INFORMATIONAL

Compensation and Mixed Capacity Trading

Guidance on Compensation and Mixed Capacity Trading

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Executive Summary

The Nasdaq Stock Market, Inc. (Nasdaq®) and NASD Regulation, Inc. (NASD Regulation) believe that market rules should enhance investor protection and promote competition among market participants. The advent of decimal pricing in the Nasdaq market has caused many Nasdaq market makers to re-evaluate methods of charging for their services, as well as the manner in which they represent customer orders in the marketplace. Consequently, firms have questioned whether Nasdaq rules accommodate different methods of compensation for a market maker's services. In turn, firms have approached Nasdaq and NASD Regulation for interpretive advice concerning their regulatory obligations when executing transactions on a commission or commission-equivalent basis. In response to these and other inquiries, Nasdaq and NASD Regulation have prepared this *Notice to Members*.

The guidance relating to mixed capacity trades and the capability to change the Automated Confirmation Transaction Service℠ (ACT℠) report capacity indicator on a post-execution basis, which are discussed below, relate principally to Nasdaq securities (Nasdaq National Market and SmallCap). Nasdaq continues to evaluate whether there is a need for similar guidance regarding securities traded in the OTC Bulletin Board, and will provide information regarding this issue in a separate document at a future date.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Nasdaq Office of General Counsel at (202) 728-8088, and the Legal Section, Market Regulation Department, NASD Regulation at (240) 386-5126.

Discussion/Background

Traditionally, the business model of Nasdaq market makers has been based on the difference between the price at which market makers were willing to buy and sell securities. The difference, or "spread," typically makes up a component of a market maker's compensation for the risk it assumes and the liquidity it supplies to the market. As a result of changes to the Nasdaq market resulting from decimalization, some market participants are seeking to alter their methods of charging and paying for market services. In many cases, this means expanding the use of a commission-based fee model.

At the outset, Nasdaq wishes to emphasize that decisions about methods of compensation should be made in arm's length negotiations between broker/dealers and their customers. Each firm and its customers must make individual, independent determinations about the fee and payment structures that are appropriate for their business relationships. Therefore, the issuance of this *Notice* does ***not*** obligate any market participant to impose, or accept, any particular compensation model, nor does it suggest the appropriate level of compensation. Instead, this *Notice* seeks to provide interpretive advice and guidance to firms to assist them in meeting their regulatory obligations arising from whichever manner they choose to participate (and pay or receive compensation for that participation) in Nasdaq.

I. Trade Capacity

Q. 1. What is a principal trade?

A. A principal trade is a trade in which the broker/dealer buys or sells for an account in which the broker/dealer has a beneficial ownership interest (*e.g.*, a proprietary account). When executing transactions from this account, the broker/dealer typically charges its customer a markup, markdown, or commission equivalent, and may also trade on a "net" basis (see Question 4).

Q. 2. What is an agency trade?

A. An agency trade is a trade in which a broker/dealer, authorized to act as an intermediary for the account of its customer, buys (sells) a security from (to) a third party (*e.g.*, another customer or broker/dealer). Such a trade is not executed in, or does not otherwise pass through, the broker/dealer's proprietary account. When executing an agency trade, the broker/dealer generally charges the customer a commission for its services.

Q. 3. What is a riskless principal trade?

A. In Nasdaq, a riskless principal trade is one in which a broker/dealer, after having received an order to buy (sell) a security, purchases (sells) the security as principal, ***at the same price***, to satisfy that order. The broker/dealer generally charges its customer a markup, markdown, or commission equivalent for its services, which is disclosed on the confirmation required by Securities Exchange Act (Exchange Act) Rule 10b-10. For further guidance on riskless principal trade reporting obligations for Nasdaq securities, please *see Notice to Members 99-65, Notice to Members 99-66*, and *Notice to Members 00-79*.

Q. 4. What is a net trade?

A. A net trade takes place when a market maker, at the request of a customer, while holding a customer order to buy (sell), executes a buy (sell) as principal at one price (from the street or another customer) and then executes an offsetting sell to (buy from) the customer at a different price. The difference between the price of the market maker's transaction and the price of the offsetting transaction to the customer is the market maker's compensation, and such compensation generally is not separately disclosed on the customer confirmation. To the extent that the market maker executes a transaction to facilitate the execution of the customer order it holds, such a transaction appears to be a riskless principal transaction. However, because the two transactions are effected at two different prices, the market maker is required under NASD trade reporting rules to report both legs (*i.e.*, the street (or another customer) side and the customer side) of the transaction to the tape. The market maker's capacity for both transactions in ACT is principal (P). *See Notices to Members 95-67, 96-10, 99-65* and *00-79* for further guidance on net trading.[1]

II. Fees In General

Q. 5. Do NASD/Nasdaq rules prohibit a member firm from charging its customer a commission or commission equivalent?

A. No. There are no NASD/Nasdaq rules or interpretations that prohibit a member firm from charging its customers either a commission when acting as agent, or a commission equivalent when acting in a principal or riskless principal capacity. It is up to each individual NASD member firm, consistent with its regulatory obligations, to reach an independent determination as to the manner in which it seeks to be paid by its customers for services rendered.

Q. 6. Can a member firm charge its customer a commission when acting in a principal or riskless principal capacity?

A. The NASD rules do not specifically address this issue. Members should, however, refer to Securities and Exchange Commission (SEC) guidance and interpretations on this issue.

III. Handling Orders in Mixed Capacities

7. Q. Can a market maker that handles orders at the same price but in different capacities (e.g., as agent, riskless principal and/or principal) combine these orders and represent them in a single quote?

A. Yes. A market maker can combine agency, riskless principal and/or principal orders and represent them in a single quote. When a market maker is displaying trading interest in its quotation in Nasdaq and that quote is accessed by another participant through a Nasdaq system, Nasdaq systems currently assume that the market maker traded on a principal basis, and consequently default the execution report in ACT to a principal capacity indicator. Nasdaq and NASD Regulation understand that it is possible that the accessed quote represents an agency order or a combination of agency interest and proprietary (principal or riskless principal) interest. Nasdaq and NASD Regulation also understand that a firm may wish to adjust its Nasdaq system-generated ACT report to indicate that the market maker handled all or a portion of the execution of a mixed capacity quote as agent.

As an accommodation, Nasdaq is providing a voluntary option that will allow firms to break out the agency and/or riskless principal components of a "mixed" capacity execution through an ACT Regulatory Report – similar to "Alternative 2" under NASD riskless principal trade reporting rules. Specifically, a market maker would submit a non-clearing/non-tape report or a clearing only report (collectively, ACT Regulatory Report) to ACT for the agency and/or riskless principal portion(s) of the larger, system-reported execution. The market maker would be required to submit the ACT Regulatory Report within 15 minutes of the original mixed capacity execution. Additionally, the ACT Regulatory Report would have to include: 1) in the memo field, the ACT control number for the original trade report generated by the Nasdaq system;[2] and 2) in the execution time field, the time the order was ***allocated*** to the agency and/or principal account. As discussed in more detail below,[3] the presumption is that the entire amount of such a mixed capacity execution has been done on a principal basis unless allocated to an agency account within a general time parameter of 60 seconds.[4]

Q. 8. Can a market maker handling orders at the same price in different capacities (e.g., as agent, riskless principal and/or principal) combine these orders for entry into a Nasdaq system (i.e., SelectNet or the National Market Execution System (NNMS or SuperSOES)) for execution?

A. Yes. While it would be preferable for such orders to be entered separately into a Nasdaq system whenever possible, a market maker can combine such orders for entry into SuperSOES or SelectNet as a single mixed capacity order.[5] Similar to the procedure for the execution against mixed capacity quotes that is described in Question 7, Nasdaq will provide a voluntary option for firms to allocate the agency and/or riskless principal components of a "mixed" capacity execution resulting from the submission of a single "mixed order" into SuperSOES or SelectNet. As described in Question 7, this will be accomplished by the submission of an ACT Regulatory Report that identifies the agency and/or riskless principal order(s) that make up any or all of the executed mixed capacity order that was entered into the Nasdaq system.

Q. 9. Is a member required to use the ACT Regulatory Report to break out executions of agency and/or riskless principal orders, as outlined in Questions 7 and 8?

A. No. Member firms are not required to use this voluntary option to allocate the execution of a mixed capacity quote that is accessed via a Nasdaq system to its capacity component parts. Similarly, member firms that choose to aggregate multiple orders of differing capacities into a single mixed capacity order, for entry into SuperSOES or SelectNet, or into an Electronic Communications Network (ECN) or Alternative Trading System (ATS), are not required to use this voluntary option to allocate the execution of such orders to their capacity component parts. The above-described approach is one, but not the only, way for firms to document the capacity in which they traded.[6]

Please see Section V for further guidance on record keeping obligations.

Additional information on this functionality will be provided in a separate Technical Update. Until that time, we have included below an example illustrating the type of reports that can be submitted to adjust portions of a mixed capacity execution.

Example 1: MMA is at the inside offer of $20.00 for 15,000 shares. MMA's quote is composed of a 7,500 share principal order and a 7,500 share agency order (both to sell). MMB enters a market order to buy 15,000 into SuperSOES. At 10:00:00 a.m., SuperSOES executes the incoming buy order for 15,000 shares against MMA's quote, and ACT reports the 15,000 share execution to the tape on behalf of MMA (ACT control number = 1150111111). MMA allocates the order to the agency account for a customer that is a non-NASD member (*e.g.*, institution) within 30 seconds of execution at 10:00:30 a.m. If MMA wishes to use the ACT Regulatory Report to break out executions of the mixed capacity order, MMA would be required to submit an ACT Regulatory Report for 7,500 shares sold, with an allocation time of 10:00:30 a.m. (in the execution time field) and an ACT control number of 1150111111 in the memo field, as set forth below, within 15 minutes of the original mixed capacity execution:[7]

Tape/Media Report Sent to ACT by SuperSOES

MMID	OEID	Volume	Price	MMA Capacity	ACT Control #	Memo	Execution Time	Tape Rpt.	Clrg
MMA	MMB	15,000	20.00	P	1150111111		10:00:00	Yes	Yes

MMA's ACT Regulatory Report

MMID	OEID	Volume	Price	**MMA Capacity**	ACT Control #	**Memo**	Execution Time	**Tape Rpt.**	**Clrg**
MMA	MMB	7,500	20.00	**A**	1150222222	**1150111111**	10:00:30	**No**	**No**

The categories in the above-referenced trade reports are for illustrative purposes only

MMID	Executing Reporting Party
OEID	Order Entry (Contra) Party
Volume	Shares executed
Price	Transaction price
MMA Capacity	Capacity indicator for Market Maker A: P = principal, A = agency, R = riskless principal
ACT Control #	Unique ACT identifier attached to each ACT report
Memo	ACT field for input of miscellaneous information. Must be used to indicate original ACT control #
Execution Time	Time of order execution. On the ACT Regulatory Report, indicated time represents the time of allocation.
Tape Rpt.	Indicates whether the ACT record is reported to the tape. For ACT Regulatory Reports, this should always be "No."
Clrg	Indicates whether the ACT record is cleared through the ACT system

Example 2: MMA is holding an agency order to buy 10,000 shares at a price not to exceed $20.00, plus an agreed upon, separately disclosed commission. MMA then receives another agency order to sell 10,000 shares at $20.00. MMA's system is programmed to match agency orders and report the agency crosses to ACT.

Q. 10. Can MMA cross two customer agency orders internally and report the transaction to ACT as agent?

A. Yes, provided that the orders are not run through the market maker's proprietary account. Here, MMA would submit one trade report to ACT indicating that MMA acted as agent and effected an agency cross.

Q. 11. Is it permissible for a market maker to use an omnibus account to allocate executions among agency, principal, and riskless principal accounts?

A. Yes. A firm can maintain an omnibus account, which ***cannot*** be the firm's proprietary account (*i.e.*, the firm cannot hold proprietary positions in the account), from which it allocates executions to sub-accounts. When allocating to an agency or riskless principal sub-account, the firm must have record keeping and supervisory systems in place that can demonstrate, on an order-by-order basis, that, prior to execution, the firm had in hand the agency or riskless principal order to which the execution in the omnibus account relates.

IV. Trade Reporting Mixed Executions

As stated previously, Nasdaq and NASD Regulation recognize that in today's market environment market makers may be representing multiple customers in multiple capacities in a single transaction. In order to assist those market participants in properly categorizing their activities for regulatory and business purposes, Nasdaq has determined to provide a voluntary mechanism for firms to break out larger mixed capacity executions into their appropriate component parts. The following questions and examples illustrate how this mechanism will work.[8]

Example 3: Assume MMA is displaying 15,000 shares to buy at $20.00. This quotation represents two agency institutional orders of 5,000 each, along with an additional 5,000 of proprietary interest for the purpose of trading with retail customers. The market maker has been given discretion by the agency customer, subject to available best execution opportunities, to fill the customer's agency orders, or any part of them, on a principal basis. MMB accesses MMA's entire quote of 15,000 shares through SuperSOES, which automatically reports the trade to ACT with MMA's capacity as principal.

Q. 12. How does MMA split out the mixed components of the execution?

A. MMA would submit an ACT Regulatory Report for each agency portion of the trade it desired to split out from the original execution. Individual reports can be submitted for each order executed on an agency basis (*i.e.*, two ACT Regulatory Reports of 5,000 shares each), or all orders executed in the same capacity can be combined in a single report (*i.e.*, one ACT Regulatory Report for 10,000 shares). Assuming that the initial transaction report to ACT disclosed MMA's capacity as principal, there will be no additional report required to indicate that 5,000 shares of the original 15,000 share execution were effected on a principal basis, and Nasdaq and NASD Regulation will assume, for regulatory purposes, that the remaining portion was executed as principal.

Example 4:

Market is	***$12.95 - $13.00***
MMA is quoting	***$12.95 - $13.10***
MMB is quoting	***$12.70 - $13.00***

MMA receives an institutional order to buy 10,000 shares at a price not to exceed $13.00, plus an agreed upon, disclosed commission. The customer requests, and MMA agrees, to handle the order on an agency basis. MMA sends an order through SuperSOES, which executes all 10,000 shares against MMB at $13.00.

Q. 13. MMA acted as agent and wishes to confirm the trade to the customer as agent. Is it permissible to change MMA's capacity to agency after the fact if MMA clearly documents the capacity in which it acted?

A. Yes. Although Nasdaq and NASD Regulation are of the view that, wherever possible, orders should be marked correctly for capacity purposes at the time of entry into a Nasdaq system, if a market maker is unable to accurately designate its trading capacity at that time (because, for example, it is acting in a mixed capacity), it may voluntarily adjust its capacity post-execution by using Nasdaq's new functionality.

However such a change may not be necessary in the above scenario. As the party that entered the SuperSOES order, MMA already possesses the capability of designating through SuperSOES its capacity as principal, riskless principal or agent when it enters the order that is executed against MMB.[9] Note that, as of the date of this *Notice*, market participants cannot enter orders into SelectNet with a riskless principal capacity indicator.

Example 5: MMA receives an institutional order to buy 10,000 shares at a price not to exceed $13.00, plus an agreed upon, disclosed commission. The customer instructs MMA to handle the order on an agency basis. MMA sends multiple SelectNet messages to fill the customer order. ECN 1 executes 9,000 shares and ECN 2 executes 5,000 shares resulting in two executions totaling14,000 shares at a price of $13.00.

Q. 14. What happens to the "overbought" portion?

A. MMA must take the "overbought" portion into inventory. Because all 14,000 shares were executed at a price of $13.00, it makes no difference which "portion" is allocated to the agency order, provided that the agency order is filled in its entirety. As the sender of the SelectNet orders, MMA may indicate agency (A) or principal (P) at the time of order entry. If MMA does not indicate agency at the time of order entry, it can change the capacity indicator to agency (A) for the order(s) by submitting an ACT Regulatory Report for those shares that are handled as agent. In the above scenario, therefore, the capacity indicator on the 9,000 shares that were purchased from ECN 1 would be changed to agency (A), and the 5,000 shares that were purchased from ECN 2 would be changed to reflect that only 1,000 shares were purchased as agent (with the remaining 4,000 shares of the 5,000 share execution having been purchased as principal).[10]

Firms should be mindful of their best execution obligations when receiving better-priced executions from ECNs at prices superior to their displayed quotations (*i.e.*, any price improvement received in such instances should be passed along to the customer).

Example 6: Assume MMA receives from Customer #1 a not held buy order for 10,000 shares at a price not to exceed $13.00. MMA contemporaneously receives from Customer #2 a not held agency buy order for 10,000 shares at a price of $13.00. MMA sends a SelectNet message to ECN 1 to buy 20,000 shares at $13.00. ECN 1 executes 15,000 and moves to $13.10.

Q. 15. How does MMA identify which portion of the execution goes to Customer #1 and which portion is allocated to Customer #2?

A. Neither Nasdaq nor NASD Regulation has mandated any particular order handling and execution priority procedures among orders. In this Example, MMA may, therefore, allocate executions among its accounts as long as it employs a reasonable methodology for allocating shares, which is adequately and properly disclosed to its customers, is fair, consistently applied, and does not unfairly discriminate against any particular class of accounts or types of orders. For example, a member could use a FIFO method for all orders, allocate to accounts on a pro-rata or an "even split" basis, or use other objective methodologies or formulae. It would be inappropriate, however, for a member's methodology to allocate shares to institutional orders over retail orders or to the orders of certain preferred accounts. To the extent a member elects to implement such an allocation methodology, the firm must describe it in firm documentation on both a current and an historical basis.

The member must further ensure that its written supervisory procedures and supervisory system review the extent to which its chosen methodology allocates shares in a manner consistent with the duty of best execution.[11] Member firms should also understand that simply because they employ a methodology for allocating shares, and that methodology is followed in a particular circumstance, that it does not automatically mean that any or all customer orders executed pursuant to such a methodology received best execution. Lastly, firms are reminded that they must always treat limit orders that they have accepted in compliance with NASD Rule IM-2110-2 (the Limit Order Protection Interpretation, a.k.a. "Manning obligations").

Q. 16. In a mixed capacity trade that is, upon execution, originally allocated to an omnibus account, do Manning obligations arise at the time of execution or allocation?

A. The presumption is that the entire amount of an execution effected in an omnibus account is effected as a principal or riskless principal transaction, and is therefore a triggering trade for the purposes of Manning obligations, at the time of execution. For mixed capacity executions, however, this presumption may be rebutted, and the amount of shares subject to Manning protection reduced if, within a general time parameter of 60 seconds after the mixed capacity execution, all or a portion of the execution is allocated to an agency account. Allocations to an agency account more than 60 seconds after the original mixed capacity execution do not relieve a market maker of its Manning obligations to any protectable customer limit orders that it holds.

For example, MMA is displaying 10,000 shares to buy at $20.00 in its quote. SuperSOES executes the full 10,000 shares, and MMA allocates those shares immediately to its omnibus account. Within 60 seconds of the SuperSOES executions, MMA, pursuant to its established allocation methodology, allocates 3,000 shares to an agency account for a 3,000 share not held agency order it is holding. In this hypothetical, MMA would, within a general time parameter of 60 seconds after the original mixed capacity execution, owe Manning fills up to 7,000 shares for any protectable limit orders that it was holding on its book to buy at $20.00 or higher. In addition, any shares remaining in the omnibus account within 15 minutes of the original mixed capacity execution will be deemed to be a proprietary position of MMA and must therefore immediately be allocated by MMA from its omnibus account to its proprietary trading account (see Question 11).

V. Record Keeping Obligations

Q. 17. Does a member firm have record keeping obligations when trading in a mixed capacity basis?

A. Yes. In addition to any applicable record keeping obligations under SEC Rules 17a-3 and 17a-4 and NASD Conduct Rule 3110, any member firm trading in a mixed capacity basis, regardless of whether they are voluntarily submitting ACT Regulatory Reports or not, must have in place systems and controls that produce records that enable the firm and NASD Regulation accurately to reconstruct, in a time-sequenced manner, the activity in accounts used to engage in mixed capacity trading. Accordingly, for any given period of time throughout the trading day, and for all accounts used to engage in mixed capacity trading, firms must be able readily to reconstruct for NASD Regulation the details of all orders worked on an agency or riskless principal basis, all trades that could have been attributed to an agency or riskless principal order and whether those trades were executed on an agency or riskless principal basis (using ACT Regulatory Reports or otherwise), or on a principal basis.

NASD Regulation will examine this activity to determine whether post-execution capacity adjustments were properly done and supported by the orders held by the firm at the time of the execution of the agency or riskless principal quote or order. Conversely, NASD Regulation will examine this activity to determine whether the firm improperly refrained from post-execution capacity adjustments due these orders.

Failure to record and retain such information could result in disciplinary action. The inability to substantiate the capacity of a trade will also cause NASD Regulation to assume that the original (and potentially incorrect) capacity that it reported to ACT is its actual capacity and assess compliance with related regulatory obligations on that basis. Moreover, NASD Regulation will examine post-execution capacity adjustments (and failures to make adjustments) for possible best execution violations.

Q. 18. How can a member demonstrate that a trade was executed as "riskless principal" where the member executes both principal and riskless principal transactions?

A: The member must have written policies and procedures to assure that orders executed and reported as "riskless principal" comply with NASD Rules 4632, 4642, and 6420, which require that the transactions offsetting a customer order executed as riskless principal occur ***after*** the customer order is received ***to satisfy*** that order. At a minimum, these policies and procedures must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are allocated to the riskless principal account in a consistent manner and on a prompt basis. Members must have supervisory systems in place that can demonstrate order-by-order compliance with this requirement. The above standard would apply to agency transactions allocated to an omnibus account as well.

VI. Order Audit Trail Obligations (OATS)

The ability to allocate, on a voluntary basis, the components of a mixed capacity execution into its individual parts requires members to provide certain additional information to OATS. The following questions and answers have been prepared by NASD Regulation to assist member firms in this regard.

Q. 19. Are there any OATS requirements if a firm submits an ACT Regulatory Report to allocate the components of a mixed capacity execution?

A. Yes. If a firm chooses to allocate, on a voluntary basis, the components of a mixed capacity execution in ACT into its individual parts, then that firm's OATS obligations are as follows:

For Orders Entered on Behalf of a Customer for Execution

Under current OATS requirements, a firm that enters an order into a Nasdaq system for execution must submit to OATS a Route Report indicating that the order was routed to a Nasdaq system. However, if a member chooses to allocate, on a voluntary basis, the components of a mixed capacity execution in ACT into its individual parts, such an allocation will take place after the time of the original execution. In addition, given the post-trade allocation process envisioned by the use of ACT Regulatory Reports, which may involve allocations among several agency orders and/or principal and riskless principal accounts, it may be that a firm has executed an order before it has had an opportunity to create a Route Report for submission to OATS. Accordingly, in this instance, a firm must submit an Execution Report to OATS rather than a Route Report. If a firm is representing multiple customer orders in the same ACT Regulatory Report, it must ensure that each OATS Execution Report contains the same branch/sequence number as reported on the ACT Regulatory Report. Alternatively, the firm may submit an ACT Regulatory Report for each separate customer order that comprises the mixed capacity execution and each such entry must contain the necessary information to ensure that the OATS Execution Report(s) can be matched to the related ACT Regulatory Report(s).[12]

For Orders Displayed for Execution

Under current OATS requirements, a firm must submit to OATS a New Order Report and an Execution Report when an order it is displaying is executed against.[13] This will still be the case if a member chooses to allocate, on a voluntary basis, the components of a mixed capacity execution that resulted from a mixed capacity displayed order. However, if the firm does a voluntary allocation, it will be required to match the OATS Execution Report to the second ACT report (the ACT Regulatory Report) by entering a branch/sequence number in both the ACT Regulatory Report and the OATS Execution Report and omitting the Reporting Exception Code of “M” from the OATS Execution Report. If a firm is representing multiple customer orders in the same ACT Regulatory Report, it must ensure that each OATS Execution Report contains the same branch/sequence number as reported on the ACT Regulatory Report. Alternatively, the firm may submit an ACT Regulatory Report to ACT for each separate customer order that comprises the mixed capacity execution and each such entry must contain the necessary information to ensure that the OATS Execution Report(s) can be matched to the related ACT Regulatory Report(s).[14]

Q. 20. If a firm elects not to use the voluntary ACT Regulatory Report to break out the executions of agency orders, as outlined in Questions 7 and 8, above, but rather relies on another approach, are there any additional OATS reporting requirements for that firm?

A. Yes. If a firm chooses to allocate, through an approach other than the use of a voluntary ACT Regulatory Report, the components of a mixed capacity execution into its individual parts, then that firm’s OATS obligations are as follows:

For Orders Entered On Behalf Of A Customer For Execution

Because such allocations will take place after the time of the original execution, it may be that the firm has executed an order before it has had an opportunity to create a Route Report for submission to OATS. In this instance, a firm must submit an Execution Report to OATS rather than a Route Report. However, unlike the case where a voluntary ACT Regulatory Report is used, there will be no related ACT report submitted that reflects the post-execution allocation. Consequently, a firm electing not to use the voluntary ACT Regulatory Report to allocate the components of a mixed capacity execution must append a Reporting Exception Code of “M” to any Execution Report(s) submitted to OATS for post-execution allocation.

For Orders Displayed On Behalf Of A Customer For Execution

The firm’s OATS reporting obligations in this situation are the same as its current OATS reporting obligations when an order that is displayed in a quotation is executed. That is, an Execution Report must be submitted to OATS with a Reporting Exception Code of “M” to indicate that no ACT match will take place because the firm did not have the ability, at the time its quote was accessed, to enter a branch/sequence number into the Nasdaq system-generated ACT report.

Q. 21. When allocating the components of a mixed capacity execution, what time should be submitted in the execution time field of an OATS Execution Report, the time of the execution or the time of allocation?

A. The time of allocation, regardless of whether the member is using the voluntary (or any other) approach to track and record subsequent capacity adjustments to portions of mixed capacity executions.

Q. 22. Do my OATS obligations change if I am using the Update feature in ACT to change the capacity of the entire execution rather than using the ACT Regulatory Report option?

A. Yes. The Update feature not only allows the capacity indicator to be changed in ACT, but it also allows a change to, or the addition of, the branch/sequence number field. Therefore, if a branch/sequence number was not entered by the firm at the time of order entry, the firm must enter a branch/sequence number in the ACT Regulatory Report and include that same branch/sequence number on the related OATS Execution Report. In this case, the execution time on the OATS Execution Report must be the same as the execution time on the corresponding ACT Regulatory Report.

Endnote(s)

1 Nothing in this *Notice to Members* is intended to change the rules applicable to markups, fair prices, and commissions. *See, e.g.*, NASD Conduct Rule 2440, Interpretive Memorandum (IM) 2440, and *Notice to Members 92-16.*

2 The "Memo" field is available through all Nasdaq trade reporting mediums, including Computer-to-Computer Interface (CTCI), the ACT Trade Report Entry Screen on the NWII ™ workstation, and the Application Program Interface (API). ACT assigns a control number to each trade report submitted to ACT. Nasdaq provides users with several methods for identifying the ACT control numbers assigned to trade reports, which will be discussed in greater detail in a later Technical Update.

3 *See* Section IV of this *Notice*.

4 *See Notice to Members 95-67*, at Question 5.

5 Nothing in this *Notice to Members* is intended to change the rules relating to the trading of Nasdaq SmallCap securities on Nasdaq's Small Order Execution System (SOES). See NASD Rules 4750-4756.

6 Firms may use the ACT Regulatory Report to break out the actual capacities of a mixed capacity execution in a variety of circumstances, including when they are: acting as the order sender or receiver (order-entry firm) through SuperSOES; acting as the order sender or receiver through SelectNet; and transacting through another execution venue, such as an ECN or ATS. In other words, members will have the ability to correct their capacity to a particular execution in ACT regardless of whether they are on the reporting side or the contra side to the execution and regardless of whether they received an execution through a Nasdaq system. Additionally, firms may use an ACT Regulatory Report to change the capacity on the entire original execution.

7 Submission of such reports is discussed in greater detail in Section IV of this *Notice*.

8 Nothing in this *Notice to Members* is intended to change the trade reporting requirements under the riskless principal trade reporting rules. *See NASD Notices to Members 99-65, 99-66,* and *00-79*.

9 *See* Technical Update #2001-22, September 24, 2001, regarding specifications, enhancements, and modifications related to riskless principal transactions through API and CTCI. The ability to enter riskless principal transactions through NW II will go into effect first quarter 2002.

10 The allocation(s) to the agency account must occur within a general time parameter of 60 seconds in order to avoid potential Manning violations. Overbought shares in the proprietary account would trigger Manning obligations for any protectable limit orders the market maker was holding to buy at $13 or higher. *See* Question 17.

11 *See Notices to Members 98-96 and 99-45.*

12 In order for OATS to electronically "match" the OATS Execution Report to the related ACT Regulatory Report, the MPID, Issue Symbol, Execution Date, Execution Time Stamp to the second, and the Branch/Sequence number must match exactly on both reports. For purposes of the ACT Regulatory Reports and related OATS Execution Reports, the time of allocation is entered into the time of execution field.

13 For these trades, the Execution Report must be submitted with a Reporting Exception Code of "M" to indicate that no ACT match will take place because the firm did not have the ability, at the time its quote was accessed, to enter a branch/sequence number into the ACT Regulatory Report.

14 *See* footnote 12 as to which elements of the OATS Execution Report and the related ACT Regulatory Report must match.