NASD Notice to Members 99-11

NASD Regulation Issues Guidance Regarding Stock Volatility

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Executive Summary

In recent months, there has been a sharp increase in price volatility and volume in many stocks, particularly of companies that sell products or services via the Internet (Internet issuers). NASD Regulation, Inc. (NASD Regulation℠) is issuing this *Notice to Members* to suggest disclosures that firms can make to retail customers to educate them about the risks of price and volume volatility. This *Notice* also describes steps taken by some on-line brokers to respond to volatility. A companion *Notice to Members* issued today, *Notice to Members 99-12*, provides members with guidance concerning the operation of their order execution systems and procedures during extreme market conditions.

Questions or comments concerning this *Notice* may be directed to Mary Revell, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

Discussion

Recently, there has been a marked increase in the price volatility of many stocks, particularly those of Internet issuers. This volatility has been coupled with record trading volume in many of these stocks. Customers eager to trade Internet stocks have flooded their brokers with large numbers of orders, leading to large order imbalances, systems queues, and backlogs. During these extreme market conditions, many firms implemented procedures that are designed to preserve the continuous execution of customers' orders while also lessening the exposure of the firm to extraordinary market risk. For example, some Market Maker firms temporarily discontinued normal automatic order executions and handled orders manually. Firms also reduced their size guarantees on individual stocks or groups of stocks (*i.e.*, stocks of Internet issuers) on a going-forward basis. Delays in order executions and executions at prices significantly away from the market price quoted at the time the order was entered then occurred, which in turn led to market losses caused by executions at prices higher or lower than customers expected, especially with respect to orders placed over the Internet.

First and foremost, NASD Regulation reminds member firms of their obligations under Securities and Exchange Commission (SEC) Staff Legal Bulletin No. 8 to ensure that they have adequate systems capacity to handle high volume or high volatility trading days.[1] In this connection, we note that the SEC staff's position relates to all firms handling orders and is premised on a legal obligation to treat customers fairly.[2] Second, firms should provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner. This *Notice* describes the types of disclosure we deem appropriate.

We also have spoken to several order entry firms that provide on-line trading services about the steps they are taking to respond to volatility. This *Notice* provides members with information about these steps.[3]

Disclosure

Recent events show that the way some stocks are traded is changing dramatically, and the change in trading methods may affect price volatility and cause increased trading volume. This price volatility and increased volume present new hazards to investors, regardless of whether trading occurs on-line or otherwise. Firms are reminded that their procedures for handling customer orders must be fair, consistent, and reasonable during volatile market conditions and otherwise. To ensure that customers are knowledgeable about these procedures, we suggest that all firms, both order entry firms (*i.e.*, firms with a retail business that route orders to other firms for execution) and integrated firms (*i.e.*, firms with a large retail business that also engage in market making and other activities), whether they offer on-line trading services or not, consider making the following types of disclosures to educate retail customers about their procedures for handling the execution of a securities transaction, particularly during volatile market conditions, along with any additional disclosures they deem appropriate. NASD Regulation notes, however, that disclosure of procedures that are unfair, inconsistent, or unreasonable would not correct deficiencies with these procedures.

Delays

Firms should consider disclosing that high volumes of trading at the market opening or intra-day may cause delays in execution and executions at prices significantly away from the market price quoted or displayed at the time the order was entered. Firms should consider explaining to customers how order executions are handled by Market Makers, and explain that Market Makers may execute orders manually or reduce their size guarantees during periods of volatility, resulting in possible delays in order execution and losses. This disclosure is particularly important with respect to on-line investors, who have come to expect quick executions at prices at or near the quotes displayed on their computer screens.

Types Of Orders

Firms should consider explaining in detail the difference between market and limit orders and the benefits and risks of each. In particular, firms should consider disclosing that they are required to execute a market order fully and promptly without regard to price and that, while a customer may receive a prompt execution of a market order, the execution may be at a price significantly different from the current quoted price of that security. Firms should tell customers that limit orders will be executed only at a specified price or better and that, while the customer receives price protection, there is the possibility that the order will not be executed.

As a related matter, firms should consider additional disclosure for customers who place market orders for initial public offering (IPO) securities trading in the secondary market, particularly those that trade at a much higher price than their offering price, or in "hot stocks" (those that have recently traded for a period of time under what is known as "fast market conditions," in which the price of the security changes so quickly that quotes for a stock do not keep pace with the trading price of the stock). Firms may disclose that in such cases customers' risk of receiving an execution substantially away from the market price at the time they place the order may be significantly reduced if they also include a cap (or floor) with the order above (or below) which the order is not to be executed, by placing a limit order.

Access

Firms should consider alerting customers that they may suffer market losses during periods of volatility in the price and volume of a particular stock when systems problems result in inability to place buy or sell orders. Customers trading on-line may have difficulty accessing their accounts due to high Internet traffic or because of systems capacity limitations. Customers trading through brokers at full-service or discount brokerage firms or through representatives of on-line firms when on-line trading has been disabled or is not available because of systems limitations may have difficulty reaching account representatives on the telephone during periods of high volume. Firms should explain their procedures for responding to these access problems.

Communications With The Public

Firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services. These communications with the public must not exaggerate the members' capabilities or omit material information about the risks of trading and the possibilities of delayed executions. Moreover, members should have the systems capacity to support any claims they make about their trading services. Misrepresentations or omissions of material facts in public communications violate National Association of Securities Dealers, Inc. (NASD®) Rule 2210 as well as Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade.

Current Practices

As stated above, on-line firms have described to us steps they have taken to respond to volatility. These procedures are detailed below. While NASD Regulation believes that these actions, when clearly disclosed to customers, may be appropriate responses to trading in securities experiencing extraordinary volatility, they may not be sufficient or appropriate responses in all circumstances. Each action provides protection to the firm and obviously also impacts a firm's customers wishing to trade those securities.

Hot IPOs And Hot Stocks

There recently has been significant volatility during the period of time when certain IPOs have opened for secondary market trading, particularly the IPOs of Internet issuers. When some of these IPOs started trading on an exchange or on The Nasdaq Stock Market, Inc., after going public, they initially have traded at a much higher price than their IPO offering price. The prices of some of these "hot" IPOs have doubled or more in initial trading (one increased more than tenfold in price), only to fall sharply in subsequent trading. This price volatility has been accompanied by significant trading volume. Certain non-IPO stocks of Internet issuers also recently have traded for a period of time under fast market conditions.

The extraordinary volume of orders and cancellations entered on-line and otherwise during those periods caused queues and backlogs for many order entry and Market Maker firms. As a result of the level of market volatility and volume of orders, a number of Market Makers discontinued their normal automatic execution of orders and began handling orders manually. Firms also reduced their size guarantees on individual stocks or groups of stocks. This in turn led to delays in order executions, executions at prices significantly away from the market quoted at the time the order was entered, and delays in execution confirmations and cancellation reports.

Order entry firms responded to this price volatility and to changes in Market Maker order handling procedures in several ways. One firm has halted on-line trading of hot IPOs and stocks, requiring customers to purchase these securities through a registered representative, either in person or via the telephone. When contacted, representatives can explain, for example, the difference between market and limit orders and the benefits and risks of each, and encourage customers whose primary goal is to achieve a target price and protect against sudden price moves, and who understand that there is a possibility that the order will not be executed, to enter limit orders. When used, this halt has been implemented only for a short period of time, typically one day.

Other firms do not accept market orders for hot IPOs, requiring customers who wish to buy these stocks to enter a limit order specifying the highest price they would pay for these issues. Still other firms do not accept any orders for certain IPOs that are forecast to be hot until the IPO begins trading in the secondary market. Finally, some firms call clients back who have placed orders on IPOs that look to be volatile. The firms alert customers to restrictions they impose by placing a notice on their Web sites.

Margin

All firms, whether on-line or otherwise, may raise margin requirements for volatile stocks. Some firms that permit on-line trading have raised the amount of equity that must be maintained in margin accounts (maintenance margin) for long positions in certain volatile stocks to between 40 percent and 100 percent.[4] The rationale for raising maintenance margin is to help ensure that the equity in a customer's margin account is sufficient to cover large changes in the price of a stock. Increasing maintenance margin requirements protects both the firm and customers by ensuring that investors have more equity in their margin accounts as protection in case of a large change in the value of a stock, which reduces the likelihood that the firm will have to liquidate assets in the customer's account to meet a margin call. Firms evaluate stocks for more stringent maintenance margin requirements by examining price fluctuations, market capitalization, and volatility.

On-line firms also have responded to recent volatility by prohibiting the use of margin to purchase certain securities. Some securities have been designated as "not marginable," requiring customers to purchase the securities with 100 percent initial margin, allowing payment to be made within three days of settlement. Firms also have designated certain securities as "cash on hand," requiring customers to have 100 percent of the purchase price of the security in the account before the transaction can be executed.

Investor Education

Many firms provide some kind of investor education on issues related to market volatility on their Web sites. This education may be found in a part of the Web site devoted generally to investor education and in firm newsletters. It may include definitions of market and limit orders, an explanation of the difference between the two types of orders, and the risks and benefits of each. Some firms encourage customers to use limit orders when they are more concerned about achieving a desired target price for a trade than an immediate execution. Investor education also can be found in some firms' account-opening documents and cash- and margin-account opening documents. Finally, many firms have customer help desks and support agents, both of which provide answers to customer questions.

Pop-up Or Splash Screens

Certain firms have added a page that a customer must view when entering the customer account pages of their Web sites indicating, for example, that maintenance margin has been raised for certain listed securities; trade reports may be delayed; only limit orders will be accepted for certain securities; and the latest "real-time" quotes viewed on the site may not be reflective of the current trading price of a stock.

Some firms use these pages to discuss what happens when customers attempt to cancel market orders and enter replacement orders. Because of delays in receiving trade reports on volatile trading days, some customers, fearing that their orders have not been executed, have attempted to cancel their initial market orders and enter new orders. Because market orders must be executed as promptly as possible, firms explain that it may not be feasible to cancel a market order, since it may already have been executed, even if a customer has not yet received a trade report confirming the execution. Customers are told that entering a cancel order and a separate replacement order may result in the customer being responsible for the execution of duplicate orders, if the cancellation order cannot be processed in a timely fashion. Firms advise customers instead to place limit orders to reduce the risk of placing a duplicate order and ensure that the price received is within acceptable limits. One firm has created another category of order called "cancel and replace": the firm will execute the second or "replace order" only if it can confirm that the initial order was in fact canceled.

Member firms are exploring the feasibility of creating more of these screens on a stock-specific or trade-specific basis. This could include, for example, a "pop-up" screen explaining that a particular stock is trading in a fast market condition when a customer seeks to place an order in the stock.

Endnotes

[1]Staff Legal Bulletin No. 8 (MR), published on September 8, 1998, states the views of the SEC's Division of Market Regulation about the need for broker/dealers to maintain enough internal systems capacity to operate properly when trading volume is high. This Bulletin is available on the SEC's Web site at: *http://www.sec.gov/rules/othern/slbmr8.htm*

[2]The Legal Bulletin cites an SEC Release in support of its position. *See* note 8, citing Securities Exchange Act Release No. 8363 (July 29, 1968), 33 FR 11150 (August 7, 1968).

[3]This *Notice* addresses possible responses to recent stock price volatility, particularly in stocks traded through on-line brokerage firms. While it does not address firms' suitability obligations in connection with recommended transactions or their know-your-customer obligations, firms are reminded that the existence of these obligations does not depend upon whether a trade is executed on-line or otherwise.

[4]This increase is from the 25 percent maintenance margin required by NASD and stock exchange rules or the 30 percent to 35 percent maintenance margin required by many firms.