

Notice to Members

AUGUST 2005

SUGGESTED ROUTING

Capital Markets
Executive Representatives
Legal & Compliance
Operations
Senior Management
Trading

KEY TOPICS

Conflicts of Interest
Order Handling
Supervision

ACTION REQUIRED

Volume-Weighted Average Price Transactions

Member Obligations with Respect to Volume-Weighted Average Price Transactions

Executive Summary

NASD reminds members that when executing a volume-weighted average price (VWAP) or other large, potentially market-moving transactions for a customer,¹ it is inconsistent with just and equitable principles of trade (Rule 2110) and a member's best execution obligations (Rule 2320) to engage in proprietary trading activity that compromises the customer's interest in favor of a member's proprietary trading interest. Moreover, members who have received such orders have a duty to disclose in writing to the customer that the member may engage in hedging or other positioning activity that could affect the market for a security that is involved in the transaction. Depending on the nature of the order and the specificity known about it by the member, a duty to disclose such trading activity may arise even before a member is awarded the order for execution.

Members are further cautioned against manipulative activity or impermissible market conditioning in connection with executing a VWAP or other large order and reminded that best execution obligations always pertain once an order is received. Members also must establish and maintain information barriers and appropriate supervisory procedures reasonably designed to ensure the integrity of the trading activity and to evaluate the execution quality of VWAP and other large orders.

Questions/Further Information

Questions concerning this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126; or Philip A. Shaikun, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Background and Discussion

Adherence to just and equitable principles of trade as mandated by Rule 2110 requires that members handle and execute any order received from a customer in a manner that does not disadvantage the customer or place the member's financial interests ahead of those of its customer. Furthermore, Rule 2320 requires a member to fill an order for a customer at a price as favorable as possible under prevailing market conditions; consequently, transactions by a member that disadvantage or place the member's financial interests ahead of those of its customer may violate Rule 2320. In the context of certain large, potentially market-moving orders—VWAPs, large institutional orders, and basket transactions, for example—a member's duty to a customer may arise even prior to the actual receipt of an order and may include an additional obligation to disclose hedging or other positioning activity that could affect the market for a security that is involved in the transaction.

The potential for the duty to arise prior to receipt of the order results from the process involved in negotiating and executing such large transactions. Typically, a customer will procure confidential bids to execute a large order in one or more stocks that could move the market if known publicly. In order to minimize its risk, a member that is awarded the order may engage in bona fide hedging or positioning activity prior to execution of the order. In some instances, members that are competing to fill the order also will enter into similar transactions in anticipation of winning the bid. Such trading activity might include buying or selling a security (if known) that is involved in the bid or buying an option or a future on the underlying security or basket of securities.

While these transactions do not constitute a per se violation of NASD rules, they can have an effect on the market for the security or securities that are the subject of the solicited transaction. For example, a member competing for a VWAP buy order might, in anticipation of winning the bid, begin to accumulate a sizeable position in the security that is being bought by the customer. Such buying activity could affect the trading price of the security and consequently the VWAP to the customer.²

When a member receives the customer's order, its duty to the customer is unequivocally established, and the member therefore is obligated to: (1) refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the member's financial interests ahead of those of its customer's, and (2) if applicable, disclose in writing to the customer that the member intends to engage in hedging and other positioning activity that could affect the market for the security that is the subject of the transaction, and consequently the cost or proceeds to the customer (collectively referred to as "the duty to refrain and disclose"). The disclosure must be made prior to receipt and/or execution of the order and be in the form of an affirmative consent letter that covers potential hedging and positioning transactions related to the handling of VWAP and other large orders. Members need not obtain affirmative consent on a transaction-by-transaction basis; however, members should at least annually take steps to have their customers reaffirm their consent.

Whether the same duty exists before a member is awarded an order for execution will turn on, among other factors, the type of order and the specifics of the order known by the member. Depending on the type of order, the specifics might include the name of the security, the size of the order, the side of the market (*i.e.*, buy or sell), the weighting of a basket order, and the timing for completion of the order. Thus, a duty could be established as early as the initial contact by the customer to seek bids for its order. In any event, once a member knows or has reason to know the order details to a degree of confidence whereby the member can engage without undue speculative risk in targeted hedging or positioning activity, then the same duty under Rules 2110 and 2320 to refrain and disclose attaches as if the member had actually received the order. This duty remains in place until the transaction is completed or the information upon which the member bid for the transaction becomes stale or obsolete. In addition, a member that bids unsuccessfully for the transaction, yet knows or has reason to know the order details to a degree of confidence, similarly must refrain from trading on, or communicating to another party, the information gleaned during the bidding process until the transaction is completed or the information becomes stale or obsolete, unless the trading is carried out by individuals who have been sufficiently walled off from obtaining the non-public information.

Other than for the purpose of fulfilling the customer order, under no circumstances may a member trade for its proprietary account on the non-public information it receives from the current or prospective customer or communicate such non-public information to another entity or person outside of the member. Such conduct is inconsistent with Rule 2110 and may also violate other NASD rules or the federal securities laws. A member may continue to engage in market making or proprietary trading in the subject securities only where the member has established effective information barriers reasonably designed to prevent internal disclosure of the non-public information.³

NASD cautions that, irrespective of whether a member is competing for or has received an order, under no circumstances may a member engage in manipulative market activity. Disclosure of hedging and positioning trading set forth above does not create a safe harbor from market manipulation, fraud, or best execution violations. Accordingly, members are reminded that they may not take any steps to create an artificial appearance of demand (supply) for the security or establish artificially high (low) prices by engaging in unnecessary trading, increased quote activity, or entering orders around the close of when a VWAP or other large order is executed. NASD will aggressively pursue any such conduct to manipulate or condition the market to achieve a favorable execution of a large customer order.⁴

Marking of Orders

Depending on the terms and characteristics of an order, a VWAP or similar transaction must be classified as either long or short for purposes of order entry and reporting. Short sale orders must be executed in compliance with all applicable NASD and SEC short sale rules and regulations. With respect to a VWAP, both the individual trades by the member to accommodate the VWAP and the aggregate VWAP trade itself are subject to those short sale rules and regulations. In the event that a member is short the securities underlying a VWAP sell order, the member's order(s) may need to be marked "short" (or "short exempt," if applicable), depending on the firm's (or aggregation unit's) overall position, even if the customer is long the subject securities. Members should refer to applicable NASD and SEC rules, interpretations, and no-action letters when determining how to mark the individual trades by the member to accommodate the VWAP and the aggregate VWAP trade itself.

Failure to accurately mark orders also may result in disciplinary action for failure to maintain proper books and records.

Compensation

Members that receive a VWAP or similar order must disclose to the customer in writing the specifics of the terms of compensation it will receive to execute the order. Thus, for example, a member must disclose if it intends to retain or split with the customer any profits that result if the member improves upon the VWAP.

Supervision

Pursuant to Rule 3010, members must have in place supervisory procedures reasonably designed to ensure that the order handling and trading activities discussed in this *Notice* comply with NASD Rules and the applicable federal securities laws. Thus, members should establish and maintain adequate procedures to evaluate the quality of execution of VWAP and other large orders. Those procedures should include, without limitation, an evaluation of proprietary trading that took place in advance of the execution of such orders. If applicable, the procedures also should be designed reasonably to ensure that customers affirmatively acknowledged the receipt of notice that the member may engage in hedging or other trading activity related to the execution of the customer's order.

Members should specify in their written supervisory procedures the circumstances under which hedging or positioning trades will be reviewed and identify which trades will be reviewed and the manner in which such review will take place. The written procedures further should identify who will conduct the review, how often the review will occur, what steps should be taken if suspicious activity is discovered, and how the discharge of the supervisory responsibilities will be documented. In addition, members should establish and maintain adequate information barriers to prevent and surveil for suspect simultaneous trading away from the sales desk.

Endnotes

- 1 Consistent with NASD Rule 0120(g), the term “customer order” for purposes of this *Notice* shall not include an order received from another broker-dealer.
- 2 Members are encouraged to review the March 2004 decision of the United Kingdom’s Financial Services Authority in which it levied a £190,000 fine against Morgan Grenfell & Company Limited for failing to disclose its hedging activity in anticipation of winning a blind bid to execute a customer’s program trade. The firm’s proprietary trading caused the customer to pay more to execute the transaction. The decision and findings can be found at: www.fsa.gov.uk/pubs/final/m-grenfell_18mar_04.pdf.
- 3 Even where a duty exists to a customer, a member is not precluded from all trading activity related to the subject securities or required to disclose every such transaction. Thus, for example, members may execute: a prior customer order; bona fide hedge transactions that the member can demonstrate are unrelated to the information received in connection with the VWAP or other large customer orders and where the member has information barriers established to prevent internal disclosure of non-public information; “black box” orders where the member has no actual knowledge that such order has been routed for execution; trades to correct a bona fide error; and odd-lot transactions to offset odd-lot orders. Furthermore, this *Notice* is not intended to prevent a member from handling multiple customers’ orders that might compete with or disadvantage each other. However, it may be a violation of Rule 2110 for a member to share information about the order other than to facilitate that specific customer transaction.
- 4 This *Notice* is not intended to set out all violations that may occur in connection with the execution of VWAP orders and other large orders; members should be aware that the conduct described may also violate other NASD rules or federal securities laws.

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