Registering as a Market Maker

All broker dealers who wish to register as a marker maker must file an application with the NASD and demonstrate that they are in good standing with the Association and that the firm meets the capital requirements to become a market maker. The broker dealer's registration will become effective upon notification by the NASD. Once approved, a broker dealer must register in each security it wishes to make a market in, prior to quoting that security. Broker dealers may not receive any consideration from the issuer or from promoters for making a market in the security. As a result of recent SEC order handling rules all market makers will be considered primary market makers and will be exempt from the NASDAQ short sale rule.

Registering as a Market Maker In an OTC BB Security

Securities that are quoted in the OTCBB do not have to meet any listing requirements and may be quoted by broker dealers who are registered as OTC marker makers. Market makers must obtain detailed information regarding the issuer as required by SEC Rule 15c2-11. Prior to quoting or resuming a quote in an OTC BB security the marker maker must have at least one of the following:

- ✓ Form 10K, 10Q, and 8K
- ✓ An offering circular effective within 40 days
- ✓ A prospectus effective within 90 days
- ✓ Other detailed financial information
- ✓ Foreign financial filings for foreign firms

The market maker entering the quote must maintain a file containing the following:

- ✓ A copy of any SEC trading suspension or public release relating to any of the issuer's securities within the last 12 months
- ✓ A record of the name of the person or people for whom the quote is published and a record of any information provided to the dealer by that person.
- ✓ A copy of other information relating to the issuer that the dealer becomes aware of.

The dealer is required to file form 211 with the NASD at least 3 business days prior to entering a quote. The firm is also required to provide the Association with the information required under SEC Rule 15C2-11. The filing should also include:

- ✓ The name of the issuer
- ✓ The dealer's initial or resumed quote
- ✓ The basis for the quote
- ✓ The type of security
- ✓ How the firm will display the quote
- ✓ A demonstration of the dealer's compliance with SEC Rule 15C2-11
- ✓ The previous name of the company if the issuer was party to a merger

TAKE NOTE!

If the dealer's initial quote is not priced and is subsequently changed to a priced quote the dealer must update their filing and must include their new quote and the basis for the quote.

The NASD will respond to the dealer's application within 3 business days and will notify the dealer if the application has been cleared, denied, or if the Association needs additional information.

TEST FOCUS!

SEC Rule 15C2-11 only relates to Non NASDAQ securities. A dealer may be exempt from the requirements of SEC Rule 15 C 2-11 if:

- ✓ The Quote is being entered based on an unsolicited customer order
- ✓ The security is listed on an exchange or trades on NASDAQ
- ✓ The dealer is "piggybacking" another dealer's quote.

<u>Piggybacking a Quote</u>

If an OTC BB security has been quoted by another dealer for a minimum of 30 days, they may simply enter their own quote by piggybacking the current dealer's quote so long as:

- ✓ The security has been quoted for at least 12 of the last 30 days (Active)
- ✓ There have been no more than four consecutive days without a quote (Active)
- ✓ There is at least one independent market maker quoting the security.

Securities that have been delisted from NASDAQ may be automatically quoted by a dealer on the OTC BB if:

- ✓ The issuer is not in bankruptcy
- ✓ The market maker quoted the security on NASDAQ in the last 30 days
- ✓ The security was quoted for 30 days continuously before being halted
- ✓ The issuer is current with all required SEC filings

If a security being quoted on the OTC BB is the subject of an SEC trading suspension, the market maker should review the information they have in their possession with regard to the issuer to ensure that it is still accurate and that they are still in compliance with SEC Rule 15C2-11. The market maker must obtain updated information if necessary.

<u>NASDAQ Quotes</u>

Most actively traded NASDAQ stocks are quoted by a large number of market makers. As market makers enter their quotes, some will be above or below the best quote known as the inside market. A market maker whose quote is above or below the inside market is said to be away from the market. As the market makers adjust their quotes, the market maker who is publishing the highest bid for the security has their bid displayed at the top of the list and their bid is published as the best bid to anyone with a NASDAQ Level I subscription service or higher. The market maker publishing the lowest offer will have their offer listed at the top of the list and published as the lowest offer to anyone with a NASDAQ Level I subscription service or higher. As a result, the best bid and offer from any two market makers will make up the inside market.

Example:

XYAD

	Bid	**Ask**
	15.00	**15.05**
MM 1	**14.90**	**15.10**
MM 2	**15.00**	**15.20**
MM 3	**14.85**	**15.05**
MM 4	**14.95**	**15.15**
MM 5	**14.98**	**15.18**

Note:

Notice how the inside market for XYAD consists of the bid from market maker 2 and the offer from market maker 3. All of the other market makers are away from the market.

Locked and Crossed Markets

Market makers may not enter quotes that would lock or cross the market. A locked market is one where the bid and offer are equal in price. For example, if another market maker came into the above listed market for XYAD known as market maker 6, and entered a bid of 15.05 or an offer of 15.00, the bid or offer entered would lock the market. A crossed market is one where a bid is entered that is higher than the offer or, one where an offer is entered that is lower than the bid. If market maker 6 entered a bid of 15.10 or an offer of 14.95 the bid or offer would cross the market. A market maker who has an order that would cause them to enter a bid or offer that would lock or cross the marker must make an effort to trade with all the market makers whose bid or offer they would lock or cross. The NASDAQ's Super Montage system helps alleviate most locked or crossed markets.

Nominal NASDAQ Quotes

All quotes published over the NASDAQ workstation are firm quotes. A dealer who fails to honor their quotes has committed a violation known as backing away. Dealers who provide quotes over the phone, which are clearly indicated as being subject or nominal, cannot be held to trade at those prices. NASDAQ qualifiers are:

- ✓ "It looks like"
- ✓ "It's around"
- ✓ "Subject"
- ✓ "Nominal"
- ✓ "Work it out"
- ✓ "Last I saw"

A response of “it is’ would indicate a firm quote. A firm quote is always good for at least one round lot or 100 shares.

NASDAQ Execution Systems

Most NASDAQ trades are executed over the NASDAQ workstation using one of its Automated execution systems. These systems allow dealers to execute orders without having to speak with one another on the phone.

Super Montage

The NASDAQ Super Montage system accepts market orders and immediately executable limit orders for both customer and firm accounts. Orders may be entered for up to 999,999 shares per order. The orders will immediately be routed to dealers on the inside market for automatic execution. Larger orders may be split up to meet the maximum order volume. Orders executed through the Super Montage system are automatically reported to act. Orders executed through the Super Montage system are executed based on the priority of price and time. Orders will be executed against the market maker that is quoting the best price first. If more than one market maker is quoting the same price, orders will be executed against the market maker who quoted the best price first. Orders may be entered in the Super Montage system by both market makers and order entry firms. Firms may modify the way that their orders are routed to market makers by selecting:

- ✓ Modified price and time; this option will take into consideration access fees that may be charged by the counter parties
- ✓ Price, size, time which takes into consideration the size of the counter parties quote

Quotes Entered Through Super Montage

Maker makers who quote securities through the Super Montage system must display the price for their quote as well as the size of their quote. The Super Montage system will also allow market makers to maintain additional shares to buy or sell in “reserve”. This reserve size is not seen by other market participants and must be for at least one round lot or 100 shares.

ABCD

Market Maker	Bid	Size	Reserve	Refresh from Reserve
MM 1	15	1000	5000	1000
MM 2	15	1000	4000	1000
MM 3	14.95	1000	3000	1000
MM 4	14.95	1000	2000	1000
MM 5	14.90	1000	1000	1000

Example:

Market makers 1 and 2 are both bidding 15 for ABCD. Market maker 1 is ahead of market maker 2 in time priority. An order to sell 10,000 shares of ABCD would be executed against the displayed size for market maker 1 and market maker 2 respectively. The order would then be executed against market maker 1's reserve size of 5000 shares. The remaining 3000 shares in the order would then be executed against market maker 2's reserve and would leave market maker 2 with 1000 shares to buy at 15. After the execution the market would look as follows:

ABCD

Market Maker	Bid	Size	Reserve	Refresh from Reserve
MM 2	15	1000		
MM 3	14.95	1000	3000	1000
MM 4	14.95	1000	2000	1000
MM 5	14.90	1000	1000	1000
MM 1				

Market maker 1 now needs to update its quote in the system. The transactions that were executed against market maker 1 only constituted one transaction with that market maker and the transactions that were executed against market maker 2 only constituted one transaction with that market maker.

Updating NASDAQ Quotes

If a market maker's quote is reduced to below one round lot or to zero, the market maker is required to update their quote. Any order that reduces the size of the market maker's quote is said to decrement the quote. Market makers may manually update their quotes or may select the automatic quote refresh (AQR) feature. Market makers may select the price and size that will be automatically entered through the AQR system. This will allow the market maker to set the system's AQR feature to operate in a way that is consistent with the firm's trading patterns. However, if the firm has entered multiple quotes for the security into the Super Montage system and one of the other quotes is better than the quote that would automatically be created by the AQR feature, the better-priced quote would be displayed. Quotes may be entered into the system:

- ✓ By the market maker
- ✓ By the system
- ✓ On a summary basis

If the market maker enters the quote the market maker is responsible for the quoted prices. If the market maker's quote is exhausted, the super montage system will generate a quote for the market maker that is one price level up from the worst quote. Quotes entered on a summary basis will allow the marker maker to maintain several different quotes in the system.

Non-Directed Orders

When a firm enters an order into the Super Montage system without specifying the market maker with whom they want to execute the order, the Super Montage system will execute the order against the market maker with the best-displayed quote. This type of order is known as a non-directed order. All non-directed orders are liability orders meaning the market maker who receives the order is obligated to trade at its quoted price. Non-directed orders may decrement or reduce the market maker's displayed size as well as its reserve. Only market orders and immediately executable limit orders may be entered as non-directed orders.

Preferenced Orders

Market participants may stipulate which firm they want to execute an order with. When a firm identifies the counter party it wants to trade with, the order is known as a preferenced order. Preferenced orders are liability orders and the receiving firm is obligated to trade at its displayed quote. A preferenced order may decrement or reduce the receiving firm's displayed size as well as its reserve. Any unexecuted portion of the order will be returned to the firm entering the order.

TAKE NOTE!

The firm who receives the directed order must be at the inside quote or the order will be rejected.

Directed Orders

A firm wishing to trade with a specific market maker may enter a directed order. Directed orders may be entered as liability orders or as non-liability orders. Market makers may elect to receive or not to receive directed liability orders. If a market maker is willing to accept directed liability orders, a "d" will appear next to their market maker ID. In order for a directed order to be considered a liability order, it must be within the receiving market maker's displayed price and size. A receiving market maker has five seconds to respond to the order. A receiving market maker must fill the liability order unless it is in the process of executing other orders when the directed liability order is received. If the receiving market maker is in the process of executing another order it may partially fill, counter, or reject the liability order. The firm entering the liability order must wait five seconds from the time of entry before attempting to cancel the order. If the receiving market maker is not in the process of executing another order and does not fill the directed liability order, then the receiving marker maker has committed a firm quote violation. If the directed order was entered with a size at least 100 shares greater than the receiving market maker's displayed size and the order was designated all or none, the order is a non liability-order. Additionally, if the order has a minimum acceptable size that is at least 100 shares greater than the receiving market maker's displayed size, the order will also be a non-liability order. Directed orders in the Super Montage system have replaced orders entered through SelectNet. Currently SelectNet is used for after hours trading when the Super Montage system is closed.

The Alternative Display Facility / ADF

The NASD operates the Alternative Display Facility from 8:00 AM – 6:30 PM EST. The ADF allows unlinked ECN participants to enter quotes, match, and report trades. The quotes entered in the ADF will not appear in the Super Montage system. However, if the quote entered in the ADF would improve the inside market, the quote will be displayed as part of the inside market. The ADF does not provide execution capabilities. All ADF participants are required to provide direct or indirect electronic access to its quotes. Direct electronic access will allow other market participants to execute an order electronically against the firm's quote. Indirect electronic access will allow another market participant to execute an order against the firm's quote through the firm's broker dealer customer. Both direct and indirect electronic access requires:

- ✓ No voice communication
- ✓ Equivalent speed, reliability, and availability as offered to participants customers
- ✓ Equivalent costs as offered to participants customers
- ✓ A two second turnaround for accepting or declining an order
- ✓ A three second or less turnaround for communication between market participants.

The NASD requires that participants who enter quotes in multiple trading centers must display the same quote in the different centers. A market participant may, however, display different sizes in different centers.

Advanced Computerized Execution System / ACES

The Advanced Computerized Execution System or ACES Pass Thru system allows an order entry firm to have direct access to a market maker's internal trading system. A market maker must grant the order entry firm access to their internal trading platform and may add, remove, or restore the access given to one or all firms as it chooses. Order entry firms that have been granted access through the ACES Pass Thru system route their order electronically to the market maker's internal system for execution. The market maker receiving the order pays the fees for executing orders through the ACES Pass thru system.

Electronic Communication Networks / ECNs

Electronic Communication Networks, or ECNs, operate independently of the NASD. ECNs display and execute third party orders and are allowed access to the Super Montage system. ECNs are widely used by both broker dealers and institutional investors to display and execute orders. ECN quotes are included in the NASDAQ quote system but the ECN is not required to maintain a two-sided market like a market maker and, ECNs do not take positions in the security. There are two ways that the ECN may participate in the Super Montage system. The ECN may be a full participation ECN or it may be an order delivery ECN. Full participation ECNs may:

- ✓ Display quotes
- ✓ Enter and accept directed and non directed orders
- ✓ Accept automatic executions
- ✓ May send orders for automatic execution through the Super Montage system

Full participation ECNs will have their ID followed by "#+" notation. Order entry ECNs may display quotes, enter and accept directed and non-directed orders. The order entry ECN may fill, decline, price improve, or allow an order it has received to expire. If the order sent to the order entry ECN expires, the order will be canceled and sent to the next participant at the inside market by the Super Montage system. Order entry ECNs will have their ID followed by a "#" notation.

Unlisted Trading Privileges

Certain exchanges are given access to the Super Montage system through unlisted trading privileges. These exchanges are referred to as UTP exchanges. UTP exchanges may enter quotes and enter directed and non-directed orders, as long as the UTP exchange has agreed to accept automatic executions. UTP exchanges that will not accept automatic executions may not participate in Super Montage.

Market Centers

As a result of the development of multiple order execution systems and centers, the SEC has enacted order execution disclosure rules. SEC Rule 11Ac1-5 requires market centers to disclose certain order execution information for covered securities. A market center is:

- ✓ An OTC market maker
- ✓ A market maker that internalizes orders
- ✓ Alternative trading systems
- ✓ National securities association
- ✓ National securities exchange

A covered security is a NASDAQ NMS security or any other security for which last sale data and quotes are disseminated through the automated quotation system. A covered order is any market or limit order received and executed during the normal trading hours (9:30AM – 4:00PM EST). SEC Rule 11Ac1-6 requires broker dealers to file quarterly reports regarding the execution of non-directed customer orders. A broker dealer does not have to file a report for market centers that make up less than 5% of non-directed order execution. A non-directed order is one where the customer did not specify the market center where the order is to be executed. The following items must be included in the report:

- ✓ The identity of the market center where non-directed orders were routed for execution.
- ✓ Any relationship the broker dealer has with the market center
- ✓ Any payment received for order flow
- ✓ Any profit sharing relationships with the market center
- ✓ Any internalization of orders

SEC Rule 11Ac1-6 requires that the reports be made public and posted on an Internet website. Customers must be notified at least annually in writing that a copy of the report will be made available to them free of charge upon request. A customer may also request market center information for a specific order that was executed by the broker dealer within the last six months.

TAKE NOTE! A broker dealer who has routed 500 customer orders or less per month during the preceding calendar quarter is exempt from the reporting requirement, but not from providing the data to customers who request such information.

NASDAQ International

The NASDAQ operates an international platform that allows European firms to trade domestic equities and other securities during the European trading session. The NASDAQ international service operates from 3:30 AM to 9:00 AM EST. European Non-NASD members may only participate during the European session, while NASD members may participate in both the domestic and European sessions by registering as an international market maker. Securities that may be traded during the European session include:

- ✓ NASDAQ NMS securities
- ✓ Exchange listed US securities
- ✓ Non Canadian foreign securities that are quoted on NASDAQ but not NMS

NASDAQ NMS Short Sales

The NASDAQ has enacted a bid test rule to keep large investors from manipulatively shorting NASDAQ NMS stocks. An investor may not sell a stock short that is traded on NASDAQ NMS at the bid price if the current best bid is at a price that is lower than the previous best bid. If the bid is lower than the previous bid, the investor may only sell the stock short at a price that is above the current best bid by the minimum increment. Exemptions from this rule include:

- ✓ A member order to offset a customer's odd lot order
- ✓ Sales that have been erroneously marked as long
- ✓ Special arbitrage accounts
- ✓ SmallCap Stocks
- ✓ Primary market makers
- ✓ Sales by a member of less than one round lot

Firms must maintain a record of customer and firm short positions. The firm must file a short interest report for short positions that have settled by the 15th of each month. If the 15th is not a good settlement date then the settlement date used for the report will be the preceding business day. All reports are required to be filed with the firm's designated examining authority (NASD or NYSE) by the end of the second business day following the settlement date.

Non NASDAQ OTCBB

The OTC Bulletin Board provides two-sided electronic quotes for OTC securities that cannot meet the listing standard of an exchange or NASDAQ. DPPs and ADRs will often be quoted on the OTCBB. The OTC BB is operational from 7:30 AM – 6:30 PM. The OTC BB displays:

- ✓ Real time Quotes
- ✓ Volume
- ✓ Last sale price

Quotes that may be entered over the OTC BB by a market maker include:

- ✓ 1Bid wanted
- ✓ Offer wanted
- ✓ Bid only
- ✓ Offer only
- ✓ Two sided quotes
- ✓ Quote modifications

Quotes displayed over the OTC BB are firm quotes unless they are quoting DPP programs. Quotes entered on the OTC BB must be for the minimum size for that security. The minimum quote size for the security depends on the price of the security being quoted. Quotes for DPP are subject quotes and may only be updated twice per day, once between 8:30 – 9:30 AM and at 12:30 pm.

Pink Sheets

Securities that do not qualify for listing on the NASDAQ, or that have been delisted from NASDAQ or one of the exchanges, may be quoted on the Pink Sheets. The Pink Sheets are published monthly and provide daily updated quotations via fax and email. The Pink sheets provide a list of market makers who are interested in trading the securities that are quoted on the Pink Sheets. All quotes displayed in the Pink Sheets are subject quotes. The electronic version of the Pink Sheets known as the Electronic Quotation Service or EQS provides real time data. Stocks quoted on the Pink Sheets trading at under $5 per share are known as penny stocks. A firm who executes a customer's order for a Pink Sheet security is required to make a reasonable effort to obtain the best price for the customer. The firm is required to obtain quotes from at least three market makers for the security prior to executing the customer's order. If the security has less than three market makers, the firm is required to obtain a quote from all market makers.

Third Market

The third market consists of transactions in exchange-listed securities, executed over the counter through the NASDAQ workstation. A broker dealer may wish to simply purchase or sell an exchange-listed security directly with another brokerage firm instead of executing the order on the floor of the exchange. These transactions are known as third market transactions. All third market transactions are reported through ACT to the consolidated tape for display. Market makers who enter quotes for exchange-listed securities must enter their quotes through the Consolidated Quotation System or CQS. CQS market makers may not execute an order for an exchange-listed initial public offering prior to the security's opening for trading on its primary exchange. The CQS operates from 9:30 AM to 6:30 PM EST.

CAES / ITS

The Computer Assisted Execution System or CAES allows CQS market makers to execute orders and allows non CQS market makers to execute agency orders with CQS market markers. The CAES facilitates third market trading of listed securities. The Inter market Trading System or ITS links the primary and regional exchanges for securities that are listed on more than one exchange. CQS market makers may execute an order for an exchange-listed security through the ITS system.

Fourth Market

A fourth market transaction is a transaction between two large institutions without the use of a broker dealer. The computer network that facilitates these transactions is known as INSTINET. Large blocks of stock, both listed and unlisted, trade between large institutional investors in the fourth market. While many trades in the fourth market are executed through the INSTINET system, many large portfolio managers execute internal crosses, which go unreported.