operations before denying any NASD member direct electronic access as defined below. An ECN is the only Market Participant that may lawfully deny access to its quotes, and an ECN may only do so in the limited circumstance where a broker-dealer fails to pay contractually obligated costs for access to the ECN's quotes. The notice provided hereunder must be based on the good faith belief of a Market Participant that such denial of access is appropriate and does not violate any of the Market Participant's obligations under NASD rules or the federal securities laws. Further, any notification or publication of a Market Participant's intent to deny access will have no bearing on the merits of any claim between the Market Participant and any affected broker-dealer, nor will it insulate the Market Participant from liability for violations of NASD rules or the federal securities laws, such as SEC Rule 11Ac1-1. The 14-day period begins on the first business day that NASD Alternative Display Facility Operations has receipt of the notice.

(4) [(3)] [Market Participants shall s]Share equally the costs of providing to each other the direct electronic access required pursuant to paragraph (a)(1), unless those Market Participants agree upon another cost-sharing arrangement.

(b) through (f) No change.

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