

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41606; File No. SR-NASD-98-08]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change, by the National Association of Securities Dealers, Inc. Relating to Trade Reporting Rules

July 8, 1999.

I. Introduction

On February 2, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association") through its wholly owned subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder.² Nasdaq filed Amendment No. 1 to the proposed rule change on May 19, 1998.³ On June 5, 1998, the proposed rule change, including Amendment No. 1, was published for comment in the **Federal Register**.⁴ The Commission received one comment letter in response to the solicitation of comments.⁵ On March 1, 1999, Nasdaq filed Amendment No. 2 to the proposed rule change.⁶ For the reasons discussed below, the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Letter from Robert E. Aber, Senior Vice President and General Counsel, The Nasdaq Stock Market, Inc., to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), SEC, May 13, 1998 ("Amendment No. 1").

⁴ Securities Exchange Act Release No. 40047 (May 29, 1998), 63 FR 30791.

⁵ The original filing proposed that every electronic communications network ("ECN") be required to report all trades executed within the ECN on behalf of its subscribers. The Commission received one comment letter, which addressed the original filing's proposed ECN reporting requirements. See letter from Charles R. Hood, Senior Vice President and General Counsel, Instinet, to Jonathan Katz, Secretary, SEC, dated June 25, 1998.

⁶ Letter from Robert Aber, Senior Vice President and General Counsel, Nasdaq, to Katherine England, Assistant Director, Division, SEC, March 1, 1999 ("Amendment No. 2"). Amendment No. 2 requests that the Commission grant a partial approval of the original filing. Specifically, Amendment No. 2 requests approval of all the proposed changes in the original filing with the exception of the proposed ECN trade reporting requirements. Amendment No. 2 states that the NASD intends to submit a separate response to the Commission regarding the Instinet comment letter received on the proposed ECN trade reporting requirements.

Commission is granting partial approval of the proposed rule change and Amendment No. 1 (as requested in Amendment No. 2), and accelerated approval of Amendment No. 2 to the proposed rule change.

II. Description of the Proposal

Nasdaq proposes to amend various trade reporting rules of the Association. Specifically the proposal would: (1) Implement a new trade report modifier to identify trades effected at a prior reference price; (2) eliminate the 10,000 share limitation on individual trades that may be "bunched" for trade reporting purposes; and (3) address riskless principal trades involving exchange-listed securities traded in the Third Market.⁷

A. New Modifier for Trades Based on Prior Reference Price

Recently, there have been situations where NASD members execute certain transactions that, although reported timely, actually relate to an obligation to trade that arose at an earlier point in the day or that refer to a prior reference price. These situations may include obligations to trade arising from a preferred SelectNet order that was not executed timely, orders that are owed the opening or closing price ("market on open" or "market on close") but that are not executed within 90 seconds of the open or close, respectively, and orders that may have been lost or misplaced. In effect, these trades are late executions, not late reports of executions. Nasdaq, therefore, proposes to implement a trade report modifier for firms to append to certain trade reports to more accurately identify transactions that are at a price which is based on a prior reference point in time.⁸ The modifier would apply to trade reports in Nasdaq securities (both Nasdaq National Market and SmallCap) as well as non-Nasdaq OTC Equity Securities (e.g., OTC Bulletin Board and Pink Sheets). The modifier would not, however, apply to exchange-listed securities traded in the Third Market.⁹

⁷ The text of the proposed rule change is in the form of an amendment to Rule 6420(d)(3)(B).

⁸ The text of the proposed rule change to implement the new modifier is contained in NASD Rules 4632(a)(9), 4642(a)(9), 4652(a)(8), and 6620(a)(6).

⁹ The NASD intends that the modifier would not apply to "stopped" stock situations. Moreover, by using the modifier, a member would not be absolved of its obligation to provide best execution, in terms of both price and timely execution. The modifier would not be required if the report was made within 90 seconds of the prior reference time.

B. Eliminating the 10,000 Share Limitation on Aggregating Trades in Nasdaq Securities That May Be Bunched for Trade Reporting

Nasdaq proposes to eliminate the 10,000 share limitation on the maximum number of shares in an individual trade that can be aggregated for purposes of reporting a "bunched" trade in Nasdaq securities, but only in the context of IPOs.

Rules governing the reporting of transactions in Nasdaq securities (both National Market and SmallCap) currently permit the aggregation of transactions into a "bunched" trade report in a variety of situations. Most notably, there is a provision whereby a firm may aggregate transactions at the same price that would be impractical to report individually, provided that no individual order of 10,000 shares or more may be aggregated.¹⁰ These reports have a ".B" modifier appended by the reporting firm and disseminated to the Nasdaq tape and vendors.

C. Trade Reporting Rules for Riskless Principal Trades in the Third Market

Nasdaq proposes to amend the trade reporting rules for exchange listed securities traded in the Third Market to ensure that all riskless principal trades, including those effected by market makers, are reported only once.¹¹

Nasdaq believes that the exception applicable to non-market makers (which

¹⁰ This rule was originally adopted in 1982 with a limitation of 5,000 shares. See Securities Exchange Act Release No. 18602 (March 26, 1982), 47 FR 14642 (April 5, 1982) (notice of filing and order granting accelerated approval of File No. SR-NASD-82-4). The rule was subsequently increased to 10,000 shares in 1984, but has remained at that level ever since. See Securities Exchange Act Release No. 21202 (August 3, 1984), 49 FR 31971 (August 9, 1984) (order approving File No. SR-NASD-84-12).

¹¹ In addition to the amendment to Rule 6420, Nasdaq proposes the corresponding interpretations:

(1) Nasdaq notes that a riskless principal trade generally is one that involves a conditional order rather than one immediately executable by the firm as principal. This condition may involve a customer order, the execution of which is dependent upon finding the other side, or a transaction dependent upon the execution of a part of the order placed with another firm or market; and

(2) Nasdaq notes that, in certain situations, a "marker" order may be a riskless principal trade. Marker orders, usually of nominal size, are used to trigger obligations to other orders the firm may be holding. Under the interpretation of a riskless principal trade, a marker order appears to merit riskless principal treatment for the size of the marker order. Nasdaq, however, believes that, given the purpose for which marker orders are used, the order need not be broken into two separate components to distinguish between a risk and riskless portion, provided, however, that the marker order is no larger than 10% of the size of an execution or group of executions that it would trigger. Nasdaq believes that the nominal size of the marker order does not, to any material extent, change the overall risk profile of the order.

treats riskless principal trades as one trade for reporting purposes) should be extended to market makers in exchange-listed stocks. For example, if a market maker in an exchange-listed security does not assume a risk position on an Intermarket Trading System ("ITS") commitment sent to another market, the market maker should not be reprinting it in its own market when it receives confirmation of an execution on the commitment. The fact that the firm is a market maker is irrelevant. Nasdaq also believes that this analysis should apply to transactions that result from orders sent to the floor even when sent outside of the ITS linkage (e.g., through a floor broker or other automated execution system of the exchange).

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations applicable to the NASD and, in particular, with the requirements of Section 15A(b)(6) of the Act.¹² Section 15A(b)(6) requires that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster, cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Most specifically, the Commission finds that this rule change will result in more accurate and reliable, information regarding last sale transaction reports consistent with the requirements of Section 15A(b)(6).

The Commission finds that requiring a separate identifier to accurately reflect "out of sequence" trades would provide better information to market participants and the public as to what these trades actually represent. The new modifier would inform the market that the price of the trade is based on an earlier reference point and may bear no relationship to the current market price. In addition, the Commission finds that the removal of the 10,000 share limitation for bunching on the first day of secondary market trading following

an IPO will facilitate more efficient and timely reporting of large numbers of trades in the IP aftermarket.

The Commission agrees with the NASD that, for reporting purposes, it is appropriate to treat riskless principal trades as one trade. The Commission finds that discontinuing the distinction between market makers and non-market makers in the context of exchange-listed securities, and thus extending the riskless principal exception to market makers, will provide more accurate trade reporting.¹³ The Commission believes that because this proposal would ensure that only one trade report results for transactions that are clearly one trade, transaction reports will be more accurate.

The Commission notes that Rule 10b-10 under the Act¹⁴ requires a broker-dealer acting as market maker in a riskless principal transaction in an exchange-listed security to confirm to its customer the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer. Under Rule 10b-10, the broker-dealer is required to report, as the reported trade price, the price at which the security was reported to the tape when the member purchased the security for, or sold the security to, its customer. This requirement remains in effect regardless of the fact that there is no corresponding requirement in the NASD rules to report that second leg of a riskless principal transaction to the tape. For example, when a market maker receives an execution report from an exchange in a listed security, through ITS or otherwise, and completes a riskless principal transaction by filling a customer order, the market maker must conform to its customer the price of the transaction that was reported to the CTA by the exchange and any mark-up or mark-down charged by the market maker. A failure by a broker-dealer to confirm to its customer the price of the security that was reported to the tape would constitute a violation of Rule 10b-10.

The Commission finds good cause for approving Amendment No. 2 to the

¹³ The Commission recently approved a proposed rule change to allow an NASD member acting as a market maker to report riskless principal transactions in Nasdaq securities as one transaction. See Securities Exchange Act Release No. 41208 (March 24, 1999), 64 FR 15386 (March 31, 1999).

¹⁴ 17 CFR 240.10b-10.

proposed rule change prior to the thirtieth day after the date of publication of notice of filing of this amendment in the **Federal Register**. Amendment No. 2 asks only that the Commission approve all of the proposed changes in the original filing and Amendment No. 1, with the exception of the proposed ECN trade reporting requirements. Furthermore, Amendment No. 2 states that the NASD will submit a separate response to the Commission regarding the Instinet comment letter addressing the proposed ECN trade reporting requirements. The Commission does not believe that Amendment No. 2 raises any new regulatory issues. The original proposal and Amendment No. 1 were published for the full 21-day comment period, and the Commission received no comments on the proposal other than the Instinet letter addressing ECN trade reporting requirements. Accordingly, the Commission finds good cause, consistent with sections 15A(b)(6)¹⁵ and 19(b)¹⁶ of the Act, to approve Amendment No. 2 to the proposal on an accelerated basis.

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the NASD, and, in particular, section 15A(b)(6). In addition, in granting a partial approval of this rule change, the Commission notes that it has also considered the proposed rule's impact on efficiency, competition, and capital formation.¹⁷

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (SR-NASD-98-08) be, and hereby is, approved with the exception of the proposed amendment to Rule 4623 "Electronic Communication Networks."

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,

Deputy Secretary.

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¹⁵ 15 U.S.C. 78o-3(b)(6).

¹⁶ 15 U.S.C. 78(b).

¹⁷ 15 U.S.C. 78c(f).

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).

¹⁹ 17 CFR 200.30-3(a)(12).