# Series 57 Qualification Exam

Securities Trader Examination

Study Manual – 44th Edition

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# Introduction

Securities Training Corporation's Series 57 Examination Training Program is designed to assist students in passing the examination regardless of their prior experience or educational level. Each phase of the program has been designed carefully to present concepts in a simple manner and logical sequence. Since this examination is under constant revision, we recommend that you visit our website at www.stcusa.com to determine whether there have been changes or supplemental materials created.

In order to obtain registration as a Securities Trader, candidates must pass both the Series 57 Exam and the Securities Industry Essentials (SIE) Exam—a general knowledge co-requisite.

This Introduction explains the various parts of the program and gives valuable information about the Series 57 Examination. Please read this entire section before beginning the program.

# About the Series 57 Examination

The Series 57 Examination is administered on a computerized testing system and consists of 50 multiple-choice questions that are scored. However, each examination includes five additional experimental questions that don't count for or against the candidate. These five questions are randomly distributed throughout the examination and are not identified as experimental. Therefore, the examination is actually 55 questions and candidates are given one hour and 45 minutes to complete it. Each question on the examination has four choices: A, B, C, or D. Since all of the questions are given equal weighting, every question should be answered. There's no additional penalty for answering a question incorrectly. The minimum required passing score is 70%.

***Equating of Test Scores*** *Since no two examinations are alike, each examination may vary slightly in difficulty. To account for these slight variations, the candidate's examination is statistically equated to a standard form of the examination. The purpose of statistical equating is to place all examinations on equal ground. Equating ensures that no candidate who takes a slightly more difficult test would be at a disadvantage, or conversely, no candidate would receive an unfair advantage by taking a slightly easier test. Therefore, candidates with comparable ability will be given the same opportunity to pass the examination regardless of the slight variations of difficulty of the forms of the examination that are administered to them. Equated scores are not the actual number of test questions correct or percentage correct.*

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Series 57 Exam questions are divided into two topical areas:

| Topics | Number of Questions |
|---|---|
| Trading Activities | 41 (82%) |
| Maintaining Books and Records, Trade Reporting, and Clearance and Settlement | 9 (18%) |
| **Total** | **50** |

A detailed listing of topics tested can be accessed on FINRA's website at the link below:

**https://www.finra.org/sites/default/files/Series_57_Content_Outline.pdf**

# Course Materials

STC's Series 57 Examination Training Program consists of the following materials:

1. Eight chapter study manual
2. Eight final examinations with explanations

## Study Manual and Exam Breakdown

The study manual, which represents the first phase of your exam preparation, consists of eight chapters that cover the topics tested on the Series 57 Examination. After reading each chapter, STC strongly suggests that students go to their *my.stcusa.com* dashboard and create a 10-question Custom Exam that contains only questions pertaining to the chapter just completed.

The Custom Exam may be taken with or without the explanations shown after each question is answered. Students shouldn't proceed to the next chapter until they fully understand the explanation for any questions that were answered incorrectly.

## Final Examinations

The final examinations and corresponding explanations represent the most important part of your test preparation. These examinations will assist you in applying the information that you learned in the study manual to questions that are posed in the multiple-choice format that's used for the Series 57 Examination.


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An examination should first be taken with the SHOW EXPLANATIONS turned on. As you read a question, try to answer it. However, whether your answer is correct or incorrect, read the entire explanation. You may find it helpful to highlight or take notes on any facts you didn't know for use in future studying.

Studying each explanation is a crucial step to passing the Series 57 Examination. By concentrating only on the correct response and disregarding the explanation, you run the risk of memorizing answers without fully understanding the underlying concepts.

After completing all of the examinations with SHOW EXPLANATIONS switched on, and if time permits based on the calendar you're following, begin the process over again by retaking each examination without the explanations shown. If taking the test for the second time, you should strive to achieve a score of 85% or better to show maximum retention of the material.

# Registering for the Examination

To register for the Series 57 Examination, you must complete the Form U4 application. Your sponsoring firm will then send both Form U4 and your fingerprints to FINRA for processing. Give yourself ample time for processing to be completed. Once your information has been processed, a confirmation will be sent to your firm.

## Taking the Exam

In order to take an exam, you will need to make a test appointment. Please use the following information to schedule an appointment and/or to learn more about the examination center:

Prometric Exam Centers
www.prometric.com/finra/
800.578.6273

The website will provide you with the most up-to-date information regarding "Test Center Security" and "Test Break Policies." At the testing facility, you will be provided with:

- A four-function calculator
- Two dry-erase boards
- Dry-erase pen

For more information regarding scheduling an exam, what to expect on the day of your exam, and what happens after your exam, please use the following link which provides information from FINRA:

www.finra.org/sites/default/files/external_apps/proctor_tutorial.swf.html

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## Sample Question Formats

There are four basic multiple-choice formats found on the Series 57 Examination.

1. **The Incomplete Sentence Format –** This type of format requires you to choose the best conclusion to complete the sentence.

   *Example*

   The Financial Industry Regulatory Authority (FINRA) is considered:

   a. An exchange
   b. A self-regulatory organization
   c. A U.S. government agency
   d. The primary regulator of the futures industry

   (The correct answer is b.)

2. **The Closed Stem Format –** In this format, you're asked a question and then must select the best response.

   *Example*

   Mutual funds may be described as which of the following?

   a. Open-end management companies
   b. Closed-end management companies
   c. Face-amount certificate companies
   d. Unit investment trusts

   (The correct answer is a.)

3. **The EXCEPT Format –** This format requires you to select the one incorrect response from the choices presented.

   *Example*

   All of the following are characteristics of Treasury bills, EXCEPT:

   a. They have a maximum maturity of twelve months
   b. They are sold at weekly and monthly auctions
   c. They are interest-bearing securities
   d. They are sold at a discount

   (The correct answer is c.)


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4. **The Roman Numeral Format –** This format is used when there's more than one correct response. Do all possible eliminations before trying to answer the question. The answer will usually include either two choices or all four choices.

   *Example*

   Which TWO of the following are true regarding an investor who buys call options?

   I. The investor has limited profit potential
   II. The investor has unlimited profit potential
   III. The investor has limited loss potential
   IV. The investor has unlimited loss potential

   a. I and II
   b. I and III
   c. II and III
   d. II and IV

   (The correct answer is c.)

## Standardized Test-Taking Tips

As with any standardized test, you may be able to increase your score by employing good test-taking techniques. An efficient technique will ensure an overall understanding of the question while helping to avoid careless errors. It will also help you to stay alert throughout the entire exam.

The following list is a step-by-step approach that may work well for you:

**Step 1: Read the question the first time through without trying to answer it.** At this point, merely form an understanding of the substance of the question.

**Step 2: Carefully read the four choices.** Remember, since a multiple-choice examination actually gives you the answer, your job is to recognize the correct choice from among the distractors. By keeping these choices in mind when you reread the question, you will be able to pinpoint the important information and filter out any extraneous material.

**Step 3: Reread the question slowly and stop at the end of each sentence to absorb the information.** You may need to exaggerate this in the beginning as you get used to applying the intense concentration required to assure that you recognize all of the important facts and catch the misleading words or phrases (e.g., not, except, etc.).

**Step 4: Make sure that you fully understand what the question is asking.** You cannot possibly answer a question correctly before you know what it's asking. You may need to look back to the question for additional facts before you're ready to choose your answer.

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**Step 5: Read each choice a second time.** As you read a choice, decide whether it's a possible answer. If you're able to eliminate three of the four choices, then you have your answer. However, if you only eliminate one or two, it will still help you narrow it down to your best choices. Reconsider the remaining choices by comparing their differences and decide which answer is more correct. Once you have made your decision, DON'T LOOK BACK!

It's important that you practice your technique so that you become proficient by the time you sit for the Series 57 Examination. The best place to practice is on the simulated final examinations. Not only will this practice build your technique, it will also help you to identify potential problem areas. A list of common test-taking problems follows.

## Test-Taking Pitfalls

**Reading the Question Too Fast** Part of the battle in attempting to pass a standardized examination is determining what a question is asking. Regardless of how many times you read a question, you cannot absorb the information if you read the question too quickly.

**Changing Answers** Going back and changing an answer means that you're second-guessing yourself. If you employ a good test-taking strategy, there's nothing you will gain from going back to a question for a second time. If you think you're likely to obtain the information you need from another question, remember that this examination is written by expert test writers who are not going to give anything away.

**Formulating an Answer Too Quickly** When you're ready to answer a question, make sure to consider all four of the choices that are given. Don't formulate an answer on your own and merely look for that choice while disregarding the others. Remember, there will often be more than one correct choice and, while your choice may be right, it may not be the best response.

**Making Careless Errors** Don't form preconceived notions when reading a test question. Always read what's written, not what you expect to see. By keeping an open mind, reading the questions slowly, and reading them at least two times through, you should be able to avoid these types of errors.

# Study Calendars

Following this Introduction, STC has included study calendars. These study calendars are designed to help students in organizing their time and allowing for a manageable amount of daily study. View each calendar and choose the one that best fits your needs. Remember, these calendars are simply suggestions for how you may plan your studies. Feel free to make any modifications that you deem appropriate.


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# Series 57 Top-Off – *One-Week Training*

**To complete each chapter:**

1. Watch the On-Demand Lecture for the chapter.
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4. Create a custom Flashcard deck for the chapter

*** To create a Custom Exam:** Log in to *my.stcusa.com*. From your Dashboard, select *Final Exams*, then scroll down and select *Create a Custom Exam*. Now, select the appropriate chapter number and, at the bottom of the screen, enter 10 in the *Number of Questions* box, and then select *Build Exam*. You can choose whether or not to have the explanation appear after each question is answered.

**For the Final Exams:** An examination should first be taken with the SHOW EXPLANATIONS turned ON. After completing all of the examinations with SHOW EXPLANATIONS switched on (and if time permits), begin the process over again by retaking each examination without the explanations shown (Explanations OFF).

| | MONDAY | TUESDAY | WEDNESDAY | THURSDAY | FRIDAY |
|---|---|---|---|---|---|
| WEEK 1 | **Complete Chapters 1 – 3**<br>*(Approx. 7.5 hours)* | **Complete Chapter 4**<br>**Take Progress Exams 1A and 1B**<br>(Review incorrect answers)<br>**Complete Chapters 5 – 6**<br>*(Approx. 8.5 hours)* | **Complete Chapters 7 – 8**<br>**Take Progress Exams 2A and 2B**<br>(Review incorrect answers)<br>**Take Final Exam 1**<br>*(Approx. 9 hours)* | **Take Final Exams 2 – 4**<br>**Take Greenlight Exam 1**<br>(Review incorrect answers from Final Exams and Greenlight 1)<br>**Take Final Exam 5**<br>*(Approx. 9 hours)* | **Take Final Exams 6 – 8**<br>**Take Greenlight Exam 2**<br>(Review incorrect answers from Final Exams and Greenlight 2)<br>*(Approx. 8 hours)* |

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**For the Final Exams:** An examination should first be taken with the SHOW EXPLANATIONS turned ON. After completing all of the examinations with SHOW EXPLANATIONS switched on (and if time permits), begin the process over again by retaking each examination without the explanations shown (Explanations OFF).

| | MONDAY | TUESDAY | WEDNESDAY | THURSDAY | FRIDAY |
|---|---|---|---|---|---|
| WEEK 1 | **Complete Chapters 1 – 2**<br>*(Approx. 5 hours)* | **Complete Chapters 3 – 4**<br>*(Approx. 5 hours)* | **Take Progress Exams 1A and 1B**<br>(Review incorrect answers)<br>**Complete Chapter 5**<br>*(Approx. 3.5 hours)* | **Complete Chapters 6 – 7**<br>*(Approx. 5 hours)* | **Complete Chapter 8**<br>**Take Progress Exams 2A and 2B**<br>(Review incorrect answers)<br>*(Approx. 3.5 hours)* |
| WEEK 2 | **Take Final Exam 1**<br>**Take Final Exam 2**<br>*(Approx. 4 hours)* | **Take Final Exam 3**<br>**Take Final Exam 4**<br>*(Approx. 4 hours)* | **Take Greenlight Exam 1**<br>(Review incorrect answers from Final Exams and Greenlight 1)<br>**Take Final Exam 5**<br>*(Approx. 4 hours)* | **Take Final Exam 6**<br>**Take Final Exam 7**<br>*(Approx. 3 hours)* | **Take Final Exam 8**<br>**Take Greenlight Exam 2**<br>(Review incorrect answers from Final Exams and Greenlight 2)<br>**Review Crunch Time Facts**<br>*(Approx. 5 hours)* |

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3. Build a 10-question Custom Exam for the chapter *
4. Create a custom Flashcard deck for the chapter

*** To create a Custom Exam:** Log in to *my.stcusa.com*. From your Dashboard, select *Final Exams*, then scroll down and select *Create a Custom Exam*. Now, select the appropriate chapter number and, at the bottom of the screen, enter 10 in the *Number of Questions* box, and then select *Build Exam*. You can choose whether or not to have the explanation appear after each question is answered.

**For the Final Exams:** An examination should first be taken with the SHOW EXPLANATIONS turned ON. After completing all of the examinations with SHOW EXPLANATIONS switched on (and if time permits), begin the process over again by retaking each examination without the explanations shown (Explanations OFF).

| | MONDAY | TUESDAY | WEDNESDAY | THURSDAY | FRIDAY |
|---|---|---|---|---|---|
| WEEK 1 | **Complete Chapters 1 – 2**<br>*(Approx. 5 hours)* | **Complete Chapter 3**<br>*(Approx. 2.5 hours)* | **Complete Chapter 4**<br>**Take Progress Exams 1A and 1B**<br>(Review incorrect answers)<br>*(Approx. 3.5 hours)* | **Complete Chapter 5**<br>*(Approx. 2.5 hours)* | **Complete Chapter 6**<br>*(Approx. 2.5 hours)* |
| WEEK 2 | **Complete Chapter 7**<br>*(Approx. 2.5 hours)* | **Complete Chapter 8**<br>**Take Progress Exams 2A and 2B**<br>(Review incorrect answers)<br>*(Approx. 3.5 hours)* | **Take Final Exam 1**<br>**Take Final Exam 2**<br>*(Approx. 4 hours)* | **Take Final Exam 3**<br>**Take Final Exam 4**<br>*(Approx. 4 hours)* | **Take Greenlight Exam 1**<br>(Review incorrect answers from Final Exams and Greenlight 1)<br>*(Approx. 2 hours)* |
| WEEK 3 | **Take Final Exam 5**<br>*(Approx. 2 hours)* | **Take Final Exam 6**<br>*(Approx. 2 hours)* | **Take Final Exam 7**<br>*(Approx. 2 hours)* | **Take Final Exam 8**<br>*(Approx. 2 hours)* | **Take Greenlight Exam 2**<br>(Review incorrect answers from Final Exams and Greenlight 2)<br>**Review Crunch Time Facts**<br>*(Approx. 3 hours)* |

***PASS THE SERIES 57!***

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# Chapter 1

# *Overview of Markets and Trading*

*Passing the Series 57 Examination is required for any person to be qualified as a Securities Trader Representative. Before covering the specifics of examination content, let's begin with an overview of the U.S. financial markets and examine the reasons for the existence of Wall Street (a slang expression for U.S. financial markets). This chapter will also provide a broad overview of the regulatory structure of the U.S. securities markets.*

# Raising Capital for Issuers

An issuer is defined as a legal entity that sells securities in order to finance its own operations. Issuers include businesses that need capital (funds) to grow and prosper, as well as governments that typically borrow funds as a means of paying their bills. In some cases, an issuer may have savings from which it may draw or it may borrow funds from investors or financial intermediaries (e.g., banks).

The process of matching investors who have money with issuers that need funding is a significant purpose of the securities industry. Ultimately, Wall Street provides the bridge between those with capital and those in need of financing.

The success of the U.S. economy is due in large part to the free flow of capital between corporations, governmental bodies, and investors. This flow of money is made possible by a highly developed capital markets system in which issuers sell securities to investors with financial firms acting as intermediaries. There are two primary methods that issuers use to raise capital—issuing *debt securities (bonds)* and issuing *equity securities (stocks)*. Let's take a moment to define each.

## Debt Securities

Both corporations and various government borrowers raise funds through the issuance of publicly traded loans, which are referred to as *bonds, notes,* or *debt instruments.* A bond is a security that evidences the amount of indebtedness (principal) of an issuer. The investors who purchase bonds are considered *creditors* of the issuer and essentially lend their funds to the issuer for a specified period (until maturity). The issuer is required to repay the principal balance of the bond at a future date and will typically make interest payments over the life of the loan. These principal and interest payments are mandatory and are referred to as the issuer's debt service obligation.

## Equity Securities

Traditionally, corporations raise capital through the issuance of stock (equity). If an investor purchases stock, he has an ownership interest in the underlying business and, at some point, may be entitled to a portion of the corporation's profits (through a dividend distribution). The ownership interest typically doesn't have a maturity date and the payment of any dividends is voluntary for the issuer.

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## Primary Markets

The capital markets can be broken down into two basic types—*primary* and *secondary markets*. The primary market is considered the market in which an issuer sell its securities to investors, such as a corporation conducting its initial public offering (IPO). An IPO represents a corporation's first attempt to attract capital from financial institutions and the public. Another example of a primary market offering includes the U.S. government conducting a weekly auction of Treasury bills. In a primary market transaction, the key point to remember is that the securities are being sold by the issuer and the proceeds of the offering are directed to the issuer. After the money is raised in the primary market, the resulting securities that have been created will begin to trade in the secondary market.

## Secondary Markets

Trading markets, also referred to as secondary markets, provide a system for trading existing financial instruments among investors. Although this resale of securities has no direct effect on the issuing corporation, the ability to resell a stock or bond (liquidity) increases an investor's willingness to invest money in securities in the first place. This willingness to invest indirectly benefits issuers that seek to raise additional capital in the future.

## Broker-Dealers

**What's a Broker-Dealer?** Broker-dealers are vital to the activities that are conducted in both the primary and secondary market. They may assist issuers in their goal of raising capital, as well as provide investors with the ability to buy or sell securities. The term *broker-dealer* actually refers to the two capacities in which a firm may operate. A *broker* is defined as any person that's engaged in the business of effecting transactions in securities for the account of others, and a *dealer* is defined as any person that's engaged in the business of buying and selling securities for its own account. Since firms are continuously effecting trades as either a broker or a dealer, it's convenient to simply term them broker-dealers. At this point, let's analyze a typical brokerage firm.

**Broker-Dealer Departments** Many broker-dealers are divided into several distinct departments. Since registered representatives may interact with employees from all of these areas, it's appropriate for Series 57 Examination candidates to have a general idea of the responsibilities of the employees who work in each of these areas.

*Investment Banking* Investment banking is the area that works directly with the issuers to arrange and structure the needed financing. For example, these financial professionals may advise an issuer that wants to raise funds through an issuance of stocks, bonds, or a combination of both. Investment bankers are also referred to as the *underwriters* of securities.

*Research* In a full-service brokerage firm, the research department's analysts study both the markets and securities in order to issue recommendations. The typical recommendations include buy, sell, or hold.


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*Sales* Historically, sales personnel have been referred to as stock or bond brokers. Financial professionals who work in the sales area typically market products to both retail investors and institutions.

*Trading* Trading professionals handle the execution of trades for both the firm's clients and the firm's own proprietary account. These trades may occur in either electronic or hybrid marketplaces.

*Operations* Operations professionals ensure that all of the paperwork, funds, and securities transfers that are associated with a trade (or processing) are handled efficiently and according to specific industry standards. Operations personnel perform functions such as generating customer statements, confirmations, and tax records, as well as assisting in the transfer of securities and/or funds. These personnel are also responsible for ensuring that all firm and client assets are organized properly and safeguarded.

# Regulation

There are four tiers to regulation—federal laws, SRO rules and regulations, state regulation, and firm-specific policies and procedures.

**Federal Regulation** For broker-dealers, all of these capital raising, sales, trading, and operations activities are heavily regulated. The primary regulation comes from laws (also referred to as Acts) that have been passed by Congress. These Acts are enforced by the Securities and Exchange Commission (SEC) which is part of the U.S. federal government. A brief description of many of these Acts will be provided shortly.

**SRO Regulation** The creation and enforcement of the day-to-day rules that brokerage firms must follow are often handled by self-regulatory organizations (SROs), such as the Financial Industry Regulatory Authority (FINRA), the various exchanges, or the Municipal Securities Rulemaking Board (MSRB).

The primary purpose of these different self-policing organizations is to promote fair and equitable trading practices. SRO rules require that firms use reasonable due diligence when dealing with customers. Since SROs are not part of the government, they don't have the power to arrest or imprison persons who violate their rules.

**State (Blue-Sky) Regulation** Each state has the authority to impose additional requirements for both issuers and financial intermediaries. Typically, a state requires both broker-dealers and registered representatives to be registered in the state in order to transact business there. Additionally, issuers are normally required to register their securities prior to sale in a given state. These rules are established under the Uniform Securities Act (USA).State securities laws are also referred to as the *blue-sky laws* due to the use of the term in a state court decision that was made in the early 1900s.

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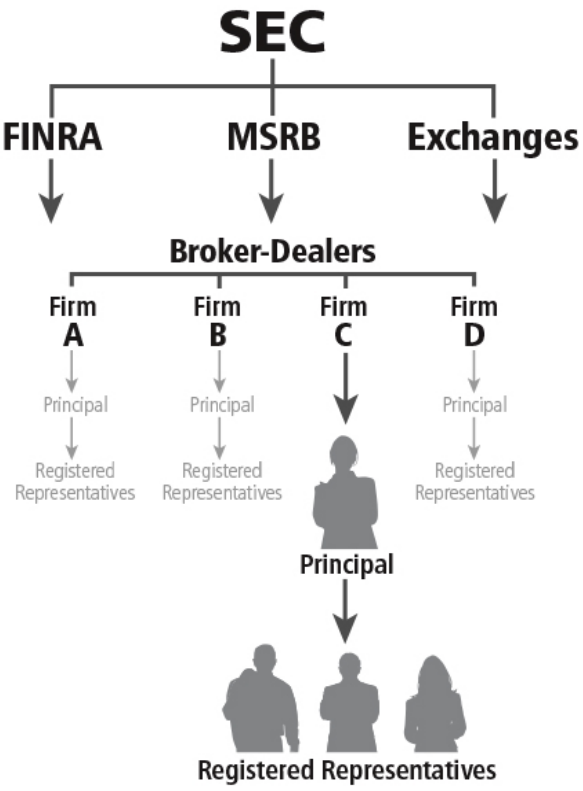
**Written Supervisory Procedures** Member firms are required to establish and maintain a system to supervise the activities of their personnel. Firms clearly outline their policies and procedures by creating their own internal Written Supervisory Procedures (WSPs). A firm's WSP is essentially a manual that details the rules and the person responsible for their enforcement.

Within a firm, there are three different categories of personnel—registered representatives (RRs), registered principals, and unregistered employees. The individuals who manage and supervise RRs are the firm's principals.

*When in Doubt…Check with a Principal* On the Series 57 Examination, it's important to recognize that when a problem occurs, the best course of action may be to inform a principal. Remember, since the examination is trying to prepare a person to function in a real-world brokerage environment, when confronted with an unfamiliar situation, checking with a supervisor is always a good idea. As evidenced by the diagram below, an RR sits on the bottom of the regulatory pyramid.





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# Federal Regulation – The Acts

Passing the Series 57 Examination requires an understanding of the regulatory environment in which securities are issued and traded. The following is a brief description of some of the major federal legislations with which candidates will need to be familiar. Each of these laws will be covered in more detail in subsequent chapters.

**The Securities Act of 1933** The Securities Act of 1933 was the first federal legislation covering the securities industry and, specifically, the primary market. As mentioned earlier, the primary market is where corporations and other issuers attempt to sell securities in the form of stocks or bonds to the investing public.

The Securities Act of 1933 is concerned with providing investors full and fair disclosure so that they're able to make informed investment decisions. The Act also provides specific rules for the conduct of issuers and the investment bankers that are hired to advise the issuers on the sale and marketing of their securities.

**The Securities Exchange Act of 1934** The Securities Exchange Act of 1934 established the rules for secondary market activities. The two best known of these secondary markets are the New York Stock Exchange (NYSE) and Nasdaq. The Act of 1934 also created the Securities and Exchange Commission (SEC) and gave it preeminent regulatory authority in the area of domestic securities dealings in both the primary and secondary markets. Additionally, the Securities Exchange Act of 1934 gave the Federal Reserve Board (FRB) regulatory oversight regarding the extension of credit in the securities industry (i.e., the use of margin).

Since it was believed that markets needed to be dynamic and not overly constrained, federal regulation has not always been welcomed. Although exchanges are required to register with the SEC and enforce SEC rules, it was felt that the markets should regulate themselves in their day-to-day operations. Therefore, self-regulatory organizations (SROs) have been created to set their own rules and regulations for their members within the broader framework of federal law and the SEC.

**The Maloney Act of 1938** This Act allowed for the creation of non-exchange SROs. Most securities transactions don't take place on an exchange, but are instead conducted in the over-the-counter (OTC) market. The National Association of Securities Dealers (NASD) was created in 1939 to act as the self-regulatory organization for the OTC market. In addition, the scope of the Maloney Act enabled the creation of the Municipal Securities Rulemaking Board (MSRB) in 1975. However, in 2007, the NYSE and NASD merged their member regulation and enforcement functions and created the Financial Industry Regulatory Authority (FINRA).

As SROs, FINRA and the exchanges are responsible for maintaining fair and orderly securities markets, promoting best execution of trades and fair treatment of clients, and establishing rules and regulations that protect investors.

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**The Insider Trading Act of 1988** The Insider Trading Act was created as a response to the scandals of the 1980s. Insider trading involves the illegal trading on the material, non-public information (i.e., information that's not available to the public which could affect the value of publicly traded securities). Although insider trading was prohibited by the Acts of 1933 and 1934, there were no specific penalties prescribed. For any individuals convicted of insider trading, the 1988 Act established criminal penalties to include a fine as high as $5 million and/or up to 20 years imprisonment. At the civil level, the SEC can sue for up to three times the profit made or loss avoided (referred to as *treble damages*).

**The Penny Stock Reform Act of 1990** The Penny Stock Reform Act covers the selling of certain low-priced securities to potential new customers. Penny stocks are defined as non-exchange-traded securities (i.e., OTC equities) that are priced at less than $5 per share and are often risky and highly volatile. The rules require a firm to have a signed disclosure document from potential buyers stating that they understand the risks involved.

# Self-Regulatory Organizations

## FINRA and the Exchanges

FINRA is the primary SRO for the securities industry and is responsible for the content of the Series 57 Examination. Many of the rules on which Series 57 Examination candidates will be tested are FINRA and exchange rules. FINRA and the exchanges have many similar rules covering the actions of representatives. The questions on the Series 57 are derived from these rules, but are not specific with regard to one exchange or SRO organization. Candidates will be required to understand which actions are allowed and prohibited by SRO rules, but will not need to know the specific FINRA or exchange rule number.

FINRA rules may be broken down into the following categories:

1. ***Conduct Rules*** These rules govern the interactions between customers and firms and cover areas such as compensation, communications, and sales practice violations.
2. ***Uniform Practice Code (UPC)*** UPC rules govern trading and the proper settlement of transactions. The goal of the Uniform Practice Code is to standardize the procedures for doing business in financial markets. Interpretations of the Uniform Practice Code are the responsibility of FINRA's Operations Committee. Examples of UPC issues likely to be encountered on the examination include good delivery, buy-ins, sell-outs, ex-dividends, and accrued interest.
3. ***Code of Procedure (COP)*** The COP covers the process which is used to discipline any person that violates FINRA rules. Remember, FINRA acts like a COP for the securities industry (using the COP).
4. ***Code of Arbitration*** The Code of Arbitration provides a process for resolving disputes between members as well as those that involve public customers. Generally, arbitration is used to settle monetary disputes.


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# House Rules

## Internal Compliance

As previously mentioned, not all oversight is handled by the SEC or SRO. Internal compliance professionals (many of whom are principals) oversee all employee and customer activities to ensure that federal securities laws and industry rules are being followed. For example, compliance personnel routinely monitor both employee and client trading activity to uncover evidence of wrongdoing, such as insider trading. In short, compliance works with sales professionals to develop policies and procedures which allow them to sell securities and to grow the firm's business in an ethical and compliant manner. Compliance professionals are responsible for creating their firms' house rules that form the basis of their *Written Supervisory Procedures (WSPs*).

## The Importance of Understanding Regulation

There are two reasons for focusing on the different regulations. The first is to reinforce the importance of these regulations by providing a framework that will be helpful once a person begins to function as a registered representative. The second is that the test itself is prepared by the major SROs—namely FINRA.

In large part, passing the Series 57 Examination is a function of knowing the rules and regulations that govern the securities industry from the perspective of the SEC and the SROs that enforce these same rules and regulations.

# Trading Overview

**Listed Equities** Trading markets are generally broken down into two categories—traditional physical trading venues, such as the NYSE, or over-the-counter (OTC) marketplaces where trades occur in dispersed dealer-to-dealer networks that connect participants through phones and/or computers. Today, although they lack a physical trading floor, many electronic trading venues (e.g., Nasdaq) are classified by the regulators as exchanges. Any equity securities that meet the standards for trading on a national securities exchange are referred to as *listed securities*.

**OTC Equities** Equities that are not listed on either a physical or electronic exchange are referred to as *OTC equities* or non-exchange-traded securities. These issues trade in non-exchange OTC venues, such as the OTC Bulletin Board (OTCBB) or on a platform created by the OTC Markets Group—the OTC Pink Marketplace. Many other securities, such as U.S. government bonds, some corporate bonds, and certain derivative products, are also traded in the OTC market through various dealer-to-dealer networks.

In order to understand the process of equity trading, attention must be paid to different variables including the creation of quotations, the placement of orders, the execution of trades, and the reporting and documenting of trade executions.

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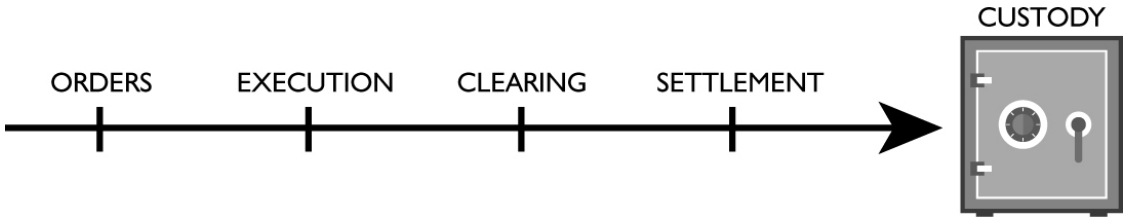
To begin, let's define two important terms—*market center* and *market participant*. A market center is a location to which orders are sent for execution (e.g., the NYSE or Nasdaq). A market participant is any entity that uses the secondary (trading) markets to buy and sell securities. These participants include retail and institutional investors as well as broker-dealers that assist these buying and selling clients.

## Secondary Market Trading – From Order Entry to Settlement

In the secondary market, trades begin with the placement of an order ticket in either a physical or electronic format. After the order ticket is completed, the firm's Sales Department forwards the order to its Trading Department. If the order is ultimately executed, the trade is *cleared* by the broker-dealer's Operations Department. Clearing involves the trade counterparties confirming the details of the transaction. Once cleared, the buying and selling broker-dealers exchange the securities for payment through a process that's referred to as *settlement* (for most securities, regular-way settlement occurs two business days after the trade, or T + 2). Finally, the buying broker-dealer maintains custody of the client's cash or securities. Custody may be maintained in either a physical vault or an electronic entity such as the Depository Trust Clearing Corporation (DTCC).

The following is a brief summary of the life cycle of an order. For the Series 57 Examination, the details of order entry and execution are the most important of the five steps. Be aware that the clearing and settlement processes involve the executing firms, not the customers.

1. **Order Entry—**The placing of a trade into the system either electronically or using a paper ticket
2. **Execution—**The occurrence of the trade in the marketplace, such as the NYSE or Nasdaq
3. **Clearing—**The agreement by executing firms as to the details of a trade
4. **Settlement—**The exchange of securities for funds that completes the transaction between firms
5. **Custody and Safekeeping—**The safeguarding of client and firm assets after settlement




**Order Entry** An order ticket, also referred to as an order memorandum, is a record of a customer's instructions regarding the execution of a buy or sell order. Traditionally, registered representatives filled out paper order tickets, but today's process is almost exclusively electronic. Essentially, many firms permit clients to fill out their own tickets through online trading accounts.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In the past, a physical order ticket was forwarded to the wire room for transmittal to the firm's traders. Obviously, today the sales and trading areas are linked by means of computer systems to greatly expedite this process. Order tickets will be discussed in more detail later.

## Settlement Date versus Payment Date

The *settlement date* for a transaction represents the date on which a selling broker must deliver securities to the buying broker in return for payment. Determining the number of days that it takes for a trade to settle will vary based on the security involved. The following table summarizes the settlement for the different types of securities:

| Type of Security or Trade: | Settlement: |
|---|---|
| Corporate Securities | Two business days after the trade date (T + 2) |
| Municipal Securities | Two business days after the trade date (T + 2) |
| U.S. Government Securities | One business days after the trade date (T + 1) |
| Option Trades | One business days after the trade date (T + 1) |
| Cash Trades for any security * | On the trade date |

* A special settlement in which the seller agrees to deliver securities and\
the buyer agrees to pay for the securities on the day of the trade.

The *payment date* represents the date on which a customer must pay for his portion of a trade that's executed in either a cash or margin account. This date is set by the Federal Reserve Board under the provisions of Regulation T. The Reg. T guidelines are found in the Securities Exchange Act of 1934. Specifically, Reg. T provides investors with a maximum payment extension of two business days after a regular-way settlement (S + 2). In other words, customers must pay by no later than four business days after the trade (T + 4). Municipal and U.S. government securities are exempt from Reg. T; therefore, payment is generally due at the time of settlement.

# Types of Transactions

As just mentioned, one of the important elements noted on the order ticket is the client's desired action or intent which may include:

- A purchase
- A long sale
- A short sale

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When making a purchase, the client must designate whether the trade will be fully paid for or be partially paid with borrowed funds (on margin). When the ticket indicates a long sale, the customer must have the position in her account or be able to deliver it to the broker-dealer promptly. However, if the ticket indicates a short sale, a more detailed explanation may be required.

**Short Positions** What's the difference between normal selling (a long sale) and short selling? A long sale occurs when the client owns the securities being sold; however, with a short sale, the client must first borrow the shares from the firm and then execute a sale.

*Short Sellers Are Bearish* Since short sellers anticipate that the price of the shares will fall in value, their investment outlook is often referred to as *bearish*. If the securities may be purchased at a later time and at a lower price, the investor will realize a profit. However, if the securities increase in value, the investor may be forced to buy the securities at a price above the price at which they were sold short and will realize a loss. Since there's no limit as to how high a security's price may increase, the short seller has unlimited risk.

*Margin Requirement for Short Sellers* Short sales must be executed in a margin account. Brokerage firms are often able to provide short sellers with stock that they have borrowed from other margin customers. Before a customer's stock is loaned to a short seller, the customer must provide her firm with permission by signing a loan consent agreement at the time her account is opened. Since the stock has been loaned, the short seller is ultimately obligated to return the borrowed shares. However, as long as the account maintains the required minimum equity, there's no set period within which this must take place. However, if a cash dividend is paid on the borrowed stock, the short seller is responsible for paying the dividend to the lender.

The process of selling short will be covered in greater detail later in the study manual.

# Price Quotes

Before the different types of orders are examined, it's important to understand how securities are valued in the secondary market. A security's quotation consists of two parts—a *bid* and an *ask* price.

| Bid | Ask | Size |
|---|---|---|
| 18.00 | 18.50 | 3 x 5 |

**Bid Price** For the firm that places the bid, it's the price at which it will purchase the security. From the perspective of a customer who enters a market order to sell, the bid price represents the price he will likely receive in the secondary market.

**Ask Price** For the firm that places the ask, it's the price at which it will sell the security. From the perspective of a customer who enters a market order to buy, the ask price represents the price he will pay in the secondary market.


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**Size** The quote size represents the number of shares a firm is willing to buy and the number of shares the firm is willing to sell. In the quote shown above, the bid is firm for three round lots (300 shares), while the ask is firm for five round lots (500 shares). If no size is displayed with the quote, it may be assumed that the quote represents one round lot of stock (100 shares).

**Spread** Stocks are quoted in dollars and cents. The difference between the bid and ask prices is referred to as the spread. Stocks that are actively traded will normally have narrow spreads, while stocks that are inactively traded usually have wider spreads.

*In the above example, a customer who wants to purchase this stock will pay $18.50, while a customer who wants to sell this stock will receive $18.00. The bid represents 300 shares, while the ask (offer) represents 500 shares. The spread is the $.50 difference between the 18.00 bid and the 18.50 ask.*

*Round Lots and Odd Lots* Again, bids and offers are posted in 100-share multiples. Investors who intend to purchase lesser amounts are considered to be trading in odd lots. For example, if an investor buys 567 shares of XYZ stock, he has purchased five round lots of 100 shares plus an odd lot of 67 shares. This order can be placed on one ticket.

Now, let's consider the process of order entry.

# Types of Orders

## Market Orders

The most basic type of order is a market order. When placing this order, the client doesn't specify a price. Instead, the order will be executed at the price that's available when it reaches the market.

While market orders will always be executed immediately, the client is not assured a specific execution price. Market orders are often used for stocks that have actively traded (liquid) markets in which buy or sell orders are unlikely to impact the price.

## Limit Orders

When customers want to buy or sell securities at a specific price, they enter limit orders. A limit order may be executed only at the specified price or better. A buy limit order may only be executed at the limit price or lower, while a sell limit order may only be executed at the limit price or higher.

As shown below, a buy limit order is placed below the current market price of a security.

*For example, let's assume that XYZ stock is currently trading at $31. A customer wants to buy the stock if it drops slightly and, therefore, enters a limit order to buy 100 shares of XYZ at $30. The order will not be executed unless the stock can be purchased at $30 or below.*

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As shown below, a sell limit order is placed above the current market price of a security.

> *Now, let's assume that a client originally bought stock at $22 and it's now trading at $29. If the client wants to sell the stock, but only if it rises slightly, he may place a sell limit order at $30. The order will not be filled unless the stock is able to be sold at $30 or above.*

Since limit orders are entered away from the market price, a person who places a limit order must be patient. Depending on which way the market moves, he may or may not receive an execution. Assuming an order is a day order and doesn't receive execution by the end of the day, the client will receive a *nothing done* notification from his firm. This notification indicates that the day order has expired and will need to be reentered on the following day.

Limit orders are often used for large orders in thinly or infrequently traded securities when the customer believes that a market order will likely cause a temporary price fluctuation. Again, the risk with this type of order is that the customer may not receive execution.

**Priority of Orders** Given the number of orders flooding into a trading location each minute, it's important to identify which orders receive priority. Market orders have first execution priority since the buyers or sellers who enter market orders don't specify a price. Remember, with a market order, a customer is willing to transact business at the best prevailing price.

Limit orders are prioritized second based on their price constraints. Buy limits are given priority from the highest price to the lowest price. For example, if three buy limit orders exist for ABC stock at $30.03, $30.11, and $30.07, the buyer who's willing to pay the highest price ($30.11) moves to the front of the buy limit line.

Conversely, sell limits are given priority from the lowest price to the highest price. If three sell limit orders are entered for XYZ stock at $70.11, $70.23, and $70.07, the seller who's willing to accept the lowest price ($70.07) moves to the front of the sell limit line.

If two or more customers enter a limit order at the same price, the order that was entered first receives priority.

To summarize:

1. Market orders have first priority.
2. Limit orders are ranked by price.
3. Limit orders that are placed at the same price are ranked by time of entry.

## Stop (Loss) Orders

Customers who enter either market or limit orders *want* to receive execution; however, stop orders are often used by customers who are trying to prevent a large loss or protect a profit on an existing stock position. In certain cases, these customers would rather not receive execution.


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A stop order becomes a market order to buy or sell securities if the order's specified price is reached or passed (i.e., the order is activated/triggered). The specific price that's indicated by the investor is referred to as the *stop price*. Once the order is activated and it becomes a market order, the investor is guaranteed execution, but is not guaranteed a specific execution price.

**Sell Stop Order** A sell stop order is always placed below the current market price of the security and is used to limit a loss or protect a profit on a long stock position.

*For example, a customer purchases 100 shares of XYZ stock at $25 and determines that she wants to limit any losses to approximately 5 points; therefore, she enters a sell stop order at $20. If the stock trades at $20 (the stop price) or below, the sell stop order is triggered and becomes a market order to sell 100 shares of XYZ. With this order, the customer is attempting to limit the loss on her position.*

Rather than XYZ stock declining in price, let's assume that it appreciates to $35. The customer may decide that she wants to protect this profit by entering a sell stop order at $33. If the stock subsequently falls and trades at or through $33, the order will be activated to sell the stock and the customer will have protected a portion of her profit.

**Buy Stop Order** A buy stop order is always placed above the current market price of the security and is used to limit a loss or protect a profit on a short sale. Remember, short sellers anticipate that the security will fall in value, but will lose money if the position appreciates.

*For example, a customer sells short 100 shares of ABC at $40 and is bearish. However, he wants to protect his position against a rise in the price of ABC and places a buy stop order at $45. If ABC stock trades at the stop price of $45 or above, the customer's order will be activated and he will buy 100 shares at the market to close out (buy back) the short position. Once the order is activated, he's not guaranteed an execution price of $45, but is guaranteed that the position will be closed out (covered).*

## Stop-Limit Order

A stop-limit order is similar to a stop order in that market trading at or through the stop price will activate the order. However, once activated, the stop-limit order becomes a limit order and will only be executed at a specified price or better. These orders are a combination of both stop orders and limit orders. Essentially, a stop-limit order presents a risk/reward arrangement. The risk is that because a specific price is set, the order may never receive execution. The reward is that, if the order receives execution, the customer will receive the preset limit price or better.

**Sell Stop-Limit Order** As with a sell stop order, a sell stop-limit order is always placed below the current market price of the security and is used to limit the loss (or protect a profit) on a long position. However, once activated, the sell stop-limit order becomes a sell limit order and, therefore, execution will only occur if the stock can be sold at the limit price or better.

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*For example, an investor purchases 1,000 shares of DEF at $15 and, fearing a decline in its price, places a sell stop-limit order at $10. After the order is entered, market transactions occur as follows:*

Trigger Execution

*$10.70…$10.45…$10.05…**$10.00…$**9.97…$9.97…**$10.00***

*The order is activated by the first trade at $10.00 and becomes a limit order to sell 1,000 shares at $10.00 or higher. Although the stock subsequently fell below the stop price, the order was executed once the stock increased back to $10.00. Remember, once activated, the risk is that unless the order is able to be filled at the limit price or better, the order will not be filled.*

**Buy Stop-Limit Order** As with a buy stop order, a buy stop-limit order is always placed above the current market price of the security and is used to limit the loss (or protect a profit) on a short position. However, once activated, the buy stop-limit order becomes a buy limit order and, therefore, execution will only occur if the stock can be purchased at the limit price or better.

*For example, an investor sells short 1,000 shares of GHI at $20 and, fearing a rise in its price, places a buy stop-limit order at $24. After the order is entered, market transactions occur as follows:*

Trigger Execution

*$23.55…$23.80…$23.95…**$24.02**…$24.03…$24.02…**$24.00***

*The order is activated by the trade at $24.02 (through the stop price of $24.00) and becomes a limit order to buy 1,000 shares at $24.00 or lower. Although the stock subsequently rose above the stop price, the order was executed once the stock decreased back to $24.00. Remember, once activated, the risk is that unless the order is able to be filled at the limit price or better, the order will not receive execution.*

## Order Adjustments

Open orders are often adjusted due to corporate actions which result in a change to the underlying securities. Examples of these corporate actions include a forward split, a reverse split, a stock dividend, or a cash dividend.

**Forward Stock Split and Stock Dividends** All open orders are adjusted for stock splits or stock dividends.

*For example, if a limit order is placed to buy 100 shares at $48 and the stock is subject to a forward split, the order will be adjusted as follows:*

- For a 2-for-1 forward split, the order will be adjusted to buy 200 shares at $24.
- For a 4-for-1 forward split, the order will be adjusted to buy 400 shares at $12.


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**Reverse Split** All open orders for a stock are cancelled if the company executes a reverse split. If the client wants to maintain an order in the system, a new order must be entered along with a new trade ticket being processed.

**Cash Dividend Adjustments** For cash dividends, only orders that are entered below the market will have their prices reduced by the amount of the dividend or, in the case of a fractional dividend, enough to cover the full dividend. Since the following order types are entered below the market, the stock's designated market maker (DMM) will reduce their prices on the ex-dividend date:

- Buy limit
- Sell stop
- Sell stop-limit

The price reduction is automatic unless the customer specifically requests that the DMM not reduce the order. Therefore, if a request is made, the order is marked DNR (do not reduce).

**Ex-Rights Adjustments** As with a cash dividend, when a stock sells ex-rights, the designated market maker will reduce any orders on its book that were entered below the market. A buy limit order, a sell stop order, and a sell stop-limit order will be reduced by the amount the stock sells ex-rights since these orders are entered below the market.

## Order Qualifiers

Now that the different types of orders that an investor may enter have been described, let's examine the various qualifications that may be used with these orders.

**Day Order** Unless otherwise specified, every order is a day order and is subject to market exposure from 9:30 a.m. to 4:00 p.m. Eastern Time (ET). If an order is not executed, it's automatically cancelled at the end of the day.

**Extended-Hours Exposure** This qualification notifies the firm that the client wants his order exposed to pre-market and/or after-market trading sessions. Since trading outside of the normal trading hours of 9:30 a.m. to 4:00 p.m. ET may be very thin (infrequent and with low volume), any customers who intend to trade in these less liquid periods must receive special disclosures prior to engaging in extended hours trading. The *risk disclosure document* may be provided in either paper or electronic form and should highlight the following risks:

- Lower liquidity
- Higher volatility
- Changing prices from the market close of the normal trading session
- Unlinked markets
- News announcements
- Wider spreads

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**Good-Till-Cancelled (GTC) or Open Order** This is an order that remains in effect on the DMM's order book until it's either executed or cancelled. Any firm that accepts GTC orders should periodically update them with the DMM and the orders also need to be updated for any partial fills.

A customer may enter an order that's good for one week, one month, or any other specified time. If the order is not executed by the end of the specified time, the brokerage firm is responsible for cancelling it.

**At-the-Open Order** An at-the-open order is an order to buy or sell at the opening price. If the order is not executed at the opening, it's cancelled.

**Market-on-Close (MOC) Order** An MOC is an order to buy or sell at or near the closing price.

**Limit-on-Close (LOC) Order** An LOC is an order to buy or sell at the close, but only if the closing price is equal to or better than the preset limit price.

**Not-Held (NH) Order** The NH qualification gives the receiving firm discretion as to an order's time and/or price of execution. Since a not-held order is limited to the day on which the order is entered, it must be filled at some point before the end of the day or reentered by the client for the next day.

**Immediate-or-Cancel (IOC) Order** The IOC qualifier indicates that the client wants immediate execution on as much of the order as possible. Any portion of the order that's not immediately executed is cancelled.

**Do Not Reduce (DNR)** All open orders are adjusted for stock splits and stock dividends unless the client specifically requests for the order to not be reduced (i.e., by giving DNR instructions). Remember, only orders that are entered below the market are adjusted for cash dividends.

## Order Review Process

Before an order is released to the Trading Department, its ticket is reviewed. In the past, this review may have been performed by a person looking for potential problems, but today, it's generally handled by software. The review considers the following questions:

- Is the trade ticket complete or is information missing?
- Does the client own the security that he's attempting to sell?
- Does the client have sufficient funds to cover a purchase?
- Is the client approved for this trading activity (e.g., margin or options)?
- If selling short, are the shares able to be borrowed?
- Is the client subject to special restrictions (e.g., employee accounts)?

**Order Validation** If an order passes this review process, it's considered a *validated* order and is then forwarded to the Trading Department. At this point, if there's a problem with the ticket, the order is rejected and returned to the Sales Department for a correction or an amendment.


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## Processing a Transaction

Every transaction that's executed by a broker-dealer must adhere to the following flow of processing:

1. *Order Department (Wire Room)* — This department transmits buy and sell orders by allocating them to a specific exchange or product area.
2. *Purchase and Sales Department* — After an order is completed, the P&S department records the transaction and compares the trade details with the broker-dealer on the other side of the trade (the contra-broker) for the purpose of reconciling possible trade discrepancies.
3. *Margin Department* — This department enforces customer account rules with regard to payment and delivery and maintains an account record for each customer and posts all trade activity.
4. *Cashiering Department* — This is where funds and securities are received and disbursed.
5. *Reorganization Department* — This department handles all post-settlement issues, such as cash and stock dividend payments, stock splits, and tenders.

## Trade Routing

Once an order has been reviewed and released by the Sales Department, the firm must decide how it will attempt to execute the trade. Depending on where a security trades or the preferences of a firm, orders may be routed to various locations that include the following:

- An internal trading desk
- The NYSE
- Nasdaq
- Other exchanges (i.e. Chicago, Boston)
- The third market
- The OTCBB
- The OTC Pink Marketplace
- ECNs
- Dealer-to-dealer marketplaces
- An affiliated executing firm (e.g., order-entry firm)

**Internal or External Execution** For execution purposes, the first decision to be made is whether the firm intends to execute the trade in-house or expose it to external markets. To understand what goes into this decision-making process, let's analyze the different possible execution locations.

# Exchange Markets

## NYSE and Traditional Exchanges

A large percentage of securities transactions occur on exchanges. A national securities exchange is a market that's registered with the SEC under Section 6 of the Securities Exchange Act. A registered exchange acts as a self-regulatory organization for its members and is required to have surveillance systems in place to detect and prevent market manipulation.

The New York Stock Exchange (NYSE), Nasdaq, and the NYSE American (formerly the NYSE MKT) are some of the best-known national exchanges, but some of the others include the Chicago, Philadelphia, Pacific, and Boston Stock Exchanges. Although many floor-based exchanges are auction markets, a national securities exchange is not required to have a traditional physical trading floor for purposes of providing an auction market.

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Exchanges that combine an auction market and electronic market may be classified as hybrid markets. In compliance with Regulation NMS (to be described later), the NYSE has become a hybrid market; however, others (e.g., Nasdaq) remain exclusively electronic.

### Nasdaq

The Nasdaq Stock Market, or simply Nasdaq, has been the dominant force in the OTC market since its inception in 1971. It became an SEC-registered exchange on August 1, 2006. Unlike traditional exchanges that have a trading floor, an auction market, and a specialist system, the Nasdaq system has grown into one of the largest securities markets in the world. Securities that are listed on Nasdaq include equities, common stocks, convertible bonds, and warrants. Its efficiency and transparency have greatly increased investor interest in trading on Nasdaq and its listed securities. Nasdaq is a decentralized, negotiated market, with a market-maker system. Communication occurs by way of electronic systems for quotation, execution, and reporting purposes.

One important function of Nasdaq is the collection and dissemination of real-time, firm quotes in selected stocks. By displaying this information on a computer screen, much of the uncertainty regarding prices in the market is removed. The exact information on the screen depends on the level of service chosen by the subscriber. The operation of the Nasdaq system will be described later in this manual.

### Unlisted Trading Privileges

In some cases, exchanges will permit their members to trade unlisted securities. Generally, these securities are not listed because the issuer has not yet applied for listing and are considered to have *unlisted trading privileges* (UTPs). In most cases, UTP securities are listed on another exchange. For example, the Chicago Stock Exchange (CHX) trades Nasdaq securities on a UTP basis. For exchanges that permit unlisted trading privileges, SEC regulations require them to monitor trading in those securities and provide information to the security's primary trading market for surveillance purposes.

## OTC Trading

A key feature of the OTC market is that it's a negotiated dealer market. At the center of trading are market makers that compete with each other on their bid/ask quotes. Customers interact with dealers when buying or selling securities for their portfolios.

Since a market is a way of bringing buyers and sellers together, it's important to understand how the dealer participants in the OTC markets interact with each other. Market makers need to know the quotes of other dealers not only to execute trades, but also to publish competitive quotes. A market maker whose quotes are out of line with other market makers will have either no business or more business than it wants.

**OTC Markets Group Pink Marketplace** One forum for quoting and trading OTC equities is the OTC Markets Group Pink Marketplace. The name is still derived from color of the paper on which quotes for unlisted OTC equities were provided. Today, the Pink Marketplace is an electronic system that's updated on a real-time basis.


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The Pink Marketplace system lists the market makers for each stock. Although some of the quotes are firm, there may also be indications of bid and ask prices. These indications are considered *subject quotes* (i.e., subject to verification) and not considered firm. Bids wanted and offers wanted from broker-dealers can also be included are not considered firm.

The Pink Marketplace permit a broker-dealer to display a quote for any OTC equity security. Essentially, the system provides quotes for stocks of companies that don't meet Nasdaq listing standards. These issues are either OTCBB eligible securities (SEC reporting companies) or non-reporting companies. Many unsponsored ADRs, in which the issuer doesn't want its shares traded in the U.S., will be quoted in the OTC Pink Marketplace. These issues are often low-priced *penny stocks*, which trade infrequently or have a thin float. Trading stocks through the Pink Marketplace involves not only more uncertainty about the companies involved, but also about whether the best price has been obtained in a transaction.

How can a broker-dealer be sure it's found the *best* price? If the OTC Pink Marketplace list 10 market makers for a stock, does the executing broker-dealer need to check all market-maker quotes? FINRA provides the following guidance:

> *In any transaction for or with a customer or a customer of another broker-dealer, a member firm must use "reasonable diligence" to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.*

FINRA actually identifies five factors that should be considered when determining whether the firm has used reasonable diligence:

1. The character of the market for the security
2. The size and type of transaction
3. The number of markets checked
4. The accessibility of the quotation
5. The terms and conditions of the order as communicated to the firm

## OTC Bulletin Board (OTCBB)

One of the industry-sponsored market services is the OTC Bulletin Board. The OTCBB is a computer-based quotation system for OTC equity securities. Although it was established as an automated version of the original Pink Sheets, it's evolved to have characteristics that are more advanced than that medium. The features of the OTCBB will be described in detail later in this manual.

## The Third Market

The third market refers to the over-the-counter trading of exchange-listed securities. While most of the trading in listed stocks still occurs on their primary exchanges, third-market volume has grown significantly.

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One of the restrictions on third-market trading concerns initial public offerings (IPOs). FINRA members may not execute third-market transactions in a security that's the subject of an IPO until the security has opened for trading on the primary exchange that will be listing the security. The opening on the exchange is indicated through a transaction report by the listing exchange on the Consolidated Tape.

## Consolidated Quotation System (CQS)

Listed stocks can be traded in a number of different markets. For example, a large company's stock may trade on the NYSE, Nasdaq, one or more regional exchanges, as well as OTC. This could lead to market fragmentation, where price competition in any one market is reduced and information about trading (transparency) becomes more difficult to obtain if these trading venues are not linked as part of a National Market System.

The Consolidated Quotation System (CQS) reduces this problem by collecting quotes for all of the markets in which a listed stock trades and displays them on one screen. For example, with IBM, the CQS will show the bid and ask quote from the NYSE, NYSE American, Nasdaq, and each regional exchange on which it trades. CQS information is distributed by quotation vendors and these vendors will also include last sale and volume information as reported to the Consolidated Tape.

The service includes all common stocks, preferred stocks, warrants, and rights that are registered or allowed unlisted trading privileges on NYSE and certain securities on registered stock exchanges.

## The Fourth Market

The fourth market refers to direct institution-to-institution trading without the services of a broker-dealer. Although some of this trading includes different portfolio managers contacting one another by phone, most true fourth-market trades are internal crosses that are set up by money managers handling several institutional accounts. Note that proprietary trading systems (PTSs) which are set up to facilitate institution-to-institution trading are often referred to as a part of the fourth market. However, the SEC doesn't consider them part of this market, since such PTSs are either registered as broker-dealers or operated by broker-dealers.

The volume of true fourth-market activity is impossible to estimate, since these trades are not subject to reporting requirements. Some studies have estimated that fourth market trading amounts to several million shares per day.

## Alternative Trading System (ATS)

Alternative trading systems are SEC-approved, non-exchange trading systems. An ATS provides an alternative method to trading on an exchange and enhances the liquidity of securities in the marketplace. Examples of these systems include a broker-dealer's internal execution system, electronic communication networks (ECNs), and trade crossing networks. An ATS is generally required to register with the SEC and FINRA as a broker-dealer, but not as an exchange. An ATS doesn't set rules or discipline its subscribers; instead, it's subject to FINRA rules and disciplinary action.


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## Over-the-Counter (OTC) Markets

By definition, an over-the-counter (OTC) transaction is one that doesn't occur on an exchange. Most of these transactions are in unlisted securities. While the companies whose securities are listed on exchanges tend to be large- or medium-capitalization firms, the range of companies whose securities trade OTC is much wider. These companies range from some of the largest in the world in terms of market capitalization to companies that are known only in their local area and have such small capital bases that they're referred to as *micro-cap* stocks.

Since the liquidity of these securities also varies widely, the OTC equity market is really a collection of markets that are developed to suit the trading characteristics of the various issues being bought and sold there. Although any type of security can be traded over-the-counter, the focus of the Series 57 Exam is on equity trading. The following section will analyze who the players are in equity trading.

# Participants in Equity Markets

To clearly understand the workings of the equity markets, it's helpful to know something about the participants. The equity market participants can be divided into two main groups:

1. Investors who are the ultimate buyers and sellers in the secondary market
2. Broker-dealers that facilitate trading in the secondary market

## Investors

Investors can typically be categorized as either retail (individual) investors or institutional investors. This classification is generally based on who makes the investment decisions and the size of the portfolio. Retail investors can own and control their own stock portfolios. Although many individuals own stock indirectly through mutual funds and pension funds, the investment decisions for these portfolios are often made by a professional manager that controls one or more large portfolios, making these trades institutional. Hedge funds and high frequency traders are considered institutional investors.

## Broker-Dealers

As described earlier, the term *broker-dealer* actually refers to the two capacities in which a firm may operate. Since a firm will continually execute trades as either a broker or as a dealer throughout the day, it's easier to simply refer to it as a broker-dealer. However, a firm cannot act as both a broker and a dealer on the same transaction.

**Broker (Agent)** In the broker (agent) capacity, a firm attempts to locate another investor (the counterparty) to take the other side of the trade. The firm then attempts to arrange the best price for its customer. Once the trade is completed (settled), the brokerage firm receives a commission as the fee for its services. When acting in this manner, the firm is considered to be a *broker* or *agent*.

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**Dealer (Principal)** In other cases, the brokerage firm might execute a transaction for a customer by taking the role of the counterparty. For example, if a customer wants to buy a security, the firm might sell it to the customer from its own inventory and include a markup.

On the other hand, it may buy stock for inventory from a customer who wants to sell and include a markdown. Since the firm is one of the parties to the transaction, it's acting as a *dealer* or *principal* by trading for or from its own proprietary account.

There are several factors that determine the mode in which a firm will operate, including the type of business in which the brokerage firm chooses to engage and the nature of the market in which the transaction occurs.

Some firms only conduct broker transactions in the equity market and will depend on the commissions that they collect as their income. These firms typically don't act as a principal in any transaction, since it involves more risk and more capital than the firm can or wants to commit.

*Riskless Principal Transactions* Some firms execute transactions on a *riskless principal* basis; however, this is a principal transaction in name only. For example, Broker-Dealer X accepts an order from a customer who wants to buy 100 shares of ABCD (an OTC stock). Broker-Dealer X buys the 100 shares of ABCD for its own account from another broker-dealer and then immediately fills its customer's order. Although, technically, Broker-Dealer X may have sold the stock to the customer from its proprietary account, the stock only passed through its inventory briefly and was never exposed to market risk. For regulatory purposes, industry rules generally treat riskless principal trades as broker transactions.

Although some OTC trades are executed on a broker basis, dealers are at the core of the over-the-counter market. A dealer holds an inventory of securities and is therefore subject to market risk on the value of those securities. Dealers also provide a reservoir of supply and demand that increases market liquidity. In the OTC market for equities, the most important type of dealer is the market maker.

## Market Makers

A market maker is a dealer that continuously stands ready to buy or sell a specific security. While a dealer may occasionally buy or sell one or more securities for its proprietary account, a market maker is always prepared to do so. *Making a market* refers to a dealer's willingness to take the other side of the transaction when an investor or another dealer wants to trade a stock.

**Market-Maker Quotes** Since market makers are willing to either buy or sell, they give two-sided quotes when they're asked for prices. Remember, the bid is the price at which they're willing to buy the security and the ask or offer is the price at which they're willing to sell the security. And again, the difference between the bid and ask prices is the *spread*.

For example, a market maker in WXYZ might quote the stock at 43.35 bid, 43.40 offer. This can also be stated as 43.35 to 43.40, or 43.35 – .40. In this case, the spread is .05 or $0.05 (43.40 minus 43.35).


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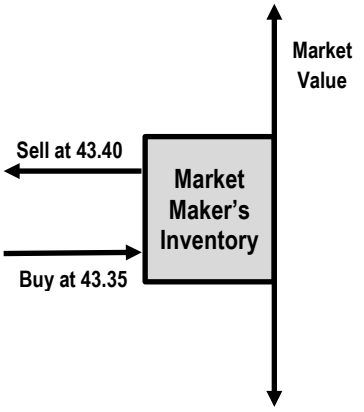
Another important part of the market maker's quote is its size—the number of shares it's willing to buy or sell at the quoted price. When size is not indicated, quotes are assumed to be good for one normal unit of trading, which is 100 shares (one round lot). Larger sizes are stated specifically.

For example, if the market maker in WXYZ shown above is willing to buy 2,000 shares and sell 3,000 shares, the quote would be 43.35 to 43.40, 20 by 30. (Size is typically quoted based on the number of round lots.)

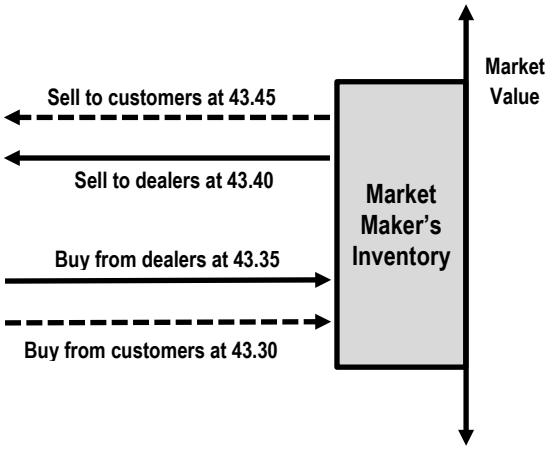
Market makers must honor their quoted prices in *interdealer* transactions (trades with other broker-dealers); however, many institutional investors are able to trade at these prices as well. The final pricing for retail customers will differ since the trade prices to these clients are generally adjusted due to markups or markdowns or additional charges (e.g., commissions).

The following diagram shows another way of looking at market-maker quotes:




This diagram shows the interdealer transactions that theoretically occur at the market maker's quote. (Even in a stable market, not all trades will occur at the bid or offer.) Each time the market maker buys at 43.35 and sells at 43.40, it will earn $0.05 per share. The more transactions a market maker executes, the more income it earns.

**Markups/Markdowns** When a market maker buys from or sells to retail customers, it typically pays less than the bid for purchases from customers and charges more than the offer for sales to customers.




In this example, a customer who buys stock from a market maker will pay 43.45 ($0.05 more than the price at which another dealer could purchase the stock). This difference is referred to as a *markup*. A customer who sells stock to the market maker will receive 43.30 ($0.05 less than another dealer would receive in the same transaction). This difference is referred to as a *markdown*. (The term markup is often used generically to refer to both markups and markdowns.)

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A later chapter will describe some of the industry rules that limit the size of the markups and markdowns that dealers can charge. Determining exactly what markup is being charged is often more complicated than the picture presented so far.

## The Inside Market

Many securities have numerous market makers that are providing quotes. When buying stock, the lowest offer is the most desirable; however, when selling stock, the highest bid is the best. Together these two prices are referred to as the *inside market*. (Regulations may also refer to the inside market as the *National Best Bid or Offer, or* NBBO). To illustrate, let's assume that MNOP stock has three market makers with the following current quotes:

| | |
|---|---|
| **Market Maker 1** | 20.25 – 20.60 |
| **Market Maker 2** | 20.20 – 20.50 |
| **Market Maker 3** | 20.35 – 20.75 |

*Since there are no sizes indicated in the preceding example, the quotes are assumed to be for 100 shares on each side.*

Of the three market makers, the best (highest) bid is 20.35 from Market Maker 3, while the best (lowest) offer is 20.50 from Market Maker 2. Therefore the inside market is 20.35 – 20.50. Notice that the inside market is not necessarily the actual quote of any single dealer; instead, it's a composite quote of the best prices currently available. A dealer that wants to sell MNOP stock would contact Market Maker 3, since Market Maker 3 indicates that it's willing to buy at the highest price of 20.35.

If a dealer contacts Market Maker 2 with the goal of buying more shares than the size quoted, the potential buyer would need to indicate this to the market maker. The market maker would then decide whether to provide a quote for the size that the dealer wants. The new quote is unlikely to be at the same price as the one for the smaller size.

Market makers have an obligation to stand behind their quotes for the size and price displayed. If the market maker is contacted by another dealer and fails to honor its quote, it's a prohibited practices that's referred to as backing away. By backing away, the market maker has violated FINRA and SEC rules because it failed to honor its displayed market and is subject to disciplinary action. Failure to honor a quote can result in a monetary fine or suspension of the firm's market making activities. This is an unacceptable practice, not only because it violates FINRA and SEC rules, but also because it damages one of the most valuable assets of the market maker—its reputation.

## Controlling Inventory

Since dealers at the inside market tend to attract the most business, a market maker will adjust its quote when it wants to increase or decrease its position in a stock.


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For example, let's assume that Market Maker 3 is the inside bid on MNOP at 20.35. Other dealers that want to sell stock will normally hit MM 3's bid, which will tend to increase MM 3's inventory of MNOP stock. When its inventory reaches the point at which it no longer wants to own additional stock, MM 3 can lower its bid to the point at which it's no longer at the inside.

Thereafter, sellers will contact another market maker that has a higher bid. Excess supply being sold at the market makers' bids will tend to depress these prices as the market absorbs more stock.

If Market Maker 3 wants to lower its inventory, it can lower its ask price to become the inside ask or offer. From the earlier example, Market Maker 2 has the lowest offer at 20.50 and will be selling stock at this time. If MM 3 lowered its offer to 20.45, it would become the inside offer and therefore be the seller of choice.

If the market maker at the inside offer notices that it's selling a large amount of stock, it will tend to raise its offer. The thinking is, if demand is high, why not sell the stock for more? Therefore, excess demand will raise market prices.

In order to know whether its bid or offer is at the inside, a market maker will need to know what the quotes are of the other market makers in that stock. For some OTC stocks this is relatively easy, since all market-maker quotes are available electronically. But for other stocks, this information can be more difficult to collect.

## Market Risk

As indicated earlier, one source of profit for market makers is the spread (i.e., buying at the bid and selling at the offer). However, markups on transactions with customers can provide income as well. And yet another source of profit (and possibly loss) is the appreciation (or depreciation) in the value of dealer's inventory as supply and demand changes the general level of prices in the market.

> *For example, let's assume that Market Maker 1's quote for WXYZ is the inside market at 43.35 – 43.40. If MM 1 is taking in inventory at its quote, it's at a cost of 43.35. Then, if it's selling from inventory at its offer of 43.40, it's earning a spread of $0.05.*
>
> *Now, let's assume that demand for WXYZ increases, which raises market maker quotes to the point at which the inside market is 44.20 – 44.25. If Market Maker 1 is still at the inside quote, it will now be selling stock at 44.25. On stock that it just recently bought at 44.20, it would earn a spread of $0.05; however, on stock that it previously accumulated at 43.35, it would earn a profit of $.90 per share (44.25 minus 43.35). In this case, only $0.05 of this gain is attributable to the current spread, since most of the gain is based on appreciation in the value of its inventory.*

This situation is illustrated in the following diagram.

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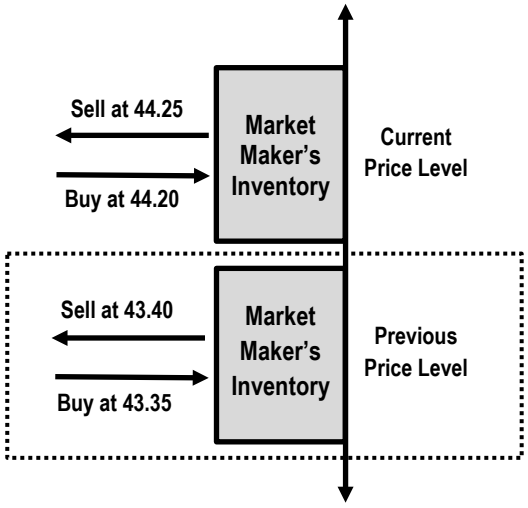
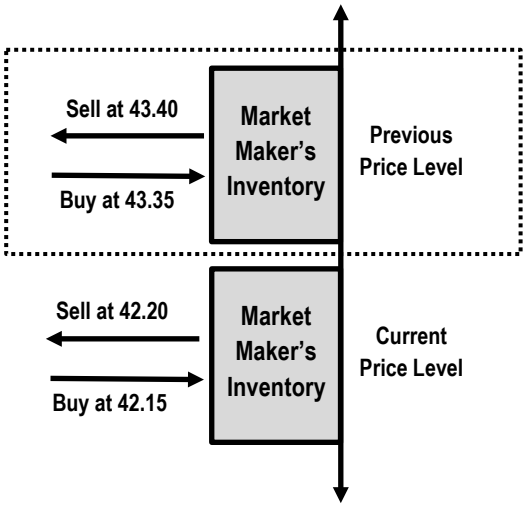



Although a market maker's inventory could show a profit, it could also show significant losses. For example, what if WXYZ stock suddenly falls in value and is quoted at 42.15 – 42.20, as in the following illustration?




While the current spread would still allow X to buy and sell at a profit of $0.05 per share, any accumulated inventory would be sold at a loss of $1.15 per share (43.35 minus 42.20). The possibility that inventory could be sold at a loss is market risk.

## Approaches to Market Making

As with most types of risk, market risk presents a double-edged sword to the dealer. The risk can cause significant losses; however, in a favorable market, inventory gains can produce attractive profits. When a dealer accumulates inventory with the belief that the stock will appreciate, this is referred to as *taking a position*.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It's not necessary for a market maker to take a position in order to perform its function. A market maker might attempt to continuously buy and sell a particular stock in a way that maintains a balance between stock coming in and stock going out. The market maker might have a goal of maintaining a *flat* position—that is, an inventory as close to zero as possible. This requires concentration, since purchases and sales may occur in spurts rather than in a smooth, continuous flow. The market maker's quote may need to be adjusted in order to maintain inventory at the desired level.

A dealer also can take a position without being a market maker. For example, let's assume that Market Maker 1 is a market maker in WXYZ stock, but not in AABC stock. However, it believes that AABC is about to appreciate quickly. In this case, it may take a long position in AABC in order to profit from any increase in its price. Of course MM 1 also recognizes that if it's wrong, it will take a loss.

## Selling Short

Although a market maker presents itself as always prepared to buy or sell a specific security, there are times when demand for the security may be so heavy that the market maker runs out of inventory. In that case, the market maker might sell the stock short and be obligated to cover the position at some later time by buying stock from customers or other market makers. The action of selling stock short (i.e., short selling) is defined as any sale of a security that the seller doesn't own, or any sale that's consummated by the delivery of a security that's borrowed by, or for the account of, the seller.

Selling short can cause substantial losses if the stock rises sharply. Therefore, a market maker will attempt to anticipate market demand and adjust its inventory accordingly by selling short only if necessary to maintain its commitment to the market. Some regulations distinguish between selling short as part of a firm's bona fide market-making activity (i.e., selling to meet customer demand) and taking a purely speculative short position.

## Where is the Market?

In the examples that have been examined so far, it's been assumed that transactions would be executed at the inside market (i.e., the best prices at which market makers have indicated a willingness to buy and sell a security). However, trades are often executed at prices that are different from the inside market. For example, let's assume that Market Maker 1 is at the inside on WXYZ stock with a quote of 43.35 – 43.40, 5 x 5 and Broker-Dealer Q is interested in purchasing 2,000 shares. B/D Q knows that it could buy 500 of those shares at 43.40 by simply taking the shares that are offered. However, since the equity market is a negotiated market, B/D Q could make a counterproposal to MM 1 and indicate that it's willing to buy 2,000 shares at 43.38. If MM 1 accepts (which is possible), the trade would be done between the best bid and offer. If B/D Q wants to sell a large block to MM 1, MM 1 will probably not pay the published bid price since the block exceeds its quoted size.

Notice that in both of these examples MM 1 didn't change its quote. As far as the other dealers are concerned, they still see a bid of 43.35 and an offer of 43.40. In other words, quotes don't necessarily indicate the prices at which trades are actually occurring. Separate trade information is needed which shows the prices at which transactions are occurring.

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## Role of the Market Maker

The market maker plays a central role in the equity market, especially when compared to exchange markets. In an exchange market, only certain stocks are allowed to trade (i.e., those that are listed or have been granted unlisted trading privileges). Typically, there's substantial trading volume in these unlisted stocks, which means that they're quite liquid. This makes trading them on an exchange feasible. When a floor broker takes a customer's buy or sell order to the post, there's a good chance that there will be some interest on the other side of the market. When there's a temporary imbalance, the actions of the single market maker on the floor—the designated market maker (DMM)—can usually keep the market orderly until additional public orders are entered.

In reality, many stocks cannot trade in this manner, due to lack of activity. If thinly traded stock was offered on an exchange floor, there might be large gaps or imbalances between buy and sell interest. In an electronic market, market makers act as reservoirs of interest, absorbing stock when there's an excess supply and providing stock when demand is high. The market makers take inventory risk and earn the spread as their compensation. The risk they take can be considerable for smaller, more illiquid stocks.


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# Chapter 2

# *The Exchanges*

# Introduction

The exchanges, including the Nasdaq Stock Market, have many rules in place to ensure that issuers and their stocks meet preset standards. All Nasdaq issuers must meet qualitative criteria that are designed to protect the interests of shareholders. These requirements, also referred to as *corporate governance standards*, include the following:

- Ensuring that a majority of its board of directors are independent
- Maintaining an audit committee with a majority of independent directors
- Providing shareholders with annual reports and making quarterly and other reports available
- Soliciting proxies and providing statements for all meetings to shareholders
- Refraining from taking certain actions or issuing securities that would disparately reduce or restrict the voting rights of existing shareholders

The Nasdaq Stock Market is registered with the SEC as a stock exchange. In order for a security to trade on Nasdaq, the issuer must meet listing standards, apply for listing, and then be accepted by Nasdaq. The specific listing standards that must be met will depend on which of the following three market tiers on which it's listed—*Nasdaq Capital Market (NCM)*, *Nasdaq Global Market (NGM)*, or *Nasdaq Global Select Market (NGSM)*.

## Nasdaq Capital Market Standards

Nasdaq Capital Market stocks must meet minimum requirements for financial strength, public float, market value, and number of shareholders. In addition, the stock must have a bid price of at least $4 per share to qualify for listing and must have at least three market makers. After listing, the issue must continue to meet standards that are slightly lower than the initial requirements, such as a continuing bid test requirement of at least $1 per share. An issue that fails to meet maintenance standards is subject to delisting. However, if the issuer choses to delist, it can do so at any time.

## Nasdaq Global Market Standards

Global Market issuers may qualify for initial listing on Nasdaq by meeting one of three alternative sets of standards. However, these standards have more stringent quantitative criteria than those that apply to Capital Market securities. The NGM continuing listing standards are also more stringent than those for Capital Market issues. On balance, NGM issues are more widely known, have more volume, and have more market makers.

## Nasdaq Global Select Standards

Nasdaq Global Select Market securities represent the top tier in the ranking of Nasdaq securities and therefore have the most stringent listing and maintenance requirements. In fact, according to Nasdaq's introductory press release on February 15, 2006, the Nasdaq Global Select Market securities have the most stringent listing specifications in the world.

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In order to be classified as a Nasdaq Global Select Market security, the issuer must meet specific listing requirements that are found in Nasdaq Rules. The rule includes issuer income requirements, minimum market capitalization, and thresholds for the number of outstanding shares.

# Nasdaq Services and Systems

Nasdaq offers several services and systems to member firms. Some of these services are also available to investors.

## Information About Nasdaq Securities

The most important function of Nasdaq is the collection and dissemination of real-time, firm quotes for selected equities. By displaying this information on a computer screen, much of the uncertainty regarding prices in the market is removed. However, the exact information on the screen depends on the level of service chosen by the subscriber. Subscribers can choose from three different levels, as described below.

**Level 1 Service** Level 1 service provides subscribers with the inside market for each Nasdaq security, as well as last sale and running volume information, but doesn't list the specific quote of each market maker. Level 1 service is used mainly by individual investors and their registered representatives. The service is usually provided to subscribers by market data vendors such as Bloomberg, Reuters, and ADP. Wire services also use this information to create the Nasdaq stock tables that are published in newspapers. Level 1 also provides comparable information about OTC Bulletin Board (OTCBB) securities.

**Level 2 Service** Level 2 Nasdaq service is considered the heart of the system and provides subscribers with the names and quotes of all registered market makers in each Nasdaq security. This service also displays the inside market for that security, which is especially useful since some Nasdaq stocks have more than 40 market makers. Level 2 also displays other market data for each security, including the current total volume for the day, the last sale, the high and low price for the day, and the net change (the difference between the last transaction price and the previous day's closing price).

Many financial institutions use Level 2 to monitor the value of their Nasdaq holdings and to make trading decisions. However, this Level is especially important to traders at Nasdaq firms. From the screen, a trader can easily determine which market maker has the best price for a particular security. Since all Nasdaq quotes are firm, the trader simply needs to call the market maker and indicate the intent to execute the trade at the price and size shown. Traders can also contact market makers electronically using the Nasdaq Market Center Execution System (described later). If the trader's order is larger than the size indicated on the screen, the trader needs to request a quote from the market maker for that size. In addition, the trader can try to negotiate a better price than the quote that's listed on the screen. Level 2 also provides market-maker quotations for OTC Bulletin Board (OTCBB) securities.


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**Level 3 Service** Level 3 service is available only to the market makers that are registered in a particular security. Although it displays the same information as Level 2, it's also interactive. Market makers can update their quotations through the Level 3 screen for their stocks, as well as make trade and volume reports to Nasdaq.

**TotalView** Nasdaq TotalView is a quotation display service that's available to professional and non-professional traders and shows the entire Nasdaq book for a particular security. TotalView displays the quote size and price of a specific stock that's available from every market participant including Nasdaq market makers, the NYSE, NYSE American, and the regional exchanges. In addition to price and size, TotalView displays the depth (aggregate number of shares) of the market at each of the best five price levels, giving traders a greater perception of market liquidity.

TotalView also displays order imbalance information for the opening cross, closing cross, halt cross, and IPO cross. Imbalance information displayed includes the number of shares and the side of the imbalance, the current reference price, the near indicative clearing price, and the far indicative clearing price. To receive all of this information, subscribers pay a monthly access fee.

## Registration as a Nasdaq Market Maker

A broker-dealer can only enter quotes into Nasdaq if it's registered as a Nasdaq market maker. A prospective market maker must file an application with Nasdaq that certifies its good standing with the SRO and demonstrates its compliance with financial responsibility rules, including net capital requirements. A market maker's registration effective only when it's notified by Nasdaq.

To make markets, market makers are required to have a minimum net capital of $100,000. There's an additional requirement to maintain a minimum dollar amount of net capital for each stock in which it makes a market based on the price of the underlying security. The per stock net capital requirement is:

- $2,500 for each stock that's selling above $5 a share, and
- $1,000 for each stock that's selling for $5 a share or less

Ultimately, the maximum net capital requirement for market making cannot exceed $1 million.

In addition to the preceding general requirements, a dealer is also required to register for the specific issues in which it intends to make a market. This is done by entering a registration request through a Nasdaq terminal. Registration becomes effective on the day registration is requested. Once a market maker's registration in a particular issue is effective, it's required to enter quotes within five business days. If it fails to begin quoting the stock, the market maker's registration for that security is terminated.

**Normal Business Hours** A Nasdaq market maker must be open for business as of 9:30 a.m. ET and may close its market by no earlier than 4:00 p.m. ET. (All times used in this Study Manual are Eastern Time [ET] unless otherwise indicated.)

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A market maker may voluntarily open its quotes to participate in the pre-market trading session, which takes place from 4:00 a.m. to 9:30 a.m. and/or reopen its quotes after the close at 4:00 p.m. to participate in the after-market trading session, which takes place from 4:00 p.m. to 8:00 p.m.

## Market Participant Identifier (MPID)

A member firm that's registered as a market maker in a specific security is assigned a four-character alpha code, which is its MPID. The first MPID that's assigned is referred to as its Primary MPID and represents the symbol by which its bids and offers are identified in the Nasdaq Market Center. If a market maker has the letter C in the quote montage next to its MPID on a security, it indicates that its quote is closed for the day.

**Supplemental MPID** A FINRA member firm may have additional displayable or non-displayable supplemental MPIDs. Some of the reasons these multiple MPIDs are used by broker-dealers include Sponsored Access Programs, prime brokerage relationships, the firm's proprietary business, and statistical or index arbitrage business. The non-displayable (non-attributable) quotes or orders are posted anonymously through Nasdaq using NSDQ as the MPID.

Firms must receive FINRA approval to use other identifications in addition to their primary MPID symbol. A trade resulting from a posted quote should be reported using the same MPID that was used for displaying the quote. Nasdaq rules prohibit using supplemental MPIDs by an equity market maker to engage in passive market making or entering stabilizing bids (these topics are described later in this manual). Two rules that don't apply to the supplemental MPIDs are the continuous two-sided quote requirement and the excused withdrawal procedures. Quotes using supplemental MPIDs can be one-sided and there's no unexcused withdrawal penalty.

## Primary Market Makers

For purposes of certain regulations, some market makers are considered *Primary Market Makers*. Primary Market Makers are firms that provide liquidity to the market, as measured by specific performance standards. However, due to the changes in the nature of the Nasdaq market following the introduction of the SEC Order Handling Rules, the previous Primary Market Maker standards have been suspended pending the creation of more relevant criteria. Until further notice, all registered Nasdaq market makers are considered Primary Market Makers.

## Market Access (SEC Rule 15c3-5)

Broker-dealers are permitted to provide both direct and sponsored access to customers. This allows customers and the firm's proprietary trading units to send orders directly to exchanges and alternative trading systems. Many of these customers are high-frequency traders (HFTs) and are not subject to the rules of the exchanges since they are not members. The broker-dealer provides these customers with its Market Participant Identifier (MPID) which allows them to trade directly with the markets. With *direct access,* the customer uses the infrastructure of the broker-dealer and orders pass through the broker-dealer's system. However, with *sponsored access,* the customer uses its own system and orders don't pass through the broker-dealer's system. The rule applies to both proprietary trading and customer accounts.


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Since broker-dealers are responsible for both direct and sponsored access, the SEC requires firms to establish and enforce risk-management controls and supervisory procedures to ensure that:

- Customer orders are not erroneous and don't violate applicable regulatory requirements
- Customer transactions are within the credit and capital thresholds
- The firm has risk-management controls that are under the direct and exclusive control of the broker-dealer

The rule applies to equities, equity options, exchange-traded funds (ETFs), debt securities, and security-based swaps. The broker-dealer is required to retain a copy of its supervisory procedures and a written description of its risk-management controls as part of its books and records. In addition, on an annual basis:

- The broker-dealer must review these policies and procedures, and
- The chief executive officer (or equivalent officer) must certify that the firm has effective procedures and risk-management controls in place.

### SEC Rule 13h-1 — Large Trader Reporting

The SEC requires the registration of large traders. Large traders are defined as persons who exercise investment discretion in exchange-listed equities or options and whose trading activity is:

- During the day, either two million shares or shares with a market value of $20 million or
- During the month, either 20 million shares or shares with a market value of $200 million

These large traders must file Form 13H, obtain a unique identification number (referred to as an LTID), and provide this number to the broker-dealers through which they trade. After the initial form has been filed with the SEC, large traders must file an annual report. This allows the SEC to identify and obtain information about large traders. Some of the information on Form 13H includes:

- The name and the officers of the business organization
- Tax identification number
- The business address of the large trader
- The businesses in which it's engages
- Other SEC or CFTC filings of the large trader
- A list of the broker-dealers at which the large trader or its affiliates has an account

## Regulation NMS

Regulation NMS mandated that changes be made in the National Market System (NMS) by requiring non-discriminatory access to quotations, automated execution of orders, and limit order protection on an interexchange basis. As a result of rules imposed by Regulation NMS, market centers that participate in the National Market System must provide automated trading systems and implement procedures that are designed to prevent trade-throughs at inferior prices of protected quotations.

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For a quotation to be protected, it must be the best price on its respective market center and it must be immediately and automatically accessible.

> *A trade-through occurs when a market center accepts and executes an order at a price that's inferior to the contemporaneous inside market. For example, a trade-through has occurred if an order to buy is executed at a price that's higher than the lowest offer, or if an order to sell is executed at a price that's lower than the highest bid.*

As an example of a trade-through, let's assume that Market Center A has an inside offer of 23.60 and Market Center B has an inside offer of 23.50. If an order to buy is sent to Market Center A, a trade-through has occurred since there was a better (lower) price available on Market Center B. Market Center A is prohibited from executing the buy order at 23.60 since the client should receive the better price of 23.50. This also benefits the market participant that was responsible for displaying the offer quote of 23.50 in Market Center B.

NMS securities include stocks that are traded on Nasdaq, the NYSE, NYSE American, and the regional stock exchanges. SEC Rules 610 and 611 are the two primary rules that address these issues and required Nasdaq to make structural and regulatory changes in order to be eligible for exchange status.

## The Order Access Rule

*SEC Rule 610*, the Access Rule, was established to promote fair and equal access to quotations. The rule promotes access to protected quotations in the following three ways:

1. It requires that market participants have access to quotations that are available on Nasdaq, the NYSE, NYSE American, and the regional exchanges through a variety of approved, private connectivity providers.
2. It places a limit on access fees of $0.003 per share in order to promote fairness and efficiency within the National Market System.
3. Trading centers are required to establish written rules that are designed to prevent market participants from displaying quotations that lock or cross the market. A *locked market* occurs when a market center displays a bid at the same price as the current lowest offer made by another market center, or when a market center displays an offer that's equal to the current highest bid of another market center. A *crossed market* occurs when a market center displays a bid that's higher than the current lowest offer made by another market center, or when a market center displays an offer that's lower than the current highest bid of another market center.

## The Order Protection Rule

*SEC Rule 611,* which is referred to as the Order Protection Rule or the Trade-Through Rule, was established under Regulation NMS to prevent trade-throughs of protected quotations. A protected quotation is one that's immediately accessible through automatic execution. Manual quotes are not protected quotations and are not subject to the Order Protection Rule. A trade-through occurs when an order that crosses the market is executed at an inferior price regardless of better-priced quotations that may be available at other market centers.


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Rule 611 requires market centers to establish written policies and procedures that are designed to reasonably prevent trade throughs within the National Market System by routing orders to the market center that's displaying the best price. However, there are exceptions to the Order Protection Rule and one of the exceptions is for intermarket sweep orders (ISOs).

**Intermarket Sweep Orders** Rule 611 creates an exception to the trade-through rule for limit orders that are designated as intermarket sweep orders. ISOs allow broker-dealers to execute trades at inferior prices in one market, while simultaneously directing orders for execution to away markets that are displaying protected quotations.

ISOs allow market participants to capture the size available at inferior prices (before the opportunity to get filled is missed and subsequent prices become even less favorable). Participants can do so by sending multiple ISOs simultaneously to both the market center that's displaying inferior prices and the market center that's displaying protected quotations.

When using ISOs, although executions of multiple limit orders occur at inferior prices, they do so simultaneously with the executions of protected quotations, thereby averting a violation of the Order Protection Rule. However, the limit orders must be designated as ISOs for the exception to Rule 611 to be recognized.

Since protected quotations are executed simultaneously with the orders at inferior prices, the executing broker-dealer's best execution obligation is met in accordance with Regulation NMS. Therefore, ISOs create a solution to the dilemma that's encountered by broker-dealers that are faced with the problem of avoiding trade-throughs and also filling orders in the most expedient manner.

**Stopped Orders** Traders will occasionally use stopped orders to guarantee a maximum or minimum price on a large trade for an institutional client. Stopped orders will give the client the comfort of knowing that it will not pay more than a specified amount when buying stock or receive less when selling stock. When executed, it may be outside the current inside market, which will normally be a trade-through violation. However, stopped orders are exempt from the Order Protection Rule and will avoid a trade-through violation if they meet the following conditions:

- The transaction that constituted the trade-through was the execution by a trading center of an order for which, at the time of receipt of the order, the trading center had guaranteed an execution at no worse than a specified price (a stopped order) where:
  - The stopped order was for the account of a customer (A customer is defined as any person that's not a broker-dealer.)
  - The customer agreed to the specified price on an order-by-order basis
  - The price of the trade-through transaction was, for a stopped buy order, lower than the national best bid in the NMS stock at the time of execution or, for a stopped sell order, higher than the national best offer in the NMS stock at the time of execution

This exception was created primarily for institutional customers (e.g., money managers) and will allow a trading center to execute an order to complete a stopped buy order lower than the changed inside bid or a stopped sell order higher than the changed inside offer.

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There are several other exceptions to the Order Protection Rule, including flickering quotes and quotations when there's a material delay in providing a response to incoming orders. Flickering quotations occur when there are multiple prices displayed within a one-second period. A material delay occurs when a trading center repeatedly fails to respond to an order within one second. Also included are exceptions for benchmarked orders, such as Volume Weighted Average Price (VWAP) and a single-priced opening or closing transaction by a market center.

# The Nasdaq Market Center Execution System

As trading in Nasdaq securities has increased in volume and speed, electronic systems have been updated. As a result, the current system provides non-discriminatory access to quotations as well as immediate and automatic order execution. The system's maximum quotation and order execution size is 999,999 shares.

The Nasdaq Market Center Execution System is an electronic, automated order quotation and execution system that allows for trading in all Nasdaq and other selected exchange-listed securities. In addition to providing automatic execution at firm quotes, the system also reports trades automatically. Trades that are automatically reported are referred to as *locked-in*.

The Nasdaq Market Center Execution System is available for trading from 4:00 a.m. to 9:30 a.m. in the premarket session, and from 4:00 p.m. to 8:00 p.m. in the aftermarket session. Ultimately, quotes are open and firm from 4:00 a.m. to 8:00 p.m. Since Over-the-Counter Bulletin Board (OTCBB) securities are not part of the Nasdaq market, they are not eligible for trading in the Nasdaq Market Center Execution System.

## Quote Types

Within the Nasdaq Market Center Execution System there are different methods of quoting that have different originating points and/or conditions:

1. Market Participant Entered (See Reserve described below) – The market participant maintains its quote.
2. System Generated – When the market participant quote that's entered is exhausted, the Nasdaq Market Center Execution System will generate a quote based on the market price of the stock. (See the following paragraphs for System Generated quotes.)

A market maker must use its market participant identification (MPID) and maintain a two-sided quote for at least one round lot (100 shares). When entering a bid or offer, a market maker must also enter a price that doesn't exceed a *designated percentage* away from the National Best Bid or Offer (NBBO). The designated percentages are:

- 8% if the security is included in the S&P 500 Index or the Russell 1000 Index
- 28% if the security is an NMS stock, but not included in the above indices and has a price that's equal to or greater than $1.00
- 30% if the security is an NMS stock, but not included in the above indices and has a price that's less than $1.00


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*For example, if the National Best Bid for a stock is $20.00, a market maker may not enter a quote below $18.40 (8% below $20.00).*

However, if the National Best Bid (NBB) increases or the National Best Offer (NBO) decreases to a level that causes the market maker's quote to be more than the d*efined limit* away from the NBB or NBO, the market maker must enter a new quote at a price that's not more than the designated percentage away from the current NBB or NBO.

The designated limits are:

- 9.5% if the security is included in the S&P 500 Index or the Russell 1000 Index
- 29.5% if the security is an NMS stock, but not included the above indices and has a price that's equal to or greater than $1.00
- 31.5% if the security is an NMS stock, but not included the above indices and has a price that's less than $1.00

**Reserve** Firms have the option of using reserve quotes. This feature allows a market participant to display a portion of its quote and hold the remainder in reserve which is unseen by other market participants. Both the displayed and the non-displayed size are available for execution.

*For example, suppose Market Makers X, Y, and Z, in time priority, are all at the inside offer for 1,000 shares, with each having 4,000 shares in reserve.*

| Market Maker | Offer Price | Displayed Size | Reserve Size | Refresh from Reserve |
|---|---|---|---|---|
| MMX | 31 | 1,000 | 4,000 | 1,000 |
| MMY | 31 | 1,000 | 4,000 | 1,000 |
| MMZ | 31 | 1,000 | 4,000 | 1,000 |

A market order to buy 8,000 shares is entered into the Nasdaq Market Center Execution System. The system will first execute against each market maker's displayed size of 1,000 shares for a total of 3,000 shares. The Nasdaq Market Center Execution System will then execute 4,000 shares against the reserve of MMX, which has time priority, decrementing it to zero. (To minimize transaction costs, only one transaction for 5,000 shares will be reported against Market Maker X's position.) The Nasdaq Market Center Execution System will execute the remaining 1,000 shares of the market order in time priority against Market Maker Y's reserve size, reducing it to 2,000 shares. (It had already been reduced from 4,000 shares to 3,000 shares when the quote was reduced from reserve after the execution of 1,000 shares at 31.) The 1,000 shares from Market Maker Y's reserve would have replenished its quote, and 1,000 shares from Y's reserve would have been used to fill the remainder of the incoming order, leaving Market Maker Y with a reserve of 2,000 shares. Market Maker Y can retain its time priority by remaining at the best offer.

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Market Maker Z would also have refreshed its displayed quote from its reserve to its previously displayed size of 1,000 shares, leaving Z with 3,000 shares in reserve.

The order would have exhausted both the displayed and reserve sizes of Market Marker X, leaving it with no remaining shares.

Following the executions and the refresh of quotes from reserve size, the display will appear as follows:

| Market Maker | Offer Price | Displayed Size | Reserve Size | Refresh from Reserve |
|---|---|---|---|---|
| MMY | 31 | 1,000 | 2,000 | 1,000 |
| MMZ | 31 | 1,000 | 3,000 | 1,000 |
| MMX | Displayed and reserve sizes exhausted. | | | |

In order to maintain a two-sided firm quote, the market maker will use an automated method to update its quote. One option is a market maker peg order, which will be described soon.

A Nasdaq market maker must maintain a two-sided quote of at least one round lot in order to maintain registration as a market maker in that security. A failure to make a two-sided quote results in a withdrawal as a market maker. If a withdrawal is inadvertent or accidental, a broker-dealer can request reinstatement under the following circumstances:

- The firm notifies Nasdaq MarketWatch that the withdrawal was inadvertent or accidental within one hour of the occurrence
- After notifying MarketWatch, it immediately provides written notice of the withdrawal and reinstatement request
- It makes clear that the withdrawal was not an attempt to avoid market-making responsibilities

Reinstatement as a Nasdaq market maker is limited to no more than:

- Two reinstatements per year for firms that were market makers in fewer than 250 securities during the previous calendar year
- Three reinstatements per year for firms that were market makers in 250, but fewer than 500 securities during the previous calendar year
- Six reinstatements per year for firms that were market makers in 500 or more securities during the previous calendar year

If a broker-dealer is unable to receive a reinstatement, it must wait 20 business days to reregister as a market maker for a specific Nasdaq security, and wait one business day to reregister as a market maker for a specific Consolidated Quotation System (CQS) security.


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**Trading Lots** In the Nasdaq Market Center, market participants may enter odd-lot, mixed-lot, and round-lot orders; however, quotation and order sizes are displayed in round lots. Odd-lot and mixed-lot orders are rounded down to and displayed at the nearest round-lot amount at the specified price level. Although odd-lot orders are not displayed as such, they are maintained in the system in time priority and are available for execution. For situations in which round lots are partially executed and reduced to a mixed lot, the balance of shares from the order are also rounded down to the nearest round-lot amount at the same price level.

## Order Types

The Nasdaq Market Center Execution System has different order types that fulfill different methods of execution for the market participant. One element that these orders have in common is that they must be firm and automatically executable. Listed below is a review of market, limit, and stop orders.

**Market Orders** Market orders don't specify a price and are executed at the prevailing inside market. Orders to buy are executed at the prevailing offer, while orders to sell are executed at the prevailing bid. Market orders are guaranteed to receive execution, but their price is uncertain.

**Limit Orders** Limit orders specify the price at which the persons who enter the orders are willing to buy or sell securities. Limit orders guarantee that the execution price will be the specified or better; however, they don't guarantee that an execution will occur unless the limit order is marketable. Buy orders that are entered at or above the lowest offer are marketable and eligible for an execution. Sell orders that are entered at or below the highest bid are marketable and eligible for an execution. A limit order that's entered away from the best bid/offer must wait for the market to meet its price before it's eligible for an execution.

**Stop Orders (FINRA Rule 5350)** A stop order to buy becomes a market order if a transaction occurs at or above the stop price, and a stop order to sell becomes a market order if a transaction occurs at or below the stop price. On the other hand, stop-limit orders become limit orders when a transaction occurs at or above the stop price (in the case of buy order) or at or below the stop price (in the case of a sell order). A member firm is not required to accept stop orders or stop-limit orders. However, if a firm does accept these types of orders, it's not permitted to label other similar, but not identical, orders as stop orders. For example, if the firm accepts an order that becomes a market order when a quote (not a transaction) occurs, it cannot label it as a stop order. In addition, the firm is required to disclose to a customer (in paper or electronic form) a description of these order types prior to the order being placed. Online trading firms are required to post these disclosures on the firm's website.

**Directed Orders** Directed orders are immediate-or-cancel (IOC) orders that are routed to an exchange without first checking the Nasdaq book. Any unexecuted portion of the order will be returned to the sender. Directed orders may be designated as ISOs which will be executed against the fully displayed size of any protected bid or offer. This is in compliance with the rules regarding ISOs which are described next.

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**Intermarket Sweep Orders** Intermarket sweep orders are multiple limit orders that sweep the book of a specific market center without regard to better-priced quotations at other market centers. At the same time a market participant is sweeping the book of the stock's home market, the market participant is also executing directed ISOs against protected quotations at external markets, thereby fulfilling its best execution obligation under Regulation NMS.

ISOs accomplish two things:

1. They allow market participants to fill their orders expeditiously without the time delays that might be caused by routing orders to away markets for execution in price/time priority.
2. They allow market participants to meet their best execution obligations by directing ISOs to the market centers that display protected quotations and receive an execution simultaneously with ISOs being executed at inferior prices on the stock's home market.

For example, on behalf of a customer, a trader wants to buy 10,000 shares of PQR that's trading on Nasdaq at 40.38. The lowest offer on the Nasdaq book is 1,000 shares at 40.35. Additional size is available for sale on the book at the following prices: 2,000 shares at 40.36, 2,000 shares at 40.37, and 3,000 shares at 40.38. However, the lowest offer, and therefore the best price in the NMS, is an order to sell 2,000 shares of PQR on the NYSE at 40.34. According to the Order Protection Rule, the order to sell 2,000 shares at 40.34 on the NYSE is a protected quotation since it represents the best price on the NYSE and the best price in the NMS and therefore cannot be traded-through. A trade-through, and a violation of Rule 611, occurs if transactions take place on Nasdaq prior to clearing the superior-priced quote of 40.34 for 2,000 shares on the NYSE.

| Offers on the Nasdaq Book | |
|---|---|
| **Price** | **Size** |
| 40.35 | 1,000 |
| 40.36 | 2,000 |
| 40.37 | 2,000 |
| 40.38 | 3,000 |
| 40.39 | 1,500 |

| Offers on the NYSE Book | |
|---|---|
| **Price** | **Size** |
| 40.34 | 2,000 |
| 40.35 | 200 |
| 40.37 | 500 |
| 40.39 | 700 |
| 40.40 | 1,200 |

Let's assume that the trader needs to fill an order that's larger than the size available on the away market (NYSE) and time is of the essence. Rule 611 provides an exception to the trade-through rule when using intermarket sweep orders. By entering multiple limit orders that are designated as ISOs, the trader can sweep the Nasdaq book, executing transactions for 1,000 shares at 40.35, 2,000 shares at 40.36, 2,000 shares at 40.37, and 3,000 shares at 40.38, thereby acquiring a total of 8,000 shares. In order for the trader to meet her best execution obligations, she must also simultaneously direct an ISO to the NYSE and acquire the 2,000 shares offered at the best price of 40.34. Doing so fulfills her best execution obligation in accordance with Regulation NMS. This completes her entire order for 10,000 shares. Because the orders at inferior prices were filled simultaneously with the protected quotation at the away market, and because the orders were designated ISOs, a violation of Rule 611 is avoided.


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Note that the top of the book at the away market is protected, but not the depth of the book. In order for a quote to be protected, it must be immediately accessible to other market participants and they must have non-discriminatory access to quotations.

ISOs have become an important adaptation in the National Market System. They facilitate the trading of orders in an electronic trading environment, while continuing to protect investors by ensuring that market participants meet their best execution obligations.

**Market Maker Peg Orders** This is a type of order that assists a market maker in meeting its quoting obligations. Previously, a market maker used a functionality that's referred to as the Automated Quote Refresh (AQR) to help meet its quoting obligations. One of the quoting obligations is that a market maker's quote should not exceed a *designated percentage* away from the NBBO, which is 8% on most NMS securities. The AQR would automatically refresh a market maker's quote for both price and size after its current quote had been decremented down to zero. The market maker determined the amount of price movement away from its previous quote and the size of its quote refreshment.

Once the market maker's quote had been refreshed, it wouldn't be impacted by changes in the market until the market maker's new quote had been decremented to zero. At this point, the AQR would again refresh the market maker's quote to allow the market maker to maintain its two-sided quote in a fast-moving market. When using the AQR functionality, if the market participant didn't designate both a refresh size and price, the system's default was a size of 100 shares at a price increment of $0.25 away from the last price. The AQR functionality is a static system that only moves the market maker's quote when its current quote has been decremented to zero.

On the other hand, a Market Maker Peg order is not static, but is instead automatically repriced due to changes in the market price of the security. Its functionality is generally designed to work on either a tick-by-tick basis when the market maker designates an offset or it may be based on a percentage of the NBBO when no offset is chosen by the market maker. A new time stamp is created with each repricing. Some of the other key attributes of a market maker peg order are:

- It must always be displayed and attributable
- It must have a limit price
- It must be one-sided
- It cannot be routable
- After execution, a new Market Maker Peg order must be reentered for a MM to maintain its quote

If the market maker places the order with an offset, it will be repriced with every tick of the security. Offsets may be placed in increments of $0.01. As the stock ticks either closer to or further away from the Market Maker Peg order, the peg will automatically be adjusted to maintain the offset amount.

*Market Maker Peg Order with Offset* Let's assume that the NBB on an S&P 500 Index security is $20.00 and a market maker enters a Market Maker Peg order to buy with an offset of $0.20 and a limit price of $19.99. The MM Peg will be set at $19.80. If the NBB subsequently moves to $19.98, the MM Peg will be repriced at $19.78 ($0.20 away from the NBB).

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If the NBB then moves to $20.10, the peg order would be repriced to $19.90. The peg moves on a tick-by-tick basis with the NBB. It's important to remember that when the NBB moves to a point where the repriced peg would be above the limit set by the market maker, the order will be cancelled and must be reentered by the market maker. If the NBB rises to $20.20, the offset of $0.20 would reprice the order to $20.00, which is above the limit set by the market maker of $19.99. In this case, the order would be rejected by the system.

*Market Maker Peg Order with No Offset* If the market maker doesn't set an offset, the system will automatically set the Market Maker Peg order at the designated percentage away from the NBBO (8% for most stocks). For example, if the inside best bid is $20.00, a MM Peg order to buy with a limit price of $19.60 would be priced at $18.40 (8% away from $20.00). The market maker's bid would be priced at $18.40, with a limit price no higher than $19.60. This type of Market Maker Peg order will not be automatically repriced on a tick-by-tick basis. Instead, when the NBBO moves to within 4% of the peg order (an amount established by Nasdaq), or moves away from the peg order by more than 9.5%, the peg will be repriced to bring it back to 8% away from the NBB (the designated percentage). As with the offset, if the repricing brings the peg above the limit price, the order will be rejected and must be reentered by the market maker.

To comply with its quoting obligation, a market maker may use this functionality or implement its own system.

**Pegged Orders** The three types of pegged orders are:

1. Primary Peg orders are pegged to the same side of the NBBO.
2. Market Peg orders are pegged to the opposite side of the NBBO.
3. Mid-Point Peg orders are pegged to the mid-point of the NBBO.

When a Primary Peg is entered as an order to buy, it tracks the bid, but when a Primary Peg is entered as an order to sell, it tracks the offer. When a Market Peg is entered as an order to buy, it tracks the offer, but when a Market Peg is entered as an order to sell, it tracks the bid. For example, if the current NBBO is $23.50 – $23.60, a Primary Peg order to buy would be priced at $23.50, a Market Peg order to buy would be priced at $23.60, and a Mid-Point Peg order would be priced at $23.55. These orders must be day orders and are supported only between 9:30 a.m. and 4:00 p.m. These orders may contain a limit price or cap. The pegged price can be set at or a minimum increment away from the bid or offer of a quote. Pegged Orders are automatically adjusted by the Nasdaq Market Center Execution System in response to changes in the bid or offer as executions occur. Therefore, Pegged Orders follow the market.

For example, the market for INXS is as follows:

| MPID | Bid | Bid Size | MPID | Ask | Ask Size |
|---|---|---|---|---|---|
| MM A | 10.50 | 500 | MM Y | 11.00 | 500 |
| MM B | 10.45 | 500 | MM D | 11.05 | 500 |
| MM C | 10.30 | 500 | MM C | 11.20 | 500 |
| MM D | 10.25 | 500 | MM B | 11.25 | 500 |
| MM X | 10.00 | 500 | MM A | 11.40 | 500 |


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If a market participant that's identified as SLID enters a Pegged Order to buy 500 shares of INXS with a price cap of 10.50 and another market participant that's identified as BJCO enters a market order to sell 700 shares of INXS, respectively, BJCO's market order would execute against MM A's quote of 500 shares at 10.50 and partially fill SLID's Pegged Order for 200 shares. The balance of SLID's Pegged Order (300 shares) would be adjusted to the next price level of 10.45.

**Discretionary Orders** A discretionary order is one that has a displayed limit order price and a non-displayed limit order price at which the participant is also willing to buy or sell (a discretionary range from the displayed price). A discretionary order can execute up to the discretionary price (with a buy order) or down to the discretionary price (with a sell order). An incoming order that's not executable at the display price, but is in the discretionary range, executes at its display price against the discretionary order.

For example, the market for MPPT is as follows:

| MPID | Bid | Bid Size | MPID | Ask | Ask Size |
|---|---|---|---|---|---|
| MM A | 12.50 | 500 | MM Y | 13.00 | 500 |
| MM B | 12.45 | 500 | MM D | 13.05 | 500 |
| MM C | 12.30 | 500 | MM C | 13.20 | 500 |
| MM D | 12.25 | 500 | MM B | 13.25 | 500 |
| MM X | 12.00 | 500 | MM A | 13.40 | 500 |

If market participant that's identified as SHBG enters a discretionary order to sell 500 shares of MPPT at 13.00 with a discretionary range of -0.02 and, subsequently, another market participant that's identified as HSML enters a market order to buy 600 shares of MPPT, the market order would execute against MM Y's quote of 500 shares at 13.00 and partially fill 100 shares of market participant SHBG's discretionary order to sell 500 shares, leaving an offer to sell 400 at 13.00 down to 12.98. If another market participant enters a limit order to buy 400 shares at 12.98, the limit order would execute against SHBG's discretionary order based on its discretionary range of -0.02. This -0.02 point range indicates SHBG is willing to accept a sell execution at any price from 13.00 down to 12.98.

A discretionary order may also be entered as a pegged discretionary order.

**Reserve Orders** A reserve order gives a market participant the ability to display a portion of an order's size and keep the remainder in reserve where it's not displayed. When the displayed portion of the order is executed and decremented below one normal unit of trading, the order is replenished from reserve to a minimum size of one round lot. The replenished order is time-stamped at the time it's replenished, while the reserve portion of the order retains its original time stamp. (For greater detail, see *Reserve* under Quote Types which was covered earlier.)

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**Non-Displayed Orders** Non-displayed orders are limit orders that are entered, but not displayed, in the system. Although not visible to other market participants, a non-displayed order is available for execution until filled or cancelled.

**Minimum Quantity Orders** Orders that specify a minimum quantity to be executed or cancelled may be entered into the Nasdaq Market Center Execution System. The orders may only be entered with a time-in-force (TIF) designation of system hours immediate or cancel, or market hours immediate or cancel. Minimum quality orders with a market hours immediate-or-cancel order time in force received prior to the opening cross or after 4 p.m. will be rejected.

**Price to Comply Orders** When a price to comply order locks or crosses the quotation of an external market at the time of entry, the order will be adjusted by the Nasdaq Market Center Execution System and entered as a non-displayed limit order. Buy orders priced above the inside offer will be repriced to the lowest offer, while sell orders that are entered below the inside bid will be repriced to the highest bid. If the market moves through the price of the order after it's been accepted, the order will be cancelled. In this way, price to comply orders prevent violations of Regulation NMS.

**Price to Comply Post Orders** When a price to comply post order locks or crosses the quotation of an external market at time of entry, the order will be adjusted and posted to the Nasdaq Market Center Execution System as a non-displayed limit order. Buy orders entered above the inside offer will be repriced to the lowest offer, while sell orders entered below the inside bid will be repriced to the highest bid. Orders entered as price to comply post orders will not get routed outside of the Nasdaq Market Center Execution System. In this way, price to comply post orders prevent violations of Regulation NMS.

## Time-In-Force Designations

**System Hours Immediate or Cancel (SIOC)** SIOC orders are limit orders that, when entered into the system, receive an immediate execution on that portion of the order that's marketable and a cancellation of that portion of the order that's non-marketable. SIOC orders may be entered into the Nasdaq Market Center Execution System during system hours from 4:00 a.m. to 8:00 p.m. ET.

**System Hours Day (SDAY)** Orders designated as SDAY will remain displayed and open for potential execution during system hours from 4:00 a.m. to 8:00 p.m. ET. If a partial execution occurs, any remaining portion will remain open and available for an execution until it's executed, cancelled, or expires at 8:00 p.m. ET. All unexecuted SDAY orders will expire at 8:00 p.m. ET.

**System Hours Good-till-Cancelled (SGTC)** An order designated as SGTC or any portion of a partially executed order designated as SGTC will remain displayed and open for potential execution each trading day during system hours from 4:00 a.m. to 8:00 p.m. ET for a period of one year from entry or until executed or cancelled.


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**Market Hours Immediate or Cancel (MIOC)** MIOC orders are limit orders that, when entered into the system, receive an execution on that portion of the order that's immediately marketable. Any unfilled portion of the order will be immediately cancelled and returned to the entering market participant. MIOC orders may be entered into the Nasdaq Market Center Execution System from 4:00 a.m. to 4:00 p.m. ET and are available for execution from 9:30 a.m. to 4:00 p.m. ET. MIOC orders that are entered between 4:00 a.m. and 9:30 a.m. ET will be held until 9:30 a.m. ET. At 9:30 a.m., the Nasdaq Market Center Execution System will determine which orders will be executed and which will be cancelled during the opening cross.

**Market Hours Day (MDAY)** Orders designated as MDAY may be entered into the Nasdaq Market Center Execution System from 4:00 a.m. to 4:00 p.m. ET and are open for potential execution during market hours from 9:30 a.m. to 4:00 p.m. ET. If a partial execution occurs, any remaining portion of the order will remain open and available for an execution until it's cancelled or expires at 4:00 p.m. ET. All unexecuted MDAY orders expire at 4:00 p.m. ET.

**Market Hours Good-till-Cancelled (MGTC)** Orders designated as MGTC may be entered into the Nasdaq Market Center Execution System from 4:00 a.m. to 8:00 p.m. MGTC orders remain displayed and open for potential execution during market hours from 9:30 a.m. to 4:00 p.m. ET. or until executed or cancelled. Any unexecuted portion of an MGTC order will remain displayed and open for execution during market hours from 9:30 a.m. to 4:00 p.m. ET each day for a period of one year from entry unless executed or cancelled.

| | Market Hours | System Hours |
|---|---|---|
| **IOC** | ***Market hours immediate or cancel (MIOC) orders are limit orders***<br>▪ When entered into the system, they receive an execution on that portion of the order that's immediately marketable.<br>▪ Unfilled portion of the order will be immediately cancelled and returned to the entering market participant.<br>▪ Entered from 4:00 a.m. to 4:00 p.m. ET<br>▪ Available for execution from 9:30 a.m. to 4:00 p.m. ET<br>▪ MIOC orders entered between 4:00 a.m. and 9:30 a.m. ET will be held until 9:30 a.m. ET<br>▪ At 9:30 a.m. ET the Nasdaq Market Center Execution System will determine which orders will be executed and which will be cancelled during the opening cross. | ***System hours immediate or cancel (SIOC) orders are limit orders***<br>▪ When entered into the system, they receive an immediate execution on that portion of the order that's marketable<br>▪ Unfilled portion of the order which is non-marketable is cancelled.<br>▪ May be entered during system hours from 4:00 a.m. to 8:00 p.m. ET. |
| **DAY** | ***Market hours day (MDAY) orders***<br>▪ May be entered from 4:00 a.m. to 4:00 p.m.<br>▪ Open for potential execution from 9:30 a.m. to 4:00 p.m. ET.<br>▪ If a partial fill occurs, any unexecuted portion of the order will remain open and available for an execution until it's cancelled or expires at 4:00 p.m. ET.<br>▪ All unexecuted MDAY orders expire at 4:00 p.m. ET. | ***System hours day (SDAY) orders***<br>▪ Remain displayed and open for potential execution during system hours from 4:00 a.m. to 8:00 p.m. ET<br>▪ If a partial fill occurs, any unexecuted portion will remain open and available for an execution until it's filled, cancelled, or expires at 8:00 p.m. ET.<br>▪ All unexecuted SDAY orders expire at 8:00 p.m. ET. |

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| | Market Hours | System Hours |
|---|---|---|
| **GTC** | ***Market hours good-till-cancelled (MGTC) orders***<br>▪ May be entered into the Nasdaq Market Center Execution System from 4:00 a.m. to 8:00 p.m. ET<br>▪ Remain displayed and open for potential execution from 9:30 a.m. to 4:00 p.m. ET or until executed or cancelled.<br>▪ Unfilled portion of an MGTC order will remain displayed and open for execution from 9:30 a.m. to 4:00 p.m. ET each day for a period of one year from entry unless executed or cancelled. | ***System Hours good-till-cancelled (SGTC) orders***<br>▪ Remain displayed and open for potential execution each trading day during system hours from 4:00 a.m. to 8:00 p.m. ET.<br>▪ Unfilled portion of an SGTC order will remain displayed and open for execution from 4:00 a.m. to 8:00 p.m. ET each day for a period of one year from entry unless executed or cancelled. |

# Other Time-In-Force Designations

**Good-till-Market Close (GTMC)** Orders designated as GTMC may be entered into the Nadsaq automated trading system during system hours from 4:00 a.m. to 8:00 p.m. ET. Any portion of a GTMC order that's not executed intraday will participate in the Closing Cross. All unexecuted GTMC orders are returned to the entering market participant after the Closing Cross. If a GTMC order is entered after the Closing Cross, it will be treated as an SIOC order.

**System Hours Expire Time (SHEX)** A SHEX order can be entered into the Nasdaq Market Center Execution System and be available for execution during system hours from 4:00 a.m. to 8:00 p.m. ET. Once entered, any unexecuted portion of an SHEX will remain open for the amount of time that's specified by the market participant that enters it. SHEX orders remain available for execution from 4:00 a.m. to 8:00 p.m. ET unless cancelled.

| Good 'till Market Close | System Hours Expire Time |
|---|---|
| ***Good-till-Market Close (GTMC) orders***<br>▪ May be entered into the Nadsaq automated trading system during system hours from 4:00 a.m. to 8:00 p.m. ET.<br>▪ Portions that are unexecuted intraday will participate in the Closing Cross.<br>▪ All unexecuted GTMC orders are returned to the entering market participant after the Closing Cross.<br>▪ If a GTMC order is entered after the Closing Cross, it will be treated as an SIOC order. | ***System Hours Expire Time (SHEX) orders***<br>▪ May be entered into the Nasdaq Market Center Execution System and be available for execution during system hours from 4:00 a.m. to 8:00 p.m. ET.<br>▪ Once entered, any unexecuted portion of an order designated SHEX shall remain open for the amount of time specified by the entering market participant.<br>▪ SHEX orders remain available for execution from 4:00 a.m. to 8:00 p.m. ET unless cancelled. |


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## Book Processing

In order to assist broker-dealers in their goal of obtaining best execution, Nasdaq has instituted the following rules for order execution. Orders are executed in the following sequence using the price/time algorithm:

1. Displayed orders
2. Non-displayed orders (the reserve portion of quotes and reserve orders)
3. The portion of a discretionary order that's discretionary

Using the price/time algorithm, orders at the best price (highest bid/lowest offer) receive an execution prior to orders at an inferior price. Orders at the same price are executed in chronological order based on their time of entry into the Nasdaq book.

When orders are executed against a contra-party, the size of the displayed order is decremented by the number of shares executed.

**Price Improvement** Price improvement is provided by the market participants that are providers of liquidity to the market participants that are takers of liquidity. For example, if market maker BGBW is displaying an offer to sell 1,000 shares of ABCD stock at 24, and market maker RGBY enters an order to buy 1,000 shares of ABCD at 25, market maker RGBY will receive an execution of 1,000 shares at the better price of 24, thereby receiving a $1.00 price improvement.

## Anonymity

**Attributable Orders** Attributable orders display the price and size of the order, as well as the market participant ID (MPID).

**Non-Attributable Orders** Non-attributable orders display only the price and size of the quotation. Market participants are able to keep their orders anonymous in the display by using the order designation NSDQ (formerly SIZE) in place of the MPID.

Although orders may be attributable or non-attributable, all orders that are executed in the Nasdaq System are anonymous with the Nasdaq Market Center Execution System as the contra-party. The actual contra-party can be identified if necessary, but only if:

1. The clearing agent ceases to act on behalf of the market participant
2. There's a regulatory reason for the disclosure or if it's necessary as a result of arbitration
3. There's consent among both parties to the transaction

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## Order Routing

Orders for securities governed by Regulation NMS which are entered into the Nasdaq Market Center Execution System between the hours of 4:00 a.m. and 8:00 p.m. ET may be routed in accordance with the following four available routing options:

1. Designated Order Turnaround (DOT)
2. Reactive Electronic Only (STGY)
3. Electronic Only (SCAN)
4. Aggressive Electronic Only (SPDY)

**Exchange-Listed Routing Options** DOT orders may be routed to either the NYSE or NYSE American. Individual orders may also be routed to the NYSE Direct+ System. (The NYSE Direct+ System is an automated, electronic execution system and is part of the NYSEs hybrid market initiative.) In addition, market participants are able to elect to not have orders routed to NYSE American.

**Designated Order Turnaround (DOT)** When orders are entered into the Nasdaq Market Center Execution System with the DOT routing option, the system first searches for available shares. If a match is not found, the system then routes the order to other market centers, as instructed by the user, and in compliance with the Order Protection Rule. Any unexecuted portion of the order is ultimately routed to either the NYSE or NYSE American at its original limit price. Only orders with time-in-force parameters—SDAY, SIOC, MDAY, MIOC, GTMC or market-on-open/close—will be eligible for DOT routing.

**Reactive Electronic Only (STGY)** When orders are entered into the Nasdaq Market Center Execution System with the STGY order routing option, the system first searches for available shares. If a match is not found, the system then routes the order to other market centers, as instructed by the user, and in compliance with the Order Protection Rule. If the order remains unexecuted, it's posted to the Nasdaq book. If another market center locks or crosses the order in the book, the order is routed to the locking or crossing market center for execution. Except for Minimum Quantity Orders, the STGY routing strategy may be used with all order types, all time-in-force parameters, and all securities.

**Electronic Only (SCAN)** When orders are entered into the Nasdaq Market Center Execution System with the SCAN order routing option, the system first searches for available shares. If a match is not found, the system then routes the order to other market centers, as instructed by the user, and in compliance with the Order Protection Rule. If the order remains unexecuted, it's posted to the Nasdaq book. If another market center locks or crosses the order in the book, the order will not be routed to the locking or crossing market center for execution. Except for Minimum Quantity Orders, the SCAN routing strategy may be used with all order types, all time-in-force parameters, and all securities. ITS commitments are routed using the SCAN designation.

**Aggressive Electronic Only (SPDY)** When orders are entered into the Nasdaq Market Center Execution System with the SPDY order routing option, the system first searches for available shares. If a match is not found, the system then routes the order to other market centers, as instructed by the user, and in compliance with the Order Protection Rule.


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If the order remains unexecuted, it's posted to the Nasdaq book. If another market center locks or crosses the order in the book, the order is routed to the locking or crossing market center for execution.

When a market order is sent with the SPDY designation, its price is adjusted to the same side of the market in which it was entered. Market orders to buy are adjusted to the highest displayed bid price, while market orders to sell are adjusted to the lowest displayed offering price. In accordance with the ITS plan, the *de minimis* exception to the trade-through rule applies to trades of less than 100 shares when automated quotation and tracking systems are being used. In transactions where the *de minimis* exemption applies, the system will ignore NYSE American prices when adjusting the price of SPDY orders during locked or crossed markets. Except for Minimum Quantity Orders, the SPDY routing strategy may be used with all order types, all time-in-force parameters, and all securities.

**Nasdaq-Listed Routing Options** There are three routing options available for Nasdaq-listed securities that may be used when market participants don't seek to have their orders routed to the NYSE or NYSE American. The three options are:

1. Reactive Electronic Only (STGY)
2. Electronic Only (SCAN)
3. Aggressive Electronic Only (SPDY)

When Pegged Orders in Nasdaq-listed securities are routed, the system will consider those quotes that are automatic and immediately accessible.

## Priority of Routed Orders

- Orders routed to another market center don't retain their order priority. Orders in the source market continue to be executed while the routed order is away.
- When orders reach a routing destination, they become subject to the rules of the destination market, including the short sale and cancellation rules.
- When orders are returned from a routing destination, they receive a new time stamp when they are returned to the Nasdaq book.

## Anti-Internalization

The Nasdaq Market Center Execution System allows a market participant to prevent internalization of orders. Internalization is a process by which firms execute orders internally rather than with another market participant. The Anti-Internalization feature is an exception to the automatic book processing system that's used by the Nasdaq Market Center and, if used by a market participant, the system will not execute any quotes or orders that are entered under the same MPID.

## Trade Execution

Trades in the Nasdaq Market Center Execution System occur automatically, except when participants opt to manually execute orders. Upon execution, both market participants are notified of the transaction. A report of the trade is automatically sent both to Nasdaq and a clearing agency for comparison and settlement. Trades that are reported automatically are termed *locked-in*.

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Auto execution can only take place for firms that are members of the National Securities Clearing Corporation (NSCC), or have a clearing arrangement with an NSCC member, or clear through a clearing corporation that's recognized by the NSCC.

**Multiple-Firm Executions** For a firm that sends orders through the Nasdaq Market Center Execution System, there's the possibility that the orders may be executed by more than one market maker. For example, Alco Broker-Dealer is an order-entry firm and one of Alco's proprietary traders enters a market order to buy 1,000 shares of BBBB. The following chart displays the current offers for BBBB:

| Market Maker | Offer Price | Displayed Size |
|---|---|---|
| MM 1 | 43.15 | 500 |
| MM 2 | 43.25 | 300 |
| MM 3 | 43.20 | 200 |
| MM 4 | 43.15 | 300 |

Alco's 1,000-share order would be executed as follows: MM 1 (500 shares at 43.15), MM 4 (300 shares at 43.15), and MM 3 (200 shares at 43.20).

## Nasdaq Initial Public Offering Process

Nasdaq has streamlined its method to integrate initial public offerings into trading in the Nasdaq Market Center. In Nasdaq's process, on the evening before trading is to begin, the lead underwriter for an IPO is expected to notify Nasdaq that the SEC has released the IPO for trading.

The lead underwriter must provide the public offering price for the security by 6:45 p.m. ET. Nasdaq uses the stock's public offering price as the first bid price in the Nasdaq Market Center at the beginning of the quote-only period before actual trading begins. The marketability of subsequent quotes and orders is checked against the public offering price. If the lead underwriter doesn't contact Nasdaq regarding the IPO and its public offering price, the IPO opens under the old system where quotes and orders may be entered into the Nasdaq Market Center and added to its book in time-priority on the morning that trading is to begin, starting at 4:00 a.m. ET. The quotes and orders are displayed during the quote-only period and become active when the IPO is released for trading. The order received by Nasdaq with time-priority is used to check the marketability for other quotes and orders, which creates a baseline price for the trading of the IPO.

## Alternative Display Facility (ADF)

The Alternative Display Facility is an electronic quotation and reporting system that's operated by FINRA. The ADF provides market makers and ECNs with the ability to display quotes for Nasdaq-listed securities. ADF-eligible securities include Nasdaq Global Market and Nasdaq Capital Market securities, Nasdaq convertible debt securities, and other exchange-listed securities that trade over-the-counter (i.e., CQS securities).


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For market makers, the ADF serves as an alternative to quoting on the Nasdaq Market Center Execution System. The ADF also provides a quotation alternative for ECNs, which are no longer permitted to display quotes on the Nasdaq Market Center Execution System.

The ADF doesn't provide order-execution capabilities; therefore, users that transact business based on ADF quotes must have order-execution services available from private connectivity providers. In addition, all transactions must be reported within 10 seconds of execution.

According to SEC Rule 600(b)(3), market participants must submit automated quotations when using the ADF. Before a trading center can be authorized to use the ADF, it must meet FINRA compliance certification requirements by demonstrating that it can maintain automated quotations during periods of peak activity. The market participant must have policies and procedures established to ensure compliance with SEC Rule 600(b)(3).

Under the rules brought about by market integration, ECNs are not permitted to display quotes on the Nasdaq Market Center Execution System; instead, only registered market makers are permitted to use the System. Nasdaq rules require market makers to make two-sided quotes and engage in principal transactions. ECNs trade for their subscribers on an agency basis and will not take positions as principals. Consequently, quotes that are made by ECNs may periodically be one-sided, which precludes ECNs from entering quotations in the Nasdaq Market Center Execution System.

Although ECNs may not quote on the Nasdaq Market Center Execution System, an ECN may display its quotes on the ADF. Market makers may also display quotations on the ADF, in addition to using the Nasdaq Market Center Execution System. Transactions that take place as a result of ADF participation must be reported within 10 seconds of execution.

**The Order Access Rule** The Order Access Rule stipulates that ADF market participants must provide direct electronic access to other market participants and all other FINRA members, and/or allow for indirect electronic access to its quote. Under the rule, market participants are either ADF registered market makers, ECNs, or Alternate Trading Systems (ATSs).

Direct electronic access represents the ability to deliver an order for execution directly against another ADF market participant's best bid or offer without the need for voice communication. The access must have the equivalent speed, reliability, availability, and cost that are made available to its own customers.

Indirect electronic access represents the ability to route an order through a market participant's customer broker-dealer for execution against the market participant's best bid and offer without the need for voice communication. The access must have the equivalent speed, reliability, availability, and cost that are made available to the market participant's customer broker-dealer providing access to the market participant's quotes.

Transactions resulting from ADF quotations must be reported within 10 seconds of execution through the ADF or another SEC-authorized reporting service.

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**Performance Standards** Since the ADF doesn't provide order execution services, broker-dealers that intend to participate in this venue will need to have systems installed to ensure that quality execution speed and minimum performance standards are met.

The minimum performance standards for ADF linkages are as follows:

- The market participant must be able to certify its ability to provide automated quotations during periods of peak volume.
- ADF participants must post a marketable quote on each side of the market at least once every 30 days in order to meet certification standards.

The performance standards must be met to ensure that adequate technology is being used to send and receive executions in a timely manner. The systems must be able to meet peak capacity standards before any authorization is given to post quotes on the ADF. Systems certification is a process that will be used to keep market participants current in standards.

The minimum performance standards for ADF linkages are (a) a two-second turnaround for an order that will be accepted or declined and (b) a three- or fewer-second turnaround for communication between market participants.

In the event that an ADF participant's linkage cannot meet performance standards and suffers system outages that leave the firm unable to post quotes or respond to orders, the firm will be suspended. The CEO and officers of FINRA have the right to grant an excused outage. However, when the participant experiences three unexcused outages during a five-business-day period, it will be suspended from the ADF for 20 business days in all or certain securities.

## Electronic Communication Networks (ECNs)

The Nasdaq Market Center Execution System is owned and operated by Nasdaq, while CQS, the Alternative Display Facility, and the OTC Bulletin Board are operated by FINRA. There are also other systems for disseminating quotes and orders that are not owned or operated by FINRA, Nasdaq, or an exchange. These systems are referred to as electronic communication networks. The SEC defines an ECN as an electronic system that widely disseminates to third parties the orders that are entered by market makers, and permits these orders to be executed against in whole or in part. The term *ECN* doesn't include crossing systems (such as ITG/POSIT) or internal broker-dealer order-routing systems. ECN subscribers can include both institutional investors and broker-dealers. ECNs are operated by a broker-dealer, registered as a broker-dealer, or registered with the SEC as a securities exchange.

An ECN trades exclusively on an agency basis by matching buyers and sellers within its system and it charges its subscribers transaction fees for its services. Quotations that reflect subscribers' orders are displayed on the ECN's trading system. An ECN may also display quotes on the ADF or an SRO trading facility, such as the National Stock Exchange (NSX).


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## ECN Interaction with Nasdaq

ECNs are not market makers and don't participate directly in the Nasdaq Market Center Execution System. They are not required to maintain a two-sided quote and they don't take proprietary positions. However, since an ECN quote can be accessed internally by subscribers to the system, which allows executions against ECN quotes through the Nasdaq automated trading system, it would create *double jeopardy* for ECNs, causing them to take proprietary positions. Therefore, special rules govern the participation of ECNs in the National Market System.

According to Nasdaq rules, in order to display quotations on the Nasdaq Market Center Execution System, a market maker must make a two-sided quote. In contrast, an ECN trades for its subscribers on an agency basis. An ECN doesn't take positions for its own account. At times, when an ECN doesn't have subscribers on both sides of the market, it can only display a one-sided quote.

An ECN may make its quotes accessible in one of three ways:

1. Market participants may subscribe to the services of an ECN and execute trades within the ECNs internal system.
2. The ECN may display its quotes on FINRA's ADF. Since the ADF is only a quotation service, and it doesn't provide executions, an ECN that displays quotations on the ADF must provide access to its quotes through private connectivity providers.
3. An ECN may also display quotations on an SRO trading center if its quotes are closely integrated within the SRO trading facility.

When an SRO trading center receives an order in response to a quote made by an ECN, rather than executing the trade at the SRO trading center, the order is immediately sent by the SRO trading center to the quoting ECN for execution. Once executed, the ECN immediately reports the execution back to the SRO trading center. In this way, the SRO trading center and the ECN can avoid a double execution, which could occur if an order was executed simultaneously in the ECN and at the SRO trading center.

In order to avoid misrepresenting quotation size, it's not permissible for an ECN to display a quotation simultaneously on more than one SRO trading facility. Similarly, it's not permissible for an ECN to display a quotation simultaneously on the ADF and on an SRO trading facility. However, it's permissible for the ECN to display a quotation internally within its trading platform and simultaneously on another SRO trading center. This doesn't misrepresent quotation size, since only the quote displayed by the SRO trading center would be visible in the Network quotation stream.

**UTP Exchanges** UTP Exchanges can participate in the Nasdaq automated execution system and must accept automatic executions. Although the Nasdaq automated execution system allows for multiple order/quote entries, national securities exchanges that trade on an unlisted trading privilege basis may not enter more than one quote unless the alternate quotes/orders are agency orders and designated as non-attributable orders. UTP Exchanges that are unwilling to accept automatic executions cannot participate in the Nasdaq automated execution system. The UTP Exchange must also be accessible by telephone or a self-created alternative link that's been agreed on by both parties.

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# CHAPTER 3

# *OTC Markets*

# OTC Bulletin Board (OTCBB)

The OTC Bulletin Board is an electronic quotation service for OTC equity securities. It's open for premarket trading from 8:00 a.m. to 9:30 a.m. ET. Trades that are executed in the premarket session must be reported within 10 seconds of execution to the OTC Reporting Facility (ORF), also referred to as the ACT Technology Platform. Quotes that are entered during regular market hours from 9:30 a.m. to 4:00 p.m. ET are firm and must be reported within 10 seconds of execution. Trades that are executed in the aftermarket session (from 4:00 p.m. to 8:00 p.m. ET) must be reported within 10 seconds of execution.

An OTC equity security is generally any equity that's not listed or traded on Nasdaq or a national securities exchange. This category includes domestic and foreign equity issues, warrants, units, American depositary receipts (ADRs), and direct participation programs (DPPs).

The OTCBB doesn't have same level of listing requirements that applies to companies that trade on Nasdaq or any stock exchanges. However, securities cannot be quoted on the OTCBB unless the issuer files periodic financial information with the SEC or another applicable regulator (e.g., a banking or insurance regulator) and these filings remain current. An issuer that becomes delinquent in its filings will be removed from the OTCBB if it doesn't make the required filings within a 30- or 60-day grace period. Members may enter a variety of quotations into the OTCBB, including:

- Two-sided quotes (bid and offer)
- Bid price only or offer price only
- Unpriced indications of interest (such as bid wanted or offer wanted)
- A bid or offer accompanied by a modifier reflecting unsolicited customer interest

Every quotation entry must include the telephone number of the firm's trading desk. During normal business hours (9:30 a.m. to 4:00 p.m. ET), a priced bid or offer must be firm, except for quotes for direct participation program securities (DPPs). As shown below, firm quotes must be good for a minimum size that's based on the price of the security.

| Price (Bid or Offer) | Minimum Quote Size |
|---|---|
| 0.0001–0.0999 | 10,000 |
| 0.10-0.1999 | 5,000 |
| 0.20–0.5099 | 2,500 |
| 0.51–0.9999 | 1,000 |
| 1.00–174.99 | 100 |
| 175.00+ | 1 |

Depending on the price level of the bid or offer for a given security, a different minimum size may apply to each side of the market being quoted by the member firm. For example, if an OTCBB security is being quoted at 0.95 – 1.05, the bid must be good for at least 1,000 shares, while the minimum size for the offer is 100 shares.

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With the exception of DPPs, the OTCBB is a *real-time* system (i.e., quotes can be updated by market makers at any time). Subject quotes for DPPs can be updated only twice per day; once between 8:30 a.m. and 9:30 a.m. and again between 12:00 p.m. and 12:30 p.m. ET.

If there are at least two market makers displaying two-sided quotations for an OTCBB security, the system will calculate and display the inside market based on all of the quotes in the system for that security, including any one-sided priced quotes. As has been described for all transactions in OTC equities, trades in OTCBB securities must be reported within 10 seconds of execution.

### Referring to OTCBB Securities

Registered representatives need to be careful when they refer to the OTCBB and the securities that trade there. It's considered misleading to allow investors to believe that this is the Nasdaq market since, unlike Global Select, Global Market, and Capital Market securities, OTCBB stocks don't need to meet listing standards. The result is that there's a wide range in the quality of issuers that trade there, from solid companies of local interest, to worthless shells that are potential vehicles for manipulative schemes. FINRA is concerned that OTCBB stocks are being falsely represented as Nasdaq stocks or as trading on the Nasdaq Bulletin Board. Investors could mistakenly believe that these securities have met some type of listing standards that are set by Nasdaq. Also, some naïve investors may be under the impression that the securities have met Nasdaq listing standards because they're assigned a ticker symbol.

## ACT Technology Platform

The ACT Technology Platform is a system that's used by the Trade Reporting Facility (TRF) for the reporting of trades involving Nasdaq-listed and other exchange-listed securities. The platform is also used by the OTC Reporting Facility (ORF) for the reporting of transactions in OTC securities. Both the TRF and the ORF contract with Nasdaq for the use of its ACT Technology Platform. The acronym ACT is derived from the formal name Automated Confirmation Transaction. Details regarding trade reporting and ACT will be addressed later in this manual.

### Trade Reporting Facility (TRF)

One of the conditions that was required by the SEC for the approval of Regulation NMS was to establish a Trade Reporting Facility (TRF). The TRF was designed for the reporting of transactions involving Nasdaq-listed securities that take place over-the-counter (OTC), as well as OTC transactions in NYSE and other exchange-listed securities (CQS securities).

The Trade Reporting Facility is a joint partnership of FINRA and Nasdaq and is operated by the Trade Reporting Facility LLC. Regulatory oversight of the TRF is provided by FINRA, while the business affairs are managed by Nasdaq. The TRF has a contract with Nasdaq for the use of its Automated Confirmation Transaction Technology Platform and is recognized as a national securities association. Although the TRF is built on the ACT Technology Platform, it's considered a separate entity for business and regulatory purposes.


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Transactions in Nasdaq-listed securities or other exchange-listed securities that occur over-the-counter, such as internalized transactions and dealer negotiated trades, must be reported to the TRF within 10 seconds of execution.

# CQS Transactions (The Third Market)

Industry rules govern over-the-counter trading in virtually all securities (except for municipal bonds). This includes OTC transactions in other exchange-listed securities (referred to as third-market transactions). Examples of CQS-eligible securities include stocks that are listed on the NYSE or the regional exchanges, but not Nasdaq-listed securities.

## Consolidated Quotation System (CQS)

Members that provide third-market quotes in exchange-listed securities typically do so through the Consolidated Quotation System. A market maker must apply to Nasdaq to function as a CQS market maker and is approved when it receives Nasdaq notification. As with Nasdaq, registration in additional CQS issues can be accomplished by entering a registration request through a Nasdaq terminal. Once registered, a market maker must enter quotes into CQS within five business days or lose its registration in that security.

**Market-Maker Obligations** CQS market-maker quotes must be firm at the price and for the size displayed. If there's no size displayed, the quote is firm for a normal unit of trading (100 shares). If a market maker maintains quotes in a security on both an exchange and in CQS, the quotes must be identical.

As with Nasdaq, the use of automatic quote update features is generally prohibited in connection with CQS, particularly when it's used to keep a market maker's quote away from the inside market (auto-quoting away). However, automatic quote updates can be used in certain circumstances. For instance, automatic update features can be used when the update:

- Is in response to an execution in the security by that firm (such as the execution of an order that partially fills a market maker's quotation size)
- Requires a physical, perceptible entry (such as a manual entry into the market maker's internal system, which then forwards the update to a Nasdaq system)
- Reflects the receipt, execution, or cancellation of a customer limit order
- Is used to expose a customer's market or marketable limit order for price improvement
- Is used to equal or improve both sides of the NBBO or add size to the NBBO

**Trading Practices** FINRA has specific guidelines covering transactions that are executed by members in the third market. These guidelines apply regardless of whether the member firm is registered as a CQS market and include:

1. Members cannot execute transactions that are fraudulent, manipulative, or deceptive. This includes practices such as a series of trades at successively higher or successively lower prices to give a misleading appearance of market activity (a version of painting the tape). Similarly, wash sales, in which there's no true change of beneficial ownership, are prohibited.

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2. Circulating information that the member knows or has reason to believe is false or misleading is prohibited. Therefore, registered representatives cannot discuss groundless rumors with clients.
3. The provisions of the Manning Interpretation, originally applicable to Nasdaq securities only, has been extended to third-market transactions. The Manning Interpretation is described later in this manual.
4. Members cannot engage in third-market transactions in order to influence the closing price that's reported on the Consolidated Tape.
5. Members cannot execute third-market transactions in a security that's the subject of an initial public offering until the security has first opened for trading on the primary exchange that lists the security. The opening on the exchange is indicated by a transaction report by the listing exchange on the Consolidated Tape.

# SEC Rule 15c2-11 – Initiating Quotations for Unlisted, OTC Securities

Although broker-dealers must formally register as Nasdaq market makers before entering quotes in that system, there's no such procedure required for making a market in OTC equity securities that are not traded on Nasdaq or any other national securities exchange. However, the broker-dealer must comply with SEC Rule 15c2-11 and maintain the required net capital. The term *OTC market maker* is defined by FINRA as a firm that holds itself out as a market maker by entering quotes or indications of interest in an OTC equity security in an interdealer quotation system (An ATS could also quote an OTC Equity Security). OTC market makers are not subject to the continuous quotation requirements of listed securities; therefore, there's no unexcused withdrawal penalty when quoting OTC equities.

If a dealer chooses to quote the same security in more than one interdealer quotation system (e.g., both OTCBB and the OTC Pink Market), the quotes must be identical.

SEC Rule 15c2-11 requires broker-dealers that intend to publish quotes for an OTC equity security to either collect and review certain information about the issuer or rely on the interdealer quotation system's review of the issuer's information. For this rule, the term *publish* means to initiate or resume quotes in any interdealer quote medium, such as the OTCBB or the OTC Pink Market.

## Information to Be Collected

Prior to initiating or resuming quotes (unless an exception is available), a broker-dealer must have in its possession one of the following five items that related to the security in question:

1. A prospectus filed with the SEC under the Securities Act of 1933 that's been in effect for less than 90 days
2. An offering circular as specified in Regulation A, effective within the preceding 40 days
3. The issuer's latest Form 10-K and all subsequent Form 10-Qs and Form 8-Ks (and the issuer must be current in its filings)
4. For certain foreign securities, financial information that's been filed with the SEC during the issuer's last fiscal year under Rule 12g3-2(b)


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5. The following information about the issuer (which must be reasonably current in relation to the day the quote is published):
    i. Exact name of the issuer (and its predecessor, if any)
    ii. Address of its principal executive offices
    iii. State of incorporation (if a corporation)
    iv. Exact title and class of the security
    v. Par or stated value of the security
    vi. Number of shares or total amount of the securities outstanding
    vii. Name and address of the transfer agent
    viii. Nature of the issuer's business
    ix. Nature of the products or services offered
    x. Nature and extent of the issuer's facilities
    xi. Name of the chief executive officer and members of the board of directors
    xii. Issuer's most recent balance sheet and profit and loss and retained earnings statement
    xiii. Similar information for such part of the two preceding fiscal years that the issuer or its predecessor has been in existence
    xiv. Whether the broker or dealer or any associated person is affiliated, directly or indirectly, with the issuer
    xv. Whether the quote is being published or submitted on behalf of any other broker or dealer and, if so, the name of such broker or dealer
    xvi. Whether the quote is being submitted or published, directly or indirectly, on behalf of the issuer, or any director, officer, or anyone who beneficially owns more than 10% of the outstanding shares or units of any equity of the issuer. (If so, the name of the person and the basis for any exemption from federal securities laws for sales on behalf of the person must be disclosed.)

It's not enough for the broker-dealer or interdealer quotation system to simply have this information on file; the rule actually requires the dealer to review the information and have a reasonable basis for believing that (1) the information is accurate in all material respects, (2) the sources from which the information was obtained are reliable, and (3) the information is current and publicly available.

## Information About the Quote

In addition to the preceding information, the dealer that publishes the quote must have the following documents and information on file:

- A record of the circumstances involved in the publication of the quote, including the identity of the person or persons for whom it's being published and any information regarding the transactions provided to the dealer by those persons
- A copy of any SEC trading suspension order for any security of the issuer during the preceding 12 months, or a copy of the SEC public release announcing the suspension
- A copy or written record of any other material information (including adverse information) about the issuer that comes into the dealer's knowledge or possession before the publication of the quote

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## Submission of Information to FINRA

Under SEC Rule 15c2-11, the documentation that's compiled by a dealer must be submitted to FINRA, along with a completed Form 211, at least three business days prior to entering a quote in a quotation medium. The filing should also specify the:

- Issuer
- Issuer's predecessor in the event of a merger or reorganization within the previous 12 months
- Type of security to be quoted (e.g., ADR, warrant, unit, or common stock)
- Quotation medium to be used
- Member's initial or resumed quote
- Particular subsection of Rule 15c2-11 with which the dealer is demonstrating compliance

In addition, if the dealer is initiating or resuming a priced quote, the firm must specify the basis on which that quote was determined. If the quote is initially unpriced, but is later changed to a priced quote, the firm must supplement its filing with the rationale for the price being quoted. Under this rule, any filings must be reviewed and signed by a principal of the member firm.

FINRA will review the material and, within three business days, notify the dealer whether the application has been cleared. Any deficiencies that are identified by FINRA must be resolved prior to quoting the security in a quotation medium.

**Exceptions to SEC Rule 15c2-11** The documentation and filing requirements of the rule are not required to be followed if:

1. The security is listed on a national securities exchange (e.g., Nasdaq or the NYSE) or was traded on an exchange on the previous business day (recently delisted). For periods outside of this time frame, a Form 211 must be filed before quoting begins.
2. A dealer is publishing a quotation on behalf of a customer and it represents *unsolicited* customer interest in buying or selling the security. Once the customer order is executed or canceled, the dealer can no longer quote the security. (Please note, unsolicited interest from a corporate insider qualifies for this exemption.)
3. A qualified interdealer quotation system (e.g., the OTCBB) or a registered national securities association has complied with the information review requirements and made public its determination of the securities compliance with the rule. (OTC market makers relying on the interdealer quotation system.)
4. The quote is for the security of a company with a worldwide average daily trading volume value of at least $100,000 as reported during the 60 calendar days immediately before the publication of the quotation and the issuer of such security has at least $50 million in total assets and $10 million in shareholders' equity as reflected in the issuer's publicly available audited balance sheet that's issued within six months after the end of its most recent fiscal year. (Actively traded securities of well-capitalized issuers.)
5. The quote is initiated by an underwriter in that security.
6. The quote is for a municipal security.


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**The Piggyback Exception** Another exemption from Rule 15c2-11 is referred to as the *piggyback exception*. This exception applies to any security that has at least one existing one-way quote (either a bid or ask), no more than four business days in succession have elapsed without a quote, the issuer information is current and publicly available, and other conditions are met.

Securities on the OTCBB that meet this exception can be readily identified since they are labeled *active*. (Quotes representing unsolicited customer interest are not counted to determine *active* status.) If at least one market maker has been cleared to quote the security on the OTCBB under 15c2-11, but the security doesn't yet meet the piggyback exception, it will instead be labeled *eligible*.

*For example, Market Maker Q wants to quote an OTC equity security, ZYXW, in the OTC Pink Market. Ordinarily, MM Q would need to comply with Rule 15c2-11 and file with FINRA all of the required information, along with Form 211. However, Market Maker P has been quoting ZYXW in the OTC Pink Market every day for the past two months. Therefore, MM Q can insert quotes for the stock in the OTC Pink Market without complying with Rule 15c2-11 by piggybacking on MM P's quotes.*

If a dealer qualifies for the piggyback exception and begins publishing quotes, it may continue to publish quotes without complying with 15c2-11 even if the other market maker on whose quotes the exception was based withdraws from the market. However, if the piggybacking dealer then ceases quotations, it must comply with the rule or find another exception before resuming quotations.

*Continuing the preceding example, let's assume that MM P stops publishing quotes for ZYXW in the OTC Pink Market three days after MM Q had begun quoting the stock there. MM Q may continue to quote the stock, despite the fact that the market maker on whose quotes it piggybacked is no longer in the market. However, if MM Q stops quoting ZYXW, and there are no other market makers quoting it in the OTC Pink Market, MM Q would need to fully comply with Rule 15c2-11 before resuming its quotations.*

The piggyback exemption is not available, and full compliance with Rule 15c2-11 is required, if:

1. The issuer has been subject to a trading suspension issued by the SEC in the last 60 calendar days.
2. The issuer is or believed to be a shell company and quotes were initiated more than 18 month ago. (This means that a new Form 211 must be filed after 18 months for the company to continue being quoted. This is because there have been cases in which a shell company ceased to exist, but quotes continued.)
3. The issuer is not filing its required financial reports and public disclosures in a timely manner, which is defined as being filed within 180 days of the end of the issuer's reporting period.

# Penny Stock Regulations

The SEC has adopted several rules regarding the solicitation and sale of low-priced OTC stock (penny stock). These securities are often quoted in the OTCBB or OTC Pink Marketplace. The rules were created to prevent certain types of abusive sales practices and to ensure that investors are provided with information about the penny stock market.

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## Definition of Penny Stock

For purposes of these rules, penny stocks are any equity securities that are NOT:

- Nasdaq securities
- Listed stocks
- Investment company securities
- OCC-listed puts and calls
- Securities with a market value of at least $5 per share
- Securities whose issuer has (i) net tangible assets exceeding $2 million, if in continuous operation for at least three years, (ii) net tangible assets exceeding $5 million, if in continuous operation for less than three years, or (iii) average revenue of at least $6 million for the last three years

## Penny Stock Disclosure Rules

SEC Rules 15g-1 through 15g-6 require that customers be provided with specific information if broker-dealers effect penny stock transactions for them. Prior to effecting any transaction for a customer in a penny stock, the broker-dealer must furnish to the customer a Risk Disclosure Document on penny stocks. The document must contain language that's specified by the SEC which describing the risks involved in penny stock investing and summarizes other disclosures that the broker-dealer must make to the customer.

In addition, for *each* penny stock transaction, the broker-dealer must disclose to the customer:

- The current quote for the security
- The compensation that the broker-dealer will receive for the transaction
- The compensation that the registered representative will receive for the transaction

If a broker-dealer has sold a security to a customer that meets the definition of a penny stock as of the last trading day of any month, the broker-dealer must provide a monthly statement to the customer as long as the security is held in the customer's account with the broker-dealer.

The statement must include (i) the identity and number of shares of each penny stock held for the customer's account, and (ii) the estimated market value for the security, to the extent that it can be determined.

**Exemptions** Securities that are sold in the following transactions are NOT subject to the penny stock disclosure rules:

- Transactions with institutional accredited investors (In this case, institutional means accredited investors [as defined in Regulation D on private placements], who are not individuals.)
- Private placements
- Transactions with the issuer, officers, directors, general partners, or 5% owners of the company's stock
- Transactions that are not recommended by the broker-dealer
- Transactions by a broker-dealer whose commissions and markups from penny stocks don't exceed 5% of its total commissions and markups


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## Sales Practice Requirements for Penny Stocks

SEC Rule 15g-9 places certain conditions on the way broker-dealers solicit penny stock transactions from customers. This provision is often referred to as the *Cold Call Rule*. Prior to the purchase of a penny stock by a customer, a broker-dealer must (i) approve the person's account for penny stock transactions according to the procedures outlined below, and (ii) obtain from the customer a written agreement to the transaction indicating the identity and quantity of the penny stock to be purchased.

**Account Approval Procedures** To approve a customer's account for transactions in penny stocks, the broker-dealer must:

- Determine that the customer is suitable for penny stock transactions based on information about the customer's financial situation and investment objectives
- Deliver to the customer a written statement regarding this suitability determination
- Obtain from the customer a manually signed and dated copy of the statement

The following transactions are exempt from Rule 15g-9 (These exemptions are identical to those for the disclosure rule, but includes the established customer exemption):

- Transactions with institutional accredited investors
- Private placement transactions
- Transactions with the issuer, officers, directors, general partners, or owners of 5% or more of the company's stock
- Transactions that are not recommended by the broker-dealer
- Transactions by a broker-dealer whose commissions and markups from penny stocks don't exceed 5% of its total commissions and markups
- Transactions with established customers

An *established customer* is one for whom the broker-dealer (or its clearing firm) carries an account and who (i) has effected a securities transaction, or made a deposit of funds or securities, more than one year previously, *or* (ii) has made three purchases of penny stocks (from three different issuers on three separate days). Please note, established customers are *not* exempt from the penny stock disclosure rules.

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# Chapter 4

# *Trading Rules*

# Quotes

Nasdaq and other markets are predominately quote-driven or, put another way, prices are set by market makers that make bids and offers for stocks they are willing to buy or sell. Since quotes are so important to the market, both the SEC and FINRA have several rules designed to protect the integrity of this information.

## SEC Rule 602 – The Quote Rule

Rule 602 covers the dissemination of quotes and was devised to improve the quality and transparency of U.S. markets. While the rule also covers quotes by exchange designated market makers, let's focus on its application to OTC market makers and begin with examining some important definitions.

- **Covered Security** – A *covered security* means any reported security and any other security for which transaction reports, last sale data, or quote information is disseminated through an automated quote system as defined in the Exchange Act. Essentially, this group includes exchange-traded securities and all three levels of Nasdaq securities.
- **OTC Market Maker** – An *OTC market maker* is any dealer that holds itself out as being willing to buy from and sell to its customers a covered security for its own account on a regular or continuous basis. This doesn't include transactions that are executed on exchanges in amounts of less than a block size. Although market makers are typically considered firms that publish quotes in systems such as Nasdaq and CQS, this definition also includes firms that don't publish quotes, but instead stand ready to buy and sell covered securities with their own customers based on the best prices available in the market. This is often referred to as *internalized order flow*.
- **Subject Security** – As it applies to an over-the-counter firm, a *subject security* refers to (i) any exchange-listed security for which the member acts in the capacity of an OTC market maker (unless the dealer accounts for less than 1% of the reported volume in the security), and (ii) any other covered security in which the firm acts as an OTC market maker and has elected to communicate those quotes to Nasdaq (i.e., register as a Nasdaq market maker). The effect of part (i), along with the definition of OTC market maker and other aspects of the rule, is that a firm that acts as a third-market maker in a particular security *must* publish its quotes *if* it accounts for at least 1% of the trading volume in that security. Prior to revisions to this rule, there were firms that did a substantial volume of OTC business in certain CQS securities through internalized order flow, but never published quotes. Now, these firms are required to publish quotes if they hit the 1% threshold.
- **Quote Size** – As it relates to *quote size*, the rule also clarifies that if a market maker doesn't publish a quote with a size specified, the size is assumed to be the normal unit of trading for that security.

**Market-Maker Obligations Regarding Quotes** This section is the heart of the rule and is referred to as the *Firm Quote Rule*. When a market maker is disseminating a quote that's covered by the rule, it's obligated to execute an order that's *presented* to it at a price at least as favorable as its published quote and for an amount up to its published quote size. The obligation to fill an order begins when the order is presented, regardless of how the order is transmitted to the market maker (e.g., over the phone).

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In the following two situations, a presented order is not required to be honored:

1. The market maker communicated to Nasdaq a revised price or size *prior* to the presentation of the order.
2. The market maker just effected or is in the process of effecting a transaction at the time the order is presented *and*, immediately after completing that transaction, communicates a revised quote to Nasdaq. (This is also referred to as the *trade ahead* exception.)

## Firm Quote Compliance System (FQCS)

To ensure compliance with SEC Rule 602, the Firm Quote Compliance System was developed. If a member believes another firm has committed a backing-away violation, it can lodge a complaint with Market Regulation. The Market Regulation Department will then enter the complaint into the FQCS. The aggrieved firm is required to file the complaint within five minutes of the alleged violation, which allows FINRA to deal with the situation on a real-time basis. If FINRA determines that there was a violation, it typically resolves the matter through a contemporaneous trade execution. The system also has the capability to review trades and quotes to look for patterns that could lead to disciplinary action against firms that violate their firm-quote obligations.

Prior to contacting FINRA, a firm that believes that it's been the victim of a backing-away violation is asked to contact the other firm and resolve the situation directly. If this is done, the normal five-minute-complaint window is waived. However, if the two parties cannot resolve the dispute directly, a complaint should then be filed with Nasdaq Market Regulation immediately.

The failure of an aggrieved firm to contact FINRA within the five-minute window does NOT relieve the offending firm from liability for a firm-quote violation. If a complaint is not filed on a timely basis, it's unlikely that the issue will be resolved with a trade execution.

## Industry Rules on Quotations

In addition to SEC quote rules, OTC market makers are also bound by industry rules. Member firms may publish or otherwise disseminate only bona fide quotes. These quotes express genuine interest in buying or selling a security and haven't been placed for manipulative or deceptive purposes. If a quote is nominal (not firm), it must be clearly labeled as such. Also, a member firm that reports that a transaction occurred must know or have reason to believe that it actually did occur.

If one member firm disseminates a quote on behalf of another firm, it must have reason to believe the quote was bona fide. In other words, it cannot use as an excuse that it was simply passing along another firm's quote. Quotes include indications such as *bid wanted* or *offer wanted*, not just priced quotes.

Another rule indicates that if a member gives a priced bid or offer, the firm must be prepared to honor it at the price and under the conditions stated. This is FINRA's version of the Firm Quote Rule. In addition, if a member publishes a subject quote (such as in the OTC Pink Marketplace) and then refuses to provide an updated firm quote when approached by another member, this refusal can be viewed by FINRA as a version of backing away. In this circumstance, there's a question as to whether the firm's original subject quote was bona fide.


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**Trade-Or-Fade Rule** Although a market maker is required only to honor its quoted size, failure to honor a larger size order will force the market maker to change its quote. This rule requires Nasdaq market makers to publish an inferior quote if they fail to execute the full size of an incoming order that's at least one normal unit of trading greater than the market maker's published quotation size. The operation of this rule is illustrated by the following example:

*Let's assume that Market Maker 1 is bidding 20 for ABCD stock, with a quotation size of 100 shares. Market Maker 2 calls MM 1 and offers to sell 500 shares at 20. If MM 1 executes less than the full 500 shares of the incoming order, it must lower its bid below 20 after the execution. If it executes the full 500 shares of MM 2's order, it may leave its bid at 20 for 100 shares.*

**Minimum Price Increments** Another provision of Regulation NMS is Rule 612 (the Sub-Penny Rule), which controls pricing increments for NMS stocks. Under Rule 612, national securities exchanges, national securities associations, alternative trading systems (ATSs), vendors, and broker-dealers are prohibited from accepting bids, offers, or indications of interest for NMS stocks as follows:

- In increments smaller than $0.01 if they are priced at $1.00 or more, and
- In increments smaller than $0.0001 (one hundredth of a cent) if they are priced at less than $1.00

*For example, a market participant that's entering a limit order to sell shares of an NMS stock when the inside market is 18.50 – 18.55 ($1.00 or more) may not enter an order with a price that extends more than two places past the decimal point. (For example, 18.559 is not acceptable, but $18.56 is acceptable.) A market participant that's entering a limit order to buy 800 shares of an NMS stock when the inside market is 0.50 – 0.65 (less than $1.00) may not enter an order with a price that extends more than four places past the decimal point. (For example, 0.51598 is not acceptable, but 0.5159 is acceptable.)*

## Nasdaq Quote Rules

Market makers that place quotes in Nasdaq are subject to that system's quote rules, in addition to the rules just described. Nasdaq quotes must be two-sided and firm. If a market maker updates its quote, but doesn't specify a size for the update, the new quote is assumed to be the same size as the *previous* one.

In order to maintain the integrity of the Nasdaq market, a market maker's quotes must be reasonably related to the prevailing market. If it appears that this is not the case, FINRA can require a market maker to reenter its quotes. Failure to do so can result in the market maker's suspension from Nasdaq.

**Locked Or Crossed Markets** Nasdaq rules generally prohibit the entry of locked or crossed markets. A crossed market occurs when a market maker enters a bid quote that's higher than the ask quote of another market maker, or an ask quote that's lower than the bid quote of another market maker. A locked market occurs when the highest bid and lowest offer are equal. The following example will clarify this point.

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*Three market makers have entered the following quotes for WXYZ stock in Nasdaq:*

| | |
|---|---|
| *Market Maker 1* | *14.80 – 15.20* |
| *Market Maker 2* | *15.05 – 15.40* |
| *Market Maker 3* | *14.90 – 15.30* |

*In this situation, the inside market is 15.05 – 15.20. A new market maker cannot enter a bid at 15.20 or higher. A new bid of 15.20 would create a locked market, since the lowest current ask price is also 15.20. A new bid of more than 15.20 would create a crossed market. For example, a bid of 15.30 would allow a trader to buy stock from Market Maker 1 at 15.20 and sell the stock to the new bid of 15.30. The trader would be guaranteed a profit (arbitrage).*

*A new market maker cannot enter an offer of 15.05 or less. A new offer of 15.05 would create a locked market, since the highest current bid price is 15.05. A new offer of less than 15.05 would create a crossed market. An offer of 15.00, for example, would allow a trader to buy stock at 15.00 and sell the stock to Market Maker 2 at 15.05, thereby guaranteeing a profit.*

Before entering a quote that locks or crosses the market, a market maker must make a reasonable effort to execute transactions with all market makers whose quotes would be locked or crossed. With previous Nasdaq systems, the problem of locked/crossed markets plagued market participants. Locked/crossed markets occurred at the market open, which caused problems being able to maintain a fair and orderly market, as well as during the day, which slowed trading. The Nasdaq Market Center Execution System addresses locked/crossed markets on both levels. As a part of the Nasdaq market, open, locked, and crossed markets are automatically processed as a part of the Nasdaq Opening Cross.

## Opening of Quotes

Market participants may voluntarily open their quotes at any point during the pre-market session from 4:00 a.m. to 9:25 a.m. During the pre-market session, quotes are firm and automatic trade executions occur in price/time priority. Any quotes that are not opened by market participants during the pre-market session will be opened by the Nasdaq Market Center Execution System at 9:25 a.m. based on the firms' instructions. A market participant may instruct Nasdaq to:

1. Open its quotes at the previous day's closing bid/ask for one normal unit of trading
2. Open any quotes that are entered between 4:00 a.m. and 9:24:59 a.m. at the state prices and sizes

Any orders that are executed at or prior to the opening cross at 9:30 a.m. will be reported with the .T modifier, designating that the execution didn't occur during normal market hours.

**Order Imbalance Indicator** The Order Imbalance Indicator is an electronic display that provides information about orders involved in the opening process.


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The information provided by the Order Imbalance Indicator includes the following:

- *The near clearing price* is the price at which all quotes and orders on the Nasdaq opening book would execute against all quotes and orders on the Nasdaq continuous book.
- *The far clearing price* is the price at which all quotes and orders on the Nasdaq opening book would execute against each other.
- *The current reference price* is the price within the bid/ask spread that in the following sequence would: (1) maximize the number of shares that could be paired, (2) minimize the order imbalance, and (3) minimize the distance from the inside market to the bid/ask midpoint.
- *The number of shares paired* is the number of shares that could be executed at the current reference price.
- *The imbalance quantity* is the number of shares that would remain unexecuted if a cross occurred at the current reference price.
- *The imbalance side* is the side of the market on which the imbalance exists (buy or sell).

## Opening Cross

In order to comply with Regulation NMS, Nasdaq has implemented changes in its market opening process. In the interest of providing one opening price for Nasdaq securities at the market open and maintaining an orderly market, Nasdaq has established the Opening Cross. The Opening Cross occurs at 9:30 a.m. and is designed to create a fair and orderly opening price by clearing locked and crossed markets prior to 9:30 a.m.

With the introduction of Regulation NMS, Nasdaq has created the following new order types and time-in-force designations. It's important to know these definitions in order to understand the process of the Nasdaq Opening Cross.

- **LOO** – *Limit-on-open* orders are limit orders to buy or sell at a stated limit price or better and are executed only at the opening cross. They may be entered, cancelled, or replaced without restriction from 4:00 a.m. to 9:28 a.m. However, after 9:28 a.m., they cannot be cancelled or replaced.
- **MOO** – *Market-on-open* orders are market orders to buy or sell that are executed only at the price determined by the opening cross. They may be entered, cancelled or replaced from 4:00 a.m. to 9:28 a.m.
- **OIO** – *Opening imbalance only* orders are limit orders that are executed only during the opening cross at 9:30 a.m. They may be entered between 4:00 a.m. and 9:29:59 a.m. They may not be cancelled or replaced, except to increase their size, from 9:28 a.m. to 9:30 a.m. An OIO order to buy is executed at a price that's equal to or lower than the 9:30 a.m. bid price. An OIO order to sell is executed at a price that's equal to or higher than the 9:30 a.m. offer price. OIO orders can only be executed against MOO orders, LOO orders, and Early Market Hours orders.
- **Market Hours Orders** are orders that are entered into the system with the time-in-force designation—MIOC, MDAY, and MGTC, as described earlier.
- **Early Market Hours Orders** are market hours orders that are entered into the system between 4:00 a.m. and 9:28 a.m. Early market hours orders are treated as market-on-open and limit-on-open orders for purposes of the opening cross.

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- **Late Market Hours Orders** are any market hours orders that are entered into the system at 9:28 a.m. or later and are treated as imbalance only orders for purposes of the opening cross.
  Both early and late market hours orders cannot be cancelled or replaced after 9:28 a.m. until the opening cross has been completed.

  Any requests to cancel or replace a market hours order during the 9:28 a.m. to 9:30 a.m. time period will be honored if the orders remain unexecuted at the end of the opening cross.
- **Open Eligible Interest** refers to other orders that participate in the opening cross, including orders with the time-in-force designations—SDAY, SGTC, SHEX, and GTMC.

**How Is the Official Opening Price Determined?** The Nasdaq Opening Cross establishes the Nasdaq Opening price for a particular security. The Nasdaq Opening Cross price is established by using the following procedure:

- The system seeks a price that maximizes volume for all LOO, MOO, OIO, and early market hour orders, as well as other executable interest.
- If more than one price still exists for the security, the cross will occur at a price that minimizes the order imbalance.
- If more than one price continues to be present, the cross will occur at a price that leaves orders unexecuted in the cross.
- Assuming more than one price is still present, the opening cross occurs at a price that minimizes the distance from the inside market to the bid/ask midpoint.
- If the price that's been established by the above process lies outside of the benchmarks that are established by a threshold amount which has been determined by Nasdaq, the cross will occur at a price that's within the threshold amount in accordance with the above process. Nasdaq periodically establishes benchmark and threshold amounts and provides prior notice of such changes to market participants.

## The Nasdaq Official Opening Price

The Nasdaq Opening Cross takes place at 9:30 a.m. and establishes the Nasdaq opening price. All quotes and orders that participate in the opening cross occur anonymously and are reported in accordance with the National Market System Plan.

Although MOO and LOO orders may not be entered after 9:28 a.m., OIO orders and normal market orders and limit orders may be entered after 9:28. Limit orders that are entered after 9:28 which are intended for normal market hours trading are treated like opening imbalance only OIO orders and are eligible to participate in the opening cross. OIO orders (and therefore normal market hours limit orders) add liquidity to the opening cross and offset any MOO and LOO orders during the cross. Any OIO orders or normal market hours limit orders that are entered during this time which are more aggressively priced will be adjusted to the inside market.

The Order Imbalance Indicator is disseminated every one second between 9:28 a.m. and 9:30 a.m. to notify market participants of the:

- Far indicative clearing price
- Near indicative clearing price


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- Current reference price
- Imbalance quantity
- Side of the imbalance (buy or sell)

After any order imbalances have been resolved, all orders that participate in the cross are executed at a single opening price. Any orders that were unable to be filled at the opening cross will trade in the normal market hours trading session according to their original order specifications.

## The Nasdaq Closing Cross

While Nasdaq has the Opening Cross to aid in an orderly market open, there's also the Nasdaq Closing Cross that helps to implement a fuller and more comprehensive market close. The Nasdaq Market Center Execution System is used to facilitate the closing cross. The process begins at 3:55 p.m. and the Nasdaq Closing Cross occurs at 4:00 p.m., at a single price that maximizes the number of shares executed.

With the introduction of Regulation NMS, Nasdaq has created the following new order types for the closing cross. It's important to know these different order types in order to understand the process of the Nasdaq Closing Cross.

- **LOC** – *Limit-on-close* orders are limit orders to buy or sell at a stated limit price or better that are automatically executable at the price resulting from the closing cross. LOC orders may be entered, cancelled, or replaced without restriction from 4:00 a.m. to 3:55 p.m. Between 3:55 and 3:58 p.m., LOC orders may be cancelled only in the case of a legitimate error, such as an error in price, size, symbol, side of the market, or order duplication. After 3:58 p.m., LOC orders cannot be cancelled or replaced regardless of the reason.
- **MOC** –*Market-on-Close* orders are orders that are entered without a price and may only be executed during the Nasdaq Closing Cross. Subject to the qualifications provided below, MOC orders may be entered between 4:00 a.m. ET and immediately prior to 3:55 p.m. ET. MOC orders may be cancelled and/or modified between 4:00 a.m. ET and immediately prior to 3:50 p.m. ET. Between 3:50 p.m. ET and immediately prior to 3:58 p.m. ET, an MOC order can be cancelled and/or modified only if the participant requests that Nasdaq correct a legitimate error in the order (e.g., side, size, symbol, or price, or duplication of an order). MOC orders cannot be cancelled or modified at or after 3:58 p.m. ET for any reason. An MOC order can only be executed at the price determined by the Nasdaq Closing Cross.
- **IO** – *Imbalance Only* Orders are limit orders that are to be executed only during the Nasdaq Closing Cross. They may be entered between 4:00 a.m. and 3:59:59 p.m. However, after 3:55 p.m., IO orders may not be modified except to increase their size. Between 3:55 and 3:58 p.m., IO orders may only be cancelled in the case of a legitimate error, such as an error in price, size, symbol, side of the market, or order duplication. After 3:58 p.m., IO orders may not be cancelled or replaced regardless of the reason. An IO order to buy is executed at a price that's equal to or lower than the 4:00 p.m. bid price. An IO order to sell is executed at a price that's equal to or higher than the 4:00 p.m. offer price. IO orders are executed during the Closing Cross at 4:00 p.m. and may only be executed against MOC orders and LOC orders.
- **Close Eligible Interest** refers to other orders that participate in the closing cross, including orders with the time-in-force designations—SDAY, SGTC, MDAY, MGTC, SHEX, and GTMC.

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## Order Imbalance Indicator

At 3:55 p.m., an order imbalance indicator begins dissemination, similar to the opening process. The imbalance indicator provides information regarding market-on-close (MOC), limit on-close (LOC), and imbalance only orders (IO). The imbalance indicator is sent every one second from 3:55 p.m. until the market close.

## Nasdaq Market-on-Close and Limit-on-Close Orders

| Nasdaq Timeline for On-Close Orders | |
|---|---|
| Prior to 3:50 p.m. ET | ▪ Nasdaq accepts MOC and LOC orders |
| 3:50 p.m. ET | ▪ Nasdaq continues accepting MOC and LOC orders; however, they cannot be canceled or modified (EXCEPT for legitimate errors) |
| 3:55 p.m. ET | ▪ Nasdaq cutoff for accepting MOC orders |
| 3:58 p.m. ET | ▪ Nasdaq cutoff for accepting LOC orders |
| 4:00 p.m. ET | ▪ The Nasdaq closing process begins |

Please note, an MOC order is executed only at the price that's determined by the Nasdaq Closing Cross.

For comparison purposes, the table shown below represents the NYSE process for dealing with on-close orders:

| NYSE Timeline for On-Close Orders | |
|---|---|
| Prior to 3:50 p.m. ET | ▪ NYSE accepts MOC and LOC orders |
| 3:50 p.m. ET | ▪ NYSE cutoff for entry, modification, or cancellation of MOC and LOC orders (EXCEPT for legitimate errors) |
| 3:58 p.m. ET | ▪ NYSE cutoff for canceling MOC or LOC orders for legitimate errors |
| 4:00 p.m. ET | ▪ NYSE regular way trading ends |

On the NYSE, after 3:50 p.m., either order may only be entered on the contra side of any published imbalance for 50,000 shares or more. For example, at 3:51 p.m., if there's a published imbalance on the buy side, only MOC or LOC sell orders may be entered. From 3:50 p.m. to before 3:58 p.m., cancellations of the orders are allowed for legitimate errors only. On or after 3:58 p.m., these orders may not be cancelled for any reason.


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## Nasdaq Closing Cross Process

The Nasdaq Closing Cross establishes the Nasdaq Closing Price for a particular security. The Nasdaq Closing Cross Price is established using the following procedure:

- The system seeks a price that maximizes the shares executed for all LOC, MOC, and IO orders, as well as other executable interest.
- If more than one price still exists for the security, the cross will occur at a price that minimizes the order imbalance.
- If more than one price continues to be present, the cross will occur at a price that leaves orders unexecuted in the cross.
- Assuming more than one price is still present, the opening cross occurs at a price that minimizes the distance between the bid and ask midpoint to the inside market.
- If the price that's been established by the above process lies outside the benchmarks established by a threshold amount that's been determined by Nasdaq, the cross will occur at a price that's within the threshold amount in accordance with the above process. Nasdaq periodically establishes benchmark and threshold amounts and provides prior notice of such changes to market participants.

## The Nasdaq Official Closing Price

The Nasdaq Closing Cross takes place at 4:00 p.m. and establishes the Nasdaq Closing Price. All quotes and orders that participate in the closing cross occur anonymously and are reported in accordance with the National Market System Plan. When the Closing Cross has been completed, any MOC, LOC, or IO orders that are not executed in the Closing Cross are cancelled. Orders executed after 4:00 p.m. are appended with the .T modifier indicating that the execution occurred outside of normal market hours.

Auxiliary procedures may be implemented based on the decision of the President of Nasdaq, or any Executive Vice Presidents designated by the President, when significant increases in volume are expected to occur at the close that may jeopardize a fair and orderly market.

It's Nasdaq's responsibility to notify market participants in advance of any alternate procedures being implemented. The following auxiliary procedures are available:

- The order-entry period for LOC, MOC, and IO orders may be set to an earlier time, but may end no earlier than 3:40 p.m.
- The period for modifying or canceling LOC, MOC, and IO orders may be set to an earlier time, but may end no earlier than 3:40 p.m.
- The period for the display of the order imbalance indicator may be set to an earlier time, but may end no earlier than 3:40 p.m. The frequency of the display of imbalance indicators may also be adjusted.
- The threshold values described in the Nasdaq Closing Cross process may be adjusted by no more than 20%.

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## The Nasdaq Halt/IPO Cross

The Nasdaq Halt/IPO Cross works in a manner that's similar to the Nasdaq Opening Cross. In the case of a trading halt, the Nasdaq Halt Cross seeks to maximize the shares traded at a price nearest the last execution price of the stock prior to the halt. For a stock that's not yet begun trading for the day, the halt cross seeks to maximize shares executed at a price nearest the stock's previous day's closing price. In the case of an IPO halt, the Nasdaq IPO Cross seeks to maximize shares crossed at a price nearest the issuer's IPO price.

Eligible interest during the Nasdaq Halt/IPO Cross includes any quotations or orders with the time-in-force designations—SIOC, SDAY, SGTC, MIOC, MDAY, MGTC, SHEX, or GTMC.

During the Nasdaq Halt/IPO Cross, the order imbalance indicator is sent every one second from the beginning of the display-only period through the resumption of trading. The display-only period is the period during a Nasdaq Halt in a security when market participants are permitted to enter quotes and orders prior to the termination of the halt and the release of the stock for trading.

When the Nasdaq Halt/IPO Cross price has been established, and less than all of the eligible open interest would be executed, remaining orders are executed at the Nasdaq Halt/IPO Cross price in price/time priority.

## The Nasdaq Imbalance Cross

The process that's used for the Halt Cross is also used for the Imbalance Cross. The term "imbalance" refers to the number of shares that are eligible for execution at a given time (referred to as the Eligible Interest) that cannot be matched with other order shares at a particular price at any given time. The Nasdaq Imbalance Cross process is used to determine the following:

1. When the market for a Nasdaq security is no longer trading in an orderly fashion, and
2. The price at which Eligible Interest will be executed in order to restore orderly trading

## Voluntary and Excused Withdrawals

A Nasdaq or ADF market maker may terminate its registration in a security by withdrawing its quotes in a Nasdaq security at any time on a voluntary (unexcused) basis. However, that market maker may not reregister as a Nasdaq market maker in that security for 20 business days. In the case of an unexcused withdrawal from quoting a CQS security, the market maker may reregister after only one business day.

A market maker may apply to Nasdaq Market Operations for excused withdrawal status under the following circumstances:

1. An excused withdrawal for up to five business days may be granted for circumstances beyond the market maker's control (such as damage from a severe storm or a sudden illness).
2. Withdrawals of up to 60 days may be granted for legal or regulatory reasons, if supporting documentation is provided and the condition is not permanent in nature. For example, the market maker may have come into possession of insider information about an issuer and may not trade the issuer's equity securities while in possession of that information until the information is released to the public.


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3. Excused withdrawal status for religious holidays may be granted, but application must be made one business day in advance and must be approved by FINRA.
4. Small firms (defined as market makers with three or fewer Level 3 terminals) may have difficulty because of vacations by key personnel. Excused withdrawals due to vacations may be granted if application is made one business day in advance and includes a list of securities for which withdrawal is requested.
5. Market makers that are participants in a securities distribution are covered by special rules that were described earlier.
6. If a firm fails to maintain a clearing relationship with a registered clearing agency or a member of a clearing agency (and is thereby not participating in TRF), it may reenter quotes after reestablishing a clearing relationship. However, if the market maker's failure to maintain a clearing relationship is voluntary, its withdrawal is considered voluntary, not excused.
7. If a firm has a fail to deliver in a threshold security at its clearing firm for a period of 13 continuous settlement days, and the security cannot be borrowed in order to effect short sale transactions as a part of bona-fide market making, the firm qualifies for an excused withdrawal.

Excused withdrawals will NOT be granted because of pending news about an issuer or because of price changes or a sudden influx of orders. Following an excused withdrawal, a market maker could reregister in the same manner as its original registration. The new registration becomes effective on the same business day that it's entered.

**Accidental Withdrawals** There have been cases where a firm has inadvertently withdrawn from making a market in a security because a person typed in the wrong symbol when communicating a withdrawal that was intended for another security. A market maker can be immediately reinstated in such a situation if (1) it notifies Nasdaq Market Operations within one hour of the withdrawal and follows up with written notification, (2) it's clear that the withdrawal was inadvertent and not an attempt to avoid market-making obligations, and (3) the number of reinstatements per year is acceptable. From two to six inadvertent withdrawals is considered acceptable, depending on the number of markets for which the firm makes. Consideration will also be given to how similar the correct and incorrect symbols were.

# Short Sales and SEC Regulation SHO

Historically, short selling has been associated with certain kinds of fraudulent and manipulative activity. For this reason, it's subject to special regulations. Technology has had an enormous influence on the evolution of the markets and regulators have been forced to reevaluate long-standing regulations regarding short sales. Some of the specific issues that have led to these changes include uncovered short selling in the Nasdaq market, decimalization, and securities futures trading. In late 2004, the SEC adopted Regulation SHO to modernize and update old rules that regulated short sales.

Regulation SHO applies to equity securities and any security that's convertible into an equity security (e.g., convertible bonds). Under Regulation SHO, there are several rules regarding short sales.

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## SEC Rule 200 – Definitions and Order Marking

Rule 200 updates regulations regarding a person who is determined to own a security, and when a broker-dealer is determined to own a security, although it may not be net long. Under this rule, a person is also considered an owner of a security if he has purchased the security or entered into an *unconditional* and *binding contract* (on both parties) to make the purchase, but has not yet received the security. A person is also considered an owner of a security if he holds a security futures contract to purchase the security, and has received notification that the position will be physically settled and he will receive the underlying security.

According to Rule 200, a broker-dealer must aggregate all of its positions in a security to determine its net position, except in instances where the broker-dealer qualifies for independent trading unit aggregation. Under this exception, in order to determine its net position in a security, each *independent trading unit* must aggregate all its positions. A firm qualifies for this exception if the following criteria are met:

- The broker-dealer has a documented organization plan that identifies each aggregation unit with specified trading objectives and supports its independent identity.
- At the time of each sale, each aggregation unit of the firm determines its net position for every security that it trades.
- All traders in an aggregation unit must follow the trading objectives or strategy of that unit and may not coordinate the strategy with another aggregation unit.
- Individual traders may be assigned to one aggregation unit at any time.

The *order marking requirement* is part of SEC Rule 200 and requires a broker-dealer to mark all orders either long or short. This applies to equity securities that are traded over-the-counter, on Nasdaq, or on any exchange.

- **Long** – The seller owns the security being sold and it's either in the possession or control of the broker-dealer or it's reasonably expected that the security will be delivered by no later than the settlement day.
- **Short** – The seller owns the security being sold, but doesn't reasonably believe that it will be in the possession or control of the broker-dealer prior to the settlement day, or the seller doesn't own the security being sold, or any sale that's effected by the delivery of a borrowed security.

## SEC Rule 201 – Circuit Breakers

This rule requires a trading center (as defined in Regulation NMS) to restrict short selling if a covered security declines by 10% or more from the prior trading day's closing price. A covered security is defined as any NMS security that's listed on the NYSE, Nasdaq, or the NYSE American. The rule doesn't apply to securities that are quoted on the OTCBB or OTC Pink Marketplace.

The restriction applies to the display and execution of short sales and is applicable during the remainder of the trading day through the next business day. The 10% decline is measured against the end of the previous day's regular trading hours. For example, on Tuesday, if MAXX closed at $30, but the stock is trading at a price of $27 on Wednesday (a $3.00 decline, or 10%), the restriction will be in effect on Wednesday and Thursday.


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It's important to remember that this restriction only takes place if an NMS security declines by 10% or more. If the security continues to fall, the circuit breaker could be retriggered and the restriction could extend beyond two business days.

If the restriction is in place, a trading center must have relevant policies and procedures that prevent the display or execution of a covered security, except at a price above the current national best bid. For example, if the circuit breaker is in effect and the current national bid is $26.75, a short sale is permitted only at a price above $26.75. The SEC did not specify a minimum price increment above the national best bid; instead, it relies on the current minimum price increment under Reg. NMS Rule 612.

## Short Exempt

A broker-dealer is permitted to mark an order ticket *short exempt* under one of two conditions:

1. If the order is priced above the national best bid at the time it's submitted (described previously)
2. If the order meets one of the exceptions specified in Rule 201 that's listed below

## Exceptions to Rule 201

- A sale by a person who is the owner of the security and will deliver the security as soon as all restrictions are removed
- Odd lot transactions by a market maker
- Domestic or international arbitrage
- A short sale by an underwriter who is effecting the transaction in connection with an overallotment
- A riskless principal transaction by a broker-dealer that's executing the transaction of a customer long sale, provided certain conditions are satisfied
- Volume Weighted Average Price (VWAP) transactions

The exceptions may differ from many previous SEC price test rules, whereas there's no exception for bona fide market-making activities.

## SEC Rule 203 – Borrowing and Delivery Requirements

Under Rule 203, in instances in which a broker-dealer knows or should have known that the sale of an equity security is marked *long*, it must make delivery by the settlement date. The broker-dealer may not use borrowed securities to make delivery; however, there are three exceptions to this rule.

**Exceptions** A broker-dealer is permitted to use borrowed securities to make delivery when:

- The broker-dealer is lending a security to another broker or dealer
- The broker-dealer knows or has been led to believe that the seller owns the security being sold and will deliver the security by the scheduled settlement date, but the seller fails to deliver
- Before a loan arrangement for a security to make delivery or before a fail to deliver, an exchange or a securities association discovers that the sale originated from a good-faith mistake, although the broker-dealer used due diligence regarding the sale, and the requirement of a buy-in would create an undue hardship, or the sale had been effected at an unacceptable price

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**Locate Requirements** Under Regulation SHO, a broker-dealer may not accept a short sale order in an equity security from another person or effect a short sale in an equity security for its own account unless it's located the security to be borrowed. This requirement protects against uncovered short selling abuses as well as a failure by a broker-dealer to deliver securities by settlement date. The following conditions must be met by the broker-dealer:

- The broker-dealer has borrowed the security or entered into an arrangement to borrow the security.
- The broker-dealer reasonably believes that it can borrow the security for delivery on the date delivery is due.

The broker-dealer executing a short sale transaction must document either of the aforementioned conditions that apply.

In order to aid in the process of locating securities, the SEC has accepted the use of *Easy to Borrow* lists. These lists, which must be less than 24 hours old, provide *reasonable grounds* for belief that a security on the list will be available to be borrowed. The securities on the list must be readily available to avoid fails to deliver. Essentially, the use of an Easy to Borrow list expedites the fulfillment of the locate provision.

*Exceptions* There are exceptions that allow a broker-dealer to forgo the requirements regarding the acceptance of short sales for its account or for the account of another person. These exceptions apply:

- When Broker-Dealer A has accepted a short sale from Broker-Dealer B. Broker-Dealer B must meet the requirement regarding the acceptance of short sales for its account or the account of another person —unless Broker-Dealer A, that's seeking to use this exception, has a contractual responsibility to comply.
- To the sale of a security on behalf of or by a person who has been determined to be the owner of such security and the broker-dealer has been informed that the person will deliver the security when all possible restrictions on delivery have been removed. If the person doesn't deliver the security within 35 days after the trade date, the broker-dealer that effected the transaction must borrow the security or buy a security that's like in kind and quantity in order to close out the position.
  - This may happen when a client owns a convertible security that's been tendered for conversion, but the underlying security cannot be physically delivered by settlement date through no fault of the customer or broker-dealer. This situation may also occur when restricted stock is sold under Rule 144, but the restricted legend cannot be removed by the settlement date.
- To short sale transactions by a market maker in a connection with bona fide market-making activities in the security for which this exception will be claimed. (This exception includes any designated market maker permitted to act as a dealer, any dealer acting as a Qualified Block Positioner, and any dealer that holds itself out as being willing to buy and sell the security for its own account on a regular and continuous basis.) A Qualified Block Positioner must be a registered broker-dealer and must be subject to and in compliance with SEC 15c3-1 (the net capital rule), and must maintain net capital of $1,000,000.
- To transactions in security futures.


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**Fail to Deliver Positions** The issues of fail to deliver positions at clearing firms have also been addressed under SEC Regulation SHO. Under the rule, if a broker-dealer has a fail to deliver position at a clearing firm in a *threshold* security for a continuous period of either 13 *settlement* days, or 35 consecutive settlement days if the security was sold under Rule 144 (settlement days are defined under the rule as business days), the broker-dealer must close out the fail to deliver immediately, by purchasing securities of a like kind and quantity. The closeout must take place on the morning of the 14th or 36th settlement date. A *threshold* security is any equity security that's registered in accordance with Section 12 of the Securities Exchange Act, or for which the issuer must file reports in accordance with Section 15(d) of the Act and:

a. There's an aggregate fail to deliver position for five consecutive settlement days at a clearing firm for 10,000 shares or more and equal to at least .5% of the total outstanding shares of the issuer
b. A self-regulatory organization (SRO) has included the security on a threshold securities list that's sent to its members

As cited in (b), SROs are responsible for the inclusion of securities on a threshold list. Surveillance of threshold securities is also maintained by the SROs from information that's provided by the National Securities Clearing Corporation (NSCC) and must be published on a daily basis. Threshold securities may include exchange-listed, Nasdaq, and OTCBB securities.

A broker-dealer that's had a fail to deliver position at a clearing firm for a continuous period of 13 settlement days in a threshold security may not accept an order to sell short that security from another person or effect a short sale for its own account without borrowing the security or entering into a bona fide arrangement to borrow the security. This requirement must be adhered to until the participant closes out the fail to deliver position with the purchase of securities of a like kind and quantity. Clients of the broker-dealer with the fail to deliver position, that rely on the broker-dealer for clearing services and market makers that generally qualify for an exception to rules regarding short sales, must also follow limitations and restrictions surrounding fail to deliver positions.

Broker-dealers with fail to deliver positions that provide clearing services for other firms may distribute portions of a fail to deliver position to its rightful firm. This can only be done if the broker-dealer can identify the account from which the fail to deliver has occurred. When this distribution is made, the requirement to close out the position is transferred to the firm that receives the allocation, rather than the broker-dealer that provides the service.

A broker-dealer may also make arrangements with another firm to purchase securities in order to close out a fail to deliver. However, the broker-dealer that has the obligation to close out the position will not be considered to have fulfilled the requirement if it knows or has reason to know that the other firm will not deliver the securities.

*Applicability* There's one condition that affects the limitations on short sales and the close-out requirement that's caused by fail to deliver positions. The obligations of a broker-dealer with a fail to deliver position in a threshold security at a clearing firm for a continuous period of 13 consecutive settlement days are not applicable to the amount of the fail to deliver in the threshold security if the equity position has been created by a registered options market maker that executed the short sale(s) to establish or maintain a hedge on options positions and was created before the security became a threshold security.

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## SEC Rule 204 – Close-Out Requirements

In order to further reduce the number of fail to deliver positions, the SEC adopted Rule 204 to Regulation SHO. Unless a certain exemption applies, broker-dealers that have a fail (as a result of not being able to deliver the equity security by the settlement date) are required to immediately purchase or borrow the security to close out the fail. If the firm is not in compliance with this rule, no short sales on this security are permitted by the broker-dealer or any broker-dealer for which this firm clears transactions unless it has borrowed or has arranged to borrow this security (pre-borrowed). This rule applies to all equity securities, whereas the 13-settlement-day rule applies only to those securities that have a large number of fails (threshold securities).

This rule requires a broker-dealer that sells an equity security to either deliver the security by settlement date (T + 2) or immediately purchase or borrow the security by no later than the beginning of trading on the next settlement day (T + 3). In Regulation SHO, the term *settlement day* has the same meaning as business day.

## Exceptions

- *Long Sales* – If the fail was a result of a long sale, the close-out requirement would be three settlement days following the settlement date (T + 5).
- *Bona Fide Market-Making Activities* – If the fail was the result of bona fide market-making activities by the broker-dealer, the close-out requirement would be three settlement days following the settlement date (T + 5). Bona fide market making include a registered market maker, an options market maker, and other market makers obligated to quote OTC equities.

In both of these situations, the broker-dealer is granted two extra settlement (business) days.

- A similar exception to Rule 203 exists if the fail was the result of the sale of a security on behalf of or by a person who has been determined the owner of such security, and the broker-dealer has been informed that the person will deliver the security when all possible restrictions on delivery have been removed. If the person doesn't deliver the security within 35 calendar days after the trade date, the broker-dealer must immediately close out the fail (on the 36th day) by purchasing securities that are like in kind and quantity. A sale under SEC Rule 144 is an example of this.

## Short-Interest Reporting

Members must maintain a record of total short positions in Nasdaq stocks in all customer and proprietary accounts. This information must be reported periodically to FINRA (currently, twice per month). All short-interest reports must be made as of the close of the designated settlement date, which is currently the 15th of the month (or the preceding business day if the 15th falls on a holiday or weekend), and as of the last trading day of the month. The report must be received at FINRA by the close of the second business day after the settlement date.

Short-interest information must also be collected and reported for listed securities. The information is reported to the firm's *designated examining authority* (e.g., FINRA).


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**Market-Maker Excused Withdrawals** Under Rule 203, a broker-dealer is required to borrow securities or enter into an arrangement to borrow securities prior to effecting a short sale for its own account or the account of a customer when there has been a fail to deliver position in a threshold security for 13 continuous settlement days at its clearing firm. Market makers are also subject to the borrowing requirement. Market makers often short threshold securities in connection with bona fide market-making activities. However, there are times when a threshold security may not be available to borrow. In this event, the market maker is permitted to make an excused withdrawal. Once the fail to deliver position is closed out, or the security becomes available, the market maker may resume its activity in the affected security.

## Nasdaq Trading Halts

Nasdaq has the authority to halt trading:

- In Nasdaq-listed securities that are traded on Nasdaq
- In other exchange-listed securities (CQS securities) that are traded on Nasdaq when a trading suspension has been imposed on the security by its primary exchange
- In an ADR that's trading on Nasdaq when a trading suspension has been imposed on the underlying security by its foreign securities exchange

Market participants cannot quote or execute any type of order in a Nasdaq security, exchange-traded security, or an ADR for which Nasdaq has imposed a trading halt, pending the release of material information. This type of trading halt may be imposed if the issuer is about to release information that could reasonably be expected to affect the value of its securities. Nasdaq issuers must notify Nasdaq of the pending release of such information. Nasdaq would then determine whether a trading halt is advisable. The purpose of a halt is to allow the information to be disseminated to the public and to give investors the opportunity to evaluate the information and consider it when making investment decisions. Nasdaq will also halt trading if there's a trade imbalance or during periods of extreme market volatility if the SEC requests it to do so.

**MarketWatch** The Nasdaq MarketWatch Department provides updates regarding the status of trading halts through the Nasdaq System and through the NasdaqTrader website. The table below identifies the codes that reflect the status of trading halts, suspensions, and Cease Trade Orders (CTOs) in Nasdaq and CQS securities:

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| CODE | DESCRIPTION |
|---|---|
| T.1 | **[Halt - News Pending]** *company symbol, name, and halt time*<br>Nasdaq issuer has an announcement that would affect the market price of the security. Trading is halted pending release and dissemination of the material news. |
| T.2 | **[Halt - News Released]** *company symbol, name, and halt time*<br>The news is in the process of dissemination in accordance with Regulation FD. |
| T.3 | **[Halt - News and Resumption Times]** *company symbol, name, and resumption time*<br>Used when adequate news coverage has occurred in accordance with Regulation FD and:<br>▪ When it has been determined that a system misuse or malfunction that caused extraordinary market activity has been corrected<br>▪ When conditions that prompted a trading halt in an exchange-traded fund (ETF) have been corrected<br><br>Prior to the resumption of trading, two times will be displayed: (1) the time when market makers may reenter quotations, followed by (2) the time that the security will be released for trading. This is referred to as the five-minute window. For example, "T.3 XYXY XY Corp. 11:15:00 a.m./11:20:00 a.m." means that market makers may resume quoting XYXY at 11:15:00 a.m., but may not resume trading until 11:20:00 a.m. Times are displayed in an hours, minutes, and seconds format (HH:MM:SS). |
| T.5 | **Single Stock Trading Pause in Effect**<br>Trading has been paused by Nasdaq due to a 10% or more price move in the security in a five-minute period. |
| T.6 | **[Halt – Extraordinary Market Activity]**<br>Used when extraordinary market activity in a security is expected to have a material effect on the security as determined by Nasdaq<br>Initiated when:<br>▪ Nasdaq has determined that the misuse or malfunction of an electronic quotation, execution, reporting, or communication system linked to Nasdaq has caused the extraordinary market activity<br>– Applies to systems that are linked to Nasdaq, a non-Nasdaq FINRA trading facility, or an exchange that's trading Nasdaq securities on an UTP basis |
| T.8 | **[Halt – Exchange-Traded Fund]**<br>A halt in the trading of an ETF for one of several reasons:<br>1. A portion of the underlying securities has ceased trading.<br>2. A trading halt has been imposed for securities equaling or exceeding 20% of the underlying index value.<br>3. Any unusual conditions that may be considered detrimental to a fair and orderly market. |
| T.12 | **[Halt - Pending Additional Information Requested by Nasdaq]** *company symbol, name, and halt date*<br>Trading is halted pending receipt of information requested by Nasdaq. |
| H.4 | **[Halt - Noncompliance]** *company symbol, name, and time of update*<br>Non-compliance with Nasdaq listing requirements |
| H.9 | **[Halt - Not Current]** *company symbol, name, and time of update*<br>Company is not current in its required filings. |
| H.10 | **[Halt - SEC Trading Suspension]** *company symbol, name, date/time of suspension, date/time suspension expires.*<br>Trading has been suspended by the SEC. |


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| | |
|---|---|
| **H.11** | **[Halt - Regulatory Suspension/Cease Trade Order]** *company symbol, name, and date/time.*<br>Trading has been suspended for regulatory reasons in conjunction with another exchange or market. |
| **D** | A security has been deleted from Nasdaq or CQS. |
| * | **Imbalance Delay** – *A delay resulting from a trade imbalance*<br>Nasdaq measures the change in the Inside Match Price from the third to the last order imbalance indicator prior to the cross, to the last order imbalance indicator prior to the cross. If the change in price has exceeded a predetermined Nasdaq price or percentage threshold, the delay will be extended for one minute. |
| **Notes:** | News codes H.4 & H.9 are activated when an issuer is not in compliance with specific Nasdaq requirements, although an SEC trading suspension or a Nasdaq trading halt has been terminated. |

| MARKET CATEGORY CODE | DESCRIPTION |
|---|---|
| **N** | Nasdaq-Listed Security |
| **C** | Exchange-Listed Security |

# Trading Halts on OTC Securities

Quotation and trading halts may be imposed by FINRA on securities that are quoted and traded over-the-counter. This includes stocks that are quoted on the OTCBB or in the OTC Pink Marketplace, as well as American depositary receipts (ADRs) that are quoted in the OTC market, and OTC equity securities that are not publicly quoted.

The circumstances under which FINRA can impose a trading halt in such securities are included in the following table:

| CODE | DESCRIPTION |
|---|---|
| **U1** | The security is listed on a foreign market or is registered with a foreign regulatory authority and the foreign regulatory authority halts trading in the stock for a regulatory reason, out of concern for the public, and not solely due to dissemination of material news, deficiencies in regulatory filings, or other operational reasons. |
| **U2** | The security is a derivative or component of a Nasdaq-listed or other exchange-listed security, and the listing exchange halts trading in the underlying security. |
| **U3** | FINRA has determined that an extraordinary material event affecting the stock has occurred or is about to occur, or there's significant uncertainty with regard to the proper clearing and settlement of the security. |

Prior to halting quotations and trading under the previous circumstances, FINRA will evaluate the information available to determine whether a trading halt is appropriate. If FINRA determines that a basis exists to impose a trading and quotation halt, it will do so by providing appropriate public notice. The halt will become effective simultaneously with the announcement.

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If FINRA issues a trading and quotation halt for an OTC security, FINRA member firms may not trade the halted security or quote it in any quotation medium. The halt will be lifted if FINRA determines that the basis of the halt no longer exists, or if the halt has been in effect for 10 business days, whichever occurs first.

### ADF Trading Halts

FINRA has the authority to halt trading on the Alternative Display Facility (ADF). Trading halts will be effected when securities have been halted in other markets for regulatory reasons. FINRA also has the authority to halt quotation activity through the ADF when it's unable to transmit real-time quotations and trade reporting. However, members are not prohibited from trading in other markets that are not halted when the ADF has system problems.

**Foreign Markets** No member firm may execute transactions for customers or for its own account (even on international markets) when the security is subject to a trading halt on a U.S. market.

## The Market-Wide Circuit Breakers

To address extraordinary volatility across the U.S. equities markets, circuit breakers were established by the NYSE for trading that occurs on the exchange. However, once the levels were created, other markets agreed to honor them. Originally, the reference index for the circuit breakers was the DJIA; however, it's now the S&P 500. The SEC approved modifications to the circuit breakers rule which applies to all National Market System (NMS) securities regardless of the exchange on which they trade. For example, if a market-wide trading halt is in effect, all NMS stocks that are listed on the NYSE and those listed on the other exchanges are required to halt trading. For any NMS stocks that trade in the OTC market, it's FINRA's responsibility to halt their trading.

| Trigger Value | Time (all times ET) | Action |
|---|---|---|
| Level 1: 7% decline | 9:30 a.m. – 3:25 p.m. | 15 minute trading halt |
| Level 2: 13% decline | 9:30 a.m. – 3:25 p.m. | 15 minute trading halt |
| Level 3: 20% decline | Any time | Trading halts for remainder of the day |

At or after 3:25 p.m. ET, trading shall continue unless there's a Level 3 halt. These levels are calculated on a daily basis and are based on the close of the previous day. For example, if the S&P 500 closed at 1,700 on Wednesday and the index declined by 119 points (a 7% decline) on Thursday at 11:00 a.m., trading in NMS stocks would halt on all U.S exchanges for 15 minutes.

### Limit Up – Limit Down (LULD)

In order to address extraordinary short-term market volatility, the SEC created individual stock circuit breakers. This is in addition to market-wide circuit breakers. The objective is preventing trades from occurring outside applicable price bands, as well as requiring exchanges and FINRA to pause trading in a stock if the price moves by more than a specified percentage (usually 5% or 10%) in a five-minute period.


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The SEC requires market centers (exchanges) to create and enforce policies and procedures that are designed to comply with LULD requirements and trading pauses. The rule applies only to NMS securities (which include exchange-traded funds).

**Price Bands** The price bands that are established under LULD are set at a percentage above and below the *reference price.* The reference price for each security is based on the opening price or quote on the primary listing exchange and, thereafter, on the trading that occurred over the preceding five minutes of trading. The price bands below are applicable between 9:45 a.m. (ET) to 3:35 p.m. (ET). The price bands are doubled during the first 15 minutes of trading (9:30 to 9:45 a.m.) and the last 25 minutes of trading (3:35 to 4:00 p.m.):

| Previous Closing Price | Percentage Parameters |
|---|---|
| For stocks greater than $3.00 | ▪ For Stocks in the S&P 500 or Russell 1,000: 5%<br>▪ For all other NMS stocks: 10% |
| For stock at and above $.75, up to and including $3.00 | 20% |
| For stocks less than $.75 | The lesser of $.15, or 75% |

**Regular State** When the LULD rule is applicable, trades that occur at prices that are equal to or greater than the lower price band, or equal to or less than the higher price band (within the price bands), will not affect trading.

**Straddle State** When the LULD rule is applicable, and when *one* side of the market is outside of the price bands, this refers to a situation when the NBB is below the lower price band or the NBO is above the upper price band. In this situation, only one side is executable.

**Limit State** When the LULD rule is applicable, this situation will occur if the NBB is on or above the upper price band, or the NBO is on or below the lower price band.

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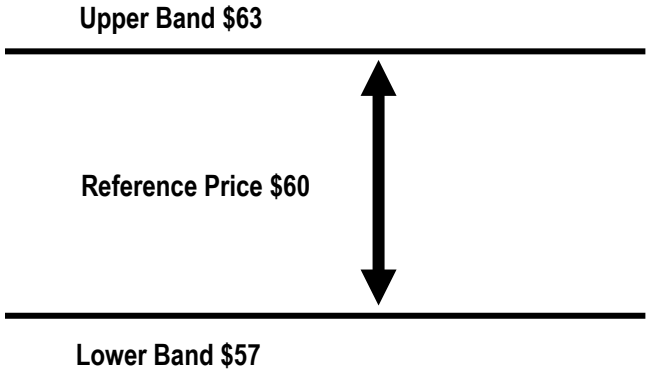
## Example

Let's assume the reference price is $60, and the pricing parameter percentage is 5% (lower band $57 and upper band $63).




No trades are permitted below $57.00 or above $63. A limit state exists if the NBO is $57 or less, or if the NBB is $63 or higher. A straddle state exists if the NBB is below $57 or if the NBO is above $63.

**Trading Pause** If the security enters the limit state and fails to move back inside the price bands within 15 seconds, the primary listing exchange will issue a five-minute trading pause in the security. The primary listing exchange is also permitted (but not required) to issue a trading pause if the security is in a straddle state. No transactions are permitted during a trading pause, but bids and offers will continue to be displayed. After the five-minute trading pause, the primary listing exchange will reopen trading using its reopening procedures and that price will be the new reference price.

# The Securities Exchange Act of 1934

The most significant federal law covering the operation of the secondary markets is the Securities Exchange Act of 1934 (the Exchange Act). While the focus of the Securities Act of 1933 is fairly narrow (the registration and sale of new issues), the Securities Exchange Act of 1934 covers many activities in the securities markets, including:

- Regulation of transactions in the secondary market, including anti-manipulation rules and regulations involving the extension of credit in securities transactions
- Registration and regulation of broker-dealers
- Oversight of industry self-regulatory organizations (SROs)
- Registration and regulation of companies that have securities trading in the secondary market, including regular financial disclosures, proxy rules, and insider reporting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Certain securities, such as U.S. government securities and municipal securities, are exempt from some parts of the Securities Exchange Act of 1934. Exempt securities are not subject to the restrictions that apply to the extension of credit, proxy solicitation, insider reporting requirements, and prohibitions against price manipulation on an exchange.

### Registration and Regulation of Broker-Dealers

Although the term broker-dealer has already been examined, let's consider how the Exchange Act defines the term:

> The term *broker* means any person engaged in the business of effecting transactions in securities for the account of others, but doesn't include a bank.
>
> The term *dealer* means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but doesn't include a bank, or any person insofar as he buys and sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.

The phrase "engaged in the business of" excludes most ordinary investors from the definition of a dealer. Most investors buy and sell securities for their own accounts, but do so as an investment, not as a regular business. On the other hand, market makers buy and sell securities as part of their regular business and are included in the definition of a dealer.

### Offerings at the Market

A member firm that's participating in the primary or secondary distribution of a security that doesn't trade on a national securities exchange may not represent that the security is being offered at the market (i.e., priced on the basis of its current secondary market value) unless the member firm has reasonable grounds to believe that an independent market for the security exists. For example, let's assume Broker-Dealer X is underwriting a new issue of Company A's stock. Some of Company A's stock already trades on the OTCBB. B/D X cannot indicate that the new issue is being priced at the market if B/D X is the only market maker in the security. Ultimately, there's no independent market in this case.

## Manipulation and Deception

Anti-manipulation rules are generally associated with Section 10 of the Securities Exchange Act of 1934. In particular, Section 10(b) prohibits the use of "any manipulative or deceptive device or contrivance" that goes against SEC rules. This very general restriction has been used by the SEC to ban a wide range of practices that are considered manipulative and to require other procedures or disclosures to prevent manipulation.

An example of such a practice is *painting the tape*, which involves small groups of investors (or market makers) trading heavily and repeatedly with each other. When these repeated transactions are reported on the Consolidated Tape or on Nasdaq, they give the misleading appearance of activity and interest in the stock.

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This is a violation of Section 10(b) of the Exchange Act. Let's consider some of the other rules that are designed to prevent deception and manipulation.

## Spoofing/Layering

Spoofing is a manipulative practice that involves bidding or offering for a stock with the plan to cancel these bids or offers prior to execution. The intent is to artificially create the appearance of buying or selling interest. The spoofer places these manipulative orders with the intention of triggering other market participants to place orders against the visible (and presumed real) buying or selling interest. This may allow a trader to get an order filled on the opposite side of the market. If the (fictitious) orders are placed at different prices with the intention to cancel, this form of spoofing is referred to as layering.

For example, a trader places a (legitimate) limit order to sell and subsequently places many (spoofing) buy limit orders at increasingly higher prices that he intends to cancel. These buy orders are designed to reflect considerable (false) buying interest and to signal to others that prices will likely increase. This false demand increases the probability that other market participants will buy the shares being offered by the spoofer. After these shares are bought, the spoofer cancels his (fictitious) buy orders. The spoofing then starts again in reverse, with the spoofer placing a (legitimate) buy order followed by several (fictitious) sell orders that he intends to cancel.

Another form of spoofing involves placing small limit orders at prices that improve the National Best Bid or Offer (NBBO) for a security, allowing the trader to take advantage of the improved prices by executing larger orders at another firm that offers execution guarantees at the NBBO. Once the larger order is executed at the artificially inflated price, the trader cancels the initial limit orders.

These activities are most often attempted by high-frequency trading (HFT) firms that use computer algorithms to enter large volumes of orders that are cancelled in fractions of a second. This conduct creates artificial market conditions that benefit the individual spoofer's interests, while harming other market participants. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act listed spoofing among its prohibited activities. Today, the SEC, FINRA, and the exchanges penalize spoofing as a form of market manipulation.

## Rule 10b-18 – Purchases of Equity Securities by Issuers

For a variety of reasons, an issuer of securities may be tempted to illegally raise the price of its own stock illegally. On the other hand, there are many legitimate reasons for an issuer to purchase its own stock in the open market, such as stock buy-back plans or funding employee stock purchase plans. To balance these legitimate interests against the possibility of manipulation, the SEC has created Rule 10b-18 to control how an issuer, or an affiliate, may buy its own stock in the secondary market.

**Safe Harbor** If the following conditions are met by an issuer, the SEC will assume that it's not trying to manipulate its own stock price. Under the rule, the issuer:

- Is permitted to use one broker-dealer during normal business hours and a different broker-dealer during after-hours' trading.
- May use one broker-dealer to place bids and make purchases during any trading session.


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- Must avoid making purchases at certain times of the day. If the securities are actively traded, the prohibition is within the last 10 minutes of the trading day. For most securities (exchange-listed and NGM), issuers cannot make purchases that are the first transaction reported that day and cannot make purchases during the last half-hour of the normal trading day.
- Must limit the bid or purchase price of securities at certain prices. The price may not be higher than the highest independent bid or the last independent transaction price, whichever is higher, for securities that are quoted or reported in the consolidated system or interdealer quotation system that displays at least two priced quotations. For all securities, purchases must be executed at a price that's no higher than the highest independent bid obtained from three independent dealers.
- Must limit the amount of stock that's purchased on any single day. The total volume on any single day may not exceed 25% of the Average Daily Trading Volume (ADTV) for that security; however, once each week, in lieu of purchasing under the 25%, the issuer may execute one block purchase if no other 10b-18 purchases are made that day. Note, the block purchase is not included when calculating a security's four-week ADTV under this rule.

Under this rule, a block purchase is defined as a quantity of stock that either (i) has a purchase price of $200,000 or more, or (ii) is at least 5,000 shares with a purchase price of at least $50,000, or (iii) is at least 20 round lots that total 150% or more of the trading volume for that security (or if trading volume data is not available, is at least 20 round lots that total $^{1}/_{10}$ of the 1% of the outstanding shares of the security, less the shares that are beneficially owned by affiliates).

Since issuer purchases can provide liquidity in periods of market turbulence, the timing and volume rule is relaxed following a market-wide trading suspension. The Rule 10b-18 safe harbor is available to an issuer that bids for or purchases its common stock either:

- From the reopening of trading to the close of trading on the same day as the imposition of the market-wide trading suspension, or
- At the next day's opening, if the market-wide trading suspension was in effect at the scheduled close of trading.

In the event that either of the aforementioned exceptions is used, the volume of purchases must not exceed 100% of the ADTV for that security. To use either of the exceptions, the issuer must still comply with the price and broker-dealer conditions described previously.

## Insider Trading

One of the most important rules under Section 10(b) of the Exchange Act is Rule 10b-5. In connection with the purchase or sale of any security, this rule makes it unlawful to:

- Employ any device, scheme, or artifice to defraud
- Make any untrue statement of a material fact or omit to state a material fact that's necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading
- Engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person

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Although this rule has been used to prohibit many types of fraudulent securities activities, one of its most important applications is concerned with insider trading. Insider trading involves the purchase or sale of securities using material, non-public information about those securities in a fraudulent manner. The SEC uses one of two theories of insider trading when prosecuting a case.

## The Disclose or Abstain Theory

This traditional theory of insider trading focuses on identifying the typical insiders, including members of a corporation's board of directors, corporate officers, and other employees who have intimate knowledge of a company's operations. A critical characteristic of these individuals is that they have a *fiduciary duty* (one of trust) to the company's shareholders. If they have inside information, they must either *disclose* the information to shareholders and the public or *abstain* from trading on the information. Failure to follow this rule is a breach of the insider's fiduciary duty, which is considered fraudulent.

The disclose or abstain theory is well-established and accepted by the courts. Over the years, the only change that's been made is that the circle of insiders who are covered by the rule has expanded. For example, some persons that are not permanently associated with a company might become *temporary insiders*. Some examples includes attorneys, accountants, M&A advisers, and investment bankers that receive sensitive information about a company while working on a financing deal. Each of these persons are bound by the disclose or abstain principle when acting on behalf of a company.

**Tippers and Tippees** In some situations, material, non-public information is passed from one person (the tipper) to another person (the tippee), with the tippee then trading on the information. If the tippee knew—or should have known—that the information was confidential, both the tippee *and* the tipper may have violated insider trading rules. For instance, let's assume that a member of a corporation's board of directors tips off a relative about a pending takeover involving the corporation. If the relative trades on the information, it's likely that this violates the Exchange Act.

## The Misappropriation Theory

A second theory involving the illegal nature of insider trading is the misappropriation theory. As in the disclose or abstain theory, a violation occurs because a person is trading on material, non-public information in a fraudulent manner. However, in the misappropriation theory, the person trading on the information (the trader) is a corporate outsider. The trader often has no direct connection with that company's shareholders and no fiduciary duty to them. The trader has obtained information involving the securities that were bought or sold from some other source, often the trader's employer. The trader is expected to keep the information confidential and not use it for personal reasons. The failure to maintain confidentiality is considered fraud.

> *Example: Let's assume that a broker-dealer's research department creates reports for its retail clients. These reports can often cause a stock's price to move significantly. It's likely that the broker-dealer has a policy that strictly prohibits the use of this information by its representatives prior to its release. If a representative personally used this information or tipped others to do so before it became public, the representative would have misappropriated information that rightfully belongs to the broker-dealer for personal use. There's a strong likelihood that the SEC would view this as insider trading.*


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## Important Insider Trading Legislation

The 1980s brought renewed congressional interest in insider trading in light of several high-profile cases. Some of these situations involved broker-dealer employees. The regulatory response to these cases was the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).

**Liability of Controlling Persons** ITSFEA made it clear that sanctions can be applied to a person who directly or indirectly controls another person who violates insider trading rules. For example, a broker-dealer can be fined if an investment banker engages in insider trading. (This is in addition to any sanctions levied against the violator.) The penalties for the controlling person can be a fine of up to the greater of $1 million or three times the amount gained (or loss avoided) by the trader. These penalties can be applied even if the controlling person didn't profit from the transactions.

**Establishment of Procedures** ITSFEA required broker-dealers to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the broker-dealer's business, to prevent the misuse of material, non-public information by the broker-dealer or any associated person.

Broker-dealers must not only create such written policies, they must ensure that they implement them. A broker-dealer with a written, well-thought-out system of procedures to prevent insider trading can still be subject to SEC penalties if it fails to follow through on the procedures. These procedures should contain several key elements, including:

- A system for monitoring employees' personal trading and trading in firm proprietary accounts
- Restriction or monitoring of trading in securities where the firm has access to inside information (e.g., watch lists, restricted lists)
- Procedures to restrict access to files that contain confidential information, including the establishment of information barriers (see below)
- Education of employees regarding insider trading issues

**Consequences of Insider Trading Violations** Violations of insider trading rules by broker-dealer employees can have serious consequences for both the individual *and* the firm.

*Civil Penalties* Insider trading violations may result in civil penalties of up to three times the amount of gain, or loss avoided, in the transactions. The SEC may also demand disgorgement of profits (i.e., the insider is required to give up the earned profits).

*Criminal Penalties* ITSFEA substantially increased the criminal penalties for violations of the Exchange Act, including insider trading. An individual is subject to fines of up to $5 million and/or imprisonment for up to 20 years, for each violation. Corporations and other non-natural persons may be fined up to $25 million per violation.

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## Information Barrier Procedures

An information barrier consists of a set of procedures for preventing the transmission of confidential information from one department to another within a broker-dealer. These barriers are sometimes physical, and sometimes procedural.

For firms that have access to confidential information, the importance of implementing adequate information barrier procedures cannot be overstated. The SEC hasn't mandated any particular system in order to account for the differences in the way various broker-dealers operate.

However, this also means there's no safe harbor for a firm's information barrier procedures—the burden is on the firm to show that the procedures are adequate. To assist the firms in creating acceptable systems, the NYSE and FINRA issued a joint memorandum which describes some of the elements that information barrier procedures should generally have. These elements include the following:

1. Broker-dealers should have *written* information barrier procedures and should document any actions that are taken under them. A haphazard collection of memos and ad hoc policies is not acceptable. To satisfy the SEC, firms must maintain documentation that's sufficient to recreate actions which are consistent with Information Barrier procedures.
2. Firms that conduct investment banking, research, or arbitrage activities must maintain some form of a *watch list* and a *restricted list*. A restricted list contains securities in which proprietary, employee, and certain solicited customer transactions are limited or prohibited. Securities on a watch list (often referred to as a *gray list*) are usually not subject to restrictions, but trading in them is subject to closer review. The identity of securities on the watch list is known only by selected compliance and/or legal department personnel. Criteria for adding or deleting securities from these lists should be part of a firm's written procedures.
3. When a department has material, non-public information, interdepartmental communications involving that area should be carefully supervised. Procedures should typically include physical separation of departments and segregated recordkeeping systems. Traditionally, firms have been concerned with isolating their investment banking area from trading and sales departments. However, the research department may also need to be isolated to prevent another department from trading ahead of research reports that are released to customers.
4. A firm should provide training to its employees to ensure that they understand federal, state, and SRO rules on insider trading, as well as the firm's own policies and procedures. Employees should also be informed promptly of any changes or updates to information barrier procedures.

Ineffective or non-existent information barrier procedures can create serious problems for a broker-dealer. Without effective information barrier procedures, the SEC assumes that inside information which is known by one person in a brokerage firm is known by all. This could cause restrictions on trading activity because of the information that's known by the investment banking department.


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# Chapter 5

# *Order Handling Rules*

# Introduction

Member firms are often subject to different rules when dealing with customers than when dealing with other member firms. Also, it should be noted that in the following rules, institutional customers are occasionally treated differently than retail customers. Even the definition of institutional customer can vary from rule to rule.

# Order Tickets

The regulators have placed increased emphasis on the paper trail that tracks the life of an order (although much of that paper trail is becoming electronic). One of the most important documents in that trail is the order memorandum, also referred to as the order ticket.

## Components of an Order Ticket

Although the order tickets that used by different broker-dealers may not all look the same, they have many common elements. The information listed below will summarize those items.

**Buy or Sell** Generally, firms have different tickets, which are also printed in different colors, for purchases and sales. Buy and sell order tickets will often have similar information; however, there are some important differences. In particular, sell tickets must be marked *long* or *short* (except for debt securities). A ticket must also be marked *short exempt* if the circuit breakers are in effect as described in Regulation SHO Rule 201.

When determining whether a short sale has occurred, FINRA rules rely on the SEC's definition—any sale of a security that the seller doesn't own or any sale that's consummated by the delivery of a security borrowed by, or for the account of, the seller. On the other hand, a person is considered to *own* a security if any of the following conditions apply:

1. The customer or the customer's agent has title to the security.
2. The customer has purchased the security, or has entered into an unconditional contract which is binding on both parties, to purchase the security, but has not yet received it.
3. The customer owns another security which is convertible into it or exchangeable for it and has tendered that security for conversion or exchange.
4. The customer has an option to purchase or acquire the security and has exercised the option.
5. The customer has rights or warrants to subscribe to the security and has exercised those rights or warrants.

Broker-dealers and their customers are considered to own securities only to the extent that they have a *net* long position in a security. For example, if a customer has two accounts, one with a 1,000-share long position in a stock and another with a 1,500-share short position in that same stock, the customer has a net short position of 500 shares.

**Account Number/Name** The name of the customer is not always sufficient for identification purposes. The customer may have more than one account, or may have the same name as another customer.

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If the person entering the order is not the person whose name is on the account, that person's name should also be entered on the ticket. This is also true for corporate accounts, especially those in which more than one person is named on the corporate resolution.

**Terms and Conditions** If no price or other terms are indicated, the order is assumed to be a market order. Qualifications that may be imposed on the order include the following:

- Price (limit)
- Stop or stop-limit
- GTC (otherwise the order is assumed to be a day order)
- At-the-close or opening
- Not-held
- All-or-none (not permitted for some types of orders/markets)
- Fill-or-kill
- Immediate-or-cancel
- Do-not-reduce/do-not-increase
- Special settlement (cash, seller's option)
- Solicited or unsolicited

**Entry/Execution Information** The order ticket must include the time that the order was entered and, to the extent feasible, the time of execution. This is usually accomplished by time-stamping the ticket. The price of execution must also be included on the document.

**Discretionary Order/Discretion Not Exercised** If the client has granted discretionary authority to the registered representative, this should be indicated for each order. It's important to check off *discretion not exercised* if that was the case, since this indicates that the customer consented to that specific trade. (Note, this is *not* the same as indicating that the trade was unsolicited.)

## Additional Information

The preceding information represents the minimum items that must be recorded on a ticket. In some circumstances, additional information should be included, especially any details that may be considered part of the order's *terms and conditions*, such as the following examples:

1. If an order has been *stopped*, this should be indicated on the ticket. An order is stopped if a trader guarantees an execution, usually at the current market, while attempting to obtain price improvement on the order.
2. Not-held orders are those in which the customer gives the executing broker-dealer discretion with respect to time and/or price. This indication on the ticket is important, since not-held orders are not protected under the Manning Rule (described later in this chapter).
3. If a customer requests that an order, which would otherwise be subject to the SEC Order Handling Rules (also described later in this chapter), not be displayed, it's prudent to note this request on the order ticket.
4. If an order is canceled, this should be noted along with the time the of cancellation.


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The ticket for a canceled order should not be discarded; instead, it must be retained in the same manner as an order that's been executed.

## Adjustment of Open Orders

FINRA members that hold open orders for customers or other broker-dealers must adjust those orders on any ex-dividend date for that security, in a manner that's similar to the adjustments being made by exchange designated market makers. If the member is holding a buy limit, sell stop, or sell stop-limit order, it must subtract the dividend from the price of the order and round the result down to the next lower quotation variation in the security's primary market. The minimum variation for Nasdaq and OTCBB securities is $0.01.

> *For example, a broker-dealer is holding a buy limit order at 24 for Oldline Corporation common stock, a Nasdaq security. Oldline stock has announced a 52.5 cent cash dividend. On the ex-date, the broker-dealer will subtract $0.525 from 24 and round the result ($23.475) down to the nearest one cent. Therefore, the buy limit order is adjusted to 23.47.*

Open orders are also adjusted proportionately for stock dividends or splits. However, in the case of a reverse split, all open orders are to be canceled. The adjustment rule doesn't apply to:

- Orders that are governed by exchange rules
- Orders that are marked "do not reduce" (DNR) or "do not increase" (DNI)
- Sell limit, buy stop, or buy stop-limit orders

## Adjustment of Open Orders and Quotes

In response to an issuer's corporate actions (e.g., dividends and stock splits), the Nasdaq Market Center Execution System will take the following actions concerning adjustments for open orders and quotes:

- All bid and offer quotes are purged from the system (not adjusted downward)
- All orders are cancelled in the event of a reverse stock split
- Sell orders will not be adjusted automatically by the system and should be modified by the market participant that entered the order

Depending on the corporate action taken by the issuer, buy orders will automatically be adjusted by the system. For a cash dividend, unless an order is marked "DNR" (do not reduce), the order is adjusted downward by an amount that's enough to cover the cash dividend.

# The SEC Order Handling Rules

In September 1996, the SEC passed a series of new regulations which affected the treatment of customer orders. These rules have become known as the *SEC Order Handling Rules* or the *SEC Order Execution Rules*. Although the new rules cover both listed and Nasdaq stocks, they have had a much greater impact on the OTC market. The Order Handling Rules consist of several regulations plus some amendments to existing rules. The two most important aspects of these changes are the Limit Order Display Rule and the ECN Amendment.

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Under Regulation NMS, the Limit Order Display Rule is referred to as Rule 604 (Display of Customer Limit Orders) and the ECN Amendment is considered Rule 602(b)(5).

## The Limit Order Display Rule

Of all the changes, this rule has likely had the greatest impact on individual customer orders and on the operation of the Nasdaq Stock Market as a whole. Prior to the SEC Order Handling Rules, Nasdaq quotes represented only the prices at which market makers were willing to buy or sell in transactions that were executed with each other. For example, let's assume that the quotes for ABCD stock on Nasdaq are as follows:

| ABCD | | | |
|---|---|---|---|
| **Inside** | 20.00 | 20.25 | 10 x 10 |
| **MM 1** | 20.00 | 20.35 | 10 x 10 |
| **MM 2** | 19.90 | 20.25 | 10 x 10 |
| **MM 3** | 20.00 | 20.35 | 10 x 10 |

These quotes represent prices at which Market Makers 1, 2, and 3 are willing to trade for their own accounts with other broker-dealers. Customer orders didn't need to be reflected in these quotes. For example, if Market Maker 1 accepted a limit order from a customer who was willing to buy 200 shares at 20.10, it wasn't required to change its quote to reflect the customer interest. In addition, most market makers felt that they were obligated to execute this order only if the inside offer price fell to the customer's limit price (20.10 in this example).

**The Display Rule** Under the new requirement, if a customer limit order is accepted by a market maker and the price on the order improves its quote, the market maker must immediately change its quote to reflect the customer's interest. Under normal conditions, the SEC interprets *immediately* to mean within 30 seconds. Abnormal market conditions that allow for some relaxation of the 30-second window include market openings (and a short period thereafter), when trading reopens after a trading halt, and when an IPO first begins trading.

To illustrate the Display Rule, consider the previous example in which Market Maker 1 accepts a customer limit order to buy 200 shares at 20.10. Within 30 seconds, MM 1 must change its quote to 20.10 – 20.35, 2 x 10.

| ABCD | | | |
|---|---|---|---|
| **Inside** | 20.10 | 20.25 | 2 x 10 |
| **MM 1** | 20.10 | 20.35 | 2 x 10 |
| **MM 2** | 19.90 | 20.25 | 10 x 10 |
| **MM 3** | 20.00 | 20.35 | 10 x 10 |

Notice that the inclusion of the customer's order in MM 1's quote also changed the inside market, thereby narrowing the spread. A customer limit order will not always tighten the spread, but market makers must still include it in their quote.


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For example, suppose that Market Maker 2 now receives a customer limit order to buy 500 shares at 20. MM 2 must reflect that customer order in its quote immediately. The market will then appear as follows:

| ABCD | | | |
|---|---|---|---|
| **Inside** | 20.10 | 20.25 | 2 x 10 |
| **MM 1** | 20.10 | 20.35 | 2 x 10 |
| **MM 2** | 20.00 | 20.25 | 5 x 10 |
| **MM 3** | 20.00 | 20.35 | 10 x 10 |

Although MM 2's customer order didn't change the inside market, MM 2 must still reflect it in its quote.

Note that a market maker is not *required* to accept customer limit orders. The Display Rule applies only *if* limit orders are accepted.

**Size** Another aspect of the Display Rule requires market makers, in some circumstances, to also change their quotes to reflect the size of a client's order. If the market maker is already at the inside market and it accepts a customer limit order that's also at the inside, it must change its size to reflect the customer's interest. However, if the size of the customer's order represents 10% or less of the market maker's size, the market maker is not required to change its quote due to the de minimis exemption.

> *For example, let's assume that the inside market for GPKK stock is 15.40 –15.50, 10 x 10 and MM 1's quote is 15.40 –15.55, 10 x 10. The market maker accepts a customer a limit order to buy 200 shares at 15.40. Although the customer's order doesn't cause MM 1 to change its bid price, the market maker must change its size to 12 by 10 to reflect the customer size at the inside bid. However, if the customer's order had been for only 100 shares, MM 1 wouldn't have been required to change its size, since the 100 shares would be de minimis (10% or less).*

Please note, if another customer submits to Market Maker 1 an order to *sell* 200 shares at 15.55, MM 1 is not required to change its offer size, since its offer price of 15.55 is not the inside offer.

In some cases, a market maker will need to adjust its size because the inside market moves to its bid or offer. For example, let's assume that a market maker is quoting a stock at 19.65 – 20.00, 10 x 10 when the inside market is 19.65 – 19.90. The market maker is holding the following three customer orders to sell:

- 1,000 shares at 20.00
- 500 shares at 20.00
- 2,000 shares at 20.00

Notice that, although the MM has reflected the price of the customer orders in its quote as required by the Display Rule, it doesn't need to reflect the aggregate size of those orders since its offer is not at the inside. However, if the inside market changes to 19.65 – 20.00, then the MM must immediately update its size to at least 3,500 shares to reflect the aggregate size of the customer orders, since its offer is now at the inside.

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**Exceptions** As is the case with many industry rules, the Display Rule has exceptions. For example, occasionally a customer may not want an order displayed as part of a market maker's quote, particularly if it's a large order. In such cases, the customer may request for the order not to be displayed. A customer may also give a broker discretion as to whether or not to display its orders. However, this exception must be applied carefully, since the SEC has warned that no-display requests must be individually negotiated with customers. Standardized disclaimers or contractual language in broker-dealer new account agreements are not considered to be an individual no-display request by a customer.

Other exceptions include the following orders:

- Block-size orders (at least 10,000 shares or $200,000 in market value)
- Odd-lot orders
- All-or-none orders
- Orders being sent to another market or broker-dealer that complies with the Display Rule
- Orders being sent to an ECN that complies with the ECN Display Alternative (see below)
- Orders that are executed immediately upon receipt

In addition, a market maker is not required to display orders that would lock or cross the market without making a reasonable effort to execute the quote that would be locked or crossed. This rule also applies to ECNs whose quotes appear on Nasdaq.

## The ECN Amendment

Another part of the SEC Order Handling Rules is the *ECN Amendment*. ECNs are electronic communication networks, which were described previously. Prior to the Order Handling Rules, the use of ECNs by market makers, along with the Nasdaq system, created *hidden markets*. In other words, market makers would often quote better prices in ECNs than they were quoting on Nasdaq. Unless a person subscribed to the ECN, this disparity would go unknown. Now, the ECN Amendment prohibits this practice.

If a market maker quotes a better price in an ECN than what appears on Nasdaq, it must update its Nasdaq quote to reflect the improved price. However, a market maker is not required to display on Nasdaq the full size of a better-priced order in an ECN.

For example, let's assume that a market maker's Nasdaq quote for a stock is 20.00 – 20.25, 10 x 10, with 1,000 shares being the minimum quote size for that stock. The MM then places a buy order in an ECN at 20.10 for 2,000 shares. At this point, it must update its Nasdaq quote to 20.10 – 20.25, 10 x 10; however, it could choose to display 20 x 10 instead.

**The ECN Display Alternative** As an alternative to changing its own Nasdaq quote once it enters a better quote in an ECN, a market maker can satisfy the rule by using a *qualifying ECN*, also referred to as a *linked* or *eligible* ECN.


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A qualifying ECN must meet two conditions:

1. The best price in the ECN must be communicated by the ECN to Nasdaq. (This quote will show up in the Nasdaq montage by the ECN quoting through the ADF or an SRO trading facility.)
2. The ECN must permit access to such orders by other market makers and dealers that are not subscribers to the ECN.

This arrangement is referred to as the *ECN Display Alternative* and it permits market makers to anonymously enter better quotes in an ECN while at the same time informing the entire market that these better prices are available. Note that to use the ECN Display Alternative, the *full* size of the ECN order must be displayed, unlike the example above in which the market maker updates its own Nasdaq quote after placing a superior price in an ECN.

# Prohibition Against Trading Ahead of Customer Orders

FINRA considers it a violation of just and equitable business practices for member firms to *trade ahead* of customer orders. The interpretation that describes this prohibition is often referred to as the *Manning Rule.* The rule applies to both exchange-listed securities (NYSE and Nasdaq) and OTC equity securities.

## Basic Requirements

If a market maker accepts an order from either a customer directly or from another broker-dealer that's acting on the customer's behalf, it must *protect* the order. This means that the executing broker-dealer may not compete with that order on a proprietary basis by virtue of its position within the market. Simply stated, the market maker must immediately execute the customer's order at the time it executes an order for its own account that would have filled the customer order. For purposes of the rule, *immediately* generally means within *60 seconds* of an execution for the firm's account.

> *For example, the inside market for a Nasdaq stock is 10.00 – 10.25 and a market maker is holding a customer limit order to buy 1,000 shares at 10.00. If the market maker buys 1,000 shares for its own account at 10.00, it must immediately fill the customer's order at 10.00 as well.*

Unless an exception applies, a member firm that accepts and holds a customer order (limit or market) in an equity security from either its own customer or a customer from another broker-dealer is prohibited from trading for its own account at a price that would satisfy the customer order. In other words, a firm must do for its client at least what it did for its own account. However, the member firm may execute an order for its own account at the same price if it immediately executes the customer's order up to the same size at the same or a better price.

The rule doesn't apply to *not held* orders in which customer has given discretion as to the price and/or time of order execution. For entry purposes, the order ticket must be marked "not held" or NH. For limit orders that are not marked "not held," the orders are considered held limit orders which require the broker dealer to execute them without hesitation if the security is able to be purchased or sold.

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## Exceptions

There are a number of situations in which a broker-dealer that has accepted a customer limit order may trade ahead of the order including:

1. *Orders from Institutional Accounts Exception* These are defined as orders from banks, insurance companies, S&Ls, registered investment companies, registered investment advisers, or any other entities with total assets of at least $50 million.
2. *Large Orders Exception – Including Those from Retail Customers* These are defined as orders for 10,000 shares or more and a value that's greater than $100,000.

For these first two exceptions, the member firm must either provide written disclosures to the customer both when the account is opened and annually thereafter, or it must provide oral disclosures on an order-by-order basis with accompanying documentation. The disclosures must include that the firm may trade in its proprietary account at prices that would satisfy the customer's order, and must also provide the customer with an opportunity to opt-in to the protection of the rule. If a customer doesn't opt-in, the member firm may reasonably conclude that the customer has consented to the member firm trading ahead.

3. *Intermarket Sweep Order (ISO) Exception*.
4. *The No-Knowledge Exception* Provided a firm has an effective system of internal controls, such as information barriers (formerly Chinese walls) that prevent one trading unit from obtaining knowledge of customer orders of another unit, a member firm may trade at prices that would satisfy a customer's order. For example, if the market-making desk of a firm is holding a customer order, no other trading desk in that firm (such as a risk-arbitrage desk) may *knowingly* trade ahead of the customer's order. If another desk executes an order for the firm's account that would have filled the customer order, the market-making desk may owe the customer an immediate execution (a print). However, if a firm implements and uses information barriers that prevent the non-market-making desk from obtaining knowledge of customer limit orders, the other desks may continue to trade at prices that are the same or better than customer limit orders.
5. *Riskless Principal Exception* The rule doesn't apply if a firm trades for its proprietary account for the purpose of facilitating the execution of a customer order on a riskless principal basis. For example, if a firm is holding an order from a customer to buy stock at $45.00, the firm could purchase the same stock at $45.00 if the execution was to fill a riskless principal order received from another customer. To comply with this exception, the firm must submit a trade report which identifies the transaction as riskless principal and has written policies and procedures that require the customer's order to be received prior to the offsetting principal transaction. Additionally, the customer's order must be executed at the same price exclusive of any markup, markdown, or commission and within 60 seconds of the order being executed for the firm's account.
6. *Odd Lot and Bona Fide Error Transaction Exception* The obligations of this rule don't apply to any proprietary transactions for an amount that's less than a normal unit of trading (i.e., an odd-lot) or to correct a bona fide error.


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## Applications

Although member firms may limit the life of a customer's order to normal market hours (9:30 a.m. to 4:00 p.m. ET), the firm and the customer may agree to allow the processing of an order outside of normal market hours. The protections under this rule apply at all times during which the customer's order is executable by the member firm.

A member firm is required to make every effort to execute a marketable customer order fully and promptly. If the firm is holding a marketable order from a customer which has not been immediately executed, it must make every effort to cross the order with any other order that's been received on the other side of the market and at a price that's no lower than the best bid or no higher than the best offer at the time the order is received. For example, if the market is 12.30 – 12.40 and the firm is holding a customer market order to buy that's not yet been executed, the member must make an effort to cross that order with any sell order that it received at the same time and at a price no higher than $12.40.

**Partial Executions** If a firm triggers a Manning obligation, it's required to fill only as much of the customer's orders as it has executed for its own account.

> *For example, the inside market for a stock is 10.00 - 10.25 and a firm is holding a customer limit order to buy 500 shares at 10.00. If the firm receives a market order to sell 200 shares and executes the order against its own position, it must fill 200 shares of the customer's limit order at 10.00. Thereafter, it would continue to hold the customer's limit order for the remaining 300 shares.*

## Effect of the Customer Order Protection Rules

If an order is subject to the Order Handling Rules, but the customer requests that it not be displayed, the broker-dealer must still protect that order under the Manning Rule.

> *For example, a market maker is quoting a Nasdaq stock at 10.00 - 10.25, which is also the inside market. The market maker is also holding a customer limit order at 10.10, which the client has requested to not be displayed. Under the rules, the non-displayed order must be protected at 10.10.*

The fact that a broker-dealer may ultimately send an order to a qualifying ECN or another market maker doesn't relieve the firm of its Manning obligations. Even in situations in which an order has been sent away, the firm is still required to protect the order.

## Price Improvement

The SEC has stated that if a market maker is holding a non-displayed limit order that's priced better than its quote, and it then subsequently receives a customer market order on the opposite side of the market, it's *NOT* appropriate for the firm to execute the market order at its published quote and the limit order at its limit price. Instead, the broker-dealer must price-improve the customer market order to the limit order price.

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*For example, the inside market for a stock is 10.00 – 10.25 and a market maker is holding a non-displayed customer limit order to buy 1,000 shares at 10.10. The market maker then receives a market order to sell 1,000 shares. The market order must be executed at the 10.10 price of the non-displayed limit order, not the inside bid price of 10.00. The market maker may execute the market order against the limit order or against its own inventory. However, in accordance with its Manning obligation, if it executes the market order against its inventory at 10.10, it owes the limit order a fill at 10.10 as well.*

In addition to receiving orders from their own customers, broker-dealers may enter into arrangements in which they execute the orders of customers of other broker-dealers. Under SEC Order Handling Rules, if the executing broker-dealer receives orders of customers of other broker-dealers, the orders must be both protected and price-improved. The relationships in which there's crossing of customer limit orders and market orders and also required price-improvement are payment for order flow arrangements and reciprocal and correspondent arrangements. Payment for order flow (PFOF) arrangements are characterized by rebates, discounts, or the payment of cash for routing orders to another broker-dealer or exchange.

*For example, Mid-Point Securities has entered into a payment for order flow arrangement with High-End Brokerage Firm. A customer of Mid-Point enters a market order to sell a stock that's sent to High-End. High-End's quote for the stock is 12.25 – 12.30. High-End is holding a non-displayed customer limit order to buy 1,000 shares of the stock at 12.28. High-End must cross the market order and the non-displayed limit order at 12.28, rather than executing the market order to sell at the bid price of 12.25. By accepting the payment for order flow arrangement with Mid-Point, High End is obligated to provide best execution to all customer orders that are received from Mid-Point.*

If a market maker *doesn't have a relationship or an understanding* that it will provide best execution to the customer orders of another broker-dealer, then incoming market orders may be executed at the inside market price of a stock without being given price improvement. However, if the market maker is holding a non-displayed customer limit order at the time of the execution, a Manning obligation would be triggered. The non-displayed customer limit order must be executed at a price that's the same or better than the price that the market maker received for its own account.

*For example, MM 1's current quote for ABCD is 9.85 – 9.98 and it's holding a non-displayed customer limit order to sell 400 shares at 9.95. MM 1 receives a market order to buy 1,000 shares from MM 2; however, MM 1 and MM 2 don't have a relationship with one another. If MM 1 executes MM 2's order at 9.98, it must also execute its non-displayed customer limit order at 9.98 in order to avoid violating its Manning obligation.*

The price improvement standards also prescribe a minimum level of price improvement that a firm must provide to trade ahead of an unexecuted limit order. In other words, the standards impose a minimum amount by which a firm must trade *to not trigger the protections* that are imposed by this rule. The firm's trade must be higher than the price of a customer's buy limit order or less than the price of a customer's sell limit order.


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*For example, the inside market for LMNO is 11.00 – 11.15. A market maker is holding a non-displayed customer limit order to sell 1,000 shares at 11.14 and receives a market order to buy 1,000 shares. If the market maker executes the market order against its inventory at a price of 11.13, a Manning obligation would not be triggered.*

| For Customer Held Limit Orders Priced: | Minimum Required Price Improvement: |
|---|---|
| Greater than or equal to $1.00 | ▪ For NMS stocks: $.01 or<br>▪ For OTC equities: the lesser of $.01 or one-half of the current inside spread |
| Greater than or equal to $.01, but less than $1.00 | ▪ For both NMS stocks and OTC equities: The lesser of $.01 or one-half of the current inside spread |
| Less than $.01, but greater than or equal to $.001 | ▪ For both NMS stocks and OTC equities: The lesser of $.001 or one-half of the current inside spread |

For OTC equity securities that have no published inside market, a broker-dealer may calculate the inside spread by contacting a minimum of two unaffiliated dealers to obtain priced quotes and then may use the highest bid and lowest offer price to determine the spread. When determining the inside market, the broker-dealer must document the name of each firm contacted and the quotes that were received.

## Net Price Orders

The price at which a customer limit order is protected is the *reportable* price; in other words, the price reported through TRF, which is exclusive of markups, markdowns, commissions, or other charges. For example, a customer who submits a limit order to buy at 10.25 is generally protected at that price, although the customer might eventually be charged a higher net price that includes a markup or commission.

Confusion can arise if the customer wants an execution at a *net* price, inclusive of all costs. The price at which such an order is protected depends on whether the broker-dealer has reached an explicit understanding with the customer as to the sales credit or markup that will be involved.

*For example, let's assume that a customer wants to buy 1,000 shares of ABCD at 10.10 net (i.e., inclusive of all costs) and the customer is told that the firm will work for a $0.10 markup. The order will then be protected at the gross price of 10.00, the price at which the order would be reported when executed.*

In order to use the gross price as the protected price, the firm and the customer must have an understanding about the credit for which the firm is working ($0.10 in the preceding example). Without this understanding, the order must be protected at the net price.

## OTC Equity Trading Rules

Certain components of Regulation NMS (described previously) apply to OTC equity securities. Since Regulation NMS is an SEC rule, the rules are also a part of the FINRA rulebook.

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Listed below is a summary of the applicable rules:

- *Sub-Penny Quoting* – An OTC equity security that's priced at $1.00 or higher cannot be quoted in an increment smaller than $0.01(one cent). An OTC equity security that's priced below $1.00 cannot be quoted in an increment smaller than $0.0001. Since some OTC equities securities may be priced at less than $.0001, a member may accept, but not display, an order or indication of interest in an increment of $0.000001.
- *Locked and Crossed Markets* – Member firms must implement policies and procedures to reasonably avoid the practice of displaying any quotes that would lock or cross the market for an OTC equity security.
- *Access Fee Cap* – A member firm is not permitted to charge non-subscribers a fee that exceeds $.003 per share for stocks that are quoted at equal to or greater than $1.00 for purposes of accessing its quotes. For stocks that are quoted at less than $1.00, the access fee may not exceed 0.3% of the published quotation price per share.
- *Limit Order Display Rule* – An OTC market maker is required to immediately display any priced quotation in an inter-dealer quotation system (e.g., the OTCBB) which improves the market maker's quote. For purposes of the rule, the definition of the term *immediately* is as soon as practical, but no later than 30 seconds after receipt. Regulation NMS has exceptions to the display rule that are similar to those found in SEC rules, such as:
  - Orders that are executed at the time of receipt
  - Orders for which the customer requests "do not display"
  - Odd-lot and all-or-none orders
  - Orders that are sent to an ECN, national securities exchange, or another market maker that will display the order
  - Block size orders
  - Due to the lower prices of OTC equity securities, the definition of a block size order is different from the SEC rule. In this case, a block size order is defined as any order for at least 10,000 shares and a market value of at least $100,000.

# Business Conduct of Members

FINRA's most general rule on business conduct states the following:

> *A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade*.

## Best Execution

The failure of member firms to use reasonable diligence to assist customers in obtaining the best price on purchases and sales is inconsistent with just and equitable principles of trade. In ascertaining that a member firm has used reasonable diligence, the factors to consider include:

- The general character of the market for the security (e.g., the price, volatility, relative liquidity, and available communications)
- The size and type of transaction
- The number of markets checked


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- Accessibility of the quotation
- As communicated to the member, the terms and conditions of the order which resulted in the transaction

A member firm that internalizes customer order flow or routes customer orders to other broker-dealers for execution on an automated, non-discretionary basis, and doesn't conduct an order-by-order review, must have procedures in place to periodically conduct *regular and rigorous reviews* of the quality of the executions of its customers' orders. The review must be conducted on a security-by-security and type-of-order basis (e.g., limit order, market order). At a minimum, a member firm must conduct the review on a *quarterly* basis; however, the firm should consider, based on its business, whether more frequent reviews are needed.

In some circumstances, a customer (usually an institutional investor) will direct a broker-dealer to route an order to a specific market or broker-dealer for execution. In this situation, the broker-dealer is *not* subject to the best execution guidelines since the order was directed by the customer. However, if the customer instructs the broker-dealer to use another member firm for execution, the receiving (not sending) dealer is subject to the best execution guidelines.

## Interpositioning

*Interpositioning* is defined as the insertion of a third party between a customer and the best market and is generally prohibited. In fact, the practice is specifically prohibited when it's to the detriment of the customer.

> *For example, a broker-dealer receives an order from a customer to buy 100 shares of XYZ at the market. The best offer of any market maker is $40. Rather than buying directly from the market maker, the broker-dealer interposes another firm that buys the stock at $40 and then sells it to the member firm at $41. The member firm ultimately sells the stock to the customer at $42 and the two firms share the one-point extra markup that was charged to the customer.*

Keep in mind, interpositioning is not prohibited if a member firm is able to demonstrate that an execution was advantageous to its customer as a result of the intervention of a third party (e.g., the use of a broker's broker). This may occur when an order is crossed with a retail order from another firm or when the member firm determines that the market might be adversely affected (to the detriment of the customer) due to the disclosure of the identity of the member firm. An order may also be channeled through a third party if (1) that party is an established correspondent, (2) if the name of the customer's member firm is provided, and (3) if the customer is not charged for the correspondent's services. The lack of sufficient personnel to effectively execute an order is NOT a suitable reason for failing to obtain the best price for a customer.

The best execution and interpositioning guidelines apply when a broker-dealer is acting in an agency or principal capacity. It's important to remember that the broker-dealer's duty to provide best execution applies to the price received by customers (which is *exclusive* of any commissions, markups or markdowns) and includes both debt and equity securities.

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## Orders for Securities with Limited Quotations or Pricing Information

When a broker-dealer executes a transaction in a debt or equity security that has a limited number of quotations or a limited amount of pricing information available, different guidelines apply. The market for a stock with one or two quotes available in the OTC Bulletin Board or OTC Pink Marketplace is very different than a stock that's quoted on an exchange. FINRA requires firms to establish policies and procedures to determine how it will handle these types of transactions. Some recommendations include contacting other sources that provide pricing information or potential liquidity. For example, if there are a limited number of quotes available for ABC stock, a firm may contact another broker-dealer with which it traded ABC stock in the past.

## Orders Involving Foreign Securities with No U.S. Market

If a customer intends to execute a transaction outside of the U.S in a security which is not available in U.S. markets, the best execution requirements may be substantially different. This may be the case if the security is an equity security which has no ADR that's traded in the United States. These foreign markets may not have best execution requirements and, in many cases, the member firm may require the services of a third party to find a market maker in the foreign market that will execute a client's transaction. The firm is required to establish written policies and procedures regarding its method of handling customer orders for these securities. The procedures must be reasonably designed to obtain the most favorable terms that are available for the customer and must consider the differences that may exist between U.S. and foreign markets.

## Front-Running

It's a violation of industry rules for member firms or associated persons to execute options orders for an account in which they have an interest or exercise discretion when they're in possession of material, non-public information about an imminent block transaction in the underlying security. This prohibited activity is referred to as *front-running*.

Similarly, an order in the underlying security cannot be executed for the previously mentioned accounts when the firm or a representative has material, non-public information about a pending block transaction in the related option. This prohibition applies until information about the block transaction has been made publicly available through reporting on the tape or through a third-party news wire service. When a partial execution of a block occurs, the ban is still in effect until information about execution of the entire block has been made public.

The restriction doesn't apply to transactions in automatic execution systems, such as the Non-Directed order process in the Nasdaq Market Center Execution System, in which market makers must accept automatic executions. The rule applies only to transactions that are required to be reported to Nasdaq, the Consolidated Tape, or the Options Price Reporting Service. For purposes of this rule, a *block* is generally a transaction involving 10,000 or more shares, or options covering that number of shares. However, in appropriate circumstances, FINRA might consider a smaller amount to be a block.


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## Trading Ahead of a Research Report

Industry regulators became concerned over the interaction between research departments and trading desks—specifically, about the adjustment in inventory made by a firm's trading department in a security that's the subject of a report about to be issued by the firm's research department.

This practice is often referred to as *trading ahead*. In the case of a favorable report, it's been argued that the firm's actions were based on its desire to meet anticipated customer demand for that security. Without such an accumulation, customers who wanted to buy the security in light of the report would need to pay higher prices due to the increase in demand. However, the regulators have not accepted this argument.

FINRA created a rule that prohibits a member from establishing, increasing, decreasing, or liquidating an inventory position in a particular security or derivative of that security based on material, non-public, advanced knowledge of the content and timing of a research report in that security. The rule covers all of the securities of the issuer, including debt and derivatives. In addition, the rule covers both exchange and non-exchange-listed securities.

The member firm is required to establish, maintain, and enforce policies and procedures that are designed to restrict or limit the flow of information between the research and trading departments of the member firm. Therefore, the rule requires the establishment of *information barriers* to isolate the research department from the trading department. These information barriers prevent a trading department from learning of a pending research report regarding a security in which it has a position.

# Fraudulent Devices

As with its business conduct rule, FINRA's rule on manipulative, deceptive, or fraudulent devices is short and seemingly uncontroversial, as indicated below:

> *No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.*

This rule covers several types of improper behavior, as spelled out in disciplinary cases or in additional rules and interpretations.

## Marking-the-Close/Marking-the-Opening

An example of a manipulative practice is *marking-the-close*. In an SEC administrative proceeding against a broker-dealer, the practice is described as follows:

> *Marking-the-close refers to a series of transactions, at or near the close of trading, i.e., at or within minutes of 4:00 p.m., which either uptick or downtick a security. . . Marking-the-close represents a possible departure from the normal forces of supply and demand that result in the fair auction price for a security, and is of concern to those who regulate the markets.*

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Similar activity at the start of the day is considered *marking-the-opening*.

**Motivation** There are two primary motivations for marking-the-close. First, brokerage firms use a security's closing price in determining what their margin requirements will be for their customers. Some firms use $5 per share as a level at which they raise margin requirements, while other firms use a lower price. When the stock drops to that price level, firms raise their requirements to 100% equity, essentially requiring full cash payment for the security.

Second, a security's closing price is the price shown in the newspapers as the final price for that security for that trading session. The concern about marking-the-close arises when the practice is repeated, and a pattern develops.

Marking-the-opening may occur when options expire, since certain contracts are settled based on the opening prices at expiration. Certain program trading strategies are also executed as the market opens.

**Potential Impact on the Market** In addition to affecting the value of the manipulator's position, marking-the-close can have a wider impact on the market. For instance, if the stock being manipulated is part of an index, the value of the index can be affected by marking-the-close activity. Indexes are used for a wide variety of purposes in the industry and are closely watched by investors who are making purchase or sale decisions.

In addition to using trades to mark-the-close, simply changing a quote can be an example of this practice. In one case, a trader engaged in a pattern of upticking his firm's quote on a regular basis within five minutes of the close. This will often cause the firm's bid to be the highest in the market at the end of the day. When the market opened the next day, the trader would downtick the bid.

**Detection Procedures** FINRA expects that a firm's written supervisory procedures will contain a process for detecting marking-the-opening or -close violations. In addition, FINRA and the exchanges have developed systems for generating marking-the-close reports to highlight suspicious activity. While firms and regulators have systems to detect possible violations, registered representatives and traders should realize that they can be held responsible if they ignore activity that should raise a *red flag*.

The responsibility to investigate red flags is not solely placed with supervisors; instead, RRs and traders have a *duty to inquire* if they believe that the market is being manipulated.

## SEC's 21(a) Report and the Department of Justice Investigation

One of the functions of the SEC is to oversee the self-regulatory organizations (SROs) that enforce most of the day-to-day rules of the securities industry. If an SRO is not fulfilling its regulatory responsibilities, the SEC can take action against it. This is precisely what happened to FINRA. The SEC believed that FINRA was aware of several warning signs that market activity on Nasdaq wasn't as free and competitive as it should be, but FINRA didn't pursue any investigation. A parallel, but separate, Department of Justice (DOJ) investigation of Nasdaq market makers focused on many of the same activities.


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As a result, the SEC sanctioned FINRA, which agreed to take certain steps to correct the behavior at issue. It's important to understand just what behaviors were found unacceptable and what's likely to draw FINRA's attention in the future.

## Collusive Behavior

There were a number of activities that the SEC viewed as collusive. In other words, the SEC discovered coordinated behavior by market makers that was anticompetitive, including:

- Following a pricing convention that's not the result of natural economic forces – One of the primary controversies was whether Nasdaq market makers followed an implicit pricing agreement by keeping spreads artificially wide.
- Discouraging other market makers from narrowing displayed quotes – The SEC pointed to tapes of conversations in which market makers that didn't observe implicit pricing conventions received threatening or harassing phone calls.
- Coordinating price quotes, increases or decreases in prices, transactions, or trade reports with other market makers
- Displaying prices at which no trading is intended in order to assist another market maker
- Delaying the reporting of a trade when requested by another market maker – Some trades were reported as on time when, in fact, they were being reported late
- Sharing information about customer orders – The information shared included the customer's identity, order size, and even trading strategies. This activity often compromises a broker-dealer's fair-dealing obligation to its customers.
- Sharing information of the market maker's own positions, strategies, research, or impending quotes
- Backing away from firm quotes, especially in a selective and discriminatory fashion in order to punish certain market makers and order-entry firms

## Initiatives

As part of its settlement with the SEC, FINRA has taken several specific steps to deal with these issues. This includes increases in staff for enforcement, examination, and market regulation programs, as well as enhanced automated systems.

The following objectives must also be met:

- More accurate and complete audit trails – The SEC demands "an accurate time-sequenced record of orders and transactions, beginning with the receipt of an order and documenting the life of the order through the process of execution." To implement this initiative, the Order Audit Trail System (OATS – described later in this manual) was created.
- Substantially improve the surveillance and examination of order handling – Increased attention will also be paid to the implementation of the SEC's Order Handling Rules.
- Significantly upgrade the ability to enforce the Firm Quote Rule – To implement this aspect of the settlement, the Firm Quote Compliance System (FQCS) was created. With this system, alleged cases of backing away can be reported and acted upon on a real-time basis.
- Amend or repeal the excess spread rule to eliminate any disincentive to narrow the spread in market-maker quotes – *The excess spread rule was repealed.*

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- Create an explicit rule or interpretation that states that coordination by or among market makers of their quotes, trades, or trade reports, and actions taken as retribution or retaliation for competitive actions of another market maker, are unlawful.

## Avoiding Compliance Problems in the Nasdaq Market

As these initiatives are fully implemented, it's obvious that the actions of market makers will be under increased scrutiny by FINRA. There's no doubt that the SRO will be much stricter in enforcing the rules.

There are a couple of areas in which traders and other market participants should be careful so as to avoid compliance headaches. Traders should avoid statements that could be interpreted as:

- Threatening, harassing, or obscene
- Asking other traders to move their quotes in any direction
- Asking other traders to delay or misreport a transaction
- Asking for any favor that's not justified by market forces
- Providing information about customer orders or strategies
- Providing information about the market maker's own position, strategies, non-public research, or impending quotes
- Backing away or threatening to do so
- Discouraging another firm from narrowing its quote

There's always the possibility that a statement made in a casual or joking way could be misinterpreted by another party. A registered person should consider how her compliance officer or a regulator may interpret what she intends to say to another person. In the current climate, interactions with other market makers should be viewed as the arm's-length transactions that they were always meant to be.

**Marking Tickets and Reporting Trades** Traders can expect more attention to be paid to correctly marking and time-stamping tickets. However, the brightest spotlight on the audit trail will probably fall on trade reporting (described later in this manual). While there are perfectly legitimate reasons why trades occasionally need to be reported as *late*, the SEC found that the percentage of trades reported as late in the OTC market was far greater than in other trading venues. If a firm shows a pattern of greater-than-normal late-trade reporting, it can expect an inquiry from FINRA. An even more serious violation is reporting a trade as *on time* when the report was in fact entered late, often because it was held back. The SEC views this as a serious distortion of market information.

**Anti-Intimidation/Coordination Interpretation** Under this interpretation, it's considered conduct inconsistent with just and equitable principles of trade for any member or person associated with a member to coordinate prices (including quotes), trades, or trade reports with any other member or person who is associated with a member, or to direct or request another member to alter a price (including a quote). It's also unacceptable to engage, directly or indirectly, in any conduct that threatens, harasses, coerces, intimidates, or otherwise attempts improperly to influence another member or person associated with a member.


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This includes, but is not limited to, any attempt to influence another member or person associated with a member to adjust or maintain a price or quote, whether displayed on any automated system operated by Nasdaq or not. Refusals to trade, or other conduct that retaliates against or discourages the competitive activities of another market maker or market participant, are likewise unacceptable.

However, FINRA doesn't want this interpretation to prevent normal, permissible business activities of its members. The interpretation doesn't limit, constrain, or otherwise prevent the freedom of a member or person associated with a member to:

- Make independent decisions as to where to set its own bid and ask in any Nasdaq security, the prices at which it's willing to buy or sell, and the quantity of shares that it's willing to buy or sell
- Make independent decisions as to where to set its own dealer spread, quote increment, or quantity of shares for its quotes in any Nasdaq security
- Communicate its own bid or ask, or quantity of shares, for the purpose of exploring the possibility of a purchase or sale of any Nasdaq security, and to negotiate for or agree to such purchase or sale communicate its own bid or ask, or the price at or the quantity of shares in which it's willing to buy or sell any Nasdaq security, to any person, for the purpose of retaining such person as an agent or subagent for the member or for a customer of the member, and to negotiate for or agree to such purchase or sale
- Engage in any underwriting (or any syndicate for the underwriting) of securities to the extent permitted by the federal securities laws
- Make independent decisions about the market makers with which it's willing to trade and the terms on which it will trade
- Deliver an order to another member for handling

## Payments for Market Making

No FINRA member or associated person is permitted to accept any payment or other compensation, directly or indirectly, from an issuer of a security, or any affiliate or promoter for:

- Publishing a quote (including indications of interest)
- Acting as a market maker in a security
- Submitting an application in connection with market-making activity

The term *affiliate* refers to an entity that controls, is controlled by, or is under common control with the member. *Control* is defined as ownership of 10% or more of the common or preferred equity or subordinated debt of another entity, or a right to 10% or more of the profits or losses of a partnership. The term common control means the same person or entity controls two or more entities. Therefore, a conflict exists if the member is underwriting its own securities, an entity in which it has a 10% ownership, an entity which owns 10% of the member, or an entity in which another company owns 10% of both the member and the issuer.

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The term *promoter* includes all persons (other than the issuer or its affiliates) who have an interest in influencing a broker-dealer to make a market in a security. Examples include a director or employee of an issuer, adviser, accountant, or attorney for the issuer, a person who owns restricted securities of the issuer, or a person who owns 5% or more of the public float of any of the issuer's securities.

The rule doesn't prohibit the member from accepting (i) payment for bona fide services, such as investment banking (which includes underwriting and fees), and (ii) reimbursement for registration fees that are paid to the SEC or a state regulator, or for listing fees that are imposed by an SRO.

# Splitting Orders

Under industry rules, a broker-dealer may not split orders into smaller ones for executions or split executions into multiple executions for transaction reporting with the intent of increasing a monetary or an in-kind amount (e.g., commissions, credits, gratuities, payments, or rebates of fees) to be received because of the execution of the orders or the transaction reporting for the orders. This prohibited practice is referred to as *trade shredding*.

An important note is that breaking up or splitting orders in order to provide a customer with a lower cost, a better execution, or to avoid a trade-through violation of Regulation NMS is acceptable.

## Electronic Blue Sheet

The SEC and SROs are both a part of the Intermarket Surveillance Group. This group may require member firms to submit requested trade information during the course of an investigation or inquiry. The report submission is accomplished by the member firms through the use of the Electronic Blue Sheet (EBS). The trade information may include trade data for both a member's proprietary account and for any customers' accounts.

# Fair Prices and Commissions

FINRA members are not permitted to charge prices or commissions that are unfair or excessive. To assist members in determining whether the level of charges is fair, FINRA has continued to use the NASD's original *5% Markup Policy*. (Although the policy is stated in terms of markups, it actually applies to markups, markdowns, *and* commissions.) The rule applies to both exchange-listed and non-exchange-listed securities and regardless of whether a firm is acting in an agency (broker) or principal (dealer) capacity.

To formulate its policy, the NASD conducted a survey of its members in 1943. Based on the information it received, the NASD realized that it would be nearly impossible for guidelines to specify what would be fair compensation on each and every transaction. Instead, all relevant factors need to be considered in judging a particular trade. In certain cases, markups exceeding 5% could be justified; however, in other circumstances, 5% may be excessive.


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When investigating possible markup violations, the NASD's board directed its District Business Conduct Committee to take into consideration that 71% of the transactions surveyed were executed with markups of 5% or less. For this specific reason, it's become known as the 5% Policy. (Remember, FINRA is the result of the 2007 merging of the NASD and the NYSE regulatory units.)

In some ways the 5% Policy seems like a fairly simple provision. For example, let's assume that Broker-Dealer X sells stock to a customer from its inventory at $21 per share when the prevailing interdealer price is $20. In this case, X charged a $1 per share markup, which is exactly 5%. The percentage is calculated by dividing the markup of $1 by the prevailing interdealer price of $20. However, part of the judgment about whether a markup is acceptable involves consideration of all relevant factors.

These issues tend to revolve around two questions:

1. When is a markup of approximately 5% acceptable; when can it be more, and when must it be less?
2. How is the markup calculated when the prevailing interdealer price is not obvious?

## Factors That Influence the Level of Markups

FINRA emphasize that the 5% is merely a guideline. It's possible in certain circumstances to justify higher markups, but conversely, there are times when even 5% is too much.

The factors to consider when determining the level of markup include:

- *The type of security involved* – Some securities carry higher markups than others as a matter of industry practice. For example, the markups on common stock or limited partnership units typically are higher than markups on bonds.
- *The availability of the security in the market* – If more effort is required to locate a particular security and execute a transaction, a higher markup is justified.
- *The price of the security* – The markup percentage generally increases as the price of the security decreases, since lower-priced securities may require more handling and expense.
- *The amount of money involved in a transaction* – A transaction for a small total dollar amount may require greater handling expenses on a proportionate basis than a larger transaction.
- *Disclosure* – Disclosure to the customer that the circumstances may warrant a higher-than normal markup helps to make the dealer's case. However, the circumstances must also justify the charges. Disclosure in the absence of circumstance doesn't justify a higher markup.
- *The pattern of markups* – FINRA tends to be most severe with cases that show a persistent pattern of excessive markups. However, the markup in each transaction must be justified on its own merits.
- *The nature of the broker-dealer's business* – Firms that offer services to customers (e.g., research) can justify higher markups than firms that don't. However, if a firm has high expenses that don't benefit customers, these expenses will not justify higher charges.

## Calculating Markups

Markups are basically defined as the difference between the interdealer ask price and sales prices to customers, while markdowns are defined as the difference between the interdealer bid price and purchases from customers.

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For example, let's assume that the inside market for MNOP stock was 19.50 − 20.00. Dealer X, a market maker, sells stock to a customer for $21 per share. Dealer X calculates its markup as $1 per share, which is 5% above the interdealer offer price. *This is acceptable only if the market for MNOP is active and competitive.* If one market maker dominates and controls the market and interdealer transactions don't frequently occur at the inside market, then the market is not active and competitive. In a dominated and controlled market, the inside market may not be the best indicator of the prevailing market price.

As an example of what can happen when the market is not active and competitive, let's consider UVWX, which is a small OTC-traded company. The stock is brought to the public by Dealer P, which is the only market maker in the secondary market. There's little national interest in the company's stock other than the business solicited by Dealer P's registered representatives. Over the last month, P has been accumulating stock by purchasing UVWX at $5 per share from retail customers. During this time, its interdealer quote was 5.25 – 5.75, but it didn't execute any interdealer trades. Suddenly, Dealer P raises its interdealer quote to 9.50 – 10.00 and begins selling UVWX to new retail customers at $10.50 per share.

Can P claim that it's charging customers only a $0.50 markup above the interdealer offer of 10.00, which equals a 5% markup? No, the markup cannot be calculated in this way. Dealer P's quote of 9.50 – 10.00 is meaningless because it dominates and controls the market for UVWX. Dealer P is not worried about having to buy the stock from other dealers at its bid of 9.50, because it knows there's little interdealer activity in the stock. Since its cost is only $5 per share, a price of $10.50 to retail customers is greater than a 100% profit.

**Policy Enforcement** FINRA has been actively enforcing its markup policy and is especially concerned that its members use the proper methodology to calculate markups. When calculating markups, a broker-dealer must determine:

- Whether it's acting as a market maker or a retail broker-dealer in the transaction
- Whether the market for the stock is dominated and controlled, rather than active and competitive
- Whether actual transactions or validated quotes may be used as the best evidence of the prevailing price

FINRA recognizes that a market maker in a competitive stock is risking its capital in the active market. The firm is entitled to earn the spread plus a markup when selling to retail customers. However, a firm that's not a market maker and simply buys from market makers and resells to customers in riskless transactions is not taking the same risk. For firms that are not market makers, the price that the firm pays other broker-dealers contemporaneously in retail sales is the best indicator of the prevailing price. (A dealer's *contemporaneous cost* is the price paid to other dealers for the security at or about the time that it made retail sales to customers.) The sole action of posting quotes in the OTCBB of on the OTC Pink Marketplace doesn't cause a dealer to become a market maker. The firm must actively participate in the market to become a market maker.

In active, competitive markets (e.g., the market for Nasdaq Global Market securities), the inside offer can usually be used as the prevailing market price when calculating markups on sales to retail customers, because such quotes can typically be *validated*.


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A quote is considered validated when:

- A competitive market for the security exists
- Interdealer sales occur with some frequency, although not necessarily contemporaneously
- On the days interdealer sales occur, they're consistently executed at prices at or around the quoted offers

In some cases, the inside offer may not be the prevailing price, even in an actively traded stock. For example, let's assume that a stock is being quoted at 24.50 – 25.00, but most interdealer trades are being negotiated by using directed orders. When calculating markups on sales to retail customers, 24.75 should be used as the prevailing price, not 25.00.

**Proceeds Transactions** The 5% policy also applies to proceeds transactions, which involve a customer directing a member firm to sell a security and use the proceeds of the sale to buy another security. In this case, the member firm should compute the markup in the same manner as if the customer had purchased for cash and should add any compensation it receives on the customer's sale to the firm's profit on the customer's purchase. For example, a customer instructs her member firm to sell $5,000 of ABC stock and use the proceeds to purchase $5,000 of XYZ stock. When computing the percentage markup, the member firm should use its total compensation (from both the customer's sale and purchase) as a percentage of the $5,000 customer sale.

## Exemptions

Transactions that are exempt from the provisions of the 5% Policy include securities that require a prospectus or offering circular to be delivered as well as securities that are sold at a specific public offering price (e.g., initial public offerings and mutual fund shares).

## Net Transactions with Customers

Although a broker-dealer acts in different capacities when executing customer trades, the firm can only act in one capacity for a single customer transaction. The possibilities include acting as agent, principal, riskless principal, or on a net basis.

Agency transactions occur when the broker-dealer buys or sells securities in the marketplace on behalf of a customer. The firm charges the client a commission, which is disclosed on the customer's confirmation. On the other hand, when executing a customer order in a principal capacity, the firm sells securities out of its inventory or buys securities into inventory. As a principal (dealer), the firm is exposed to risk in its inventory value. Transaction prices are based on the market price of the security, rather than the inventory value of the dealer. In the case of a customer purchase, the firm charges the customer a markup above the market price of the security. When the customer sells, the dealer marks down the proceeds that the customer receives.

When a firm buys securities into its inventory to fill preexisting customer orders, its capacity is that of a riskless principal. For instance, in quick succession, a dealer receives 10 customer market orders each to purchase 100 shares of stock. The firm may choose to buy 1,000 shares as principal and then resell the securities to its customers at the *same* price, plus a markup.

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In this case, the firm must disclose its capacity as riskless principal, since the purchase by the firm and sale to the customers didn't expose the dealer to price risk. The firm's markup is disclosed on customer confirmations.

In the previous example, if the dealer had sold the securities to the customers at a different price than the price it paid, the executions are described as occurring on a net basis. In a net-basis trade, the dealer profits by charging a different price for the securities, rather than charging a markup. FINRA rules place disclosure and consent requirements on dealers that execute net-basis trades with customers. However, the profits that's obtained in these transactions is not disclosed on customer confirmations.

Both legs of a net-basis transaction are reported as principal to the Trade Reporting Facility, since they occurred at different prices. If a firm intends to execute a net-basis transaction with a customer, it must disclose the conditions for handling the order and obtain the client's permission prior to the execution of the trade. The rule applies to transactions between a dealer and a customer, rather than dealer-to-dealer.

The following conditions apply to net-basis transactions:

- For non-institutional (retail) customers, written consent must be obtained on an order-by-order basis, prior to the execution of net trades.
- For institutional customers, the firm may obtain consent in one of three different ways:
  1. Oral permission before each net-basis transaction, or
  2. Written permission before each net-basis transaction, or
  3. Blanket permission through the delivery of a negative consent letter. The letter discloses the terms and conditions of handling the order and gives the client an opportunity to opt out. If the client doesn't express any objections, the dealer may interpret this as permission to execute net-basis trades in the future.

For fiduciaries, the broker-dealer must:

- Provide disclosure to the party that has been granted trading authorization
- Obtain permission from the party that has been granted trading authorization
- Follows the same disclosure and consent requirements that apply to institutional customers if the fiduciary is an institution

## Charges for Services

Members are allowed to charge for services such as collection of dividends or safekeeping of securities; however, these charges must be reasonable and cannot unfairly discriminate between customers.

## FINRA Sanctions

In markup cases, the most severe sanctions have occurred when a single market maker (or a few market makers acting together) has dominated and controlled the market. In these situations, it's more appropriate to use the dealer's contemporaneous cost, rather than quotes or prevailing market price. If the firm has not recently made interdealer purchases, it should use the price it paid customers for the stock (adjusted for an imputed markup that conforms to the 5% Policy).


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**Responsibilities of Broker-Dealer Personnel** While sanctions in markup cases are usually assessed against the broker-dealer or its controlling persons, individual registered representatives may be held accountable as well. Traders are particularly important, since part of a trader's job is determining a security's prevailing price. In addition, traders are in a position to know whether their firms dominate and control a market.

Registered representatives can also be held liable if they benefit from the solicited transactions on which excessive markups are charged. According to FINRA:

> *Registered representatives, particularly those reaping some of the ill-gotten gains derived from unfair pricing to customers, may also be held responsible for excessive markups and unfair pricing to customers. A salesperson may certainly be deemed to share responsibility where he participates in determining the prices the firm charges to customers, and also where he knew or should have known that the prices being charged are excessive based on a comparison of the gross commission or markup to the total price charged the customer. Registered representatives do not merely function as salespersons. They are securities professionals operating in a highly regulated environment, and they are required to know and comply with the relevant laws and rules. Registered representatives may not claim ignorance of FINRA's markup policy or case histories to avoid being included in an investigation of a firm's role with respect to particular securities. In short, they cannot solicit transactions for excessive gains with regulatory impunity.*

So, although a broker-dealer's markup policy may be set at senior-management levels, it's important for registered representatives to be aware of how the policy affects their clients.

# Disclosure Rules

The SEC was concerned that the growth in the number of market centers was contributing to market fragmentation, as well as the lack of order-execution information at these centers. In order resolve concerns, the SEC focused its attention on requiring more visibility in order executions and routing practices. In response to these concerns, the SEC added two new rules to the Securities Exchange Act of 1934—*SEC Rule 605* and *606*.

By requiring greater disclosure, the SEC seeks to increase quotation competition, promote price discovery and transparency, and encourage liquid markets that minimize short-term price volatility.

## SEC Rule 605

SEC rules require market centers to disclose order-execution information. Under Regulation NMS, SEC Rule 11Ac1-5 was changed to Rule 605 (Disclosure of Order Execution Information). Rule 605 requires a market center to disclose order execution information in NMS securities. Under the rule, a *market center* is considered any national securities exchange, alternative trading system, OTC market maker, national securities association, and/or a member firm that internalizes orders. Since these categories of market centers can potentially make markets in National Market System securities, they're subject to disclosure requirements.

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Market centers that trade NMS securities are required to produce monthly electronic reports that include uniform statistical measures of execution quality for covered orders. A *covered security* is defined as any NMS security and any other security for which a transaction report, last sale data, or quotation information is disseminated through an automated quotation system. This includes exchange-listed securities, as well as Nasdaq Global Select Market, Nasdaq Global Market, and Nasdaq Capital Market securities.

However, exchange-listed options and OTC Bulletin Board securities are not included. A *covered order* is any market or limit order received and executed during normal business hours (9:30 a.m. - 4:00 p.m. ET). This includes an immediate-or-cancel order, but excludes any order for which the client provides special instructions. These reports must be made public.

The required information must be categorized by:

- Security
- Order type (market, marketable limit, inside-the-quote limit, at-the-quote limit, and near-the-quote limit)
- Order size (100-499, 500-1,999, 2,000-4999, and 5,000 or more)

The report must contain the following information:

1. Effective spreads—the spreads actually paid by investors
2. The execution of market orders that vary in size compared to public quotes
3. The execution of orders that have price improvement and no improvement, fill rates, and execution speed

**Effective Spread** Evaluating the effective spread is a way to measure the quality of execution that an order received. The effective spread is equal to twice the difference between the actual trade price and the prevailing bid-ask midpoint. The effective spread shows how far above the midpoint price a client received on a buy order and how far below the midpoint price a client received on a sell order.


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# Sample Monthly 605 Report

**Market Center:** United Trading Exchange
**Issue:** ABCD - Alphabet Cider, Inc. - Common Stock
**Report Type:** Comprehensive - April 20XX
**Execution System:** Sonic Slide
**Order Size:** 100-499

| Order Type | Number of Orders | Number of Shares | Canceled Shares | MC Exec. Shares | Other MC Exec. Shares | 0-9 Seconds | 10 - 29 Seconds | 30 - 59 Seconds | 60 - 299 Seconds | 5 - 30 Minutes |
|---|---|---|---|---|---|---|---|---|---|---|
| Market Orders | 5,326.00 | 1,153,183 | 180,243 | 972,940 | | 957,169 | 14,986 | 1,082 | | |
| Marketable Limit Orders | 30,524.00 | 6,123,226 | 551,350 | 5,571,876 | | 5,526,366 | 40,860 | 3,450 | 1,200 | |

| Order Type | Avg. Realized Spread | Avg. Effective Spread | Price Improved Effective Shares | Avg. Price Improvement Amount | Price Improved Avg. Exec. Amount | At Quote Exec. Shares | At Quote Avg. Exec. Time | Outside of Quote Exec. Shares | Avg. Outside of Quote Amount | Outside of Quote Avg. Exec. Time |
|---|---|---|---|---|---|---|---|---|---|---|
| Market Orders | - 0,0061 | - 0.0311 | 18,848 | 0.018 | 3.9 | 747,820 | 0.5 | 206,272 | 0.0209 | 2.5 |
| Marketable Limit Orders | - 0.0084 | - 0.210 | 99,580 | 0.0248 | 5.3 | 5,080,336 | 0.4 | 391,960 | 0.0157 | 2.3 |

## SEC Rule 606

Under Regulation NMS, SEC Rule 11Ac1-6 was changed to Rule 606 (Disclosure of Order Routing Information). *Each calendar quarter*, Rule 606 requires a broker-dealer to make its order-routing information publicly available for all non-directed orders in NMS securities, which includes securities that are listed on the NYSE, NYSE American, Nasdaq, as well as exchange-listed options. The two main components to this rule are the quarterly reports on order routing and individual customer requests for information on the firm's order routing relating to the customers.

For orders that are externally executed for a broker-dealer, the customer can either choose the market center at which the order will be executed or leave that determination to the broker-dealer. With a *directed order,* the customer designates the location at which the order is to be executed. On the other hand, with a *non-directed* order, the broker-dealer chooses the place of execution for the order because the customer has not made a market center determination.

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These order routing reports are designed to provide the public with information on how broker-dealers route their customer orders. These reports are based on non-directed customer held orders in NMS stocks and options contracts. A held order is typically entered by a retail customer and is intended to be represented in the market or executed as soon as practicable without discretion. A "not-held" order that's entered by an institutional investor is one in which the broker has discretion over the time and/or price of execution.

These quarterly reports must be broken down by calendar month and posted on a free website which remains accessible for three years following the initial posting. There must be a section dedicated to option contracts, while the section on NMS stocks must be separated into the following two categories: (1) NMS stocks that are included in the S&P 500 index and (2) Other NMS stocks

Each of these sections must include the following information:

- The percentage of total orders for the section that were non-directed orders, and the percentages of total non-directed orders for the section that were market orders, marketable limit orders, non-marketable limit orders, and other orders
- The identity of the 10 venues to which the largest number of total non-directed orders for the section were routed for execution and of any venue to which 5% or more of non-directed orders were routed for execution, the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, total non-directed marketable limit orders, total non-directed non-marketable limit orders, and total non-directed other orders for the section that were routed to the venue
- For each venue identified, the net aggregate amount of any payment for order flow received, payment from any profit-sharing relationship received, transaction fees paid, and transaction rebates received, both as a total dollar amount and per share, for each of the following non-directed order types:
  - Market orders
  - Marketable limit orders
  - Non-marketable limit orders
  - Other orders
- A discussion of the material aspects of the broker-dealer's relationship with each venue, including a description of any arrangement for payment for order flow, any profit-sharing relationship, and a description of any terms of such arrangements, written or oral, that may influence a broker-dealer's order routing decision, including:
  - Incentives for equaling or exceeding an agreed upon order flow volume threshold, such as additional payments or a higher rate of payment
  - Disincentives for failing to meet an agreed upon minimum order flow threshold, such as lower payments or the requirement to pay a fee
  - Volume-based tiered payment schedules
  - Agreements regarding the minimum amount of order flow that the broker-dealer will send to a venue


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**Customer Specific Request for Order Routing Information** When requested by a customer, a broker-dealer must disclose all of the following information:

- Orders in NMS stocks that are submitted on a held basis
- Orders in NMS stocks that are submitted on a not-held basis and the broker-dealer is not required to provide the customer the detailed information under paragraph (b)(3) of this rule
- Orders in NMS securities that are option contracts, the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, regardless of whether the orders were directed or non-directed

**Not-Held Order Disclosure** One of the significant changes made to the original rule was the required disclosures of not-held orders. This section—referred to as (b)(3)—provides institutional customers with detailed disclosures concerning their not-held orders. In addition to providing information of its ordering routing information as described previously, the broker-dealer must provide statistical information on order execution as well as fees paid and rebates received from trading venues. Some of the detailed information that must be disclosed regarding not-held orders includes:

- Execution routing
- Order execution
- Orders that provide liquidity
- Orders that remove liquidity

At least annually, customers must also be provided with written notification that a copy will be provided to them on request. A firm's order-routing information is required to be posted on its website, be free of charge, and be accessible to the public.

## Exemptions from SEC Rule 606

There are two exceptions to Section (b)(3) regarding not-held order disclosure information. One exception is based on the firm level, while the other is based on customer level.

**Firm Level** A broker-dealer is not required to provide a report if not-held orders for NMS stocks are less than 5% of the total shares of NMS stocks that the broker-dealer receives from its customers over the prior six months.

**Customer Level** A broker-dealer is not obligated to provide the report to a particular customer if that customer trades through the broker-dealer on average each month for the prior six months less than $1,000,000 of notional value of not-held orders in NMS stocks.

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# Complex Options Positions

The following section will examine some complex options positions that the Series 57 Examination may address. For test purposes, the focus is on identifying the position and determining its strategy. The positions to be described are straddles, combinations, and spreads.

Straddles, combinations, and spreads are strategies that involve the use of two or more options. These transactions should be executed on one order ticket which indicates either a maximum amount the client is willing to spend (the gross or net debit) or a minimum amount the client is willing to receive (the gross or net credit).

## Straddles

A straddle is established with either the purchase of both a call and a put or the sale of both a call and a put. Each option will have the same underlying security, the same exercise price, and the same expiration date. If an investor buys both options, the position is referred to as a long straddle and, if the investor writes both options, it's referred to a short straddle. Each individual option position is often referred to as a leg of the straddle.

| Long Straddle | Short Straddle |
|---|---|
| Buy 10 ABC May 60 calls<br>Buy 10 ABC May 60 puts | Sell 10 XYZ July 40 calls<br>Sell 10 XYZ July 40 puts |

The purpose of either buying or writing a straddle is to speculate on the potential price movement (or lack thereof) in the underlying security. The buyer of a straddle expects the price of the underlying stock to be volatile, while the seller of a straddle expects the price of the underlying security to be stable (no volatility).

## Long Straddles

An investor who buys a straddle anticipates that there will be substantial movement in the price of the underlying security, but is uncertain as to the specific direction of that movement. Since a long straddle involves buying both a call and a put, the investor has the opportunity to profit from any subsequent increase or decrease in the price of the underlying security.

## Short Straddles

An investor who writes a straddle is seeking to generate income from both the call and put premiums. The seller is neither bullish nor bearish; instead, the seller expects there to be little or no fluctuation in the market price of the underlying stock. In other words, the seller of a straddle is expecting stability.


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## Combinations

A combination is simply a straddle position with contracts that have different exercise prices and/or different expiration months. The following is an example of a long combination:

**Buy 5 DEF March 50 Calls at 3**
**Buy 5 DEF March 40 Puts at 1**

## Spreads

The next combined option position to examine is a spread. Spreads are option positions in which investors are willing to accept a limited gain for the assurance of knowing that they have a limited loss. Spreads involve the simultaneous sale and purchase of two calls, or two puts, on the same underlying security; however, the expiration months and/or strike prices will be different. For exam purposes, it's important to become familiar with the different types of spread positions and to be able to classify them.

**Classifying Spreads** The first classification of a spread is simply whether both options are calls (a call spread) or both options are puts (a put spread). Once that determination is made, it's important to analyze the differences between the two options based on the strike price and/or expiration of each option.

- **Price Spread** When the two options of the spread have the same expiration month, but different strike prices, it's referred to as a price, dollar, or vertical spread. The term vertical is based on the concept of strike prices being listed on a chart vertically.

  Buy 1 ABC March **30** call
  Write 1 ABC March **40** call

- **Time Spread** When the two options of the spread have the same strike price, but different expiration months, it's referred to as a time, calendar, date, or horizontal spread. The term horizontal is based on the concept of time always being measured on the horizontal.

  Buy 1 ABC **March** 30 call
  Write 1 ABC **June** 30 call

  Note: For time spreads, the option with the longer expiration will have the larger premium.

- **Diagonal Spread** If the two options of the spread have different strike prices and different expiration months, it's referred to as a diagonal spread. The term diagonal is based on the merging of both a vertical and horizontal spread.

  Buy 1 ABC **March 30** call
  Write 1 ABC **June 40** call

Notice that when a spread is created, an investor is receiving a premium for the option being sold as well as paying a premium for the option being purchased.

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## Net Debit Spreads

Let's consider the following example:

**Buy 1 ABC March 40 Call at 3**
**Sell 1 ABC March 45 Call at 1**

*Step 1: Which leg is dominant?* In this example, the purchase of the 40 call is the dominant leg since the premium of 3 is larger than the premium of 1.

*Step 2: Is the investor a buyer or seller?* Because the dominant leg is the buy leg, the investor is considered the buyer of the spread.

*Step 3: Is it a debit or credit spread?* The sale and purchase will result in either a net debit spread (more money paid out than taken in) or a net credit spread (more money taken in than paid out). In this example, since the investor bought the option that has the higher premium and sold the option that has the lower premium, he has established a net debit spread. An investor who creates a net debit spread is considered the buyer of the spread or long the spread.

| *Creating a Net Debit Spread* |
|---|
| 1) An investor buys 1 ABC March 40 call at a premium of 3. |
| 2) The investor also sells 1 ABC March 45 call at a premium of 1. |
| 3) Since the investor paid out 3, but received 1, the net debit is a premium of 2. (3 Out – 1 In). |

| Cash Out (Debit) | Cash In (Credit) |
|---|---|
| 1) $300 | |
| | 2) $100 |
| 3) $200 | |

*Step 4: Is the investor bullish or bearish on the underlying stock?* By recognizing that the dominant leg of the spread is the purchase of the 40 call, it's easy to determine that the investor is bullish on ABC stock. In the example, the investor bought the 40 call in hopes of the stock rising moderately. By selling the 45 call, the investor received the premium which serves to lower his cost of creating the bullish position.

## Net Credit Spreads

Let's consider the following example:

**Sell 1 XYZ October 65 Put at 7**
**Buy 1 XYZ October 55 Put at 1**

*Step 1: Which leg is dominant?* In this example, the sell leg is dominant since the premium of 7 is larger than the premium of 1.

*Step 2: Is the investor a buyer or seller?* Because the dominant leg is the sell leg, the investor is considered the seller of the spread.


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*Step 3: Is it a debit or credit spread?* The sale and subsequent purchase results in a net credit spread (more money taken in than paid out). In this example, since the investor sold the option that has the higher premium and bought the option that has the lower premium, he has established a net credit spread. An investor who creates a net credit spread is considered the seller of the spread or short the spread.

| ***Creating a Net Credit Spread*** |
|---|
| 1) An investor sells 1 XYZ October 65 put at a premium of 7. |
| 2) The investor also buys 1 XYZ October 55 put at a premium of 1. |
| 3) Since the investor received 7, but paid out 1, the net credit is a premium of 6. (7 In – 1 Out). |

| Cash Out (Debit) | Cash In (Credit) |
|---|---|
| | 1) $700 |
| 2) $100 | |
| | 3) $600 |

*Step 4: Is the investor bullish or bearish on the underlying stock?* By recognizing that the dominant leg of the spread is the sale of the 65 put, it's easy to determine that the investor is bullish on XYZ stock. In the example, the investor sold the 65 put with the belief that the stock would rise moderately. By purchasing the 55 put, the investor has limited the potential loss of the stock actually declining in value.

## Spread Strategies

The goal of this final spread section is to provide students with some basic tools in order to quickly answer exam questions. By identifying the dominant leg of the spread (the option with the larger premium), much of the mystery is eliminated.

As it relates to questions of whether an investor is bullish or bearish, remember the following basic options chart:

| | Buyer | Seller |
|---|---|---|
| **Call** | Bullish Strategy (right to buy) | Bearish Strategy (obligation to sell ) |
| **Put** | Bearish Strategy (right to sell) | Bullish Strategy (obligation to buy) |

A particular challenge that the exam may introduce is a spread example that doesn't indicate the premiums associated with the two options. To address these questions, it becomes imperative to remember that the lower the strike price of a call spread, the higher the premium; and the higher the strike price of a put spread, the higher the premium.

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Let's consider the following four examples without premiums and determine as much as possible from the given information:

Example 1: Buy 1 XYZ May 30 call
Sell 1 XYZ May 40 call

Since the investor bought the 30 call (lower strike), he's bullish. Also, as a buyer, the investor has created a debit spread and wants the spread to widen. Notice the five letter theme with the words buyer, debit, and widen.

Example 2: Buy 1 XYZ May 80 call
Sell 1 XYZ May 70 call

Since the investor sold the 70 call (lower strike), she's bearish. Also, as a seller, the investor has created a credit spread and wants the spread to narrow. Notice the six letter theme with the words seller, credit, and narrow.

Example 3: Buy 1 XYZ May 50 put
Sell 1 XYZ May 40 put

Since the investor bought the 50 put (higher strike), he's bearish. Also, as a buyer, the investor has created a debit spread and wants the spread to widen. Again, buyer, debit, and widen.

Example 4: Buy 1 XYZ May 20 put
Sell 1 XYZ May 30 put

Since the investor sold the 30 put (higher strike), she's bullish. Also, as a seller, the investor has created a credit spread and wants the spread to narrow. Again, seller, credit, and narrow.

# The Marketplace for Options

Options may be purchased either on one of the options exchanges or in the over-the-counter market. If the contracts are traded on an exchange, they're referred to as listed options. A key feature of exchange-traded (listed) options is that their terms are standardized. Listed options will be the focus of the remainder of this chapter. Currently, listed options trade on the following exchanges:

- The Chicago Board Options Exchange (CBOE)
- NYSE American
- Nasdaq OMX PHLX (formerly Philadelphia Stock Exchange)
- The International Securities Exchange (ISE)


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## Trading Floor Participants

The CBOE employs a market-maker system in which each of the options is assigned to several market makers to facilitate the trading of the contracts. Under this method, firms that are referred to as *Designated Primary Market Makers (DPMs)* act as principals by purchasing and selling option contracts for their individual accounts. This market maker system is different from the NYSE system of assigning each security to one specified Designated Market Maker (DMM) that's able to act in either an agency or principal capacity.

Orders are brought to a trading post by exchange members that are referred to as *floor brokers*. Floor brokers acts as agents in executing orders from both the public and other members.

The CBOE utilizes an exchange employee that's referred to as the *Order Book Official (OBO)* to maintain the public customer limit order book. The OBO acts as a broker's broker for specified classes of options and is responsible for recording and executing these orders.

**Order Execution** For a listed option, before an order may be executed on the floor of an exchange, an order ticket must be completed in full. The order ticket must contain the following information:

- Whether it's a buy or sell order
- Whether the position is uncovered (naked) or covered
- The number of options contracts to be bought or sold
- The name of the underlying stock
- Both the expiration month and exercise price
- Whether the order is for a call or a put
- The terms of the order (e.g., market, limit, stop, etc.)
- Whether it's an opening or closing transaction
  - Basically, orders are entered to either open a new position or close a previously opened position.

| An Opening Purchase | is offset by a | Closing Sale |
|---|---|---|
| An investor creates or increases a long position | | The investor eliminates or reduces a long position by selling an equivalent contract |
| **An Opening Sale** | **is offset by a** | **Closing Purchase** |
| An investor creates or increases a short position | | The investor eliminates or reduces a short position by purchasing an equivalent contract |

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**Bids and Offers** Options markets provide two-sided quotes and typically have $.05 pricing increments; however, some options currently trade in $.01 increments. For example, the quote for ABC June 45 calls is shown below:

| Bid | Offer |
|---|---|
| 5.10 | 5.15 |

Based on the quote, an investor who places a market order to buy will be filled at the offer price of $5.15. If another client places a market order to sell, she will be filled at the bid price of $5.10.

**Placing Orders for Complex Strategies** Orders for complex strategies, such as spreads and straddles, involve buying and/or selling more than one option position. These types of trades are typically entered as a single order with the customer specifying the maximum premium he's willing to pay (in the case of net debt transactions) or the minimum he's willing to accept (in the case of net credit transactions). For example, a customer who intends to create a debit call spread will specify the underlying issuer, expiration months, and strike prices of each contract and will provide the broker-dealer with a maximum net premium he's willing to pay for the combined purchase and sale. On the other hand, a customer who intends to establish a credit put spread will specify a minimum net premium she's willing to accept for the two trades.

Some customers may choose to have each component of the strategy executed individually. For example, a customer who wants to establish a long straddle may choose to purchase the call initially and wait to buy the put shortly thereafter. The process of buying each option separately is referred to as *legging in*. On the other hand, if the owner of the straddle chooses to liquidate either the call or the put individually, the process is referred to as *legging out*.

**Floor Trading** The information included on an order ticket is transmitted directly to the exchange floor either electronically or by phone from the member firm's office. The member firm's clerk who is located on the exchange floor must record the time the order was received.

As with stock trading, the highest bid price and the lowest offer price are given the highest order priority. Therefore, an investor who places a market order will normally buy at the offer and sell at the bid. If trading is halted in the underlying security of a particular option contract, all of the trading involving that security's option contracts will also be halted on the options exchanges.

After the execution of an order, the transaction must be submitted for clearance to the Options Clearing Corporation (OCC). The client's broker-dealer is required to settle the trade with the OCC prior to 10:00 a.m. ET on the next business day. An investor who holds an option will not receive a certificate to indicate ownership; instead, evidence of ownership will be the confirmations and statements that are sent to the customer by the firm.


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## Daily Quotations for Options

Closing prices for options are disseminated each business day by the options exchanges. This information will appear on certain websites as well as in most major newspapers such as *The Wall Street Journal* and *The New York Times*. A portion of a daily option table for IBM is shown below:

| 1 | 2 | 3 | | | 4 | | |
|---|---|---|---|---|---|---|---|
| Option & NY Close | Strike Price | Calls-Last | | | Puts-Last | | |
| | | Jan. | Feb. | Apr. | Jan | Feb. | Apr. |
| IBM | 115 | 9.35 | S | 12.40 | .30 | s | 1.75 |
| 123.13 | 120 | 5.00 | 6.40 | 8.40 | 1.20 | 2.30 | 1.40 |
| 123.13 | 125 | 2.20 | 3.65 | 5.40 | 3.50 | 4.75 | 6.00 |
| 123.13 | 130 | .75 | 1.70 | 3.50 | 7.15 | 8.00 | 8.75 |

**COLUMN 1** indicates the name of the underlying stock and its closing price on the New York Stock Exchange. In the example above, IBM closed at $123.13.
**COLUMN 2** indicates the strike prices that are available for IBM calls and puts. Strike prices are set by the exchange with intervals that vary based on the market value of the underlying security.
**COLUMN 3** indicates the last reported premiums for the call options that are due to expire in January, February, and April. Expiration cycles are set by the exchange. The "s" in the table indicates that no option is offered, while an "r" indicated that the option didn't trade during the day.
**COLUMN 4** indicates the last reported premiums for the put options that are due to expire in January, February, and April.

**Finding a Premium** The Series 57 Examination may require a person to demonstrate her ability to locate a contract's specific premium. Using the previous table, let's identify the premium for the IBM January 120 call. First, find the 120 strike price in column 2, then move across to column 3 and line up with the January expiration. In this example, the IBM January 120 call has a premium of 5, or $500. The total premium of 5 is made up of 3.13 of intrinsic value and 1.87 of time value.

## Position and Exercise Limits

Both the Options Clearing Corporation and the options exchanges limit the number of contracts that an investor, or group of investors that are acting in concert, may accumulate on the same underlying security. These position limits differ for each underlying security.

An equity security is assigned a maximum position limit that's based on its trading volume and outstanding shares. The status of the underlying security is reviewed every six months in order to determine the appropriate limit.

Along with position limits, investors are subject to exercise limits (based on the same numerical limit). An exercise limit represents the maximum number of contracts that an investor may exercise within five consecutive business days.

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The limitations apply to contracts on the same side of the market—bullish on one side and bearish on the other. The bullish side of the market includes long calls and short puts, while the bearish side of the market includes long puts and short calls.

| Bullish | Bearish |
|---|---|
| Long Calls | Long Puts |
| Short Puts | Short Calls |

*For example, ABC Company has a 75,000-contract position limit. If an investor owns 50,000 ABC calls and is short 25,000 ABC puts, he has reached the maximum on the bullish side of the market. The investor may not buy additional ABC calls or write additional ABC puts.*

However, the investor is permitted to buy ABC puts and or sell ABC calls up to a total of 75,000 contracts since these transactions are on the bearish side of the market. Also, because the limits apply to each underlying security, the investor is allowed to purchase calls or write puts on another underlying stock.


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# CHAPTER 6

# *The New Issue Market*

# Capital Formation

As previously described, when a corporation intends to raise capital, it typically does so by issuing securities through a formal offering.

## Offering Securities to Investors

**Public Offering versus Private Securities Offerings (Private Placements)** Securities may be offered or issued in two ways—private placements and public offerings. The main advantage of a public offering is the large number of investors (both retail and institutional) who are permitted to participate. However, the disadvantages include both the costs involved and the length of time needed to undertake this type of offering due to the requirements of the Securities Act of 1933.

In some cases, institutional investors, (e.g., venture capitalists or private equity investors) provide start-up capital to new companies. The capital is typically raised through a form of non-public offering that's referred to as a private placement. The primary advantage of a private placement is that it's faster and less costly than a public offering. On the other hand, a disadvantage faced by an issuer that's engaged in a private placement is that there are limits related to whom the offering may be directed and/or the number of investors that may participate.

**An Initial Public Offering Versus a Follow-On Offering** When an issuer offers securities to the public for the first time, the process is referred to as its initial public offering (IPO). However, if a company has already gone public and intends to raise additional capital through a sale of common stock, it's conducting a *follow-on* offering. In a follow-on offering, the company itself is issuing new shares which dilute the ownership of existing shareholders. Keep in mind, these offerings are still considered primary distributions since the proceeds of the offering are being directed to the issuer.

*Combined (Split) Offerings* In a combined offering, some of the shares are offered by the issuer, while the remainder are offered by selling shareholders. The shares being offered by the company are newly created and represent a primary offering. The corporation issuing these new shares will receive the proceeds on that portion of the sale. The existing shares being offered by the current shareholders are considered a secondary offering and the proceeds from this portion of the offering are directed to the individual sellers (not the issuer).

If the offering is split, it's imperative for the underwriters to disclose to any purchaser that a portion of the offering's proceeds will be paid to the selling shareholders. Selling shareholders may include officers of the company or early-entrance investors (the institutional investors mentioned previously) that are seeking to either cash out or scale back their holdings in the company.

**Private Investment in Public Equity (PIPE)** A PIPE offering is a private placement of securities in which a broker-dealer assists an issuer by distributing restricted (i.e., unregistered) securities to a small group of accredited investors, such as hedge funds.

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The issuer of the securities already has publicly traded securities that are outstanding. These restricted securities are purchased at a price that's below the current price of the common stock at the time of the announcement. Once the PIPE offering is announced, the company's share price will often decline. This price decline is in part a reflection of the increase in the number of shares outstanding (potential dilution), but also due to the perception that the company is not only in need of capital, but that it has limited means available to raise the capital.

Prior to the offering, a registered salesperson is permitted to solicit and accept indications of interest from investors for the purchase of the PIPE. Often PIPE investors hold the restricted securities for a short period and will then quickly resell them in the public marketplace.

**Spin-Off Transactions** Spin-off transactions occur when a parent company distributes shares of a subsidiary company to its current shareholders. In a spinoff, each shareholder of the parent retains her original shares, but is also given shares in the newly created entity. For the recipients of the new shares, there's no immediate tax consequence. Spinoffs are used by sellers in the hopes that the combined valuation that the market assigns to the two (now) separate companies will be greater than that of the single combined entity.

## Private Placements

Section 4(2) of the Securities Act of 1933 doesn't require the registration of securities that an issuer is selling through transactions "not involving any public offering." These non-public offerings are referred to as *private placements*. The problem with utilizing this private placement exemption is that it doesn't specify the concept of a non-public offering. Instead, the burden of proof is on the issuer, which can create uncertainty. However, through Regulation D, the SEC did eventually create a set of rules that describe how an offering can qualify as a private placement.

## Regulation D

Under Regulation D, an issuer's private placement of securities qualifies for an exemption if the following conditions are met:

- The issuer reasonably believes that the buyer is a sophisticated investor (i.e., one that's experienced enough to evaluate any risks involved).
- The buyer has access to the same financial information that's normally included in a prospectus. This information is provided in a document that's referred to as a private placement memorandum.
- The issuer is assured that the buyer doesn't intend to make a quick sale of the securities. This is usually accomplished by means of an investment letter (also referred to as a lock-up agreement).
- The securities are sold to no more than 35 non-accredited investors.

**Accredited Investor** For private placements, there's no restriction on the number of accredited investors. An accredited investor includes any of the following:

- Financial institutions (e.g., banks), large tax-exempt plans, or private business development companies
- Directors, executive officers, or general partners of the issuer


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- Individuals who meet either one of the following criteria:
  - Have a net worth of at least $1 million or
  - Have gross income of at least $200,000 (or $300,000 combined with a spouse) for each of the past two years with the anticipation that this level of income will continue

**Restricted Securities – Lock-Up Agreements and Legends** A lock-up agreement dictates the amount of time that pre-IPO investors (e.g., private placement buyers, management, venture capitalists, and other insiders) must wait to sell their shares once the company has gone public. Although a lock-up agreement will generally expire six months following the closing of the company's IPO, there's no statutory time limit. The lock-up is designed to prohibit management and venture capitalists that initially funded the company from immediately liquidating their shares once the issue goes public.

The lock-up period also restricts or limits the supply of shares being sold in the market. Shares that are subject to a lock-up agreement will carry a restrictive legend that's printed on the face of the certificate to indicate that the securities have not been registered with the SEC and are not eligible for resale unless the legend is removed. In many cases, the removal of the legend is accomplished under SEC Rule 144.

# The New Issue Rule

Under the New Issue Rule, also referred to as the Equity IPO Rule, a FINRA member firm is required to make a bona fide offering of new issues to the public and is prohibited from withholding shares for its own account, the accounts of any of its employees, or for the accounts of industry insiders. However, an exemption exists which allows personnel of a limited broker-dealer to purchase shares of a new issue. A limited broker-dealer is a firm that restricts its business to investment company/variable contract securities or direct participation programs.

## New Issue Definition

New issues include *all* initial public offerings (IPOs) of equity securities that are sold under a registration statement or offering circular. However, the following securities are not considered new issues and may be sold to restricted persons:

- Secondary offerings
- All debt offerings, including convertible and non-investment-grade debt
- Private offerings
- Preferred stock and rights offerings
- Investment company offerings
- Exempt securities as defined under the Securities Act of 1933
- Real estate investment trusts (REITs)
- Direct participation programs (DPPs)

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## Preconditions for Sale

Prior to selling a new issue to an account, a firm must satisfy the *pre-conditions for sale* requirement. In other words, the firm must obtain verification from an account holder or any authorized party for the account that the account is eligible to purchase new issues. The representation from the account holder may be in the form of an *affirmative written statement* or *electronic communication* (but not oral statements) that positively declares that the account is eligible. Thereafter, a member firm is required to re-verify eligibility at least every 12 months and also retain copies of all of the information and records that are used for verification for at least three years.

For accounts that are held by banks (domestic and foreign), broker-dealers, investment advisers, or other *conduits* that purchase new issues on behalf of their customers, the firm must obtain a representation that all of its purchasers of new issues are in compliance with the New Issue Rule.

## Prohibited Sales and Restricted Persons

A member firm or any person who is associated with a member firm is prohibited from offering or selling a new issue to any account in which a *restricted person* has a beneficial interest. According to the New Issue Rule, all of the following are considered restricted persons:

- Member firms and all of their associated persons (i.e., employees)
- An immediate family member of a member firm employee if *any one of the following three* conditions apply:

    1. The employee gives/receives material support to/from the immediate family member. (*Material support* is defined as providing more than 25% of the person's income or living in the same household as the person who is associated with the member firm.)
    2. The employee is employed by the member firm that's selling the new issue to the immediate family member.
    3. The employee has the ability to control the allocation of the new issue.

For purposes of the rule, immediate family members include a person's spouse, children, parents, siblings, in-laws, and any other person to whom the member firm employee provides material support. Aunts, uncles and cousins are not defined as immediate family members; therefore, they're not considered restricted persons.

> *Example 1, if John is employed by ARW Investment Bank and supports his brother, his brother is considered a restricted person.*
>
> *Example 2, Keith is employed by NJF Investment Bank and the firm is the managing underwriter of Mattco's IPO. Due to Keith's employment with a member firm, his immediate family members are restricted from purchasing shares in the Mattco IPO from NJF.*

Other restricted persons include the following individuals:

- Finders and fiduciaries (e.g., attorneys and accountants) who are involved in the offering of the new issue and any person to whom they provide material support.


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- Portfolio managers who purchase the new issue for their own accounts. This provision includes persons who typically buy or sell securities on behalf of institutional investors (e.g., banks, investment companies, investment advisers, insurance companies, savings and loan institutions). The reason for their restricted status is that these persons are in a position to direct future business to the firm.
- Persons who own a broker-dealer. This generally incorporates persons who have 10% or more ownership of a brokerage firm which requires them to report their restricted person status on Form BD.

## General Exemptions

The New Issue Rule provides specific exemptions which allow equity IPOs to be sold to the following accounts:

- An investment company that's registered under the Investment Company Act of 1940
- The general or separate account of an insurance company
- A common trust fund
- An account in which the beneficial interest of all restricted persons doesn't exceed 10% of the account. (This *de minimis* exemption allows an account that's owned in part by restricted persons to purchase a new issue if their combined ownership is minimal.)
- Publicly traded entities, other than a broker-dealer or its affiliates, that engage in the public offering of new issues
- Foreign investment companies
- ERISA accounts, state and local benefit plans, and other tax-exempt plans established under IRS Code 501(c)(3)

Another exemption under the rule allows a broker-dealer to purchase shares of a new issue if the offering is under-subscribed. This provision allows an underwriter that's entered into a firm commitment agreement with an issuer to purchase shares for its own investment account if it's unable to sell them to the public. However, this exemption doesn't allow an underwriter to sell shares of an undersubscribed issue to other restricted persons.

The rule also contains an anti-dilution provision that allows restricted persons that already own shares of the security to purchase shares of a new issue, but only if doing so will allow them to keep their equity interest at the same level. Under this provision, the buyer must have owned the shares for at least one year prior to the offering and the new shares cannot be resold for three months following the effective date.

## Issuer-Directed Securities

The clear intent of the New Issue Rule is to eliminate the selling of equity IPOs to certain purchasers. The prohibitions don't apply to securities that are specifically directed by the issuer to persons that are restricted under the Rule; however, the securities directed by the issuer may not be sold to or purchased by:

- A broker-dealer
- An account in which any restricted person has beneficial interest, unless the person, or a member of his immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer

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*For example, a partnership has recently decided to incorporate and, with the help of an underwriter, is planning to conduct an equity IPO. Jerry, one of the founding partners who was recently appointed as the new company's CEO, wants to ensure that his family is able to share in this investment opportunity. Will Jerry's mother and father be allowed to purchase the new issue or are they restricted? Since Jerry is an officer of the issuer, he's able to have the underwriter allocate shares to his parents. What about Jerry's brother, who happens to be a registered representative of a broker-dealer; is he allowed to purchase the securities? Yes. The issuer-directed sale provision allows an otherwise restricted person (e.g., an RR) to purchase the securities as long as he or his immediately family member is an employee or director of the issuer.*

# Regulation M

Before major federal securities laws were passed in the 1930s, underwriting syndicate members would often *condition the market* for new issues they were about to sell. After these underwriters sold their allotments and stopped their behind-the-scenes activities, the stocks involved would often drop precipitously, causing unwary investors to suffer large losses.

Due to the SEC's concern about manipulative activities in the securities markets, it passed a series of trading practice rules over the years that restricted certain practices in the market for securities that are being sold by a syndicate. These rules became complex and contradictory, making it difficult for underwriters and traders to know whether they were in compliance. It was also difficult to apply the rules to the growing Nasdaq Stock Market, since the rules were originally envisioned for a market in which the majority of trading occurred on exchanges.

In response to changes in the securities markets, the SEC decided to enact new regulations in this area by replacing the old trading practice rules with a new set of rules—*Regulation M*. The overall effect has been to significantly liberalize the restrictions on trading during syndicate distributions. Regulation M consists of several rules the cover different aspects of a distribution and related secondary market activity.

## Rule 101 – Activities of Distribution Participants

The purpose of Rule 101 is to prevent any persons that are *interested* in a distribution from manipulating secondary market trading for their benefit. Distribution participants include syndicate members, selling group members, and any other broker-dealers that assist in selling the security being offered to the public (referred to as the *subject security)*. These participants are not permitted to buy or bid for the subject security within a critical time frame called the *restricted period*.

**Length of Restricted Period** The restricted period generally begins five business days prior to pricing, or whenever the broker-dealer becomes a participant, *whichever comes later*. The period ends when the broker-dealer's participation ends. However, if the subject security has an average daily trading volume (ADTV) of at least $100,000 and the issuer's public float is $25 million or more, the five-business-day standard is reduced to one business day.


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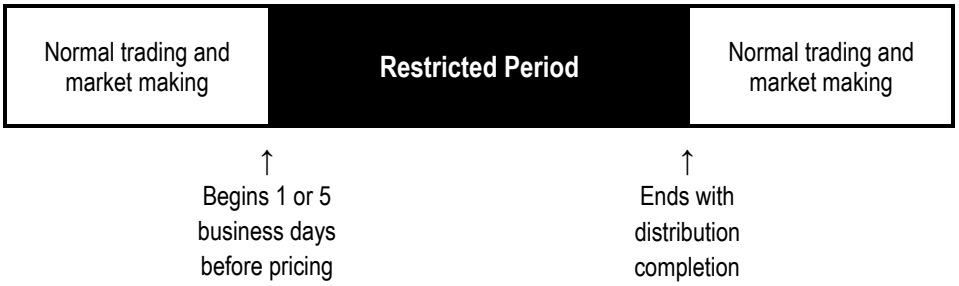


When determining the restricted period for a security, the SEC recognizes that securities with higher trading volume are more difficult to manipulate. For that reason, the restricted period for these securities will be shorter.

In the case of a distribution relating to a merger, acquisition, or exchange offer, the restricted period is defined as the day the proxy solicitation materials are first disseminated to holders of the securities and ending on the completion of the distribution.

The following table provides details regarding the restricted period based on a security's public float and average daily trading volume (ADTV):

| | |
|---|---|
| **Five Days Prior to Pricing** | ▪ Public float of less than $25 million and ADTV of less than $100,000 |
| **One Day Prior to Pricing** | ▪ Public float between $25 million and $150 million and ADTV of at least $100,000 |
| **No Restricted Period** | ▪ Municipal securities, Government securities, and non-convertible investment-grade debt<br>▪ Actively traded securities – Public float of at least $150 million and ADTV of $1 million |

**Reference Securities** The prohibition on making purchases or bids doesn't only apply to the subject security (i.e., the security that's the subject of a distribution), but also to any *reference securities* into which the subject security may be converted. For example, if ABC Company convertible bonds are being distributed, the bonds are the subject security and ABC's common stock is the reference security. Together, both subject and reference securities are referred to as *covered securities* and are subject to the restrictions of Rule 101.

Although common stock is a reference security for an offering of rights, warrants, or convertibles (subject securities), the reverse is not true. For example, if XYZ Corporation is issuing common stock, warrants for XYZ common stock are NOT reference securities, since the SEC believes they don't, by their terms, affect the value of the security being distributed. Derivative securities are generally not subject to trading restrictions when the underlying security is being distributed. The SEC seems to believe that it's difficult to manipulate the price of an underlying security by trading the derivative itself.

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There are circumstances under which an instrument will be a reference security, even though it cannot be obtained through conversion of the subject security. For instance, if an equity-linked security is tied to the value of certain common stock, the common stock is a reference security despite the fact that there's no conversion feature.

**Exceptions to Rule 101** There will be many cases in which the restrictions of Rule 101 don't apply because of the exceptions allowed. However, exceptions are not an invitation to interfere with market forces. Activity that's obviously manipulative will still violate general SEC antifraud rules. Exceptions to Rule 101 include the following.

- Transactions involving government and municipal bonds, non-convertible investment-grade debt and preferred stock, and registered investment company securities
- Actively traded securities, which are those with an ADTV of at least $1 million and where the public float of the issuer's common stock is at least $150 million
- Odd-lot transactions
- The exercise of any option, warrant, right, or similar instrument during the restricted period, regardless of when it was acquired
- *Unsolicited* brokerage transactions and *unsolicited* purchases when acting as a principal
- Securities of domestic and foreign issuers that are eligible for an exemption from the Securities Act of 1933 under Rule 144A if sold to qualified institutional buyers (QIBs), and certain Regulation S transactions
- Transactions in the subject security that are part of a basket strategy, if the basket is not used for manipulation—the subject security must be no more than 5% of the basket, which must contain at least 20 securities

Another exception from the rule applies to unaccepted bids and purchases that don't exceed 2% of the security's ADTV as long as the broker-dealer maintains and enforces written policies and procedures that are designed to prevent violations. If inadvertent transactions are discovered, subsequent *de minimis* transactions are no longer given the exception.

**Research** Under both the old trading practice rules and new Rule 101 underwriters are prohibited from inducing others to purchase a covered security. In the past, this was interpreted to include the distribution of research reports by participating broker-dealers. Although the SEC granted certain types of no-action relief for normal research report mailings, it was still often unclear as to what was acceptable.

Rule 101 of Regulation M addresses this issue more clearly. Research reports that refer to covered securities can be distributed during the restricted period if they meet the conditions of Rules 138 and 139 of the Securities Act of 1933. This usually requires that the reports be distributed with reasonable regularity in the normal course of business. The SEC also expects that the recipients of the reports regularly receive the broker-dealer's research. So, for example, adding new recipients to the mailing list is permitted if it's intended that they will receive all future research as well. On the other hand, sending just one report to a potential customer during the restricted period doesn't qualify for the exception.


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## Rule 102 – Activities of Issuers

Imagine that you hold thousands of shares of stock in a company that's conducting a follow-on offering. It may be tempting to push the price of the stock up just before the company's offering is distributed to investors.

Because of this temptation, Regulation M prohibits issuers and selling security holders (mainly insiders) from supporting or raising the price of a security being distributed. In other words, these persons cannot purchase or bid for a covered security, or induce others to do so.

**Exceptions to Rule 102** Rule 102 contains some of the same exceptions as Rule 101, including unsolicited purchases, transactions in Rule 144A securities, the exercise of convertible securities, odd-lot transactions, and transactions in exempted securities. However, since issuers and selling shareholders don't play the same role in the market as intermediaries (e.g., broker-dealers), some of Rule 101's exceptions are not available to them. For example, issuers may NOT bid for or purchase the following:

- Actively traded securities of the issuer or an affiliate
- Basket transactions involving a covered security
- Inadvertent (de minimis) transactions

In addition, the Rule 101 provision that allows for the issuance of research on a covered security under certain conditions is not available to the issuer or its affiliates.

## Rule 103 – Passive Market Making

The liquidity of Nasdaq stocks can be adversely affected when market makers that are also syndicate members suspend their normal activity during an offering because of the provisions of Rule 101. Therefore, Regulation M contains Rule 103, which permits distribution participants to continue making markets in a Nasdaq stock that's the subject of an offering during the restricted period of Rule 101, but only on a *passive* basis.

**What's Passive Market Making?** Market makers that are involved in a distribution may not enter a bid or effect a purchase at a price that exceeds the highest independent bid on Nasdaq. (Independent bids are those that are placed by market makers that are not involved in selling the new issue.) In a falling market, when the last independent bid drops below that of a passive market maker, the passive market maker may maintain its bid until its purchases have reached or exceeded the lesser of two times the minimum quotation size for that security (200 shares), or the passive market maker's remaining daily limit (described below). At that point, the passive market maker must drop its bid to or below the highest independent bid.

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*For example, Dotted Line Capital (DTLN) is involved in the secondary offering of BNBR. Under Rule 103, Dotted Line may continue to act as a market maker. MM A is an independent market maker and is at the inside bid for BNBR at 16.59. DTLN may enter a bid or effect a purchase up to, but not greater than, 16.59. The bids in the market for BNBR are as follows:*

| | ***Bids*** | |
|---|---|---|
| *MMA* | *16.59* | *(Independent)* |
| *DTLN* | *16.59* | *(Passive MM)* |
| *MM C* | *16.50* | *(Passive MM)* |

*If MM A lowers its bid to 16.45, DTLN must lower its bid to 16.45 after having purchased 200 shares of BNBR or upon reaching its remaining daily limit. DTLN cannot lower its bid to 16.50 since MM C is also a passive market maker.*

In a rising market, a passive market maker may raise its bid when the best independent bid rises, but is not required to do so. Please note, if there are no independent market makers (i.e., all of the market makers in the security are involved in the distribution), passive market making is NOT allowed.

**Daily Purchase Limit** A passive market maker's daily purchase limit is the greater of 30% of *its* ADTV in the stock (as determined by FINRA) or 200 shares. Once a passive market maker's *net purchases* (purchases in excess of sales) for that day are more than its purchase limit, it must withdraw from the market for the rest of the day. However, a passive market maker that's close to the limit is allowed to execute any single order even if doing so will exceed its daily limit.

*For example, let's assume that a passive market maker's daily purchase limit is 10,000 shares and it currently has net purchases of 9,500 shares. It may purchase 1,000 shares at this point if it's a single order, even though it knows its total net purchases will exceed its limit. Of course, it must then withdraw from the market. The firm may not aggregate orders into a single transaction for purposes of evading the rule. In the preceding example, two 500-share tickets cannot be combined into a 1,000-share transaction.*

**A Complication** One factor that complicates passive market making is the existence of the SEC's Order Handling Rules. These rules may require a market maker to include a customer's limit order in its quote; however, if the customer's limit price to buy is higher than the highest independent bid, the rules conflict. According to the SEC, a market maker may reflect a customer's order to buy in its bid under the Order Handling Rules, even if the bid will otherwise violate Rule 103 of Regulation M.

*For example, the highest independent bid for ABCD stock is 21.55 and a passive market maker receives a customer limit order to buy 1,000 shares ABCD at 21.70. The passive market maker will display 1,000 shares at 21.70 despite that fact that this appears to be in violation of Rule 103 of Regulation M.*


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## Rule 104 – Stabilizing

*Stabilizing* is defined as the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or otherwise maintaining the price of a security. By definition, stabilizing is a manipulative activity. However, the SEC considers its benefits (facilitating an orderly distribution) to outweigh its disadvantages and, for that reason, stabilizing is a *permitted* manipulative activity as long as the SEC's rules governing it are followed. There's no specific limit on the length of time an offering can be stabilized.

Rule 104 of Regulation M attempts to strike a balance between the desirability of an orderly distribution and the need to prevent manipulation of a new offering. Purchases by the syndicate that aren't necessary to prevent or retard a decline in a security's price, or which have a manipulative purpose, are illegal. Also, stabilizing is not permitted for an *at-the-market* offering (an offering of securities at a price that's not fixed).

**Initiating a Stabilizing Bid** Only one distribution participant is permitted to enter a stabilizing bid in a security. The maximum price at which a stabilizing bid may be initiated is the last independent sale price or the highest bid in the market. In the case of an IPO, the bid may not be higher than the public offering price (POP). The application of the rule depends on whether stabilizing begins when the security's principal market is open or closed. A security's principal market is the market that accounts for most of the security's trading volume.

*Initiating Stabilizing When The Principal Market Is Open* After the opening of quotes for the security in the principal market, stabilizing may be initiated in any market at a price that's no higher than the last independent transaction price for the security in the principal market if (i) the security has traded in the principal market on the day stabilizing is initiated or on the preceding business day, and (ii) the current ask price in the principal market is equal to or greater than the last independent transaction price. If either one of the preceding conditions is not satisfied, stabilizing may not be initiated in any market after the opening of quotes in the principal market at a price that's higher than the highest current independent bid for the security in the principal market.

*For example, BNBR stock has just opened for trading in its principal market; however, no transactions have taken place in the stock. Dotted Line Capital (DTLN), a participant in the initial public offering of the security, wants to maintain a stabilizing bid in the security. MMA, an independent market maker, is at the inside bid for BNBR at 24.55. DTLN may not enter a bid that's higher than the highest independent bid (as shown below).*

| Bids | | |
|---|---|---|
| MMA | 24.55 | (Independent) |
| MMB | 24.54 | (Independent) |
| DTLN | 24.55 | (Stabilizing) |

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*Let's assume that BNBR was trading in the principal market for one day prior to DTLN's attempt to place a stabilizing bid. If the last transaction in BNBR was at a price of 24.56 and the current ask price is 25.00, DTLN is able to maintain a bid of 24.56.*

*Initiating Stabilizing When the Principal Market Is Closed* When the principal market for the security is closed, the price at which stabilizing can be initiated is generally limited to the lower of the price at which stabilizing could have been initiated in the principal market at its previous close, or the last independent transaction or bid in the market on which stabilizing will be initiated.

Any person that enters a stabilizing bid must grant priority to any independent bid at the same price, regardless of the size of the independent bid. Once initiated, a stabilizing bid may be raised to match independent bids in the market.

**Disclosure and Notification** If a syndicate decides to stabilize, it must notify the market in which stabilizing will occur and must disclose the purpose of the stabilizing bid to the person with whom the bid is entered.

**Aftermarket Activities** The SEC has noted that certain aftermarket activities can have economic effects that are similar to stabilization, especially syndicate short covering purchases and the imposition of penalty bids. Rule 104 requires syndicates that engage in either of these activities to notify the SRO for the principal market in which the security is traded (see "Stabilizing Bids on Nasdaq" on the following page).

**Stabilizing in an Era of Global Markets** The SEC has structured Rule 104 by taking global markets into account. For example, the rule permits stabilizing bids to be carried over from one market to another, regardless of the intervening changes in the independent bids or transaction prices in the security. For a global broker-dealer that passes its book from New York to Hong Kong to London and back, this makes compliance with Rule 104 easier.

To further accommodate cross-border transactions, the SEC permits stabilizing outside of the United States during an offering in the U.S. without complying with Rule 104. However, the following conditions must be met:

1. There's no stabilizing in the U.S.
2. Stabilization is not conducted above the U.S. offering price.
3. The foreign stabilization occurs in a country with regulations that are similar to U.S. rules (e.g., the U.K.).

Other provisions of the rule that take into account international transactions, include the following points:

1. Stabilizing bids may be placed in the currency of the market in which the bid is made.
2. Adjustments to stabilizing bids are allowed to account for fluctuations in exchange rates.


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## Rule 105 – Short Sales in Connection with an Offering

Rule 105 of Regulation M addresses the concern of having large institutions participating as buyers of securities offerings. Over time, it's been argued that the price-setting power has been transferred from the underwriters to large institutions. This occurs when investors believe that a new issue will be unsuccessful and that the stock will be sold short and then covered with positions that are purchased from underwriters. This activity disrupts the orderly distribution of the securities.

Rule 105 stipulates that it's a violation for any person to sell short the security that's the subject of an offering, and then purchase the offered security from an underwriter if the short sale was executed during the period beginning five business days prior to the pricing of the offering and ending with the pricing of the issue. If the pricing of the offering occurs within five business days of the filing of the registration statement, then Rule 105 applies from the filing date until the pricing of the issue. The rule doesn't apply to offerings that are not conducted on a firm-commitment basis. The basic concept is that a person is prohibited from buying securities in a firm-commitment underwriting if that person had sold the security short during the restricted period.

There are two exceptions to Rule 105—the *bond-fide purchase exception* and the *separate accounts exception.*

**Bona Fide Purchase Exception** This exception allows a person that was unaware of the offering, or changes her mind, to close out the short sale at least one business day prior to the day of the pricing and still purchase the offered securities.

**The Separate Accounts Exception** This exception allows a person to purchase the offered securities in an account in which there was a short sale in another related account during the restricted period, but only if decisions regarding securities transactions for each account are made separately and without any coordination of trading or cooperation among or between the accounts. For two accounts to be considered separate, there must be no sharing of profits and losses or allocation of positions between accounts. Information barriers must exist between any persons that are managing each account in order to maintain the exception.

# Related Industry Rules

There are several industry rules that relate to the types of activities being covered by SEC Regulation M.

## Stabilizing Bids on Nasdaq

If a market maker intends to stabilize the price of a Nasdaq security under the conditions required by Regulation M, it must submit a request to Nasdaq Market Operations to enter a one-sided bid. The quote is identified on Nasdaq as a stabilizing bid by the abbreviation *SYND*.

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In order to stabilize on Nasdaq, the following additional conditions must be met:

1. Only one market maker may enter a stabilizing bid in a security.
2. In order to enter a stabilizing bid, there must be one independent market maker that's entering quotes for the security.
3. A stabilizing bid must be available for all freely tradable outstanding securities of the same class as the security being offered.

The market maker's request to stabilize doesn't need to be in writing, but the market maker must confirm its request in writing by no later than the close of business on the day on which the stabilizing bid is entered. This can be accomplished by sending to Nasdaq Market Operations either of the following:

- An Underwriting Activity Report (UAR), which is obtained from the FINRA Corporate Financing Department
- A written confirmation that includes (i) the identity of the security and its Nasdaq symbol, (ii) the contemplated effective date and pricing date of the offering, (iii) the date and time that an identifier should be included on Nasdaq, and (iv) a copy of the cover page of the preliminary or final prospectus or other offering document.

## Market-Maker Status

In order to comply with parts of Regulation M, a market maker may need to be granted excused withdrawal status or passive market-maker status by FINRA. The syndicate manager must apply for this status on behalf of any affected syndicate member by no later than the business day prior to the first entire trading session of the one- or five-day restricted period under Rule 101.

This can be accomplished by submitting a Regulation M Restricted Period Commencement Form to Nasdaq Market Operations. The manager then notifies each affected syndicate member that it will have passive market-maker status or that its quote will be withdrawn on an excused basis, unless that market maker directly notifies FINRA otherwise. The manager will also request that excused or passive market-maker status be rescinded when the offering terminates. Passive market makers are identified on Nasdaq by the abbreviation *PSMM*.

## Penalty Bids and Syndicate Covering Transactions

The syndicate manager must provide written notice to FINRA if it intends to impose a penalty bid on a subject or reference security under Rule 101, or if it intends to engage in syndicate covering transactions under Rule 104. The notice must be provided prior to the start of either of these activities. The notice must include (i) the identity of the security and its Nasdaq symbol, and (ii) the date on which the member intends to impose the penalty bid and/or conduct syndicate covering transactions. A Regulation M Trading Notification Form, part of the Underwriting Activity Report, can be used for reporting this information. By no later than 30 days after the effective date of the offering, the manager must also maintain information in its files about the amount of the syndicate short position. Let's define penalty bids and syndicate covering transactions.


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- *Penalty Bid* – This is an arrangement whereby the managing underwriter is permitted to reclaim a selling concession from a syndicate member in connection with an offering when the securities that were originally sold by the syndicate member are purchased in syndicate covering transactions. Penalty bids are identified on Nasdaq by the abbreviation *PBID*.
- *Syndicate Covering Transaction* – This involves the placing of any bid or the effecting of any purchase on behalf of the sole distributor or the underwriting syndicate or group to reduce a short position that was created in connection with the offering. Syndicate short positions can arise from *overallotments*, in which syndicate members sell more than the number of shares being offered. This can occur if the syndicate anticipates that some indications of interest will be withdrawn by customers. In some cases, the short positions can be covered by syndicate stabilizing purchases; however, in a rising market for the offering, this could result in significant losses to the underwriters. In this case, an alternative is to invoke the *Green Shoe* option (if available). This is a provision that can be included in the registration statement that allows the syndicate to purchase up to 15% more shares than were originally registered, on the same terms and at the same price as the original shares, in order to cover overallotments. As with any aspect of a new offering, overselling by a syndicate is covered by antifraud rules and cannot be manipulative.

## New Issue Allocations and Distributions (FINRA Rule 5131)

Based on FINRA's continuing concerns with the integrity of the new issue marketplace, it has created regulations that focus on the allocation, pricing, and trading of initial public offerings (IPOs). A firm's equity trading department needs to be familiar with the trading aspects of Rule 5131.

**Flipping** Flipping is defined as the initial sale of a new issue within 30 days following the offering date of an IPO. In many circumstances, this may create downward pressure on the price of the security in the secondary market and, for this reason, underwriters may try to discourage these types of sales. Underwriters will use a penalty bid to recoup the selling concession from syndicate members on flipped trades.

Previously, some firms had used a different method to accomplish this objective by trying to recoup the selling concession from registered representatives when their retail customers flipped a new issue. This type of activity is not permitted since it creates an incentive for an RR to advise a customer to hold an IPO for more than 30 days. Ultimately, this favored institutional investors since the sale to an institution was typically not penalized if the institution flipped the IPO. Based on this, FINRA prohibits a member, or a person associated with a member, from directly or indirectly recouping, or attempting to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares of a new issue that are subsequently flipped by a customer. Of course an exception is made if the managing underwriter has assessed a penalty bid on the entire syndicate.

**Market Orders** An investor who places a market order prior to the secondary market trading of an IPO may be subject to a high degree of price risk. For example, an IPO that's priced at $22 may have its first trade in the secondary market at a price of $35. The investor who places a market order may end up purchasing the stock at $35, despite the fact that the stock was priced by the underwriters at $22. The rule prohibits a member from accepting a market order for the purchase of shares of a new issue in the secondary market prior to the commencement (beginning) of trading of the shares in the secondary market.

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The prohibition applies to both NMS stocks and OTC equity securities. A firm is permitted to accept limit orders and not-held orders. For purposes of this rule, the dissemination of the first reported transaction by the primary exchange (for NMS stocks) or ORF (for OTC equity securities) is considered the commencement of trading.


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# Chapter 7

# *Trade Reporting*

# Trade Reporting

| Quotation Systems | Execution Systems | Reporting Systems |
|---|---|---|
| Nasdaq and CQS (Third Market) | Nasdaq Market Center Execution System | Trade Reporting Facility (TRF) |
| ADF (NMS Securities Only) | Proprietary Systems (ATS) | ADF Reporting Service |
| OTCBB or Pink Marketplace (OTC Equities) | Manual Fills or Proprietary Systems | OTC Reporting Facility (ORF) |
| Traditional Floor Trading | Exchange's Proprietary Systems | Exchange's Proprietary Reporting Mechanism |

## The Automated Confirmation Transaction (ACT) Technology Platform

FINRA rules require the reporting of transactions involving both domestic and foreign equity securities. Transactions involving Nasdaq-listed and other exchange-listed securities (e.g., NYSE or NYSE American) that occur over-the-counter are reported to the Trade Reporting Facility (TRF), while transactions involving OTC equity securities are reported to the OTC Reporting Facility (ORF). Both the Trade Reporting Facility and the OTC Reporting Facility utilize the Nasdaq ACT Technology Platform. These two separate and distinct reporting services contract with Nasdaq for the use of its platform. Both the TRF and the ORF are open from 8:00 a.m. until 8:00 p.m. Keep in mind, the TRF is not a system that's used to report transactions that are executed on the floor of the NYSE; instead, these transactions are reported by the exchange on the Consolidated Tape.

Nasdaq's Automated Confirmation Transaction Technology Platform is a system that facilitates the reporting and clearing of Nasdaq and OTC transactions by allowing both order-entry and market-making firms to enter priced trades. This information is then used to report, match, and clear transactions. Trades that are entered into ACT have already been negotiated between the parties or have been executed in another system, such as the Nasdaq Market Center Execution System.

Although FINRA rules require members to report transactions in OTC equity securities (which include foreign equities, such as ADRs), the reporting requirement excludes foreign security transactions if they are executed on and reported through a foreign securities exchange, or executed OTC and reported to the regulator of a foreign securities market. If the trade is executed OTC and is not reported by the foreign exchange or to a foreign regulator, it must be reported by the broker-dealer within 10 seconds through the ORF and in U.S. dollars.

Transactions involving securities that are quoted on the ADF and executed through private connectivity providers are reported through the ADF.

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**Trade Reporting** Transactions are reported to the TRF through the ACT Trade Report window on Nasdaq Workstation II terminals. Both the market-maker and order-entry sides of the transaction use the Trade Report window. The market maker selects "MM"—the market-maker function—before entering its trade details. The order-entry firm selects "OE"—the order-entry function—prior to entering its information. However, only the data from the market-maker function is reported to the appropriate organization for dissemination to the market. Nasdaq receives the data for securities that are listed there, while the Securities Industry Automation Corporation (SAIC) receives the data for other listed stocks. To avoid double counting in a trade between two market makers, the buying market maker reports using the order-entry function as a non-reporting principal.

**Time Stamping** Broker-dealers are required to time-stamp all of their trade tickets at the time of execution. The execution time must be reported on all of the last sale reports and be expressed in hours, minutes, and seconds based on Eastern Time.

**Clearing and Comparison Rules** Broker-dealers are also required to input trade reports for clearing purposes. These procedures are similar, but not identical, to TRF transaction reporting. The reports are used for clearing purposes, rather than for dissemination of trade information. In this context, the *reporting* party refers to a broker-dealer that's a member of a registered clearing agency which is required to report the transaction for clearing or comparison purposes. After trade data is reported, the other side of the transaction is required to use the *browse* function to accept or decline the trade. For broker-dealers that are not members of a registered clearing agency, they are required to have an agreement with a clearing member firm. These non-clearing firms are referred to as correspondent or introducing brokers.

Trade reports may be submitted using either a short format or a long format. The short format is faster and permits all of the trade details to be entered on one line. However, the long format allows the entry of information that's not permitted using the short format, such as *give-up* and T + 1 transactions. (In a give-up arrangement, an executing broker-dealer submits trades to the TRF on behalf of a participant broker-dealer. The participant broker-dealer agrees to accept and honor all of the trades that are reported on its behalf. To establish a give-up relationship, both firms must execute and submit a written agreement to Nasdaq.) A *step-out* arrangement is another method which is used by broker-dealers that have previously executed a transaction and then allocate all or part of the transaction to another broker-dealer for clearing purposes.

**Market-Maker Obligations** Industry rules require market makers to:

- Report to the TRF any over-the-counter transactions in Nasdaq Global Select Market, Nasdaq Global Market, and Nasdaq Capital Market securities, as well as CQS issues within 10 seconds (during applicable hours), and enter trade details for all clearable and internalized transactions using the market-maker function on Nasdaq Workstation II
- Correct, decline, or cancel trades, when necessary

**Order-Entry Firm Obligations** Industry rules require the order-entry (non-reporting principal) side of a transaction to take *one* of the following actions for each transaction:

1. Enter a version of the trade within 20 minutes of execution using the OE function on Nasdaq Workstation II


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3. Accept the market-maker trade entry on ACT Trade Scan (described below) within 20 minutes of the execution, or
4. Decline an incorrect market-maker trade entry on ACT Trade Scan or cancel the trade entry

Once a trade has been matched, either because the order-entry side accepted the trade on ACT or because ACT matched the trade details that were entered by the market-maker and order-entry sides, the transaction is considered locked-in for clearing purposes.

**Reporting ECNs** A Reporting ECN is a participant of a registered clearing agency (for clearing or comparison purposes) or one that has a clearing arrangement with a clearing firm. These ECNs submit trade reports to the Trade Reporting Facility and identify themselves as the reporting party. They may also submit reports on behalf of another reporting party (i.e., another FINRA member), provided the reporting party is identified in the report. Reporting ECNs include both electronic communication networks and alternative trading systems.

**Cancelled Trades** Trades that have been reported to the Nasdaq Market Center, but have later been cancelled, must be reported as such. The cancellation of a trade report must be done by the firm that reported the trade or was obligated to report it based on automated lock-in.

Trades that are executed during normal business hours and cancelled either at or before 4:00 p.m. on the date of execution should be reported within 10 seconds. If the trade was executed during normal business hours and cancelled after 4:00 p.m., but before 8:00 p.m., the firm should use its best effort to report the cancellation by 8:00 p.m. If the trade was executed during normal business hours and cancelled after 8:00 p.m., the firm must report the transaction by no later than 8:00 p.m. on the next business day.

For trades that are executed outside normal business hours and cancelled prior to 8:00 p.m. on the date of execution, the firm must report the cancellation by 8:00 p.m. If the trade was executed outside of normal business hours and cancelled after 8:00 p.m., the firm must report the transaction by no later than 8:00 p.m. on the next business day.

**ACT Trade Scan** ACT Trade Scan can be used by both order-entry firms and market makers to:

- View trades that are entered into the system
- Accept, decline, or cancel open trades (Market makers can also correct trades using the No/Was or Update commands.)
- Break a matched or accepted trade (Both sides must agree.)
- Change an entry from principal (P) to agent (A) or riskless principal (R), or from A to P or R

**ACT Trade Corrections** As indicated above, a market maker can correct trade information in ACT Trade Scan by using the *Update* or the *No/Was* commands. Corrections that can be made using the Update command are limited to changes to Principal/Agent, short sale, No Clearing, and Match Only. Any other adjustments to an unmatched trade must be made using the No/Was command button, which displays the No/Was trade correction window. The No/Was option on Trade Scan is not available on T + 1. The entry must be made on the trade date (T) before ACT closes at 8:00 p.m.

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**Other ACT Functions** ACT has several other functions that assist participants in reviewing and managing their trading activity. For example, *ACT Statistics* allows a clearing or executing broker to view its own total volume, by the number of trades and by the volume.

Clearing firms often place limits on the total amount of trades or the size of any one trade that may be executed by brokers for which it clears (executing brokers). The *Risk Management* function allows clearing brokers to access and update data regarding the trading of their executing brokers and permits executing brokers to access information regarding their own limits. *Risk Management Alert* warns clearing firms of any executing brokers that are near or above their clearing threshold. When a broker-dealer attempts to report a trade with an executing broker that's near its limits, the ACT system will indicate that the trade is *held*, meaning that the clearing broker must give permission for it to be completed. The clearing broker can use *ACT Clearing Broker Scan* to allow or inhibit the trade (as a *blockbuster* or *sizeable* transaction).

**Blockbuster Trades** Blockbuster trades are those that are in excess of $1 million. Under the ACT Risk Management function, when a blockbuster trade is reported to ACT, the clearing firm of a broker-dealer is given 15 minutes to accept or decline the trade. If the clearing firm takes no action, the trade is accepted for normal processing.

**Trade Reporting and Processing Methods** According to industry rules the following are acceptable methods for trade reporting and processing:

- Trade by Trade Match—Both reporting parties submit data to the Trade Reporting Facility and the system performs an online match.
- Trade Acceptance—The reporting party enters its version of the trade into the system and the contra-party reviews the trade report and accepts or declines the trade. An acceptance results in a locked-in trade, while a declined trade report is purged from the system at the end of trade date processing.
- Aggregate Volume Match—This is a batch type comparison run at the end of the trade day for previously entered trades that remain uncompared. In this process, if the information of the trades match, the volume will be added together to effect a match.
- T + N—Used for next-day clearing and may be submitted until 5:15 p.m. each business day.

**Requirements for Trade Reporting and Processing through FINRA Facilities** The requirements of trade reporting and clearing are intended to ensure that appropriate payments are made for clearing services. SRO rules generally prohibit a firm from submitting a clearing report to a FINRA facility (e.g., the Trade Reporting Facility), unless the trade was previously reported to the same FINRA facility. A reporting member may not step out of a trade that's reported to the exchange by reporting a clearing-only transaction to a different facility. In other words, to step out of a trade, a member must report the clearing step-out on the same facility as the original trade report.

An exception to this rule applies for riskless principal transactions, where one side is reported to the FINRA facility (for dissemination to the public), while the other side is reported as a clearing-only trade. Since clearing-only trades are not reported to the Tape, they are not disseminated to the public. This is an acceptable condition for riskless principal transactions provided one leg is reported to the public.


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# Reporting Transactions in Nasdaq and other Exchange-Listed Securities

**Normal Trading Hours** During normal trading hours (9:30 a.m. to 4:00 p.m.), over-the-counter transactions in Nasdaq-listed securities that are not executed on the Nasdaq Market Center Execution System must be reported to the TRF through the ACT technology platform *within 10 seconds of execution*. If the ACT platform is not available due to service or transmission problems, the trade must be reported by phone to the TRF Operations Department. If trades are not reported within 10 seconds, they must be reported as promptly as possible thereafter and must include the .Z identifier along with the time of the transaction.

**Transactions Executed Outside of Normal Market Hours** The reporting requirements for trades that are not executed during normal market hours are dependent on the exact time of execution (all on ET).

- *Midnight to 8:00 a.m.*—Trades are to be reported to the TRF on the trade date by 8:15 a.m. using the .T identifier. If a trade is reported after 8:15 a.m., it must be reported with the .U modifier.
- *8:00 a.m. to 9:30 a.m.* —Trades are to be reported to the TRF within 10 seconds of execution with the .T identifier. Trades that are not reported within 10 seconds must use the .U modifier.
- *9:30 a.m. to 4:00 p.m. (normal market hours)* —Trades are to be reported to the TRF within 10 seconds of execution. Trades that are not reported within 10 seconds must be reported as promptly as possible thereafter and must use the .Z identifier.
- *4:00 p.m. to 8:00 p.m.* —Trades are to be reported to the TRF within 10 seconds of execution with the .T identifier. Trades that are not reported within 10 seconds must use the .U modifier.
- *8:00 p.m. to midnight*—Trades are to be reported to the TRF on the next business day (T + 1) by 8:15 a.m. and designated "as/of."

If the TRF is not available due to service or transmission problems, the trade must be reported by phone to the TRF Operations Department.

| Nasdaq-Listed and Other Exchange-Listed Securities | |
|---|---|
| ***Trade executed between*** | ***Report to TRF*** |
| **Midnight – 8:00 a.m.** | Between 8:00 – 8:15 a.m.; designated as .T; if not reported by 8:15 a.m., it must be reported using the .U modifier |
| **8:00 a.m. – 9:30 a.m.** | Within 10 seconds; designated as .T; trades that are reported later than 10 seconds must be reported using the .U modifier |
| **9:30 a.m. – 4:00 p.m.** | Within 10 seconds; if late, designated .Z |
| **4:00 p.m. – 8:00 p.m.** | Within 10 seconds; designated as .T; trades that are reported later than 10 seconds must be reported using the .U modifier |
| **8:00 p.m. – Midnight** | If reported T + 1 between 8:00 a.m. – 8:15 p.m. trades are designated as/of and must be reported using the .T modifier. If not reported by 8:15 a.m., trades must be reported using the .U modifier. |

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**Exceptions from Reporting** The following transactions need not be reported to the TRF:

- Transactions that are reported automatically by another system, such as the Nasdaq Market Center Execution System. Since trades that occur on the Nasdaq Market Center Execution System are executed and reported automatically, trade entry into the TRF is not required.
- Transactions that are a part of primary or secondary distribution private placements
- Transactions in which the buyer and seller have agreed to a price that's substantially unrelated to the current market for the security (e.g., to make a gift)
- Purchases or sales that are related to the exercise of an option or convertible at a preset price that's unrelated to market value
- Purchases of securities off of the floor of an exchange, as the result of a tender offer

**Form T** Form T requires transactions that were not reported to the TRF or the ORF (according to the preceding rules) to be reported to the Market Regulation Department as soon as it's practical. This will typically occur if the ticker symbol for the security is no longer available or the MPID of the market maker is no longer active. A Form T may also be used if the transaction occurred on a non-business day (i.e., holiday or weekend) or if the transaction was executed more than 365 days prior to the submission date. However, if the transaction can be reported through a FINRA reporting system (ORF, TRF, or ADF), whether on the trade date or subsequent date (reported as an *As/Of* trade), the member must use the system and is not permitted to use Form T.

FINRA now requires member firms to submit Form T electronically through its Gateway system. (Previously they were submitted via e-mail.) This will allow firms to view, edit, and delete draft filings as well as to view previously submitted filings.

**Which Firm Reports the Transaction?** To avoid *double counting*, the transaction is reported to the TRF or ORF by only one side of the trade, as described below:

1. In a transaction between two member firms, the executing party is required to report.
2. In a transaction between a member firm and a non-member firm or customer, only the member firm reports.

The definition of the executing party is the member firm that received an order for handling or execution or is presented an order against its quote and, rather than rerouting the order, the firm executes the transaction. If an alternative trading system (ATS), which includes an ECN, received and executed an order, the ECN is the executing party. If two firms meet this definition, the selling firm is required to report the transaction. This is the case if a negotiated transaction was between two member firms and was executed using the telephone.

**Riskless Principal Transactions** The problem of double counting can also arise in the context of a *riskless principal transaction*. A riskless principal transaction is defined as a trade in which a member firm either (i) after having received an order to buy a security, buys the security at the same price as principal, in order to satisfy the order to buy or, (ii) after having received an order to sell a security, it sells the security at the same price as principal, in order to satisfy the order to sell.


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This definition applies to firms that make a market in the security involved as well as non-market makers. When determining whether two trades are done at the same price, commission, markups, and markdowns are excluded.

> *For example, Market Maker 1 receives an order from a customer to sell 1,000 shares of ABCD, a Nasdaq stock. MM 1 sells 1,000 shares of ABCD to MM 2 at 21 as principal. MM 1 then fills the customer's order at 20.80 net as principal (taking into account a markdown of $0.20). Since the price of both trades is 21 when the markdown is excluded, this is considered a riskless principal transaction. As a seller in a trade between two market makers, MM 1 has a reporting obligation and may choose either one of two alternative methods to report these transactions.*

*Method 1* MM 1 may report the transaction with MM 2 to the TRF and mark the report "riskless principal." MM 1 doesn't report the offsetting transaction with the customer.

*Method 2* MM 1 may report the transaction with MM 2 to the TRF and mark the report "principal." MM 1 will also submit one of the following two reports of the trade with the customer as "riskless principal": (i) a clearing-only report (if necessary) to clear the transaction with the customer, or (ii) a non-tape, non-clearing report (if a clearing entry is not necessary because, for example, the trade is internalized). In either case, the customer leg of the transaction is not reported to the Tape. A non-tape report is a report that's not submitted for public dissemination.

A broker-dealer may elect to use either Method 1 or Method 2 for all of its reportable riskless principal transactions, or it can choose which method to use on a trade-by-trade basis.

In some cases, a trade will be reported as part riskless principal and part principal. For example, MM 1 receives an order from a customer to sell 10,000 shares of ABCD. MM 1 sells 7,500 shares to MM 2 from its own account, but decides not to try to find a buyer for the remaining 2,500 shares; instead, it fills the customer order against its own inventory. In this case, MM 1 reports a 7,500-share transaction using the preceding rules for riskless principal trades, but reports a 2,500-share principal transaction with the customer using the normal trade reporting rules.

**Identify Other Member Firms for Agency and Riskless Principal Transactions** In addition to the riskless principal reporting rules, the FINRA member that's required to report the transaction to the TRF may have another reporting obligation. This is the case if the executing party was acting on behalf of another member firm. For example, Broker-Dealer A buys from Broker-Dealer B on behalf of Broker-Dealer C. Since Broker-Dealer C is not identified to FINRA, Broker-Dealer A will report the trade to the TRF and submit a non-tape report which identifies Broker-Dealer C. A similar situation applies if a broker-dealer matched or crossed a transaction between two different broker-dealers.

**What's Reported?** The following information must be included in a report to the TRF:

- Nasdaq symbol
- Number of shares (round lots only)

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- Price (In general, the price reported doesn't include commissions, markups, markdowns, or service charges.)
- Whether the trade is a buy, sell, or cross (A cross is a transaction in which the broker-dealer is acting as agent for both the buyer and the seller; it's also referred to as a dual-agency trade.)
- Time of execution in Eastern Time expressed in military format (HH:MM:SS)
- Symbol which indicates whether the transaction is a buy, sell, sell short, or cross

For clearing purposes, trade reports must include certain information in addition to what's reported to the TRF. The clearing trade report must also include the following items:

- A symbol which indicates principal, agency, or riskless principal transaction
- Whether the party submitting the order is a market maker or order-entry side
- The contra-side executing broker
- The contra-side introducing broker in the case of a give-up trade

**Trade Modifiers** As described earlier, in certain situations, a special symbol is appended to a trade report. A more complete list follows:

- **.Z** *Late Trade Report* – Trades that are not reported within 10 seconds of execution; actual time of execution must also be appended (Some systems use .SLD symbol instead.)
- **.T** *After Hours Execution* – Time of execution must also be included if the trade is not reported within 10 seconds.
- **.O** *Price Override* – Used when the inside market changes within the 30-second reporting window.
- **.C** *Cash Trade* – Trades that settle on the same day as the trade date
- **.N** *Next Day Trade* – Trade will settle on T + 1(Some systems use .ND instead)
- **.R** *Extended Settlement or Seller's Option* – Used for trades that will settle after regular-way. The NN represents the extended settlement date, from 4 to 60 days later. (Some systems use .SNN instead.)
- **.U** *Pre-open and Aftermarket Trades Not Reported Within 10 Seconds* – Used to identify preopen and aftermarket trades that are reported late (some systems use .ST instead).
- **.W** *Stop Orders* – Used to report stop-stock transactions (a transaction that's the result of an order for which two parties have agreed that the order will be executed, and it has been, at a *stop-stock price* or better. W is also used as a trade modifier for weighted average trades or trades that are executed using another special pricing formula.
- **.P** *Prior Reference Price* – Trade that should have been executed at an earlier time, but was not actually executed until now (Some systems use .PRP instead).

The use of the .P modifier is illustrated in the following example:

> *At 2:15 p.m., Market Maker 1 receives a call from MM 2. MM 2 claims that MM 1 failed to execute a liability order that MM 2 transmitted at 1:45 p.m. At the time, MM 1's offer was 500 shares at 20, which is the offer that MM 2 attempted to lift. After checking its records, MM 1 finds that it did indeed back away from the order and it offers to fill MM 2's order at 20.*


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*However, in the intervening 30 minutes, the inside market has moved up to 23.50 – 23.60. If MM 1 fills MM 2's order for 500 shares at 20 at 2:18 p.m., it would report the trade within 10 seconds of 2:18 and append the modifier .P. In the trade report, it will also the time that the execution should have taken place (1:45 p.m.).*

.P is used to report late *execution*, while .Z is used to indicate a late trade report (not within 10 seconds of execution). Note that a pattern or practice of late reporting, barring exceptional circumstances, is a reason for disciplinary action.

## ADF Trade Reporting and Comparison Service

Users of the ADF include market makers that seek an alternative to the Nasdaq Market Center Execution System and ECNs, which are unable to quote on the Nasdaq Market Center Execution System because they lack market-maker status. The ADF is a quotation system that doesn't provide execution services. Execution services are provided by private connectivity providers and trade reporting must be performed through the ADF Reporting Service. This is in contrast to the Nasdaq Market Center Execution System, which provides automatic executions and trade reporting.

ADF reporting requirements and exceptions are similar to those examined for the TRF and ORF. However, one difference is that ADF hours of operation are 8:00 a.m. to 6:30 p.m.

**Transactions Reported to ADF** ADF-eligible securities include Nasdaq Global Select Market securities, Nasdaq Global Market securities, Nasdaq Capital Market securities, Nasdaq convertible debt securities, and other exchange-listed securities that trade over-the-counter (CQS securities).

There's one reporting option that's different from the TRF and ORF. ADF will give market participants the option to enter a three-party trade. The three-party trade option will make it easier to report riskless principal transactions and for ECNs to report trades between themselves and their subscribers. The ADF will also offer a trade comparison service that does the following:

1. Compare trade information from ADF participants
2. Submit locked-in trades to the Depository Trust Clearing Corporation (DTCC)
3. Automatically transmit reports of the transactions to the particular securities information processor (if necessary) for public dissemination
4. Allow for the monitoring of locked-in trading

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| Trade Reporting for ADF-Eligible Securities | |
|---|---|
| ***Trade executed between*** | ***Report to ADF*** |
| **Midnight – 8:00 a.m.** | Between 8:00 – 8:15 a.m.; designated as .T; if not reported by 8:15 a.m., it must be reported using the .U modifier |
| **8:00 a.m. – 9:30 a.m.** | Within 10 seconds; designated as .T; if trades are reported later than 10 seconds, they must be reported using the .U modifier |
| **9:30 a.m. – 4:00 p.m.** | Within 10 seconds; if late, designated .Z |
| **4:00 p.m. – 6:30 p.m.** | Within 10 seconds; designated as .T; if trades are reported later than 10 seconds, they must be reported using the .U modifier |
| **6:30 p.m. – Midnight** | If reported T + 1 between 8:00 a.m. – 8:15 p.m. trades are designated as/of and must be reported using the .T modifier. If not reported by 8:15 a.m., trades must be reported using the .U modifier. |

## Reporting Transactions in Convertible Securities

The rules for reporting transactions in Nasdaq convertible bonds are very similar to those for other Nasdaq securities. For example, during normal market hours, Nasdaq convertible bonds are subject to a 10-second reporting requirement. Outside of normal hours, the rules are the same as for Nasdaq securities, as described in the table on page 7-5. The rules governing which party reports and which transactions are given an exception from reporting are also the same. However, one minor difference is that the information reported includes the number of bonds rather than the number of shares.

## Reporting Transactions in OTC Equity Securities

Since many OTC equity securities are thinly traded and prone to manipulation, FINRA increased its surveillance in this market by requiring transactions involving member firms to be reported. Industry rules require trade reporting of transactions in OTC equity securities, which are defined as equity securities for which real-time trade reporting is not otherwise required. These securities include any equity security that's not listed on a national exchange. OTC transactions in certain securities that are listed on regional exchanges must be reported under this rule as well if the securities are not eligible for reporting to the Consolidated Tape. However, the term OTC equity securities doesn't include restricted securities, as defined in SEC Rule 144, or transactions that are executed under SEC Rule 144A. The reporting rule covers transactions in OTC Bulletin Board issues, OTC Pink Marketplace stocks, and those that appear on any other particular quotation medium.

With the exception of foreign OTC equities, the requirements for the reporting party as well as what's reported are virtually identical to the rules for Nasdaq securities. Reporting is made through the OTC Reporting Facility, which uses the ACT technology platform. Note that the determination of the party that's responsible for reporting is dependent on whether a firm is a market maker in a particular OTC equity security.


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For OTC equity securities, the rule defines a market maker as a broker-dealer that holds itself out as a market maker by entering proprietary quotations or indications of interest for a particular OTC equity security in any interdealer quotation medium, such as the OTCBB or OTC Pink Marketplace.

**Exceptions from Reporting** The following transactions in OTC equity securities are not required to be reported:

- Transactions that are a part of a primary or secondary distribution
- Private placements
- Transactions in which the buyer and seller have agreed to a price that's substantially unrelated to the current market for the security (e.g., to make a gift)
- Purchases or sales that are related to the exercise of an option or convertible security at a preset price which is not related to the current market value

## OTC Reporting Facility (ORF)

Industry rules require the reporting of most over-the-counter (OTC) equity transactions of non-exchange-traded securities, including transactions in foreign OTC equities. These trades are reported through the OTC Reporting Facility which, like the TRF, employs the use of Nasdaq's ACT Technology Platform. The TRF and the OTC Reporting Facility are separate and distinct reporting services; however, they both contract with Nasdaq for the use of the ACT Technology Platform.

The ACT Technology Platform facilitates the reporting and clearing transactions by allowing order-entry and market-making firms to enter priced trades. This information is then used to report, match, and clear the transaction.

The OTC Reporting Facility shouldn't be confused with the Trade Reporting Facility (TRF). The TRF is used to report transactions of Nasdaq-listed and other exchange-listed securities that occur over-the-counter; however, the ORF is used to report transactions exclusively in OTC securities that don't trade on Nasdaq or the other exchange markets.

The OTC Reporting Facility is *not* an order-execution system; instead, trades that are entered into the OTC Reporting Facility have already been negotiated between the parties or have been executed in another system. Also, the OTC Reporting Facility is *not* a system that's used to report transactions on the floor of the NYSE, since these trades are reported by the exchange to the Consolidated Tape.

**Trade Reporting** Transactions in over-the-counter (OTC) securities that occur from 9:30 a.m. to 4:00 p.m. must be reported to the OTC Reporting Facility within 10 seconds of execution. This rule applies to both market makers and non-market makers, such as order-entry (OE) firms.

If a transaction cannot be reported by entering the data into the OTC Reporting Facility due to a system failure, the market participant must report the transaction by telephone to the ORF Operations Department within 10 seconds of execution. All transactions that are not reported within 10 seconds of execution are designated as late with the .Z (or .SLD) modifier.

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Rules for trade reporting to the OTC Reporting Facility are essentially the same as for reporting to the TRF, with the addition of reporting requirements for foreign OTC securities, which don't meet the listing requirements of Nasdaq or the exchanges.

| OTC Securities (*including Domestic Issues, ADRs and Canadian Issues*) | |
|---|---|
| ***Trade executed between*** | ***Report to OTC Reporting Facility (ORF)*** |
| **Midnight – 8:00 a.m.** | Between 8:00 – 8:15 a.m.; designated as .T; if not reported by 8:15 a.m., it must be reported using the .U modifier |
| **8:00 a.m. – 9:30 a.m.** | Within 10 seconds; designated as .T; trades that are reported later than 10 seconds must be reported using the .U modifier |
| **9:30 a.m. – 4:00 p.m.** | Within 10 seconds; if late, designated .Z (or .SLD) |
| **4:00 p.m. – 8:00 p.m.** | Within 10 seconds; designated as .T; trades that are reported later than 10 seconds must be reported using the .U modifier |
| **8:00 p.m. – Midnight** | If reported T + 1 between 8:00 a.m. – 8:15 p.m., trades are designated as/of and must be reported using the .T modifier. If not reported by 8:15 a.m., trades must be reported using the .U modifier. |

## Order Audit Trail System (OATS)

The Order Audit Trail System (OATS) allows FINRA to effectively review market activity in regard to customer orders within a member firm, conduct surveillance, and enforce rules. OATS records the life of an order from receipt, to routing, to modification (if applicable), and cancellation or execution. FINRA rules concerning these reporting requirements are broken down in three areas: (1) order origination and receipt, (2) order transmittal, and (3) order modifications, cancellations, and executions. OATS also creates the obligation for market participants to synchronize both computerized clocks and mechanical time-stamping devices that are used in reporting. Time synchronization is done on a daily basis before the market opens and must be within one second of the National Institute of Standards and Technology (NIST) standard. As the information is received, it must be recorded in hour, minute, second (HH:MM:SS) format (i.e., military time).

Information that must be reported to FINRA in an OATS report includes:

- From whom the order was received (customer or other member)
- The time that the order was received from the customer
- Order identifier
- Date and time of receipt
- How the order was received (manually or electronically)
- Terms of the order
  - Buy or sell
  - Long or short
  - Stock and number of shares
  - Price


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  - Whether the order is an intermarket sweep order
  - Order type (market, limit, etc.)
  - Time in force
  - Special handling requests
  - Account type
- Location to which the order was routed for execution
- How it was routed (manually/electronically)
- Whether the order was modified
  - Cancelled or changed
  - Date and time
- Execution
  - Price
  - Full or partial execution
  - Date and time
  - Capacity (agent, principal, riskless principal)
  - The exchange when the trade was reported
- Whether there's a separate reporting agent for OATS

OATS transmissions must be reported either on the same day that the order was received or the day that such information first becomes available. OATS reports must be transmitted *daily*, either in a single submission or in multiple electronic submissions. According to the Order Audit Trail System rules, all orders in Nasdaq-listed securities and OTC equity securities that are received or sent by a broker-dealer must be compliant with OATS rules.

OATS defines an order as any oral, written, or electronic instruction to effect a transaction, including an order that was received by a member from a customer, or one that's originated by a department of the same member firm or another member firm. For example, if a firm received an order from a client and that order was sent to the firm's trading desk, both of these events would be defined as an order. OATS rules would not apply to any transaction that was originated by the firm's proprietary trading desk in the ordinary course of business of the firm's market-making activities.

To summarize, under OATS requirements, the following type of information is required to be recorded by the member firm:

- Information concerning the order origination and receipt, order transmittal, and order modification, cancellation, and execution
- The order origination or receipt time (i.e., the time the order is received from the customer)
- The date and time the order is received by the reporting member
- The date and time the order was transmitted to an ECN, the member's trading department, another member firm, or a national securities exchange
- The date and time the order was executed, cancelled, or modified

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# Chapter 8

# *Settlement and Clearance*

# Settlement and Clearance

Once a transaction is reported to the TRF, many of the issues that are connected with completing a transaction are handled by automated systems, clearing agencies, and a broker-dealer's back office. However, traders are expected to know a few of the specific Uniform Practice Rules that can impact an OTC trade.

## Rule 10b-10 – Confirmations

SEC Rule 10b-10 requires broker-dealers to provide customers with a detailed confirmation of any purchase or sale. A broker-dealer must give or send a confirmation to the customer at or before the completion of the transaction.

Rule 10b-10 is complex and the exact disclosure required on a confirmation will vary from trade to trade. However, the following information is typically included:

- The identity and price of the security being bought or sold, along with the number of shares, units, or principal amount
- The date of the transaction, as well as the time of execution or a statement that the time will be furnished upon written request
- The *capacity* in which the broker-dealer acted, which could be as:
  - Agent for the customer
  - Agent for another person
  - Agent for both the customer and another person (i.e., a *cross* transaction)
  - Principal for its own account
- The dollar price and yield information on debt securities
- Whether a debt security is callable (and the statement that further information is availabe upon request)
- The settlement date

A *cross trade* is one in which a broker receives a buy and a sell order for the same stock at the same price and makes a simultaneous trade between the two customers.

**Commissions/Markups** The term *commission* refers to the charge that a broker-dealer assesses for executing an agency trade for the customer. A *markup* is the difference between the price charged to the customer and the prevailing interdealer price for a principal transaction.

All remuneration that's received by a broker-dealer for acting as an agent (i.e., commissions) must be disclosed on the confirmation. Traditionally, confirmations for principal transactions reported only a *net* price, which included the markup. However, the regulatory trend has been toward increased disclosure of markups. Currently, there are two situations in which markups must be disclosed:

- Riskless principal transactions, in which the broker-dealer purchases the security for resale to the customer only when the customer's order has already been received
- Principal transactions in Nasdaq stocks or in listed stocks that are traded OTC (third-market trades)

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**Payment for Order Flow** Many firms automatically route certain types of small retail customer trades to a specific broker-dealer for execution. The executing broker-dealer will often pay a per-share fee to the originating broker-dealer for this arrangement. This is referred to as *payment for order flow*. Confirmations for transactions that are executed under such an arrangement must disclose this practice and offer to provide additional information upon request. In addition, a broker-dealer must provide written information about its payment-for-order-flow practices at the time that a new account is opened, and annually thereafter.

**Requests for Further Information** As noted previously, a confirmation frequently indicates that further information is available to a customer upon request. Generally, a firm has five business days after the request to provide the additional data. However, if the transaction occurred more than 30 days prior to the request, the firm may take 15 business days to supply the information.

**Errors** After examining a confirmation, either the customer or the registered representative may detect an error. At that point, the procedures to be followed depend on the nature of the error and the firm's own policies. However, registered representatives are generally *not* allowed to make their own decisions on how to correct errors. Instead, they should bring the mistake to the attention of a supervisor.

## Additional Disclosures

In addition to the information that SEC Rule 10b-10 requires on a confirmation, a broker-dealer may need to make other disclosures to customers on certain trades. This information can be provided on the confirmation or in some other written form.

**Control Relationships** If the broker-dealer is executing a transaction for a customer in which it's *controlled by, controlling, or under common control with* the issuer of that security, an additional disclosure is required. An example a control relationship is a broker-dealer that's owned by a publicly traded company. In such a case, the broker-dealer must disclose the existence of such a relationship, either verbally or in writing, *prior to executing the trade for the customer*. If this initial disclosure was not in writing, a written disclosure must also be provided at or before the completion of the transaction.

**Disclosure of Interest in a Distribution** If a broker-dealer is participating in a distribution of securities (e.g., it's a syndicate member) *and* it's receiving an investment advisory fee from a customer to whom it intends to sell such securities (e.g., a wrap account customer), this is a conflict of interest. The firm is obligated to provide written disclosure of its interest in the distribution at or before the completion of the transaction.

**Investment Advisory Disclosures** Many broker-dealers are also registered as investment advisers. If a broker-dealer plans to execute a transaction for an investment advisory client by acting as a principal or as an agent for the other party, it must obtain written authorization from the investment advisory client to enter into these types of transactions and must disclose the conflicts that exist. The broker-dealer is also required to disclose the capacity in which it acted on the confirmation.


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**Wrap-Fee Accounts** As defined under the Investment Advisers Act of 1940, a wrap-fee account is a program in which a client is charged one fee (typically based on the value of the account) that's not based directly on transactions in a client's account for investment advisory services and execution of transactions. This account differs from a managed money account in which the client is charged a fee for advisory services based on the value of the account and commissions based on the number of transactions executed.

**Completion of a Transaction** Several SEC rules require a broker-dealer to perform action "at or before the completion of the transaction." The point at which a transaction is completed depends on the timing of payment or delivery of securities by the customer.

1. For a customer purchase, completion typically occurs when the customer makes payment of any part of the purchase price to the broker-dealer. If payment is made by a bookkeeping entry (such as deducting the payment from a money-market account), completion occurs when the broker-dealer makes a bookkeeping entry for any part of the purchase price. However, for a purchase, if the customer pays prior to the time the payment is due, completion occurs when the broker-dealer delivers the securities into the customer's account.
2. For a customer sale in which the security is not in the custody of the broker-dealer, completion occurs when the customer delivers the security to the firm. If the security is in the broker-dealer's custody, completion occurs when the security is transferred out of the customer's account. However, for a sale, if the customer delivers the securities prior to the time that delivery is due, completion occurs when the broker-dealer makes payment into the account of the customer.

## When, As and If Issued/Distributed Contracts

New issues of securities that begin trading before they are physically available for settlement are usually traded on a *when, as and if issued* (WI) or *when, as and if distributed* basis. This could occur in the case of a newly registered offering or when securities are issued in connection with a spin-off, merger, or some other corporate reorganization. FINRA regulates how these transactions are handled while the parties involved are waiting for the security to be issued, as well as what happens if a person receives a materially different security than what was expected at settlement.

**Confirmations** At a minimum, a dealer-to-dealer confirmation for a WI trade should contain:

- An adequate description of the security and the plan (if any) under which it's to be distributed
- The designation of FINRA as the party with the authority to rule on the performance of the contract (Uniform Practice Code matters are typically handled by the Operations Committee.)
- Provisions for marking the contract to market

A *mark to market* is the revaluing of a contract based on current prices, which may be necessary if there's a long delay in the issuance of the security.

**Settlement** The settlement date for WI transactions is generally determined by the Operations Committee. However, if the Committee doesn't set the date, the seller may make delivery after giving notice of one business day to the buyer. If the issue is being distributed by a syndicate or selling group, settlement will occur on the day that syndicate contracts are settled.

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**Cancellation** A WI transaction is cancelled if the security involved is not issued or distributed. Also, contracts are generally cancelled if the security that's issued or distributed is materially different from what was described in the initial confirmation. Any disputes regarding the security are settled by the Operations Committee.

## Ex-Dividend, Ex-Rights, or Ex-Warrants Transactions

SEC Rule 10b-17 requires issuers of publicly traded securities to give FINRA notice of a pending distribution at least 10 calendar days prior to the record date. The distributions which required notice include those involving dividends, stock splits or reverse splits, and rights or other subscription offerings.

Typically, the ex-dates for these distributions are set as follows:

1. For cash dividends, stock dividends, or warrants that are less than 25% of the value of the subject security, the ex-dividend date is one business day preceding the record date, if the record date falls on a business day.
2. If the distribution has a value of 25% or more of the subject security, the ex-date is the first business day *after* the *payable* date.
3. In the case of stock dividends and/or splits relating to ADRs or foreign securities, the ex-date is designated by the Operations Committee.
4. With respect to rights offerings, the ex-rights date is normally the first business day after the effective date of the registration statement.

The Nasdaq Market Center Execution System will take the following actions concerning adjustments for open orders and quotes:

- All bid and offer quotes will be purged from the system.
- All orders will be cancelled in the event of a reverse stock split.
- Sell orders will not be adjusted automatically by the system and should be modified by the market participant that entered the order.
- Buy orders will automatically be adjusted by the system depending on the corporate action that's taken by the issuer. For example, in the case of a cash dividend, the order is adjusted downward by the amount of the cash dividend, unless the order was marked DNR (do not reduce).

## Clearly Erroneous Transactions

FINRA provides a mechanism for correcting or voiding transactions if one of the terms of the contract is clearly in error. This rule was created as the result of a complaint from a FINRA member that a trade was executed 10 points away from the inside market (obviously a mistake), but the contra-party refused to cancel the trade. Prior to the passage of this rule, FINRA didn't have the authority to adjust these types of transactions, even when the error was obvious.


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FINRA defines the term *clearly erroneous* to refer to an obvious error in any term, such as price, number or shares, or other unit of trading, or identification of the security. FINRA takes into account the circumstances at the time of the transaction, the maintenance of a fair and orderly market, and investor protection. This rule pertains to disruptions and extraordinary market conditions and not to unauthorized trading or market manipulation.

The determination of a clearly erroneous execution is based on certain thresholds—one for exchange-listed securities and another for OTC equity securities.

| Numerical Threshold for Exchange-listed Securities | | |
|---|---|---|
| **Reference Price: Consolidated Last Sale** | **Normal Market Hours (9:30 a.m. to 4 p.m. ET) Numerical Guidelines (Subject Transaction's % Difference from the Consolidated Last Sale)** | **Outside Normal Market Hours Numerical Guidelines (Subject Transaction's % Difference from the Consolidated Last Sale)** |
| Greater than $0.00 up to and including $25.00 | 10% | 20% |
| Greater than $25.00 up to and including $50.00 | 5% | 10% |
| Greater than $50.00 | 3% | 6% |
| Multistock event – filings involving five to 19 securities by the same member will be aggregated into a single filing | 10% | 10% |
| Leveraged ETF/ETN securities | Normal market hours numerical guidelines multiplied by the leverage multiplier (*i.e.*, 2x) | Normal market hours numerical guidelines multiplied by the leverage multiplier (*i.e.*, 2x) |

FINRA may also expand the numerical guidelines due to a Multi-Stock Event involving 20 or more securities whose executions occurred within a five-minute period or less. This will be done to maintain a fair and orderly market and protect investors. For both market hours and outside market hours, FINRA uses a threshold of 30% away from the reference price.

FINRA Rule 11893 governs clearly erroneous determinations involving transactions in OTC equity securities. The rule is structured in a form that's similar to FINRA Rule 11892 which governs exchange-listed issues, but uses different numerical guidelines when determining if a transaction is erroneous. Many of these potentially erroneous transactions occur in periods of extreme market volatility, or are the result of system malfunctions and/or disruptions. At times, the determination as to whether a given transaction price is erroneous involves more than simply examining a pricing difference.

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In an attempt to maintain fair and orderly markets, FINRA may choose to use alternative reference prices in unusual circumstances and will examine other causal factors to determine whether a given trade price is fair, such as (1) whether the security was subject to a stock split or other corporate action, (2) whether the stock was recently halted or resumed trading, or (3) whether the security is an IPO.

| Numerical Threshold for OTC Equity Securities | |
|---|---|
| **Reference Price** | **Numerical Guidelines (Subject Transaction's Percentage Difference from the Reference Price)** |
| $0.9999 and under | 20% |
| $1.0000 up to and including $4.9999 | Low end of range, minimum 20%<br>High end of range, minimum 10% |
| $5.0000 up to and including $74.9999 | 10% |
| $75.0000 up to and including $199.9999 | Low end of range, minimum 10%<br>High end of range, minimum 5% |
| $200.0000 up to and including $499.9999 | 5% |
| $500.0000 up to and including $999.9999 | Low end of range, minimum 5%<br>High end of range, minimum 3% |
| $1,000.0000 and above | 3% |

**Procedures for Reviewing Transactions** If a member firm receives an execution that it believes is clearly erroneous, it must submit a written complaint within 30 minutes of the execution time. In the case of an *Outlier Transaction,* a request may be made within 60 minutes after the transaction. An Outlier Transaction is a transaction in the Nasdaq market for which the execution price of the security is greater than three times the current numerical guidelines. A FINRA Officer or Nasdaq official has the authority to declare a transaction null and void. The officer will generally take action within 30 minutes after becoming aware of a transaction in an exchange-listed security. In the case of an OTC equity security, the officer will take action as soon as possible, but in all cases, by 3:00 p.m. on the next trading day.

**Appeal Process** Under this rule, a decision of a Nasdaq or FINRA officer can be appealed to the Market Operations Review Committee (MORC) or the Uniform Practice Committee (UPC). The appeal must be in writing and must be received within 30 minutes after the person making the appeal is given notification. For exchange-listed securities, the decision will be made as soon as practical, but generally on the same trading day. If a request for an appeal is made after 3:00 p.m., the decision may not be made later than the next trading day. For OTC equity securities, the decision will be made as soon as practical, but no later than two trading days after the execution under review.


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## Nasdaq Obvious Error Rule for Options

As it relates to options, Nasdaq will also cancel or adjust the execution price of a transaction if there's an obvious error. An obvious error has occurred if the execution price of a transaction is higher or lower than the theoretical price for that series of options by an amount equal to at least:

| Theoretical Price | Minimum Amount |
|---|---|
| Below $2.00 | .25 |
| $2 to $5 | .40 |
| Above $5 to $10 | .50 |
| Above $10 to $20 | .80 |
| Above $20 | 1.00 |

The theoretical price is either the last National Best Bid price with respect to an erroneous sell transaction or the last National Best Offer price with respect to an erroneous buy transaction, just prior to the transaction; or a price that's determined by Nasdaq MarketWatch if there are no comparison quotes. If either side of the trade believes that it participated in a transaction that was the result of an obvious error, it must notify MarketWatch through a written or electronic complaint within 20 minutes of the execution.

In the absence of unusual circumstances, Nasdaq will not grant relief under this Section unless notification is made within the prescribed periods. A qualified Nasdaq official will either adjust or cancel the trade (adjust or bust). However, both parties may agree to the erroneous executed price even if the trade meets the definition of an obvious error.

# SEC Rule 15c6-1 – The Settlement Cycle

Broker-dealers must ensure that the settlement provisions of their trades comply with SEC rules. A broker-dealer may not enter into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities (i.e., settlement) by later than the second business day after the trade date *unless otherwise expressly agreed to by the parties at the time of the transaction*. Situations where this condition doesn't apply include transactions in exempted securities, government and municipal bonds, commercial paper, bankers' acceptances, and limited partnership interests that are not listed on a national exchange (NYSE or Nasdaq).

## Settlement Date versus Payment Date

The *settlement date* for a transaction represents the date on which a selling broker must deliver securities to the buying broker in return for payment. Determining the number of days that it takes for a trade to settle will vary based on the security involved.

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The following table summarizes the settlement for the different types of securities:

| Type of Security or Trade: | Settlement: |
|---|---|
| Corporate Securities | Two business days after the trade date (T + 2) |
| Municipal Securities | Two business days after the trade date (T + 2) |
| U.S. Government Securities | One business days after the trade date (T + 1) |
| Option Trades | One business days after the trade date (T + 1) |
| Cash Trades for any security * | On the trade date |

* A special settlement in which the seller agrees to deliver securities and the buyer agrees to pay for the securities on the day of the trade.

The *payment date* represents the date on which a customer must pay for his portion of a trade regardless of whether the trade was executed in a cash or margin account. This date is set by the Federal Reserve Board under the Regulation T provisions of the Securities Exchange Act of 1934. Specifically, Regulation T provides investors with a maximum payment extension of two business days after a regular-way settlement. In other words, customers must pay no later than four business days after the trade.

The Regulation T payment date of four business days (regular way settlement + 2 business days) applies to corporate securities and options contracts. Since municipal and U.S. government securities are exempt from Reg T, payment is generally due at the time of settlement.

## Prime Brokerage

Prime brokerage is a service that's been developed for institutional and large retail customers who trade actively and typically use the services of several broker-dealers to execute transactions. Prior to prime brokerage, clients were required to open a separate account at each executing broker-dealer. Each broker-dealer then provided confirmations and statements to the client. Then the client would be required to combine the information that they received from its various accounts to understand its overall position.

In a prime brokerage arrangement, the client chooses one firm as its *prime broker*. The client still uses several broker-dealers for execution (and as a source of research), but all trades are ultimately handled through its account at its prime broker. At this point, the client simply receives one set of reports, rather than several.


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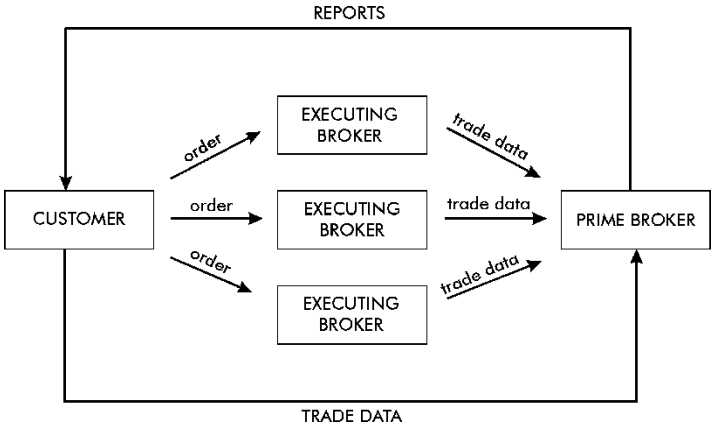
A simplified picture of this relationship is shown below:




Orders that are placed with the executing broker are executed through an account with the executing broker, in the name of the prime broker, for the benefit of the customer. The executing broker buys or sells securities in accordance with the customer's instructions. On the trade date, the customer notifies the prime broker of the trade done through the executing broker. The transaction is then recorded in the customer's account at the prime broker. The prime broker also records the transaction in a *fail-to-receive/deliver* account with the executing broker.

The executing broker confirms the transaction with the prime broker through the Depository Trust Company's (DTC) Institutional Delivery (ID) system. The prime broker will affirm the trade if the information in the ID system matches the information it has from the customer.

**Conditions for Prime Brokerage** As prime brokerage services developed, participants in these relationships were concerned that they might be in technical violation of several SEC and industry rules. For example, after a transaction, the confirmation should actually be sent by the executing broker, but in prime brokerage, the prime broker sends it instead. After inquiries from broker-dealers, the SEC issued a no-action letter allowing prime brokerage services to continue to be offered, but only if the following conditions are met:

1. A broker-dealer must notify its Designated Examining Authority that it intends to act as a prime broker.
2. To act as a prime broker, a firm must have net capital of at least $1,500,000. To act as an executing broker that clears prime broker trades, or to clear prime broker trades on behalf of an executing broker, a broker-dealer must have net capital of at least $1,000,000.
3. Prime brokerage customers must maintain a minimum net equity of at least $500,000 (cash or securities with a ready market). If the customer's account is managed by a registered investment adviser, the net equity requirement is $100,000.
4. Before commencing any activity, there must be a contract between the prime broker and the executing broker's clearing firm (which may be the executing broker itself) defining the obligations and responsibilities of each, consistent with the SEC no-action letter.

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An introducing executing broker-dealer must have a similar contract with its clearing firm. The customer must also sign agreements with the prime broker and each executing broker.

5. Customers may elect, in writing, to have confirmations sent from the executing to the prime broker and the prime broker will then issue them to the customer. This written authorization needs to be a separate document from any other written agreements. This arrangement is not allowed to be a condition for entering into a prime brokerage arrangement and cannot be induced by differences in fees for giving such permission.
6. There are several conditions that apply to short sales. The SEC requires the distribution of responsibility for these requirements. The executing broker is responsible for:
   i. Marking the sell ticket long or short, and
   ii. Determining, from the prime broker or otherwise, that shares can be borrowed to make delivery

   The prime broker is responsible for recording the transaction as a short sale in the client's margin account and collecting the appropriate margin.
7. By the morning of the business day after a trade, both the customer and the executing broker must inform the prime broker of the contract amount, the security, the number of shares or units, and whether the trade was a purchase, a long sale, or a short sale. (Clearing facilities that provide this information may be used.)
8. The prime broker is responsible for settling any confirmed trades. For any trade it doesn't disaffirm, it must treat the customer as its own for Reg T purposes. (Disaffirm means to reject a previously affirmed trade. An affirmed trade represents one in which the trade data from the customer and the executing broker match.) If a prime broker disaffirms a trade, that transaction becomes the responsibility of the executing broker.
9. Broker-dealers may not engage in prime brokerage activities with other broker-dealers or customers whom they know or have reason to believe are not in compliance with the SEC no-action letter.

In order to protect the executing brokers from the risk of disaffirmed trades, industry participants have agreed among themselves on additional conditions. For example, with the consent of the customer, executing brokers now have access to client information in the possession of the prime broker.

While prime brokers still have the right to disaffirm trades, they may only do so "in good faith and in accordance with reasonable commercial standards." In addition, a disaffirmation by a prime broker is considered to apply to *all* trades for that client with the same trade date and the previous trade date. This prevents the prime broker from selectively disaffirming riskier trades. A disaffirmation also requires the prime broker to either withdraw from its relationship with the customer or notify the customer's other executing brokers of the disaffirmation.

## The Options Clearing Corporation

Listed options are issued and guaranteed by the Options Clearing Corporation (OCC). The OCC is regulated by the Securities and Exchange Commission and is proportionately owned by the exchanges on which listed options trade.


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The OCC acts as the third party in all options transactions and functions in a similar capacity to that of the DTCC in equity and bond markets. The OCC handles the exercise of option contracts and removes counterparty risk in the event that a writer is unable to fulfill its obligation.

Broker-dealers deal directly with the OCC rather than with each other. When customers buy options contracts, their broker-dealers must settle the transactions with the OCC within one business day. Also, selling firms will receive a credit for the sale of the option on the next business day.

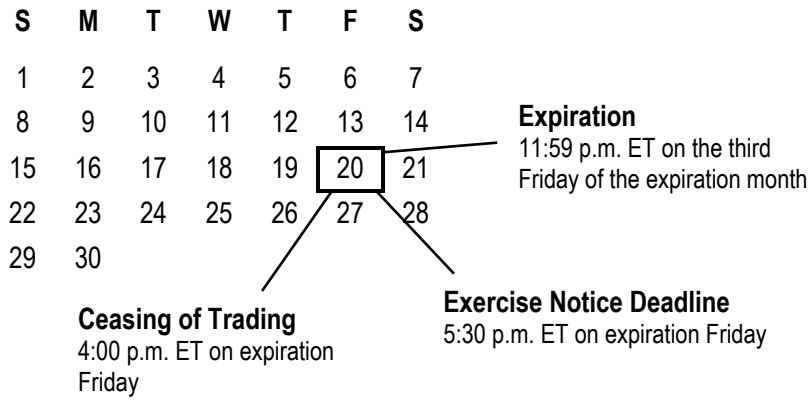
## Supervision of Options Activities

The OCC has established rules regarding the supervision of a firm's options activities which have been adopted by both the options exchanges and FINRA. Every member firm is required to develop and implement written procedures for carrying out these activities which must be included in the firm's written supervisory procedures (WSPs) manual. The procedures must be implemented under the supervision of a designated Registered Options Principal (ROP). The ROP is typically an officer or general partner of the member firm who has qualified by examination to serve in this role.

The ROP is specifically responsible for the firm's compliance program as it relates to its options activities and is required to perform an audit function to determine that these activities are conducted in compliance with current applicable rules and regulations. Some of the ROP's primary duties include establishing guidelines for options communication with the public and reviewing all of the communications that are used. Additionally, the ROP is responsible for reviewing the method that his firm uses to allocate exercise notices to clients who are short an option contract.

## Deadlines for Standardized Option Contracts

Equity options are typically issued with expirations of up to nine months. All equity options expire at 11:59 p.m. Eastern Time (ET), on the third Friday of the expiration month. An expiring option will cease trading at 4:00 p.m. ET on the same business day that it expires (Friday). Although the option doesn't actually expire until 11:59 p.m., a buyer must express her intent to exercise the option by 5:30 p.m. ET on the same business day that it expires (also Friday).

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**Exercising Options Contracts** A member firm is allowed to accept an exercise notice after the OCC's cutoff time, but only in cases where errors have made in good faith or where exceptional circumstances exist relating to a customer's ability to communicate with the member firm.

When the OCC receives exercise instructions from the firm that represents the purchaser, it will *randomly* assign the exercise notice to a broker-dealer whose account shows a short option position that's identical to the long option position being exercised.

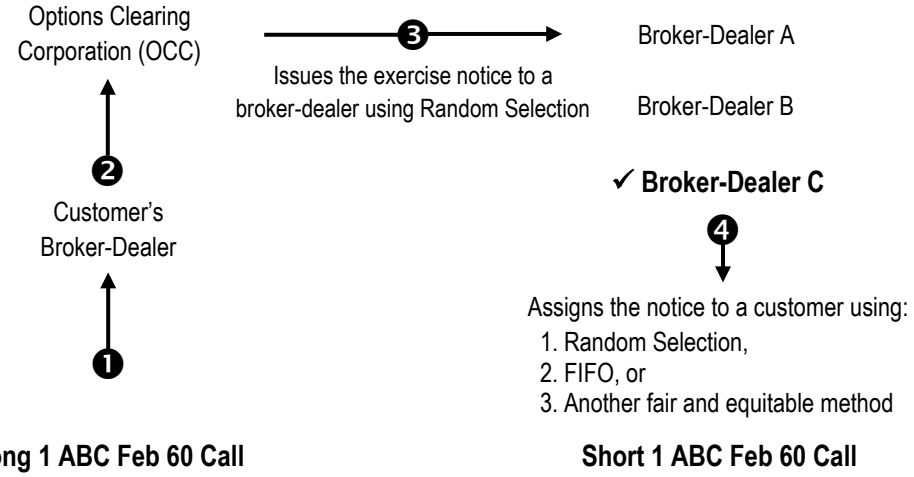
If a broker-dealer receives an assignment notice, it must select a client to whom the notice will be assigned. There are three methods by which this selection may be accomplished:

1. Random selection,
2. First-in, first-out (FIFO), or
3. Any other method that's deemed to be *fair and equitable*

Every member firm must notify its clients as to which method is used and how it will be implemented. An option that hasn't been exercised by the OCC's cutoff time will expire worthless. However, at expiration, if an option is in-the-money by at least $.01, it will be automatically exercised by the OCC.

**Assignment Due to Exercise** Remember, equity *option trades* settle on the next business day following the trade date, or T + 1. On the other hand, since the exercise of an option involves the purchase and sale of the underlying stock, settlement of an *exercised option* occurs in two business days.

With index options, remember that there's no physical delivery of shares at the time of exercise. Instead, the writer of the index option pays the buyer of the index option an amount of cash that's equal to the difference between the contract's strike price and index value (the in-the-money amount). This cash amount is due one business day after the option is exercised.





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**Non-Equity Option Expiration** Both *stock index and foreign currency options* also expire at 11:59 p.m. ET on the third Friday of the expiration month. On the day of expiration, narrow-based index options cease trading at 4:00 p.m. ET, while broad-based index options cease trading at 4:15 p.m. ET. Also, on the day of expiration, customers who intend to exercise must submit their exercise notices by 5:30 p.m. ET.

# Clearing Options Contracts

The Options Clearing Corporation is responsible for clearing option trades. Additionally, the OCC guarantees that a buyer will be able to exercise her right in the event of a deficiency (e.g., bankruptcy) on the part of a writer. In essence, the OCC removes counterparty risk from standardized options transactions by acting as seller for every buyer and a buyer for every seller.

## Adjustments to an Option Contract

If a corporation executes a stock split or pays a stock dividend, its option contracts must be adjusted. In some cases, an adjustment is made to the number of option contracts, while in other cases, it's the number of shares underlying the contract that must be changed. However, in all cases, the exercise price of the option will be adjusted proportionately. Ultimately, regardless of the terms being changed within the contract, the aggregate value of the contract will remain the same.

**Even Stock Split** Any split for one (e.g., 2 for 1, 3 for 1, etc.) is referred to as an *even stock split*. When a corporation executes an even stock split, the adjustments made to existing option contracts are an increase in the number of option contracts an investor owns and a decrease in the exercise price of the contracts. The number of shares underlying each option is not adjusted for the split.

*For example, if XYZ stock is split 2-for-1, an investor who currently owns:*

- *1 XYZ May 30 call will now own 2 XYZ May 15 calls with each contract still representing 100 shares. Notice that the original 100 shares x $30 equals $3,000 and the adjusted 2 contracts for 100 shares x $15 also equal $3,000.*

To adjust the number of contracts, multiply 1 contract by the 2-for-1 split ratio ($1 \times {}^{2}/_{1} = 2$ contracts). To adjust the exercise price, multiply the $30 exercise price by the inverse of the split ratio ($\$30 \times {}^{1}/_{2} = \$15$ exercise price).

Remember, the only time the *number of contracts* changes is if the corporation executes an even split.

**Odd Stock Splits** When an odd split is executed (e.g., 3 for 2, 5 for 4, etc.), the adjustments made to existing option contracts are an increase in the number of shares underlying the contracts and a decrease in the exercise price of the contracts. In this case, the number of contracts doesn't change.

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*For example, if XYZ stock is split 3-for-2, an investor who currently owns:*

- *1 XYZ May 30 call (representing 100 shares) will now own 1 XYZ May 20 call (representing 150 shares). Notice that the original 100 shares x $30 equals $3,000 and the adjusted contract for 150 shares x $20 also equals $3,000.*

To adjust the number of shares, multiply 100 shares by the 3-for-2 split ratio (100 x $^{3}/_{2}$ = 150 shares). To adjust the exercise price, multiply the $30 exercise price by the inverse of the split ratio ($30 x $^{2}/_{3}$ = $20 exercise price).

**Reverse Stock Split** In an effort to increase the market price of its stock, a corporation may choose to execute a reverse stock split. With a reverse stock split, the adjustments that are made to existing option contracts are a reduction in the number of shares that the contract represents and an increase in the exercise price of the contract. Again, the contract's aggregate value will be the same before and after the adjustment.

*For example, if ABC stock is split 1-for-5, an investor who currently owns:*

- *1 ABC October 10 call (representing 100 shares) will now own 1 ABC 50 call (representing 20 shares)*

To adjust the number of shares, multiply 100 shares by the 1-for-5 split ratio (100 x $^{1}/_{5}$ = 20 shares). To adjust the exercise price, multiply the $10 exercise price by the inverse of the split ratio ($10 x $^{5}/_{1}$ = $50 exercise price).

**Stock Dividend** An option contract is also adjusted for a stock dividend on the ex-dividend date. The adjustments made are identical to those that are made for an odd stock split (i.e., the number of shares per contract increases and the exercise price decreases proportionately).

*For example, if XYZ declares a 25% stock dividend, an investor who currently owns:*

- *1 XYZ May 30 call (representing 100 shares) will now own 1 XYZ May 24 call (representing 125 shares)*

The additional number of shares is determined by multiplying the original contract size of 100 shares by the stock dividend percentage (100 x 25% = 25 additional shares). Therefore, the new contract size for the option is 125 shares. Since the aggregate value of the contract must remain constant, the adjusted exercise price is determined by dividing the original aggregate exercise price of $3,000 (100 x $30) by the adjusted number of shares (125).

$$\frac{\$3{,}000}{125} = \$24 \text{ adjusted strike price}$$


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**Cash Dividend** Cash dividends are considered the property of the investor who owns the stock as of the record date. The holder of a call will receive the dividend on the underlying security as long as the option is exercised before the ex-dividend date. The owner of a put option who holds the underlying stock must wait to exercise the option until the ex-dividend or after in order to retain the dividend on the stock. The exercise price of a listed option will not be affected by the payment of an ordinary cash dividend.

The chart below summarizes the adjustments that must be made to an option contract for splits and dividends:

| | Adjusting 1 XYZ May 30 Call Option | | |
|---|---|---|---|
| | **Number of Contracts** | **Number of Shares** | **Strike Price** |
| **Even Split** (e.g., 2 for 1) | Increase<br>1 x $^{2}/_{1}$ = 2 | Unchanged<br>100 shares per contract | Decrease<br>\$30 x $^{1}/_{2}$ = \$15 |
| **Odd Split** (e.g., 3 for 2) | Unchanged<br>1 contract | Increase<br>100 shares x $^{3}/_{2}$ =<br>150 shares per contract | Decrease<br>\$30 x $^{2}/_{3}$ = \$20 |
| **Stock Dividend** (e.g., 25% dividend) | Unchanged<br>1 contract | Increase<br>100 shares x 125% =<br>125 shares per contract | Decrease<br>\$3,000 ÷ 125 = \$24 |
| **Cash Dividend** | Unchanged<br>1 contract | Unchanged<br>100 shares per contract | Unchanged<br>\$30 |

# Options Products

## Stock Index Options

Equity options provide investors with the opportunity to profit from the increases or decreases in the value of a particular stock. Rather than being limited to the movement of a particular stock, index options provide investors with the opportunity to either speculate on, or hedge against, the movement of the market.

There are two types of indexes—*broad-based* and *narrow-based*. A broad-based index is composed of a group of stocks that reflects the performance of the entire market (e.g., the S&P 500 [SPX] or S&P 100 [OEX]). A narrow-based index measures the performance of a particular market segment or industry group (e.g., pharmaceuticals).

Index options may be used to assist in reducing two specific risks that are associated with investing in equity securities:

1. The risk associated with the specific industry in which a corporation operates
2. The risk associated with how a specific corporation will react to trends in the stock market

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The first risk (industry risk) may be partially reduced with the use of index options of a specific industry (e.g., narrow-based index options). The second risk may be limited through the use of broad-based index options.

**Contract Specifications – Dollar Value and Premiums** The price of an index option contract is based on the index value multiplied by $100. For example, if an index has a value of 242.00, the dollar value is equal to $24,200 (242.00 x $100). This is similar to equity option contracts in which each contract is based on 100 shares of the underlying security.

As with equity options, index option premiums are expressed in points and decimals, with each point equaling $100 (1 x the multiplier of $100). For example, a premium of 3.13 equals $313 (3.13 x $100).

**Exercise** With an index option, an important point to remember is that, if the option is exercised, there's no exchange of physical securities; instead, the exercise results in a cash settlement. If the option is in-the-money, the buyer receives a cash amount equal to the difference between the strike price of the option and the closing value of the index on the day the option is exercised. Of course, if exercised against, the writer of the option is obligated to pay this amount.

*For example, an OEX May 800.00 call option is exercised when the underlying index closes at 808.00. The call is in-the-money by 8 points; therefore, the writer is obligated to pay the buyer $800 (8 points x $100).*

Index option buyers must be careful when they exercise their option contracts since exercise is based on the closing index value for that day. Therefore, if an index option is exercised during the day and ultimately closes out-of-the-money, the buyer may experience a loss due to being required to pay the writer the out-of-the-money amount.

*For example, the owner of an OEX March 240 call enters an exercise notice at 2:00 p.m. when the index is at 245.00; however, the index ultimately closes at a value of 238.00. Since the closing index value (238.00) is less than the strike price of the call (240.00), the option is 2 points out-of-the-money and the buyer is required to deliver $200 to the writer as settlement for the exercise.*

## VIX Options

The CBOE's Volatility Market Index (VIX) option is a broad-based index option that's calculated using the bid and ask quotes of the S&P 500 Index options. The VIX weighs both the nearby and second nearby options that have at least eight days to expiration to produce a 30-day measure of the volatility of the S&P 500 Index.


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Listed below are some of the characteristics of VIX options:

| | |
|---|---|
| **Trading Hours:** | 9:30 a.m. to 4:15 p.m. ET |
| **When Trading May Commence:** | For each trading sessions, only once the SPX rotation is completed |
| **Position and Exercise Limits:** | Currently unlimited |
| **Exercise Style:** | European style, with settlement in cash |
| **Premium Quotation:** | Each full point is equal to $100 |

*For example, since VIX options use a multiplier of $100, the purchase of a VIX August 11.00 call at a premium of 3.25 will cost $325. The call will be in-the-money if the VIX Index is above 11.00.*

The expiration cycle for VIX options is different than what's used by other index options. VIX options expire on the Wednesday that's 30 days prior to the third Friday of the following calendar month. The cash amount of settlement will represent the difference between the exercise-settlement value and the strike price of the option multiplied by $100.

The VIX is often considered to be a gauge of investors' sentiments or fears of expected stock market volatility over the next 30 days. The VIX will typically move inversely to the S&P 500 Index—the VIX rises when the S&P 500 Index falls and falls when the S&P 500 Index rises. Investors will buy VIX calls when they expect the market to decline and volatility to increase or, conversely, they will buy VIX puts when they expect the market to rise and volatility to decrease. Another possibility is that investors may buy VIX call options as a hedge against a possible decline in the market.

VIX options give traders a way to trade volatility without being required to factor in the price changes of the underlying instrument, dividends, interest rates, or the time remaining to expiration. An increase in volatility often occurs during a declining equity market and, rather than using index options, a trader may purchase VIX call options as a hedge.

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## Long-Term Equity Anticipation Securities (LEAPS)

LEAPS® are equity options that have expirations of up to 39 months that operate in the same manner as other standard listed equity options. Some of the significant advantages of these long-term options include that they:

- Lose their time value at a much slower pace than standard options
- Offer long-term protection against unfavorable movement in the market value of an underlying stock position
- Provide a long-term opportunity to participate in the price movement of a security

Currently, long-term equity options are traded on several underlying stocks including Microsoft, IBM, General Electric, as well as several indexes. The contract specifications for these options are generally the same as those of traditional equity options and are summarized in the following table:

| | |
|---|---|
| **Underlying Value** | 100 shares of the underlying security |
| **Expiration** | Expirations are in January and occur on the third Friday of the month; new expirations are added once per year |
| **Exercise** | American style, with delivery of the underlying stock in two business days |
| **Premiums** | Every one point equals $100 |
| **Strike Prices** | At the time of listing, one strike price is set above the market price of the stock, one at the market price of the stock, and one below the market price of the stock |
| **Settlement** | Next business day |


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