



**APPENDIX TO  
REPORT PURSUANT TO SECTION 21(a)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
REGARDING THE NASD AND THE NASDAQ MARKET**

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This Appendix provides additional information and elaborates on certain of the issues identified in the Commission's Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market ("NASD Report").<sup>1</sup> As described in Part IV. of the NASD Report, the Commission staff's investigation of the NASD and the Nasdaq market occurred over a period in excess of eighteen months and included the review of thousands of hours of taped conversations, hundreds of thousands of pages of documents, and the testimony of dozens of market participants and NASD officials, employees, and committee members.

Part I. of the Appendix describes certain conduct of Nasdaq market makers and the resulting problems with the operation and functioning of the Nasdaq market. Part I.A. describes the coordination by numerous market makers of quotes, trades, and trade reporting, including the pricing convention and the NASD's failure adequately to investigate and prosecute potential violations of its rules and the federal securities laws.<sup>2</sup> Part I.B. focuses on the problem of late trade reporting and the NASD's failure to enforce adequately the late trade reporting rules. Part I.C. describes the failure of numerous market makers to honor their quotes and the NASD's failure to enforce adequately the firm quote rules.

Part II. of the Appendix describes other deficiencies in the NASD's performance of its statutory obligations as an SRO, as well as a number of other areas of general regulatory concern. Part II.A. focuses on the issues surrounding the NASD's small order execution system ("SOES"), including the SOES rules, examination and discipline of SOES firms, and impediments to membership. Part II.B. discusses the NASD's laxity in enforcing its excused withdrawal rules and MSRB Rule G-37. Part II.C. discusses other issues identified in the investigation as areas of regulatory concern: (i) the excessive authority of District Business Conduct Committees; (ii) the excess spread rule; (iii) participation in contested elections; and (iv) the need for improvements to the audit trail.

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<sup>1</sup> As is the case with the Report, the findings made herein are solely for the purpose of the Report and this Appendix and are not binding on any other person or entity named as a respondent or defendant in any other proceeding. It should be noted that the issuance of the Report and this Appendix, and the concurrent enforcement action against the NASD, do not preclude further enforcement actions against other persons or entities arising from activities uncovered in the investigation.

<sup>2</sup> The record varies as to the degree of participation of particular market makers in the specific activities described in this Report.

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## I. PROBLEMS OF THE NASDAQ STOCK MARKET

### A. Quotes, Trades, and Trade Reporting

#### 1. The Pricing Convention and Related Practices

The evidence gathered in this investigation revealed that Nasdaq market makers widely followed an anticompetitive pricing convention concerning the increments they used to adjust their displayed quotes, which resulted in many Nasdaq stocks being quoted only in even-eighths.<sup>3</sup> Various market makers also discouraged one another from narrowing the inside spread. Adherence to the pricing convention and this tendency to avoid narrowing spreads have often had the effect of increasing the transaction costs paid by many investors. Market makers who either entered quotes inconsistent with the pricing convention or narrowed spreads were sometimes subjected to harassment by other market makers. The NASD was aware of, at least as early as the summer of 1990, facts and circumstances evidencing both the pricing convention and allegations of intimidation and pressure directed against market makers that narrowed spreads. It did not, however, take appropriate action to address the issues raised by this information.

##### a. The Pricing Convention

Prior to late May 1994, the pricing convention was widely followed by Nasdaq market makers. According to testimony from Nasdaq traders, the convention was based on tradition and represented the "professional" way to trade in the Nasdaq market. Market makers expected other market makers to follow the convention. Several traders testified that senior traders at their respective firms trained them to follow the pricing convention. Still other traders admitted to following a practice of setting quote increments based on the size of the dealer spread, but stopped short of characterizing the practice as a "convention."<sup>4</sup>

Under the pricing convention, stocks with a dealer spread of  $\$3/4$  or more were to be quoted in even-eighths ("even-eighth stocks"). Stocks for which the dealer spread was less than  $\$3/4$  could be quoted in both odd and even-eighths.<sup>5</sup> The existence of this convention is confirmed by the testimony of traders who make markets on Nasdaq, documentary evidence,

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<sup>3</sup> An even-eighth is  $2/8$ ,  $4/8$ ,  $6/8$ , or  $8/8$ . An odd-eighth is  $1/8$ ,  $3/8$ ,  $5/8$ , or  $7/8$ . The Nasdaq pricing convention is further discussed herein at I.A.1.a.

<sup>4</sup> Traders have also described the practice as an "ethic," a "custom," or a "tradition."

<sup>5</sup> Nasdaq accepts market maker quote increments of  $1/8$  or greater for stocks bid ten dollars and over. Stocks bid less than  $\$10$  per share can be quoted in smaller increments.

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taped conversations, and through analysis of the price and quote data in the Nasdaq market.<sup>6</sup> Prior to May 1994, more than 80% of all domestic Nasdaq National Market stocks,<sup>7</sup> of which there were more than 3,200, followed the pricing convention.<sup>8</sup> Of the more than 1,900 domestic National Market stocks priced greater than \$10 per share, more than 90% followed the pricing convention and approximately 78% were even-eighth stocks.<sup>9</sup>

Often the effect of this convention was to limit how small the inside spread of even-eighth stocks could be. When stocks are quoted only in even-eighths, the minimum inside spread will be \$1/4. Stocks that are quoted in both even and odd-eighths can have an inside spread of \$1/8. Figure 1 below shows that market makers, consistent with the pricing convention they described

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<sup>6</sup> For this analysis, the Commission used Nasdaq Market Maker Price Movement data from December 1993 through May 23, 1994 which identifies, for every market maker, the time, price, and size (i.e., amount) of each quote update (i.e., a change in the market maker's quotes).

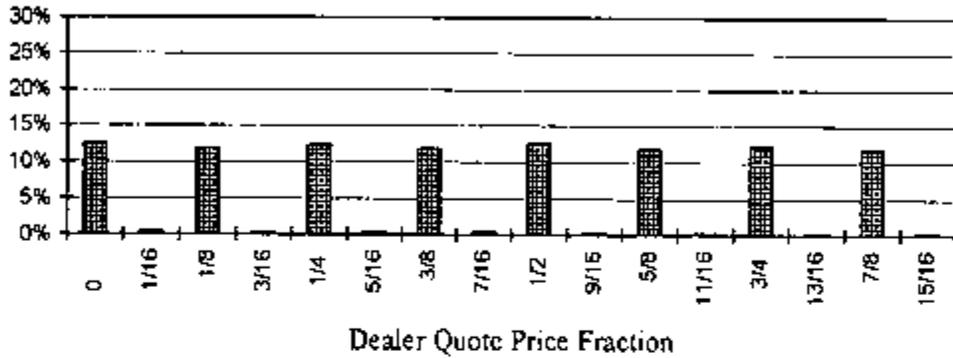
<sup>7</sup> Nasdaq National Market stocks (also referred to herein as "NMS stocks") are the top tier of Nasdaq stocks in terms of capitalization, number of shareholders, and activity. These companies comprise over 95% of the capitalization of all Nasdaq companies.

<sup>8</sup> The Commission's analysis of the data confirms widespread adherence to the pricing convention, including, substantial, albeit lesser adherence in stocks priced less than \$10, which under Nasdaq rules may be quoted in increments of \$1/16 or finer.

<sup>9</sup> For the analysis in Figures 1 to 4 and the accompanying text, stocks were classified using a percentage test. A stock was initially classified as one with a dealer spread of \$3/4 or greater if on a particular day more than 90% of quote updates in that stock on that day resulted in a dealer spread at or above \$3/4 (Group A). Likewise, a stock was initially classified as one with a dealer spread below \$3/4 if more than 90% of quote updates in that stock on that day resulted in a dealer spread below \$3/4 (Group B). All stocks were then classified on a monthly basis. If a stock belonged to Group A every day of the month, the stock was classified as one with a predominant dealer spread at or above \$3/4. Similarly, if a stock belonged to Group B every day of the month, the stock was classified as one with a predominant dealer spread below \$3/4. Stocks belonging to Group A were classified as following the convention during the month if odd-eighth quotes comprised less than 10% of all odd and even-eighth quotes. Stocks belonging to Group B were classified as following the convention during the month if both odd and even-eighths were used; thus, a stock with a dealer spread of \$1/2 in which less than 10% of all quote updates were in odd-eighths would not be classified as following the convention. Therefore, all stocks were classified into one of three groups: (1) following the pricing convention with a predominant dealer spread of \$3/4 or greater; (2) following the pricing convention with a predominant dealer spread of less than \$3/4; and (3) not following the convention.

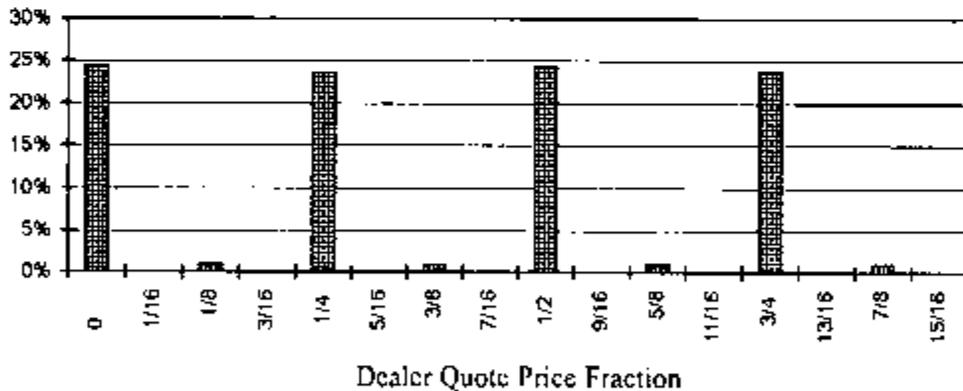
in their testimony, quoted stocks with dealer spreads less than  $\$3/4$  in odd-eighth quotes approximately as often as in even-eighth quotes.

FIGURE 1:  
Market Maker Quotes for All Domestic NMS Stocks  
with Dealer Spreads Less than  $\$3/4$ : 12/1/93-5/23/94



This stands in stark contrast to the way market makers quoted stocks with dealer spreads greater than or equal to  $\$3/4$ . Figure 2 below shows that market makers, consistent with the pricing convention they described in their testimony, quoted these stocks in odd-eighths less than 5% of the time and in even-eighths the rest of the time.

FIGURE 2:  
Market Maker Quotes for All Domestic NMS Stocks  
with Dealer Spreads  $\$3/4$  or Greater: 12/1/93-5/23/94



The dealer spread was understood by market makers as indicating which of the two quotation increments applied to a particular security. Although under the excess spread rule<sup>10</sup> it is possible for market makers to quote dealer spreads of  $\$5/8$  when other dealers have spreads of

<sup>10</sup> The Nasdaq excess spread rule requires that a market maker's spread not exceed 125% of the average of the three lowest dealer spreads in a stock. Hence, the range of allowable market maker spreads for a stock is limited to groups such as  $\{\$1/2 \text{ and } \$5/8\}$ ,  $\{\$5/8 \text{ and } \$3/4\}$ ,  $\{\$3/4, \$7/8, \text{ and } \$1\}$ , and  $\{\$1, \$1 \ 1/8, \text{ and } \$1 \ 1/4\}$ .

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$\$3/4$ , adherence to the pricing convention precluded the use of such quote combinations since it would be unclear whether the stock should be an even-eighth or odd-eighth stock.<sup>11</sup> The data show that a sharp line was maintained between the two groups of stocks. For domestic Nasdaq NMS stocks, the combination of dealer quotes of  $\$5/8$  and  $\$3/4$  in a particular stock occurred less than 0.8% of the time.<sup>12</sup> Thus, the Commission's analysis of more than 18 million quote updates supports the testimony of the market makers as to the functioning of the pricing convention and underscores the extent to which the convention was followed in the market.

Market makers' adherence to this pricing convention often increased the transaction costs paid by customers trading Nasdaq securities.<sup>13</sup> Most customer orders, particularly those to purchase or sell smaller amounts of stock, are executed by market makers at the inside bid or offer.<sup>14</sup> Because market makers generally moved their quotations in even-eighth increments for the majority of Nasdaq NMS stocks, the inside best bid and offer for these stocks almost always moved in  $\$1/4$  increments. As a result, the inside spread for even-eighth stocks almost never narrowed to  $\$1/8$ . Investors purchasing and selling even-eighth stocks at the inside spread

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<sup>11</sup> Similarly, dealer quote combinations such as  $\{\$3/4 \text{ and } \$7/8\}$ ,  $\{\$7/8 \text{ and } \$1\}$  and  $\{\$1 \text{ and } \$1 \ 1/8\}$ , all of which are permissible under the excess spread rule, were, in the pre-May 24, 1994 Nasdaq market, rarely or never used by market makers. Natural economic forces do not explain the absence of such quote combinations, but such an absence would be expected under the pricing convention.

<sup>12</sup> In circumstances where market makers acted to narrow their dealer spreads in stocks routinely quoted with dealer spreads of  $\$3/4$  or better, they typically narrowed from  $\$3/4$  directly to  $\$1/2$ , skipping  $\$5/8$ .

<sup>13</sup> The spread between the inside bid and ask prices is a cost that investors bear in buying and selling stocks at those prices.

<sup>14</sup> An analysis of over 10 million Nasdaq NMS trades from February 1994 through May 1994 compared trade prices to the inside quotes which existed at the time of execution, or the reported time if the execution time was not available. Over 60% of all trades were executed at the inside quotes. Smaller trades were executed at the inside quotes more often than larger trades. For example, in May 1994, over 90% of customer trades less than 1,000 shares were executed at the inside quotes, compared to approximately 75% of 1,000-5,000 share customer trades. Nevertheless, almost 60% of 5,000 share or greater customer trades were executed at the inside quote. Many small orders (1,000 shares or less) are executed automatically through SOES or market makers' internal small order execution systems at the inside spread (market maker internal systems sometimes automatically execute orders up to 2,000 or 3,000 shares at the inside quotes). Institutional customers, who typically trade in larger size than retail customers, and who have access to other means of price discovery, may have a degree of economic leverage to bargain for better prices. Nonetheless, the inside quotes may serve as a benchmark from which the negotiations proceed.

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thus rarely traded at odd-eighth prices. This often resulted in wider inside spreads and caused trades to be executed at prices that were less favorable for investors than if there had been no pricing convention.

Similarly, the quotations can affect the ability of institutional investors to obtain favorable prices. The quotations may be part of the mix of information that factors into the efforts of institutional investors to negotiate the best prices possible and may serve as benchmarks for such negotiations. Quotations which are kept wide by the pricing convention may place institutional investors at a disadvantage in such negotiations and create a distorted picture of the market.

Although adherence to the pricing convention acted to prevent market makers from displaying odd-eighth quotes for even-eighth stocks on Nasdaq, it did not constrain them from entering odd-eighth bids and offers for those same stocks on Instinet<sup>15</sup> and SelectNet.<sup>16</sup> Market makers regularly placed orders to buy or sell even-eighth stocks at odd-eighth prices on these systems, while quoting the same stocks almost exclusively in even-eighth increments on Nasdaq.<sup>17</sup>

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<sup>15</sup> Instinet is a proprietary screen-based automated trading system consisting of a network of computer terminals that permits broker-dealers and institutions to enter anonymously orders to buy and sell and execute against those orders through a computerized system. Instinet does not accept retail customers. Nothing in this Report or Appendix is intended to suggest improper or illegal activity by Instinet.

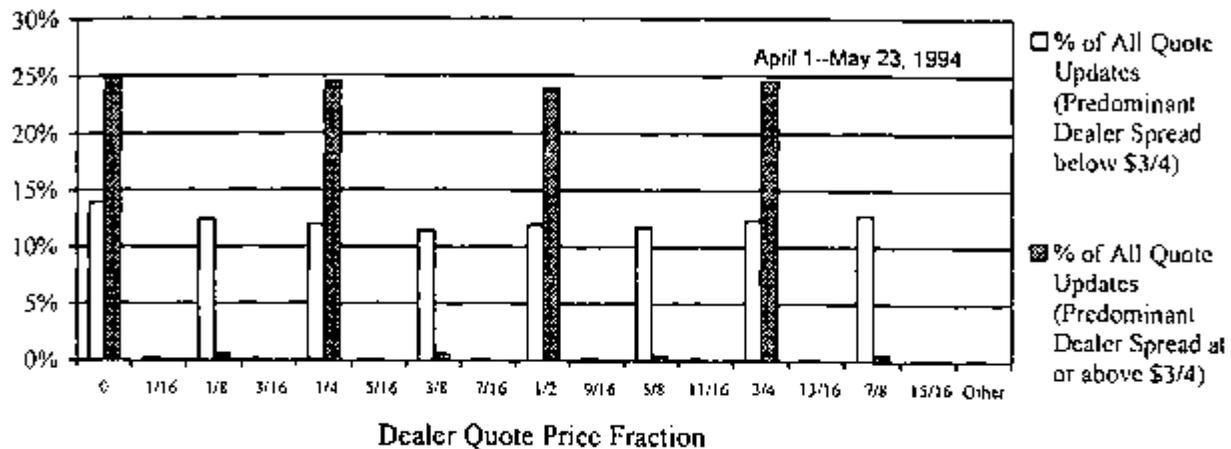
<sup>16</sup> SelectNet is an electronic trading system owned and operated by the Nasdaq Stock Market, Inc. and is available as a trading vehicle only to NASD member firms.

<sup>17</sup> A tape obtained in the investigation contains a conversation by a market maker who refuses to put an odd-eighth quote on Nasdaq when requested to do so by a retail broker, but indicates he will put an order on Instinet containing the odd-eighth quote. He explains to the broker that displaying an odd-eighth quote in the stock on Nasdaq would make a "Chinese market," which is considered unprofessional and which other market makers do not like. He stated: "I really can't do that 'cause it creates what they call a Chinese market, stock trades in 1/4 point. I'm on Instinet. If somebody wants to whack me at 7/8ths, that's where they're going to whack me."

The Commission recognizes the potentially pejorative connotation of the term "Chinese market," and by repeating it herein does not condone its use by any Nasdaq market makers.

Figure 3 below shows how market makers entered quotes in Nasdaq for odd and even-eighth stocks. As discussed above, for stocks with a dealer spread of \$3/4 or greater, odd-eighth quotations are rarely used in the Nasdaq market.

FIGURE 3:  
Market Maker Nasdaq Quote Updates  
All Domestic Nasdaq NMS Stocks

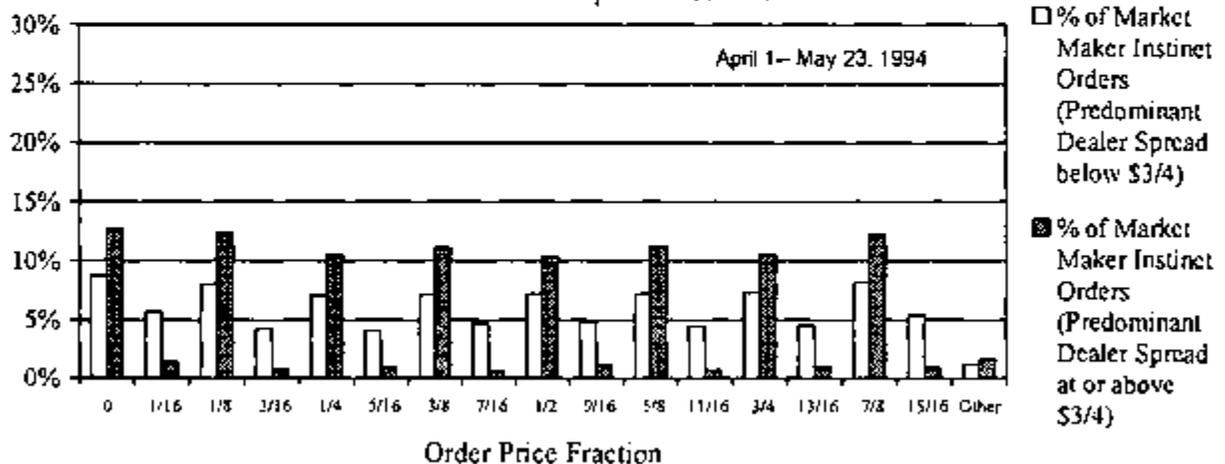


This can be contrasted with the way market makers place quotes (in the form of limit orders) in Instinet.<sup>18</sup> As shown in Figure 4 below, even and odd-eighths are as frequently used for odd and even-eighth stocks.<sup>19</sup>

<sup>18</sup> Because Instinet orders express market makers' willingness to deal at stated prices, such orders may be regarded as the functional equivalent of market maker quotes, and are referred to as quotes for the purposes of this Report.

<sup>19</sup> In addition to the Market Maker Price Movement data obtained from Nasdaq, the Commission obtained from Instinet the Instinet Activity Report, which includes times, prices, sizes, and identities for orders placed and executed in Instinet for the months of April, May, and June 1994.

FIGURE 4:  
Market Maker Instinet Quotes  
All Domestic Nasdaq NMS Stocks



The routine use of odd-eighths by market makers in Instinet for stocks quoted in even-eighths in the Nasdaq market lends additional support to market maker testimony, documentary evidence, and taped conversations regarding the pricing convention and clearly indicates that adherence to the pricing convention, as detailed in this Report, was not the result of natural market forces. Moreover, the size of trades in Instinet and Nasdaq were essentially the same. During April through June 1994, the average trade size for NMS stocks on Instinet was approximately 1,600 shares, smaller than the Nasdaq average of approximately 1,900 shares for all NMS trades. The median trade size was 1,000 shares for both Instinet and Nasdaq.<sup>20</sup>

Access to the quote information and trade opportunities displayed on Instinet and SelectNet, however, was limited only to certain brokers, market makers, and institutional investors. Individual investors and other market participants did not have direct access to the information or trading opportunities that were offered on these systems.<sup>21</sup> Thus while Instinet

<sup>20</sup> These trade sizes for Instinet and Nasdaq are roughly the same for all months in the sample.

<sup>21</sup> In the following conversation, two traders comment upon a suggestion made by another trader (Trader 3) at a meeting that retail customers should be given access to Instinet:

Trader 1: What did he [Trader 3] have to say?

Trader 2: 'I come from [firm], and we do a lot of retail, and I think there ought to be a way that our customers have access to Instinet.' I'm like,

Trader 1: What?

(continued...)

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and SelectNet provided avenues for market makers to quote and trade at odd-eighth prices with a limited subset of market traders, many investors, particularly retail customers, could only observe and trade at the Nasdaq quotes, where odd-eighth prices often were not available because of market makers' widespread adherence to the pricing convention.<sup>22</sup>

Instinet and, to a lesser extent, SelectNet, have emerged as primary arenas for market

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<sup>21</sup>(...continued)

Trader 2: What?

Trader 1: Well, then you wouldn't do the retail, you moron.

Trader 2: Like [name of Trader 3], then there'd be no need for you, you jarhead.

<sup>22</sup> Some traders recognized that by trading through Instinet, they could trade inside the Nasdaq spread. This contributed to wide spreads on Nasdaq. The following conversation between two traders reflects that understanding:

Trader 1: The thing I think should be done is allow the public to participate. For example, the market is 9 to 1/2. Years ago that stock would be 9 to a 1/4. And if it was trading 9 to an 1/8, the only way you would compete or get in the flow, was offer at an 1/8 and bid 9.

Trader 2: Yep.

Trader 1: Today, you don't have to do that.

Trader 2: Because you could just use the stupid toy [Instinet].

Trader 1: Exactly.

Trader 2: Bid an 1/8 on [Instinet].

Trader 1: Right. You don't have to put it in. I think there's got to be something done. For example, yesterday 9 to a 1/2. I bid an 1/8 and I buy for 4,000 from a guy. I know there are sellers out there. He should be required, after he makes a sale at an 1/8 and has more to do, to offer at an 1/8 in [Nasdaq].

Trader 2: Yeah.

Trader 1: OK.

Trader 2: Yeah, how can you — how can you, how can you enforce that, though?

Trader 1: Well, let's put it this way. We don't want them to enforce it. But if we make a suggestion that maybe that's something that could be done, it would do two things. It would cut the spread down from 9 to 1/2 to 9 to an 1/8.

Trader 2: It would also keep them off our back for a while.

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makers to attract, negotiate, and execute trades within the inside spread.<sup>23</sup> In these trading systems, market makers can enter quotes and trade at prices better than the inside spread without creating a new inside market at which all market makers regard themselves as being obligated to trade with their customers.<sup>24</sup> Analysis of data for May 1994 shows that approximately 85% of bids and offers displayed by market makers on Instinet and 90% of bids and offers displayed on SelectNet were at better prices than those posted on Nasdaq. In addition, approximately 77% of trades executed on Instinet and 60% of trades executed on SelectNet were at prices superior to the Nasdaq inside spread.<sup>25</sup>

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<sup>23</sup> Instinet is larger than any of the organized U.S. stock markets other than the New York Stock Exchange or Nasdaq, even though it excludes retail order flow. For example, in 1994, trading volume on Instinet was approximately 10.8 billion shares with an approximate dollar volume of \$282 billion. By comparison, Nasdaq had 74 billion shares traded with an approximate dollar volume of \$1,449 billion (including the volume on Instinet). In 1994, the New York Stock Exchange had trading volume of approximately 76 billion shares with an approximate dollar volume of \$2,841 billion. Market makers and other broker-dealers are responsible for most of the trading volume in Instinet. Institutional investors account for the remaining volume. Instinet trading constitutes a significant share of total Nasdaq trading. An analysis of market data for the month of May 1994 shows that Instinet trades represented over seventeen percent of all NMS trades and approximately fifteen percent of NMS trading volume during the period.

<sup>24</sup> Some traders believe that Instinet has emerged as a preferable "market" to Nasdaq. In a conversation between two traders discussing the narrowing of the spreads of certain stocks in the spring of 1994 (see Part I.A.1.e.), the traders discussed Instinet:

Trader 1: It would be interesting to see if this does anything to, to Instinet. It's really not right to give two different quotes.  
Trader 2: I agree.  
Trader 1: You know, if people start looking in Nasdaq first and Instinet second, that's what you got to get doing. But you go and see these accounts, and stop up at their offices, they all have Instinet. That's the first place they look.  
Trader 2: Instinet's the market. You're right, that's it.  
Trader 1: If something's offered and they're in the middle and they have it to buy, they take it.  
Trader 2: Yeah, yeah.  
Trader 1: They don't even look at the \*\*\*\*\* box. They don't care what it looks like.

<sup>25</sup> These numbers are representative of the trading activity during all months of the sample described supra note 14. The quality of trade executions on Instinet and SelectNet may be compared with the quality of trade executions in Nasdaq as described supra note 14, where most trades are executed at the displayed inside quotations.

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The market participants who most often traded at the superior prices available on Instinet were market makers. Analysis of data for May 1994 shows that approximately 90% of all trades executed on Instinet had a market maker on at least one side of the trade, while institutional investors were direct parties to less than 20% of Instinet trades. All trades on SelectNet involve NASD member firms; institutional and retail investors cannot trade on this system.

The trading activity on Instinet and SelectNet indicates that these systems have been used by market makers to facilitate adherence to the pricing convention. Notwithstanding the benefits of the pricing convention to market makers, at times they wanted to trade at prices that would be inconsistent with the convention. The availability of private systems allowed market makers to trade at prices better than the Nasdaq inside quotes without violating the pricing convention and without affecting the prices at which other market makers trade with the public.<sup>26</sup> The availability of these systems, particularly Instinet, reduced the necessity to narrow the Nasdaq spreads, thereby facilitating adherence to the pricing convention and reducing competition in the Nasdaq market.<sup>27</sup>

The trading activities of market makers on Instinet and SelectNet, together with the activities meant to enforce the pricing convention, demonstrate that adherence to the convention, as detailed in this Report, was not the result of "natural" market forces or a custom that evolved for ease of administration.<sup>28</sup> The limitation of quote updates to even-eighth increments allowed

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<sup>26</sup> The advantages to market makers of such limited access systems have fostered the development of a two-tiered market — the public Nasdaq market for retail investors and some institutional investors, and the private, limited access systems where broker-dealers and certain large institutional investors can observe and trade at better prices, yet in similarly sized trades, as in Nasdaq.

<sup>27</sup> One trader's testimony illustrates this point:

Back in the eighties you really did not have Instinet as it was [sic] today and so sometimes you would move your market up, you would close your spread to try to signal to another market maker hey, in this case, say going up in the bid I am a buyer and you might go twenty-nine and an eighth bid and stay there for a while and then go down to let people know you are a twenty-nine and an eighth buyer. You have tried institutional and you cannot find. Instinet was not what it was [sic] today, they did not do that kind of volume, so the only way to really let the world know you are a buying [sic] rather than just take them the twenty-nine and a quarter stock is to close your spread or do what you call the odd[-]eighth.

<sup>28</sup> Pertinent to this point is the partial breakdown of the pricing convention after the May 24, 1994 Bear Stearns meeting (discussed in Section I.A.1.e.), at which the NASD urged market makers to narrow spreads, and the subsequent publicity over the Christie-  
(continued...)

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market makers to maintain artificially wide spreads. This increased their profits, but often had a negative impact on the prices paid by investors.

**b. Disincentive to Breaking the Spread**

Market makers usually set their dealer spreads at levels no narrower than the spreads displayed by other dealers in that particular stock. As a result, until May of 1994,<sup>29</sup> even when market makers could have narrowed their spreads consistent with the pricing convention, dealer spreads nevertheless were rarely narrowed, even if the pricing convention was followed. The evidence obtained in the investigation indicated that a number of market makers discouraged their peers from entering dealer spreads narrower than the dealer spreads entered by other market makers in any particular security, even if such a narrowing conformed with the pricing convention.<sup>30</sup> If market makers in a particular security were quoting dealer spreads of  $\$3/4$

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<sup>28</sup>(...continued)

Schultz study's conclusion of tacit collusion. The number of stocks following the pricing convention dropped from over 80% before October 1994 to approximately 68% by July 1995, as shown in Figure 5 in the text *infra* Part I.A.1.e. These changes in dealer quotation activity further indicate that the adherence to the pricing convention, as detailed in this Report, was not a natural pattern of conduct.

<sup>29</sup> Spreads in a number of high volume stocks began to narrow beginning in late May 1994 and thereafter following the Bear Stearns meeting on May 24, 1994, publicity concerning the Christie-Schultz study, which suggested possible implicit collusion among Nasdaq market makers, and the filing of class action litigation against a number of market makers alleging price fixing in the spreads of Nasdaq stocks.

<sup>30</sup> For example, on September 20, 1994, the initial public offer of the common stock of Comcast U.K. (CMCAF) was made. In the minutes preceding the opening of trading, various market makers displayed a  $\$3/4$  dealer spread in their quotes, but one market maker (MM 1) displayed a  $\$1/2$  dealer spread in its quotes. MM 1 was called by the lead underwriter for CMCAF (MM 2), who informed MM 1 that MM 2 had displayed a  $\$3/4$  dealer spread and that a  $\$3/4$  dealer spread was the right thing to do. MM 1 then changed its quotes to a  $\$3/4$  dealer spread.

This point is also exemplified by the market for McCaw Cellular stock (MCAWA) on April 8, 1994. On this day, all market makers were displaying  $\$3/4$  dealer spreads or wider, except one who displayed a  $\$1/2$  dealer spread. Another market maker then changed its quotes to reflect a  $\$1/4$  dealer spread. Due to the excess spread rule, all other market makers were then required to display quotes having a dealer spread of  $\$5/8$  or less. A number of dealers displayed quotes having a  $\$1/2$  dealer spread. Shortly thereafter, three market makers made an effort to widen the dealer spread out to  $\$3/4$  again by displaying  $\$5/8$  dealer spreads in the apparent hope of inducing other market

(continued...)

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and \$1, other market makers understood that they were not supposed to "break the spread" by quoting a dealer spread narrower than  $\$3/4$ . A reduction in the dealer spread to less than  $\$3/4$  by one dealer could, if joined by other dealers, result in quotation increments being reduced to  $\$1/8$  increments pursuant to the pricing convention and the inside spread being reduced to  $\$1/8$ . Like the pricing convention, the disincentive against "breaking the spread" contributed to the artificially wide inside spreads on Nasdaq.

This general disincentive against narrowing the spread is a further anticompetitive influence in the Nasdaq market. A number of market makers discouraged their peers from price cutting, even within the pricing convention. This practice artificially interfered with the free flow of competition.

c. **Size Convention**

Traders testified to the existence of another market maker practice that discouraged a narrowing of the inside spread in certain circumstances. This practice provided that a market maker that moves a quote to create a new inside bid or offer must be willing to trade at that new price level for a quantity of shares significantly greater than the minimum required by NASD

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<sup>30</sup>(...continued)

makers to follow them. If all or almost all the market makers had followed them to  $\$5/8$ , they could have then widened to a  $\$3/4$  dealer spread without violating the excess spread rule. Two of them engaged in the following dialogue:

MM 1: Hey, alright, uh, we're still goofing around with this MCAWA. I just went down an eighth on the bid.

MM 2: Okay.

MM 1: And that let me do that. So I told [MM 3] to go down an eighth.

\* \* \* \*

MM 2: If that's what you guys want me to do, I'll do it.

MM 1: Try it and then I'm going to try and go down another eighth, you know what I mean, and get it, get it back to  $\$3/4$  spread.

This attempt to widen the dealer spread to  $\$3/4$  failed because too many market makers continued to display  $\$1/2$  dealer spreads. However, the willingness of three market makers to act collectively in an effort to widen the spread almost immediately after it narrowed is indicative of the disincentive against narrowing the spread even in compliance with the pricing convention.

In addition, the negative reactions of some market makers to narrowings of the spreads in certain heavily traded Nasdaq stocks in late May 1994 further demonstrates this disincentive. See *infra* discussion notes 47-51 and accompanying text.

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rule (which requires 1,000 shares for the more heavily traded stocks).<sup>31</sup> Traders have testified that a market maker who creates a new inside bid or offer should be willing to trade in the range of 2,000 shares to 5,000 shares (and sometimes more) at that new price level. If a trader is only willing to trade 1,000 shares at a new inside bid or offer, the accepted practice is that the market maker refrain from moving the quote to that price level.<sup>32</sup> This practice discouraged traders from entering quotes that would improve the inside bid or offer when they were seeking to trade only the legal minimum quantity of stock.<sup>33</sup>

Certain market makers testified that, in connection with the size convention, they were not concerned with the narrowing of spreads but rather with the improved price they would have to give to customers. They testified that their concern was that the creation of a new inside bid raised the price they would have to pay for customer sales and the creation of a new inside ask lowered the price they would have to accept for customer purchases. This, however, only points to the significance of narrower spreads. When market makers, through the size convention, discouraged new inside quotations that improved the price given to investors, the flexibility and fairness of prices were artificially impaired.

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<sup>31</sup> NASD Manual, Schedule D to the By-Laws, Part V, § 2, (CCH) ¶ 1819 (1995) (prescribing minimum sizes of quotations).

<sup>32</sup> Some traders have testified that if the market maker at the inside does not have substantial size to trade, that market maker is "distorting" the market, that his quote is not "real," and that his quote is making negotiations with other market makers' customers more difficult. In these circumstances, some market makers ask the market maker quoting the inside bid or ask to move its quote. The notion that an inside quote for the minimum required number of shares is not "real" is fallacious, because a market maker is only required to be willing to trade the legal minimum. Some traders have testified that the inside quote in some circumstances is the starting point for negotiations with institutional customers, and another market maker's quote can affect such negotiations. This dynamic, however, does not justify interference with the other market makers' pricing decisions.

<sup>33</sup> One market maker testified that the size convention (which he characterized as a "practice") does not apply when the price of the stock is rising or falling generally, but rather when the market maker disseminating the new quotation is "sticking out." In one instance in 1994, this market maker and a second market maker harassed one of their peers for narrowing the inside spread by putting an odd-eighth quote for Intel, a stock then normally quoted in even-eighths. The harassers claimed that they were upset not by the use of odd-eighths but by the fact that the firm narrowing the spread would only trade the legal minimum of 1,000 shares with them, rather than 2,500 or more shares. Even if one gives credence to this testimony, the harassment in this instance impedes the free flow of competition by burdening price changes with a much greater volume requirement than the minimum prescribed by NASD rule.

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Thus, the size convention inhibited price transparency by limiting quote changes to those circumstances where a market maker was willing to trade substantially greater volume than its NASD required minimum quotation size. This impaired price competition in the Nasdaq market, because quotations meeting only the NASD minimum quotation sizes were deterred. Spreads were wider because the size convention artificially restrained aggressive pricing. The size convention operated independently of the pricing convention, in that it applied to the creation of new inside prices both in conformity with and in violation of the pricing convention. Thus, its effect was cumulative to the anticompetitive effects of the pricing convention.

d. **Pressure and Harassment**

Various Nasdaq market makers have exerted pressure on market makers who acted inconsistently with the above-described trading conventions, narrowing the inside spread, and consequently reducing the profits of all other market makers in the stock. The investigation has developed evidence of instances where market makers entered quotes that narrowed the inside spread in contravention of established trading and pricing practices and then were the subject of harassing telephone calls. These calls involved other market makers questioning or complaining about the narrower spread, requesting or demanding that the market maker widen the spread back out, asserting that the market maker was ruining the market or was unprofessional, unethical, or embarrassing, or accusing the market maker of "making a Chinese market."<sup>34</sup> Some market makers have also complained about other market makers narrowing the spread by disseminating messages over the SelectNet system.<sup>35</sup> In addition, market makers who violated the conventions occasionally encountered refusals by other market makers to trade with them.

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<sup>34</sup> The term "Chinese market" is used by Nasdaq traders to describe a market that is quoted in a manner that is inconsistent with the usual quoting pattern for the stock. For example, if the market makers in a stock are quoting dealer spreads of  $\frac{3}{4}$  of a point, and one market maker publishes a dealer spread of  $\frac{3}{4}$  of a point at odd-eighth intervals, e.g., 20  $\frac{1}{8}$  bid to 20  $\frac{7}{8}$  offer, that market maker would be considered to be making a Chinese market.

At times, a degree of imagination was applied to the harassing telephone calls. When one market maker narrowed the spread on certain occasions from  $\frac{1}{4}$  to  $\frac{1}{8}$ , it received anonymous telephone calls in which the caller, in a phony Chinese accent, ordered chop suey, moo goo gai pan or other Chinese food, in an apparent allusion to the understanding among market makers not to make "Chinese markets."

<sup>35</sup> In addition to delivering orders, SelectNet can be used to transmit short text messages. Examples of messages complaining about spread narrowings are set forth in *infra* note 48.

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e. **Bear Stearns Meeting and Subsequent Narrowings**

In the spring of 1994, market makers began to narrow spreads in a number of high profile stocks. Several events appear to have precipitated this development.

On May 24, 1994, the Security Traders Association (the "STA")<sup>36</sup> sponsored a meeting to discuss the width of spreads at the Manhattan offices of Bear Stearns (the "Bear Stearns Meeting"). The meeting was attended by approximately one hundred traders from many of the major Nasdaq market making firms, as well as senior officers of the STA and the NASD. The President of the STA began the meeting by urging traders to narrow spreads voluntarily or face regulations forcing a tightening of spreads.<sup>37</sup> NASD senior officers then made a presentation showing that the spreads of top Nasdaq securities had widened and that in many stocks, the displayed spread was substantially wider than the spread at which the stock actually could be traded.<sup>38</sup> The NASD officers suggested that because of such spreads, there existed a substantial risk that some significant Nasdaq companies would leave Nasdaq to list on the New York Stock Exchange, thereby reducing the trading revenues of Nasdaq market makers. The NASD officers urged traders to examine the stocks that they traded, particularly the high profile Nasdaq stocks, to see whether or not they could reduce their displayed dealer spreads. NASD officers also pointed out in response to a comment in the audience that intimidation against market makers that narrowed spreads was a violation of NASD rules.

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<sup>36</sup> The STA is a trade association composed of individuals in the securities industry which largely represents the interests of market makers.

<sup>37</sup> In his prepared remarks the STA President stated:

[L]et me suggest that if we do not voluntary (sic) close . . . quotes, it will be done by regulation by the NASD, the SEC or Congress and in the meantime we will lose many companies to the exchange and receive much bad and distressing publicity.

He also quoted from the Christie-Schultz study and a letter from an issuer complaining about its spread.

<sup>38</sup> The presentation included slides showing a list of the top 25 Nasdaq stocks by market value and their inside spreads, a list of six large Nasdaq stocks with substantial spreads, and charts tracking average spreads on Nasdaq, the growth of Nasdaq market value and capitalization, and related increases in market maker trading revenue.

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One NASD officer pointed out that spreads had not narrowed since certain SOES rules changes, which had reduced market maker exposure on SOES,<sup>39</sup> had taken effect in January 1994. He pointed out that for a long time many market makers had stated that SOES activity was the cause of widening spreads.<sup>40</sup> This individual indicated that the interim rules, by reducing SOES tier sizes from 1,000 to 500 shares, had reduced the pressure on market makers to maintain wide spreads, but that following that reduction the spreads had not narrowed. He argued that market makers should therefore focus on reducing spreads in light of their reduced SOES exposure.

On May 26, 1994, several major newspapers reported that the Christie-Schultz study had concluded that market makers may tacitly collude to maintain wide spreads.<sup>41</sup> The publicized allegations of collusion, the perceived threat of regulatory action, and the possibility of Nasdaq

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<sup>39</sup> These rule changes, known as the interim SOES rules, included a reduction of the maximum SOES order size from 1,000 shares to 500 shares, a reduction in the number of times that a market maker would be exposed to SOES executions from five to two (thereby effectively reducing the market maker's exposure from 5,000 shares to 1,000 shares), the authorization for the Nasdaq Stock Market, Inc. to offer an automated quote update feature that moved a market maker's quote away from the inside quote after receipt of a SOES execution, and a prohibition on short sales in SOES. See NASD Special Notice to Members 94-1, Jan. 5, 1994. The NASD proposed these changes on the basis that they would narrow spreads. Exchange Act Release No. 32143 (Apr. 21, 1993) 58 Fed. Reg. 21484 (Apr. 24, 1993).

<sup>40</sup> Market makers generally have attempted to blame active SOES trading for the width of the Nasdaq market spreads. Some market makers anticipated that the changes brought by the SOES interim rules would put pressure on market makers to narrow spreads because they could no longer blame wide spreads on SOES abuse. A January 7, 1994 memo to the STA Board of Governors from the STA Trading Issues Committee states:

[Spreads w]ill probably become THE hot issue for 1994 in the minds of the issuers and, therefore, the NASD. With the interim SOES rules removing SOES abuse as a (legitimate) excuse, pressure on spreads will become intense. Look for questions about market-maker quotations at one price, and bids/offers in SelectNet/Instinet/private systems at a different price.

The absence of an overall narrowing of spreads after the adoption of the interim SOES rules is inconsistent with the argument that SOES trading is responsible for wide spreads.

<sup>41</sup> The NASD had received a draft of the Christie-Schultz study in late 1993, and was concerned about its conclusions. Some market makers became aware of the study in early 1994 before the study was widely publicized.

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issuers moving to the exchanges led to heightened concerns over spreads.<sup>42</sup> These concerns appear to have prompted certain market makers to reduce the spreads of several high profile Nasdaq stocks beginning on May 26 and 27, 1994.<sup>43</sup> One market maker narrowed its spread in the common stock of Microsoft Corporation after the market closed on May 26, 1994. On May 27, 1994, other market makers<sup>44</sup> tightened their dealer spreads in Microsoft, Amgen Inc., Apple Computer Inc., Cisco Systems, Inc., and Wellfleet Communications, Inc. These stocks and their respective spreads had been displayed on the slides presented by the NASD staff at the Bear Stearns meeting.<sup>45</sup> In the days following the meeting, certain market makers narrowed

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<sup>42</sup> On May 27, 1994, several class action lawsuits were filed against certain market makers alleging violations of federal and state antitrust and securities statutes. Additional class actions were filed in the summer of 1994. In the fall of 1994, more than two dozen class action complaints were consolidated into one action in the United States District Court for the Southern District of New York alleging an unlawful conspiracy among leading Nasdaq market makers to eliminate odd-eighth quotations in order to increase spreads in violation of the Sherman Act (earlier allegations of violations of the securities laws were dropped).

<sup>43</sup> In several taped telephone conversations, traders attributed the narrowing of the dealer spreads in late May to the Bear Stearns meeting and the reports of the Christie-Schultz study conclusions. The head trader at the market maker who first narrowed the dealer spread in the common stock of Apple Computer Inc. testified that he narrowed because of the issues raised at the Bear Stearns meeting. He also testified that he called the market maker that was the first to narrow the dealer spread in the common stock of Microsoft Corporation and told the trader that if his firm could set an example in Microsoft, then he could set an example in Apple. Traders at the firm that first narrowed the spread in Microsoft after the market closed on May 26, 1994 testified that they narrowed their dealer spread because of a stock split one week before and not because of any issues raised at the Bear Stearns meeting.

<sup>44</sup> Some of the market making firms that took the lead on narrowing several of the high profile Nasdaq stocks were represented on the Trading Committee of the NASD. The Trading Committee had been involved in analyzing the issue of wide spreads and the competitive threat posed by the New York Stock Exchange as early as 1990. At least some members of the Committee were also aware of the issues of market maker intimidation and the operation of the pricing convention.

<sup>45</sup> Three of these stocks, Amgen, Wellfleet, and Apple, were listed on a slide entitled "LARGE NASDAQ STOCKS WITH SUBSTANTIAL SPREADS." [emphasis in original] The slide showed a substantial difference between the displayed spread and the spread at which market makers actually traded the stocks. Microsoft, Apple, Amgen, and Wellfleet were listed on the slide displaying the inside spreads of the Nasdaq top 25 stocks by market value. The slide showed the inside spreads of these four stocks as being  $\$1/4$ , while other stocks on the list had inside spreads of  $\$1/8$ .

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their dealer spreads in these stocks from \$3/4 to \$1/2 and began to move their quotes in \$1/8 increments, instead of \$1/4 increments.<sup>46</sup>

This movement toward narrowing spreads on certain stocks generated resistance. Market makers recognized that the spread reduction in these few stocks could lead to tightening of spreads in other Nasdaq stocks.<sup>47</sup> Some traders called the market makers who narrowed their spreads to raise questions or complain. Other market makers broadcast messages over the SelectNet system that criticized the change in the dealer spreads.<sup>48</sup> Certain market makers then narrowed their dealer spreads in one stock even further to \$1/4, apparently as an expression of their frustration.<sup>49</sup> Because of the operation of the excess spread rule, the additional spread tightening to \$1/4 forced market makers to quote these stocks with even tighter spreads, making

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<sup>46</sup> In Microsoft, Amgen, and Cisco, at least three market makers moved to cut the dealer spreads to \$1/2. Because the excess spread rule requires that no market maker can enter a spread more than 125% of the three narrowest dealer spreads, the narrowings forced all of the market makers in these stocks to enter dealer spreads no greater than \$5/8.

<sup>47</sup> The head trader of a firm discussed the implications of the narrowings in a taped telephone call:

You can still make markets, stocks will still move around, but certainly the margins are going the wrong way, and it's going to be a hell of a lot more difficult. I don't see how any trading desk can keep their profitability up if the trend continues, and they start breaking down these other stocks.

The next day, he told another trader:

I'm not going to initiate it [a narrower spread]. Why should I do that? You know? We might as well milk it for as long as we can, and you know, it's going to be a different business. Hopefully, we'll all figure a way to make money in it.

<sup>48</sup> The messages included "Rediculous [sic]," "Great Market," "Stpkidding," "Howbout 64s," and "NotFunny."

<sup>49</sup> In Microsoft, three market makers had narrowed their spreads to \$1/2 by the time the market opened for trading on May 27, 1994. Within 25 minutes, three other market makers narrowed their spreads to \$1/4. One of the traders who narrowed to a \$1/4 dealer spread testified that he narrowed to express his frustration to the market maker that narrowed its dealer spread to \$1/2 and that he felt Microsoft was too volatile a stock to trade at a \$1/2 dealer spread. On a tape, a trader at another firm that narrowed to \$1/4 spread explained that the head of the Nasdaq trading desk "did it [permitted Microsoft to be quoted with a 1/4 point spread] just to \*\*\*\* everybody up."

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it difficult to trade.<sup>50</sup> One market maker, who was angry that another market maker had narrowed the dealer spread of Microsoft, began to use odd-eighths in quoting the common stock of Cisco. This trader intimated to another trader that he cut the spread in Cisco to retaliate against the market maker who had narrowed the spread in Microsoft, whom he knew to be one of the largest volume traders of Cisco.<sup>51</sup>

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<sup>50</sup> Several traders testified that there was no economic reason to narrow the dealer spread to \$1/4 in these stocks. At these levels, the market maker would always be quoting either the inside bid or offer, and would therefore always be exposed to SOES and other orders, requiring intensive monitoring of quotes and executions.

<sup>51</sup> In the taped telephone conversation, the trader who narrowed Cisco (Trader 2) speaks of a third firm which had narrowed the spread in Microsoft:

Trader 1: Hi.  
Trader 2: Hi. What's up?  
Trader 1: Oh, tell me.  
Trader 2: What, you mean with these spreads?  
Trader 1: Yeah.  
Trader 2: Well, [name of third firm] started it with Microsoft, so . . . .  
Trader 1: Oh, that what happened?  
Trader 2: Yeah. You know, did you see the Journal today? And all that \*\*\*\* that's going on.  
Trader 1: What, no. I'm sorry. It was all, it was kinda, it had to be done?  
Trader 2: It doesn't have to be done. It's the end of the business. It's the end of your profits. If you make 600 a month, you gonna make 400 a month.  
Trader 1: . . . I'm \*\*\*\*\* sitting here with a knot in my stomach you can't imagine.  
Trader 2: Yeah.  
Trader 1: It \*\*\*\*\*. Oh, so [third firm] cut the Microsoft? Oh, okay. What was in, what's in the Journal?  
Trader 2: It's a whole study about how spreads are too big.  
Trader 1: Oh. If that's what's going to happen, that's what's got to be, right?  
Trader 2: Yup.  
Trader 1: Yeah.  
Trader 2: Alright.  
Trader 1: I know you didn't want to . . . I know, I knew it wasn't your style, you know . . . .  
Trader 2: No. But I did it [narrowed the spread in Cisco]\* to get him [third firm]\* back. I knew he was involved in Cisco.

(continued...)

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Over the summer of 1994, the spreads in other Nasdaq stocks were narrowed by market makers. The trend appears to have been reinforced following additional negative publicity in October of 1994. On October 19, 1994, reports of a Justice Department investigation of allegations of price-fixing by Nasdaq dealers were published. The following day, the Los Angeles Times began a six-part series highly critical of the Nasdaq market.<sup>52</sup>

Thereafter, market makers began to narrow the spreads of other stocks. Market makers narrowed spreads both by following the pricing convention and narrowing their dealer spreads to less than  $\$3/4$ , and by using odd-eighth quotations with  $\$3/4$  dealer spreads. Figure 5 shows the changes in market maker quotation behavior from December of 1993 to July of 1995.

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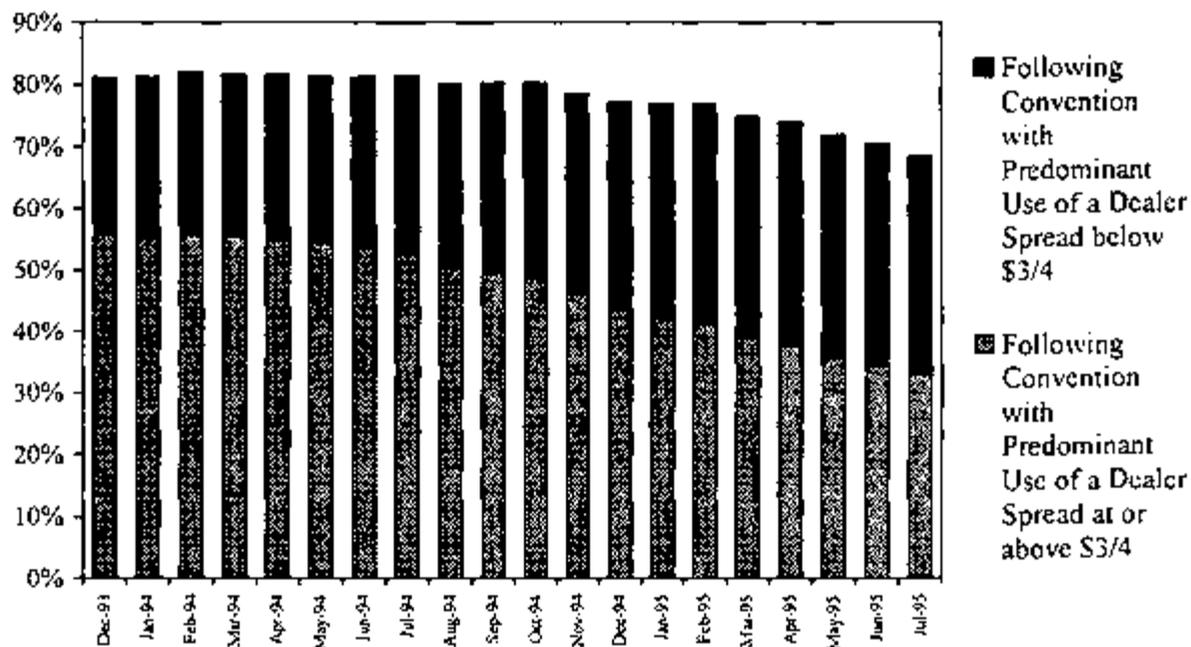
<sup>51</sup>(...continued)

- \* Trader 2 testified that this sentence had the meaning indicated in the brackets.

Within three minutes after Trader 2 used the odd-eighth quote in Cisco, three other market makers narrowed their dealer spreads to one-half and began moving their quotes in eighth point increments.

<sup>52</sup> Scot Paltrow, "Inside Nasdaq, Questions About America's Busiest Stock Market," The Los Angeles Times, Oct. 20, 1994, at 1. See *infra* note 69 and accompanying text. The first article identified a trader at one market making firm ("Firm A") that reportedly called the market maker that cut the spread of Intel Corporation, an even-eighth stock, to  $\$1/8$  and "complain[ed] 'You guys break the spread for 1,000 shares?'" The next day, Firm A began to move its quotes for Intel in  $\$1/8$  increments, although it temporarily continued to quote a  $\$3/4$  dealer spread. On October 24, Firm A was the second market maker to cut its dealer spread to  $\$1/2$ .

**FIGURE 5:**  
**Percent of All Domestic Nasdaq NMS Stocks**  
**Following Pricing Convention**



Starting in the summer of 1994, there was a shift of stocks to the less than \$3/4 dealer spread category along with what appears to be the beginning of a more general breakdown of the pricing convention.<sup>53</sup> The potential liabilities associated with the allegations of collusion, government investigations, and the private lawsuits more than likely played a significant role in discouraging adherence to the pricing convention and may have reduced the use and effectiveness of peer pressure to discourage those market makers that narrowed the spread.

In sum, the pricing convention, the size convention, the disincentive against narrowing the spread, their attendant enforcement mechanisms, and the availability of nonpublic trading systems for market makers resulted in a fragmented market for Nasdaq stocks where investors, institutional and retail, transacted at a considerable disadvantage to market makers. Investors were often confronted by artificially wide, inflexible spreads, and frequently could not transact in the markets at the best prices. Attempts by dissident market makers to compete on the basis of price were in a number of instances met with hostility and harassment.

<sup>53</sup> Some traders have testified that the pricing convention is no longer followed consistently.

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## 2. The NASD's Failure to Address Adequately the Pricing Convention and Related Practices

The investigation inquired into how the NASD addressed the issues raised by the anticompetitive activities described above. The issue of the width of spreads for Nasdaq securities has been raised frequently by market participants and other observers over a number of years. The registered stock exchanges, which compete with Nasdaq for listings, have focused on the issue of spreads in marketing materials designed to encourage issuers to list on the exchanges. Various issuers have raised concerns about what they have perceived to be wide spreads in their stocks, and investors have complained about the issue. Economists have studied spreads as a measure of transaction costs paid by investors, and articles and academic studies have appeared identifying the issue as a problem on Nasdaq. In the course of reacting to the issue of the size of spreads on Nasdaq, the NASD became aware of both a pricing convention operating in the Nasdaq market and the allegations that certain market makers harassed and intimidated those who narrowed spreads.

At a June 27, 1990 meeting of the Trading Committee of the NASD, the issue of spreads was raised in a discussion about a New York Stock Exchange letter to a Nasdaq issuer questioning the width of spreads on Nasdaq. During the meeting, committee members and senior NASD staff<sup>54</sup> discussed facts evidencing the pricing convention, its enforcement, and the rigidity of Nasdaq spreads. The pricing convention was described by one committee member as an "ethic" in the Nasdaq market, part of which was not to close spreads or make "Chinese markets." Two other committee members stated that if a market maker attempts to break a spread, it gets calls from large firms questioning the reason for the narrower spread. The committee concluded that it was inadvisable to legislate spreads and that the Security Traders Association of New York, an industry trade association, should address the issue of the "ethic" because it was an "internal" matter.<sup>55</sup>

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<sup>54</sup> Seven of the nine committee members present were representatives of Nasdaq market making firms (and one of these seven members was also a member of the NASD Board of Governors at the time). The NASD staff present included members of the Office of General Counsel, Division of Market Surveillance, and Division of Market Operations.

<sup>55</sup> The official minutes of the meeting state: "The Committee also discussed the inadvisability of trying to legislate spreads; that whatever movement necessary to narrow spreads must come from within the market itself, and through industry groups such as the Securities [sic] Traders Association."

Beginning in 1990, certain Nasdaq traders serving as governors of STA encouraged market makers to narrow voluntarily their dealer spreads. These efforts were not successful, as spreads did not begin to narrow generally until mid-1994. Some market makers indicated to one STA governor that they were not willing to narrow their dealer spreads because they were concerned about receiving phone calls from other market makers pressuring them not to narrow.

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Despite the presence at this meeting of senior NASD staff, the NASD did not take any action following this meeting to investigate the existence, impact, or legality of an "ethic" that market makers should not break spreads or make "Chinese markets," or the practice of market makers discouraging one another from narrowing spreads.

In 1992, a senior NASD executive undertook an evaluation and analysis of the issue of widening spreads as part of an effort to achieve a 1992 NASD corporate goal to reduce spreads.<sup>56</sup> In connection with this effort, the staff member discussed the issue of widening spreads with members of the Quality of Markets Subcommittee of the Trading Committee.<sup>57</sup> The subjects of "Chinese markets," the quoting patterns dictated by the pricing convention, and the intimidation of market makers were discussed during at least one meeting of the Quality of Markets Subcommittee, held on March 24, 1992, at which NASD staff members were present. The senior officer wrote a memorandum dated June 30, 1992 summarizing his thoughts and proposing a number of initiatives to address the issue of widening spreads (the "June 1992 Memo"). The June 1992 Memo was distributed to most of the senior officers of the NASD.

The June 1992 Memo identified an absolute increase in inside spreads from the first quarter of 1989 through May 1992 from \$0.226 to \$0.369, an increase of 63%. It then set forth the author's opinions as to the reasons for the widening spreads. The June 1992 Memo described order flow arrangements, the increased use of SelectNet and Instinet, and market maker exposure to SOES trades as contributing factors. It also identified the stigma associated with making a "Chinese market" and the observance of uniform quote increments as contributing to widening spreads, stating:

Unlike auction markets, dealers do not change prices one side at a time and there is a stigmatism [sic] associated with making so called "Chinese" markets. Tangential to this, is statistical evidence that shows, stocks that move (i.e. the next quote change) in 1/8 point increments have narrower spreads than 1/4 pt., 1/4 pt. narrower than 1/2 pt. etc. No one attempts to do just a "little" better with their published quote change (e.g. 1/16) where as in negotiation of the trade itself that smaller price improvement is accomplished. As a result stocks that get stuck in a particular quote increment mode never seem to change e.g. Apple always moves in 1/4 pt. increments. MCI happens to enjoy a 1/8 point increment. What's the difference?

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<sup>56</sup> Although some NASD witnesses testified that the primary reason for the initiative was to reduce the transaction costs paid by investors trading at the inside spreads, the weight of the evidence indicates that concerns about losing issuer listings to the exchanges was the primary motivation for the NASD's efforts to reduce spreads.

<sup>57</sup> The Quality of Markets Subcommittee was formed in early 1991 to address two issues: the development of the short sale rule and the issue of spreads. The Subcommittee was composed only of representatives of market making firms.

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The June 1992 Memo then discussed the subject of peer pressure associated with the narrowing of spreads:

Dealer spreads are arbitrarily established at the time of an IPO [initial public offerings] and after initially set, there is no incentive to reduce them. I understand that when attempts are made by individual dealers to do so, peer pressure is brought to bear to reverse any narrowing of spreads. I have no hard evidence of this and the information is only anecdotal and this was not described as happening in every case. However, enough people have said it for me to believe it to be true.

The memo then outlined proposed solutions to the problem of wide spreads. These proposals included modifying SOES tier limits and SOES exposure, converting SOES from an order execution system to an order delivery system, modifying the limit order file, and redefining the excess spread parameters. The memo also addressed the issue of peer pressure:

We need to support those market makers who attempt to compete through the price improvement process and also make it clear that tampering or using coercion in influencing other's [sic] pricing decision[s] is a violation of fair trade practices.

The issues set forth in the June 1992 Memo were discussed at a meeting of NASD senior management in July of 1992. At the meeting, the author repeated the observations set forth in the memo. Members of NASD senior management inquired about specific instances of intimidation or harassment, but received no specific examples.

The NASD did not take appropriate steps to investigate the issue of dealer intimidation or uniform quoting practices described in the June 1992 Memo. No attempts were made to assess more comprehensively the impact of these market maker practices on spreads or trade executions. NASD management did not undertake a study of the competitive issues confronting the market nor did it utilize the NASD's enforcement resources to inquire into the conduct of market makers to assess compliance with the NASD's rules.<sup>58</sup>

Beginning in 1992, the NASD considered regulatory and structural measures which it described as being designed to narrow the spreads on Nasdaq in a manner that would be acceptable to the market making community. These measures focused on modifying the SOES system to convert it from an automatic order execution system to an order delivery system, thereby allowing market makers to reject orders delivered through SOES. This approach was

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<sup>58</sup> NASD witnesses testified that they did not pursue these matters because they did not have any specific information as to instances of intimidation or harassment. The absence of specific information about incidents of intimidation or harassment did not excuse the NASD from proactively ascertaining whether or not its rules had been violated or whether the integrity of the Nasdaq market was in jeopardy.

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intended, in part, to respond to the demands of market makers advocating the elimination of trading sponsored by SOES firms.<sup>59</sup> The NASD staff also considered proposing changes to the SOES limit order file that would allow market orders to interact with limit orders between the inside spread, thereby increasing the number of trades executed inside the spread.<sup>60</sup> The NASD staff anticipated that although many market makers would oppose this change in the limit order file, they would accept the changes, if proposed in conjunction with the changes in SOES strongly advocated by market makers.<sup>61</sup> Conversely, the NASD staff apparently believed that

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<sup>59</sup> Many market makers believed that active SOES trading resulted in substantial losses to market makers. Consequently, they exerted significant pressure on the NASD to eliminate active trading on SOES. Market makers publicly blamed wide spreads on active SOES trading. They claimed that because of the automatic execution feature of SOES, SOES traders had an unfair trading advantage in periods of volatility, when they could execute trades in SOES before the market makers had an opportunity to adjust their quotes in response to the changing market. Market makers also claimed that the trading risks created by SOES traders forced them to widen their spreads to reduce their market exposure, and many took the position that they would not narrow their spreads until the alleged "SOES abuse" was curbed. The NASD publicly accepted the view that SOES trading was a primary cause of wide spreads, submitting several studies to the Commission allegedly demonstrating this to be true, and pursued a solution to the issue of wide spreads that first and foremost addressed the concerns of the market making community. See *infra* Part II. for a discussion of the market makers' influence on the NASD. As discussed in note 40 *supra*, the fact that market makers did not narrow their spreads on an overall basis after receiving regulatory relief through the interim SOES rules is inconsistent with the argument that SOES trading was responsible for wide spreads.

<sup>60</sup> Additionally, the NASD implemented changes to the excess spread rule that were intended to create downward pressure on spreads. The rule, however, inadvertently created incentives for dealers to discourage one another from narrowing spreads. See *infra* Part II.C.2. NASD senior staff members were aware of this possible consequence of the rule. The 1993/1994 Business Plan of the Market Surveillance Department states in a section headed "External Environment" that "[n]ew excess spread policy may lead to collusion amongst firms to widen spreads."

<sup>61</sup> In a July 31, 1992 memo to members of NASD senior management, the author of the June 1992 Memo stated:

There are a number of solutions which I originally suggested in my June 30th memorandum. . . . For pure [sic] tactical reasons, I recommend we narrow the solution, at this time, to only one. Specifically, link the change of SOES to a [sic] order routing system with the interaction of that order with the limit order file (emphasis in original).

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the SEC would not accept the SOES changes without a proposal to reform the limit order file.<sup>62</sup> Thus, the NASD staff made a "tactical" decision to link SOES reform to changes in the limit order file in order to gain acceptance of the package by both the SEC and the market makers.

The NASD staff proposals to reform SOES did not address the other issues that were identified in the June 1992 Memo as contributing to excessively wide spreads. The NASD did, however, target the SOES execution system for elimination, thereby satisfying a priority of the Nasdaq market makers, the NASD's most powerful constituency.

The NASD continued to receive indications of a lack of vigorous price competition in the Nasdaq market. An article appeared on August 16, 1993 in *Forbes* magazine entitled "Fun and Games on Nasdaq," describing market maker practices, including the harassment of traders that narrow spreads. A December 8, 1992 comment letter submitted to the SEC by the American Stock Exchange contained allegations that Nasdaq quoted spreads almost never vary, and that dealers do not narrow spreads because of concern that other market makers will then not "play ball" with them and help them lay off position risk.<sup>63</sup>

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<sup>62</sup> A November 16, 1992 memo from a NASD Senior Vice President to members of the Quality of Markets Subcommittee states:

Attached is a proposal for changing the SOES execution system to an order delivery system. Because this will be viewed as a diminution of the public's access to the market, this proposal also contemplates a change to the Limit Order File.

The body of the circulated proposal states in part:

[T]here is no possibility that the SEC will approve modifications to SOES that disadvantage some market orders without some form of quid pro [sic] quo.

<sup>63</sup> Questions about the integrity of Nasdaq market makers were raised in other areas. In late 1993, the NASD undertook a survey of institutional investors concerning their perceptions of the Nasdaq stock market. The findings of the survey were presented to the senior management group of the NASD and Nasdaq, and to the Trading Committee and Institutional Investors Committee of the NASD using a series of overhead slides. These slides included direct quotations from particular institutional investors interviewed and included the following quotes:

"There is a sense that dealers collude and share information that we don't see."  
[emphasis in original]

(continued...)

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While the NASD failed to address adequately these indications of potentially improper market maker practices, it was aggressively promoting the Nasdaq market.<sup>64</sup> As part of these efforts, the NASD pursued economic research projects to portray the Nasdaq market favorably and counter negative publicity.<sup>65</sup> In one instance, the NASD explicitly retained the right to prevent publication of the results of economic research it commissioned because of concerns that the results could be negative for the Nasdaq market.<sup>66</sup>

Beginning in the spring of 1994, the Christie-Schultz study generated substantial negative publicity about the Nasdaq market. In addition, class action lawsuits were filed against market makers, and, in the fall of 1994, the media published reports of government investigations of the Nasdaq market. The NASD developed a public relations campaign designed to counter the

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<sup>63</sup>(...continued)

"Market makers are self-serving. They take care of their own accounts first, then their 'broker buddies.' We're the last ones they care about." [emphasis in original]

"There's no accountability on the part of market makers. They make excuses about SOES bandits prohibiting them from executing a trade. These excuses insult our intelligence. We'd rather go out of our way to alternative trading systems to sidestep market makers and the games they play." [emphasis in original]

The NASD did not take any action to address the issues raised by the survey results.

<sup>64</sup> From 1992 to 1994, the annual marketing expenditures of the NASD and Nasdaq combined rose from \$23,971,000 to \$42,986,000. Even though this was a period of increasing revenues and expenditures for the NASD and Nasdaq, marketing expenses rose from 10.7% to 12.9% of the combined expenditures of the NASD and Nasdaq. In the same period, regulatory staff dropped from 37.7% to 35.7% of total staff at the NASD and Nasdaq.

<sup>65</sup> To ensure that research would generate results favorable to Nasdaq, staff of the NASD's Economic Research Department from time to time conducted preliminary research of an area being considered for an NASD commissioned study before hiring an outside economist to perform the research.

<sup>66</sup> An agreement between the NASD and an economist retained as a consultant to study the issue of individual versus institutional transaction costs provided that the NASD could prevent the consultant from publishing the results of his study by paying him an additional \$1,000. An internal NASD memorandum stated that the provision was created "[b]ecause of the negative publicity that may be generated by poor results. . . ."

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conclusions of the study and to promote Nasdaq as a competitive market without collusion.<sup>67</sup> NASD senior officials publicly criticized the Christie-Schultz study, and senior NASD officers disclaimed the existence of anticompetitive problems on Nasdaq.<sup>68</sup> NASD economists prepared a rebuttal to the Christie-Schultz study. The NASD also commissioned outside economic studies to challenge the notion that there was collusion among Nasdaq market makers to keep spreads wide. While pursuing this effort, the NASD took few significant steps to address the underlying issues or to investigate the indications of the problem described herein.

In October 1994, the Los Angeles Times series critical of the Nasdaq market described instances of harassment of a market maker, Domestic Securities Inc. ("Domestic"), that narrowed spreads in particular securities.<sup>69</sup> The NASD decided to investigate these incidents.

Domestic had previously complained to the NASD's Market Surveillance Department about at least one of these incidents. Domestic sent a letter to the Market Surveillance Department on June 6, 1994 describing the episode and attaching a printout of a harassing SelectNet message. According to Domestic's letter, a market maker sent the message "Pathetic" to Domestic immediately after Domestic had narrowed the inside spread in Intel from 1/4 to 1/8.<sup>70</sup> The Market Surveillance Department sent a form letter to the market maker in question on June 6, 1994, asking for its explanation for sending the "Pathetic" message. The market maker responded by letter on June 20, 1994, asserting that when its trader observed Domestic's tightening of the spread, he tried to trade with Domestic. The letter stated that when Domestic refused to enter into a trade, the trader transmitted the "Pathetic" message to Domestic. A review of the NASD's own equity audit trail, however, would have revealed that Domestic, in

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<sup>67</sup> This broad public relations campaign resulted in the development and implementation of numerous projects targeting various NASD constituencies, the press, and the academic community. The NASD's determination to defend the status quo rather than objectively examine its market was exemplified in an internal memorandum dated April 5, 1995, which praised outside economists hired by the NASD for attacking the Christie-Schultz study and described the economists hired by the NASD as "[o]ur surrogates."

<sup>68</sup> In a memorandum to Nasdaq market makers discussing press reports of the Justice Department inquiry into trading practices on Nasdaq, a senior NASD officer, who had reviewed the June Memo, stated "As you well know, The Nasdaq Stock Market is stringently overseen by both the SEC and the NASD and neither we nor the SEC have ever found anti-competitive practices to exist in our market."

<sup>69</sup> The first installment discussed the width of spreads on Nasdaq and the harassment of renegade dealers who tried to narrow spreads. The article described several incidents of such harassment when Domestic narrowed the inside spreads in three Nasdaq securities in June and July 1994.

<sup>70</sup> NASD records confirm this sequence of events.

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fact, purchased 1,000 shares of Intel from the market maker. The NASD closed the matter without further investigation.

It was only after the Los Angeles Times article was published that the NASD revived the investigation.<sup>71</sup> In November 1994, the staff of the Market Surveillance Department spoke to the three market makers involved in the incidents noted in the articles. All three market makers denied that any statements they made to Domestic were in retaliation for its breaking the spread. Instead, the traders attributed any disparaging remarks to Domestic's refusal to trade for more than 1,000 shares.<sup>72</sup> The NASD did not attempt to expand the inquiry beyond the discrete events noted in the Los Angeles Times article.

A report summarizing the findings of the NASD's investigation was given to the Compliance Subcommittee of the Market Surveillance Committee in January 1995. The members of the Compliance Subcommittee were reluctant to impose sanctions on any of the three market makers because they believed that comments concerning the depth of the market were common between traders. The NASD staff stated that the Subcommittee should consider the matter seriously and carefully, given the existing environment of class-action lawsuits, government investigations by the Department of Justice and the SEC, and a spate of negative press articles. In the end, the Compliance Subcommittee recommended that a Letter of Warning, which is the lightest sanction available to the NASD, be sent to one market maker.<sup>73</sup> After similar discussion at the Market Surveillance Committee the next day, the Letter of Warning was issued and the other matters dismissed.

### 3. Coordinated Activity Among Market Makers

The evidence indicates that instead of dealing as competitors at arms length, certain Nasdaq market makers have coordinated particular trade and quote activities with one another, furthering their proprietary interests at the expense of investors and other market participants.

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<sup>71</sup> According to the Los Angeles Times article of October 20, 1994, market makers made the following comments to Domestic: "You guys break the spread for 1,000 shares?," "You're embarrassing and pathetic. . . . You're breaking spreads for everybody," and "This is \*\*\*\*\*. I have institutional customers who come to me and I have to match your price. It's \*\*\*\*\*, you guys going down an eighth for a thousand shares."

<sup>72</sup> As noted in Part I.A.1.c., supra, there is a widely observed industry custom of not initiating a new inside bid or offer unless the market maker is willing to trade in large (at least 2,000 to 5,000 shares) size, even though the NASD firm quote rule only calls for market makers to be willing to trade 1,000 shares, at the most.

<sup>73</sup> The Subcommittee distinguished between the fact that the "Pathetic" message was sent on SelectNet, while the other two comments were made over the telephone. The staff indicated that this fact was not a meaningful basis for distinction, but failed to convince the Subcommittee to change its recommendation.

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This coordinated conduct has included: (a) arrangements under which these market makers agree to move their published quotes at the request of other market makers, or assist one another in executing trades; (b) agreements to delay reporting specific trades likely to have a negative impact on the value of the requesting market maker's trading position or to obscure the true sequence of trades from customers or other market participants; and (c) the routine sharing of information by these market makers concerning customer orders, securities positions, trading strategies, and intended quote movements. Although many market makers attempt to coordinate their activities on a widespread basis, such coordination is particularly pronounced among market makers that have regular and close contact in the course of trading the same securities. Some traders in testimony have referred to these cooperative traders as "friendly competitors."

In addition to impeding competition with respect to specific transactions, the existence of groups of cooperating "friendly competitors," and the demonstrated unwillingness of some market makers to trade with firms they dislike, poses a significant obstacle for new entrants to market making. The obstacle of obtaining membership in one or more groups of cooperating market makers is in addition to a number of other start-up requirements confronting new entrants in the market, including requirements imposed by regulators. For example, significant business and regulatory requirements would include: (a) the need for personnel with substantial knowledge and experience in the securities industry who are duly licensed by the NASD and have a thorough knowledge of the markets and the rules that govern them; (b) substantial capital in order to obtain the necessary facilities and equipment and meet regulatory capital requirements; and (c) admission to NASD membership (which, as is discussed further in the text, may be a difficult process for certain applicants). In addition, attracting order flow can be a significant obstacle for new entrants. As described herein, attempts to obtain order flow competitively by narrowing the spread may well result in harassment and refusals to trade.

#### a. Coordinated Quote Movements and Transactions

Certain Nasdaq market makers have engaged in a practice of discussing among themselves their prospective quote movements and transactions in specific securities, and coordinating the sequence, timing, and size of particular quote changes and transactions. Taped telephone conversations have revealed numerous instances of market makers asking other market makers to make specific quote movements,<sup>74</sup> sometimes requesting the market maker who is quoting the best bid or offer to move that quote away from the inside quote or in a manner that creates a new inside market.<sup>75</sup> In other instances, market makers ask other market makers to

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<sup>74</sup> In some circumstances, market makers have moved their quotes only after obtaining approval from other market makers.

<sup>75</sup> Because market makers view the prices quoted at the inside spread as benchmarks for the prices given to customers, effecting changes in the inside quotes can allow market makers to trade with their customers at more profitable prices. For example, in one taped conversation, a trader asked another trader to move his quote down before the market

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join an existing inside bid or ask quote, to create the impression of increased buying or selling interest that may facilitate a transaction by the requesting market maker. Some traders have testified that they accede to these requests out of "courtesy," and in some instances, because of an expectation that the requesting market maker will reciprocate in the future.

By working together to coordinate quote movements or transactions, these market makers can sometimes move the quoted price of a stock up or down, thereby facilitating trades at prices that are more favorable for the market makers, often at the expense of their customers.<sup>76</sup> Some

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<sup>75</sup>(...continued)  
opened:

Trader 1: Hi [name of Trader 2], it's [name of Trader 1], can I help for [name of another trader]?

Trader 2: Yeah, if he's not involved in Lotus, can he slide down. I got 'em for sale this morning.

Trader 2 testified that he had accounts that wanted to sell Lotus to him. He believed that the reason he wanted the other firm to move its quotes down was because he did not want to get caught holding the Lotus stock at a price at which there were no buyers. Data shows that Trader 1's firm was at the inside bid when the conversation occurred and that subsequently it moved its bid down.

<sup>76</sup> An example of market makers coordinating quotations in an apparent effort to create the appearance that the market for a stock is moving up, or that buying interest is emerging, is set forth in the following taped telephone conversation. One trader, holding a long position in the stock Parametric Technology Corp. (PMTC), asked another to move his bid up:

Trader 1: Are you doing anything in Parametrics [sic]?

Trader 2: Ah, running for the hills, bro.

Trader 1: Okay, can you. . .

Trader 2: What can I do for you?

Trader 1: Can you go 1/4 bid for me?

Trader 2: Yeah, sure.

Trader 1: If you want, I'll sell you two at 1/4, just go up there. I'm long them and I want it going.

Trader 2: Yeah.

Trader 1: Okay, I sold you. . .

Trader 2: Two. That would be great.

Trader 1: I sold you two at 1/4. Just go up there, okay?

Trader 2: I'm goosing it, cuz.

Trader 1: Thank you.

(continued...)

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market makers refer to these practices as "holding hands."<sup>77</sup> In certain circumstances, such undisclosed collaboration can be injurious to the interests of investors.<sup>78</sup> For example, a market maker helping another market maker dispose of an unwanted long position in a security will find itself in conflict with the firm's obligation to obtain the best price for those of its customers to whom it sells those securities. This cooperation can improperly influence prices, create an inaccurate picture of the market, and in some cases may evidence market manipulation, in violation of the antifraud provisions of the securities laws.<sup>79</sup>

#### b. Agreements to Delay Trade Reports

The investigation has uncovered instances in which some market makers entered into explicit agreements to delay reporting trades. These arrangements have occurred in situations

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<sup>76</sup>(...continued)

The requesting trader (Trader 1) was engaged in selling substantial quantities of Parametric stock. A third market maker had just minutes earlier raised its bid price (and the inside bid) to \$26 1/4, and in complying with Trader 1's request, Trader 2 became the second market maker to move its bid up to \$26 1/4.

<sup>77</sup> One trader described "holding hands" as follows:

It is, like, two market makers would be kind of in cahoots, one guy would know what the other guy is doing. It would be, like, two guys would talk on the stock, instead of the one guy going down to the offer, then he would let somebody else go to the offer for him or go to the bid for him. For instance, if [a large market maker] was on the bid, nobody would hit him -- because everybody thinks he is the real buyer, he wouldn't go to the real bid. Everybody runs away from [the large market maker], because they think they are always big. . . . He might send a little, small guy up there instead to buy stock.

<sup>78</sup> The Commission is not suggesting that for market makers to use multiple agents to obtain executions of customer orders is per se improper.

<sup>79</sup> The term "antifraud provisions" as used herein refers to Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1994), and Sections 10(b) and 15(c)(1)(A) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78o(c)(1)(A) (1994), and Rules 10b-5 and 15c1-2 promulgated thereunder, 17 C.F.R. §§ 240.10b-5 and 240.15c1-2 (1995). In addition, there is evidence that market makers from time to time have entered into agreements to widen their dealer spreads in particular stocks. Such conduct has serious anticompetitive implications and may also constitute market manipulation in violation of the antifraud provisions.

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where a timely report of a significant trade could have resulted in a market price movement unfavorable to the market maker's position in such security. The delay of a trade report under such circumstances creates a window of opportunity for the market maker to trade at prices not affected by knowledge of the trade. This practice could allow the market maker to take unfair advantage of other market participants, thereby obtaining an undeserved economic benefit. Certain market makers have also entered into agreements to delay trade reports in order to prevent customers with whom they were trading from seeing the prices of other contemporaneous trades.<sup>80</sup> In both situations, the true appearance of the market is deliberately obscured, and the ability of investors to make accurate price discovery is hampered. In addition, depending upon the circumstances, an intentional delay of a trade report may violate NASD rules and the antifraud provisions of the federal securities laws.

c. **Information Sharing**

The investigation has further identified a number of practices, which are loosely characterized as "professional" or "ethical" obligations by Nasdaq traders that generally govern market maker trading activities. Certain market makers share information with other market makers concerning the size of their customers' orders, and in some instances, the identity of their customers. They also disclose to each other their own market making positions and their intended trading strategies and quote movements. Market makers may also discuss non-public

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<sup>80</sup> The following conversation is an example of market makers agreeing to delay a print to hide it from a customer.

Trader 1: I just sold 25 at 1/4, 1/8 for any part of whatever you want.  
Trader 2: Oh, that's \*\*\*\*\* beautiful, buddy.  
Trader 1: . . . .  
Trader 2: Why don't I sell you - This sounds so horrible - I'm gonna sell you, is 10 G's okay? . . .  
Trader 1: . . . .  
Trader 2: . . . I'd love to sell you 10, I owe you one.  
Trader 1: I bought 10 at 1/8, and don't print it for, for a few minutes, 'cause I told the guy I'm just making a sale out of the blue. Alright?  
Trader 2: I'll, I'll print after the bell.  
Trader 1: Thanks, bud.

The conversation took place at approximately 3:54 p.m. The trade was reported late after the close of the market at 4:01:40 p.m. Trader 1 testified that he had told the salesperson at his firm that he was selling "out of the blue," which meant that he was selling out of inventory rather than crossing the trade. He explained that certain customers, such as large mutual funds, do not like to see multiple trade reports, which reflect the customer buying from the market maker who is buying from another market maker who is buying from another customer, often with mark-ups at each trade. Trader 1 testified that he therefore wanted the trade prints to be separate from one another.

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news releases, and research reports and recommendations concerning particular stocks.<sup>81</sup> In accordance with these so-called "professional" practices, it is understood that market makers who receive this information will not use it to trade against the disclosing market maker's interest.<sup>82</sup> Nor is such information expected to be disclosed to other market participants. The evidence shows that market makers who engage in this behavior typically disclose the full extent of their customers' orders when negotiating a trade with another market maker.<sup>83</sup> If additional orders are received from the customer, the market maker with the order may also consider itself under

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<sup>81</sup> Market makers often warn their regular market maker contacts about anticipated market price movements and suggest that they move their quotes or establish positions to avoid trading losses. For example, in the following conversation, Trader 1 warned Trader 2 before the opening of the market that the stock Applied Bio-Sciences [APBI] had been taken off of Trader 1's firm's "focus list" of recommended stocks, and that Trader 1 was about to sell stock for his customers by hitting the bids in the market:

Trader 1: Applied Bio, go down, I took it off my focus list, I'm gonna rip it [sell stock by hitting the bids].  
Trader 2: Oh. Update down a quarter.  
Trader 1: I just didn't want you to be up there while [inaudible].  
Trader 2: I appreciate it, my friend.

As a result of the call, Trader 2 moved his bid quote down from 5 3/4 to 5 1/2, off the inside bid. Trader 1 had similar conversations with other market makers of APBI, who also moved their quotes down prior to the market opening. The warnings created downward pressure on the market price for the stock. At the time of the calls, Trader 1 had retail customer orders to sell 15,000 shares. Trader 1 sold 11,000 shares at an average price of 5 5/8 during the first five minutes following the opening. Approximately five minutes following the last of these sales, after the inside bid had dropped to 5 3/8, Trader 1 bought 11,200 shares of APBI from his customers at prices between 5 3/8 and 5 5/8. Trader 1, by disclosing his intent to hit the bids and warning market makers to move off of the inside bid, helped move the market price down, against his customers' interest.

<sup>82</sup> For example, it is understood among market makers that if a market maker tells another market maker that he is selling a substantial block of stock, the market maker to whom that information is disclosed is under an "ethical" obligation not to attempt to sell stock ahead of the market maker that is selling the substantial block. A market maker may disclose this type of information to another market maker (a) in connection with a request that the other market maker help work the order or move his quotes in a manner that facilitates trading, (b) to warn the other market maker that the market will be moving in a particular direction as a result of the trading activity, or (c) to find trading interest.

<sup>83</sup> Some traders have testified that they do not disclose this information to all market makers with whom they trade, but only to those market makers they trust.

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a "professional" obligation to seek to trade first with the market maker with whom he last traded. It is also generally understood that a market maker that hits another market maker's bid or lifts its offer will not thereafter move its quotes without first consulting the market maker with whom it just traded.

Market makers who fail to observe these practices are considered "unprofessional," at times receive complaints and harassing phone calls from other market makers, and risk losing access to information and trading opportunities provided by others.<sup>64</sup> Market makers rely on each other to provide order flow, information, and cooperation to help them trade positions profitably.<sup>65</sup> Traders do not want other market makers to perceive them as being

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<sup>64</sup> For example, in one taped conversation, a trader complains to another trader who did not fully disclose his customer's order when they first traded:

Trader 1: . . . if you had more you should just show me your picture. I try and make good prints for you. But —

Trader 2: . . . I'm dealing with a very difficult customer. I ask him, "How much have you got to sell?" . . . They don't even — they say, "\*\*\*\* you. I ain't telling what's for sale. This is what I've got. Work it."

Trader 1: Ok.

Trader 2: That's how it's done — I mean, I'm not playing games. Believe me. I'm the last person in the street to play those things.

Trader 1: Ok, I was, it's just that, I mean I got long the stock trying to move it with my retail when you offer it down. And I don't have any room to pay out the credit to my broker. Then I get stuck, stuck long 10. You offer it down. Then I end up having to go out and hit the stock. And I mean it's not doing anybody any good.

. . .

Trader 2: Alright . . . I hear you.

Trader 1: Just . . . I understand with these guys you can't communicate with them. But if in the future, if you'd like to try, think it would make us both a lot more money.

Trader 1 later complains to a trader at another firm about Trader 2: "You know, we try to do the right thing. We keep an orderly market. And this guy just \*\*\*\*\* all over us."

In this situation, Trader 1's desire to keep the quotes from dropping while making retail sales is inconsistent with the interests of the customers to whom his firm is selling stock.

<sup>65</sup> In one taped conversation, two traders discuss the benefits of sharing information and cooperating:

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"uncooperative," "unethical," or "unprofessional" because that perception may result in their losing access to their trader networks. Market makers may refrain from sharing information with or offering trading opportunities to market makers who fail to comply with the "professional" trading practices discussed herein. Exclusion of market makers who do not follow these practices serves to deter competition in the Nasdaq market.

Disclosure by market makers of their inventory positions, trading strategies, and future quote movements to other market makers would normally be risky for the disclosing market maker, because the receiving market makers could use such information to their advantage. The existence of an expectation that the receiving market makers will not use the information against the disclosing market maker is a further indication of the degree of collaboration in the Nasdaq market.

These information sharing courtesies can affect customers of the market makers. The information shared pursuant to these "professional" or "ethical" courtesies (the size of customer orders, inventory positions, intended trading strategies, future quote movements, and the identity of the customer) would normally be viewed as proprietary. A primary purpose of the sharing by market makers appears to be protecting each other from inventory risks that might arise otherwise. These information sharing "courtesies" were usually not extended to customers, and could conflict with duties owed by broker-dealers to customers. Investors may be deprived of benefits that would otherwise be available in a competitive market. For customers trading in large size, a market maker who reveals the size of a market order from the customer may impair the ability of the customer to obtain the best execution. Market makers learning of the order could adjust the price and size of their quotations in ways disadvantageous to the customer. In

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<sup>85</sup>(...continued)

Trader 1: . . . you've bailed me out a couple of times too. That's the game.  
Trader 2: Yep.  
Trader 1: You know? And, uh —  
Trader 2: And by you helping me out in some of these other ones. I mean, I'll always make you money in the Vicor [VICR] that, you know, anytime you get a position and stuff like that. That's, you know, that's nice that way. You know —  
Trader 1: Help each other. I'm more than, even if I have to lose a lot of jake [money]. I don't care.  
Trader 2: Yeah.  
Trader 1: Because, bottom line is everything comes out.  
Trader 2: Well, it makes my life a \*\*\*\*-of-a lot easier knowing that you can tell me what's going on when I got some things going, you know — Like the other times I got something going on in something so I can just tell you. And just tell you to get the \*\*\*\* out of the way —

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situations where market makers share the customer's identity, the customer's ability to seek competitive quotations from market makers is significantly hampered.<sup>86</sup>

## **B. Late Trade Reporting**

### **I. Late and Inaccurate Trade Reports**

Market participants rely on trade reports for trading Nasdaq securities and are thus affected by the quality of trade reporting. Numerous broker-dealers on Nasdaq repeatedly failed to report transactions on an accurate and timely basis in accordance with NASD rules.<sup>87</sup> Late and inaccurate trade reporting occurred frequently in this market and undermined the accuracy of the last sale transaction report information that was disseminated by the NASD. The NASD accorded a low regulatory priority to trade reporting issues and failed to enforce adequately its trade reporting rules.

Analysis of late trade reporting on Nasdaq begins with trades which are reported as late trades. NASD rules require that a trade report which is late be designated as such so that

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<sup>86</sup> One reason advanced by some market makers for disclosing the identity of a customer is the suspicion that the customer is doing business with more than one market maker. Traders testified that they will share the identity of a customer when they believe the customer is trading with both market makers at the same time, in order to better evaluate the risks of trading with that customer. This testimony indicates that because the dealers trade with customers as principal, they may at times be tempted to overlook their obligation to deal fairly with their customers. A customer may properly deal simultaneously with more than one market maker in order to secure the best execution of its orders. This is one way in which the customer obtains the benefit of a dealer market. However, for a market maker to collaborate with other market participants against the interests of its customer is inconsistent with the fair dealing obligations of market makers in a free and open market.

<sup>87</sup> Pursuant to Rules 11Aa3-1 and 11Aa3-2 under the Exchange Act, the NASD adopted a transaction reporting plan for National Market System securities in 1982. Exchange Act Release No. 18590 (Mar. 24, 1982), 47 Fed. Reg. 13617 (Mar. 31, 1982). As part of this plan, transactions in designated Nasdaq securities must be reported by the broker-dealer with reporting responsibility within 90 seconds after execution. A pattern or practice of late reporting without exceptional circumstances may be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Article III, Section 1 of the Rules of Fair Practice. NASD Manual, Schedule D to the By-Laws, Part X, § 2(a) (CCH) ¶ 1867 (1995).

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market participants will recognize it as an out of sequence report.<sup>88</sup> The scope of such late trade reporting is set forth in Table 1 below.

Table 1

Time Period:	Percent of Trades Marked Late	Percent of Volume Marked Late
2/94 to 12/94	3.6	4.5
1/95 to 7/95	1.9	2.9

Underlying the figures in Table 1 are, for the period February through December 1994, approximately 1.12 million Nasdaq NMS trades that were reported as late trades.<sup>89</sup> These late trade reports embodied a trading volume of over 2.6 billion shares.<sup>90</sup> During the same period, late trades accounted for only .09% of reported trades and .49% of reported volume on the New York Stock Exchange.<sup>91</sup> While the figures for the period January 1995 to July 1995 show a reduction in the degree of late trade reporting, the extent of the problem remains significant.

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<sup>88</sup> The party obligated to report the trade is required to designate as late all trades reported more than 90 seconds after execution by appending to the trade report a modifying code, ".SLD." See NASD Manual, Schedule D to the By-Laws, Part X, § 2(a)(8) (CCH) ¶ 1867 (1995). The reporting responsibility in a transaction between two market makers or between two non-market makers is on the broker-dealer representing the sell side. In transactions between one market maker and one non-market maker, only the market maker is required to report. In addition, all transactions between a broker-dealer and customer are reported by the broker-dealer. NASD Manual, Schedule D to the By-Laws, Part X, § 2(b), (CCH) ¶ 1867 (1995).

<sup>89</sup> These figures are based on all trades reported on Nasdaq and include trades reported through systems such as SOES, SelectNet, and ACES.

<sup>90</sup> Excluding trades executed through automated systems such as SOES, SelectNet, and ACES, which automatically report trades and generally eliminate the possibility of late trade reports, late trades in 1994 accounted for approximately 4.5% of all reported trades and 4.9% of all reported volume. Approximately 20% of Nasdaq NMS trades and 8% of volume are reported through ACES, SelectNet, and SOES.

<sup>91</sup> From January through July 1995, following the initiation of the Commission's investigation and increased scrutiny by the NASD of late trade reporting problems, late trade reports declined to 1.9% of trades and 2.9% of volume.

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In addition to reported trades marked late, analysis of audit trail data revealed that a significant percentage of trades between broker-dealers were reported late but were not properly designated late by the reporting broker-dealer. The Commission staff reviewed data for a sample of trades between broker-dealers that were not designated as late reports, and found that from February to December, 1994, 6.7% of trades and 8.7% of volume in transactions between broker-dealers were reported as regular trades when they were in fact late and should have been identified as such by the broker-dealers having the reporting responsibility.<sup>92</sup> These transaction reports violated the NASD trade reporting rules set forth in Schedule D of the NASD By-Laws.<sup>93</sup> While the sample consists only of broker-dealer to broker-dealer trades for which both parties submitted trade reports, these transactions, constituting approximately 20% of total Nasdaq volume, are an important segment of the market. Such a degree of undesignated late trade reporting in this segment alone warrants serious concern.

Because reports of larger trades are more likely to affect prices and liquidity than smaller trades, market makers seeking to fill an order or cover a position may have a greater incentive to delay intentionally large trade reports than they do small trade reports. Analysis of the data shows that the proportion of designated and undesignated late trades is significantly higher for larger trades than for smaller trades. In 1994, 2.2% of trades in Nasdaq NMS stocks between 501 and 1,000 shares were reported as late trades. This rate increased to 4.5% for trades between 5,000 and 9,999 shares, and to 5.2% for trades for 10,000 shares or more.<sup>94</sup>

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<sup>92</sup> The analysis was based on a sample that represented approximately 20% of all NMS trades, and included all trades between broker-dealers containing both a trade report time and a counterparty report time. The sample does not include trades executed through SOES, SelectNet, or ACES (which have automated trade reporting), nor does it include broker-dealer trades with customers. The trades in the sample were identified by comparing the time that the counterparty to the trade (the party without the trade reporting obligation) confirmed the trade with the time of the report from the dealer with the reporting obligation. Because the counterparty cannot confirm a trade before the trade has been executed, trades confirmed by the counterparty more than 90 seconds before the trade report were necessarily reported late by the broker-dealer with reporting responsibility. Even when a three-minute delay was used as a benchmark of lateness (rather than the legally required 90 seconds), 3.1% of broker-dealer to broker-dealer trades accounting for 4.3% of volume in the sample were reported as regular trades when they were late and should have been identified accordingly.

<sup>93</sup> The percentages of unreported late trades in the sample of broker-dealer to broker-dealer trades declined in 1995, falling to 5.4% of trades and 7% of volume.

<sup>94</sup> The late trade rate for trades of 500 shares and less is also high at 4.2%. This is attributable to operational problems experienced by several broker-dealers, including dealers that handle a large number of retail orders. In fact, a review of monthly data by trade size shows that the late trade rate for this group of trades fell by half in February 1995 when the operational problems were corrected.

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A similar pattern was found in broker-dealer to broker-dealer trades reported late without being designated late. In 1994, 4.6% of the sample of broker-dealer to broker-dealer trades between 501 and 1,000 shares were undesignated late trade reports. The rate of undesignated broker-dealer to broker-dealer late trade reports increased to 8.6% for trades between 5,000 and 9,999 shares and to 11.7% for trades of 10,000 shares or more. Percentages for this sample were similarly disproportionate for 1995, with 3.8% of trades between 501 and 999 shares, 6.9% of trades between 5,000 and 9,999 shares, and 9.6% of trades of 10,000 shares or more being reported late without being designated as such.

Because of the greater incentive to report large trades late, these higher percentages for large trade reports raise a concern that such late trade reports may have been the result of intentional reporting delays rather than negligence or computer errors. Testimony from traders and tapes obtained during the investigation indicate that some trades were intentionally reported late. A trade report, particularly the report of a large trade, may result in the market price of a stock moving in a manner detrimental to the reporting market maker's inventory position.<sup>95</sup> Some traders therefore deliberately delayed reporting trades to allow themselves time to cover their positions in a market in which prices and liquidity are unaffected by a timely trade report. In such situations, the trader covering his position is trading at a significant informational advantage to his counterparty.<sup>96</sup> The intentional delay of a trade report in such circumstances could be construed as an attempt unlawfully to manipulate the market.

Examinations of broker-dealers conducted in connection with this investigation confirmed the frequency of late trade reporting. The examinations uncovered hundreds of trades that were reported late but were not designated as late, in accordance with Schedule D of the NASD By-Laws.<sup>97</sup> The examinations also revealed numerous other inaccurate trade reports including (i) trades executed after the market closed and not identified accordingly; (ii) trades identified as

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<sup>95</sup> For example, if a market maker sells short a substantial block of stock to a customer, and reports the trade before the market maker covers its short position, other market participants, based upon the reported information, may perceive that the market maker has a substantial short position that it needs to cover and will demand a premium price for the stock.

<sup>96</sup> As noted *supra* in Part I.A.3.b., there is also evidence that certain market makers delayed trade reports in circumstances where they were buying or selling stock from a customer and contemporaneously covering their positions in the market, because they did not want their customer to see the prices obtained by the market maker or other parties in substantially contemporaneous trades.

<sup>97</sup> The staff conducted examinations of sixteen Nasdaq market makers, representing a sample of large New York based dealers, regional and mid-sized dealers, and wholesalers. In addition, examinations were conducted of certain market makers that, from a review of Nasdaq audit trail data, appeared to have reported numerous late trades without designating the reports as late.

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late that were not submitted late; (iii) trades reported incorrectly as executed after the market closed; (iv) trades not reported; and (v) inaccurate execution times submitted in trade reports.

The examinations also found that many of the order tickets created by the broker-dealers examined were inaccurate or otherwise deficient. Numerous order tickets contained the wrong execution time of the trade.<sup>98</sup> Other order tickets examined did not reflect any execution time for the trade. For a number of trades examined, the broker-dealers were unable to produce any order tickets at all, in violation of Rule 17a-4 of the Exchange Act.<sup>99</sup>

In sum, the scope of the trade reporting problem created significant difficulties for investors. This late trade reporting distorted the appearance of the market, misleading those who rely on the tape to make trading decisions and monitor the cost and quality of trade executions. Trade reporting problems also hamper the ability of investors, firms, and regulators to monitor broker-dealer compliance with a variety of investor protection rules, including limit order protection and markups. Intentional late trade reporting raises serious concerns about possible manipulative activity in the market. Thus, late and inaccurate trade reporting undermines the integrity of the Nasdaq market.<sup>100</sup>

## **2. The NASD's Enforcement of Trade Reporting Rules Was Inadequate**

The investigative record indicates that the NASD's enforcement of the trade reporting rules was inadequate. Until this investigation began, the NASD's surveillance program to detect

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<sup>98</sup> The execution times shown on many of the order tickets examined contradicted information shown on other records of the firm or on the audit trail. Posting incorrect trade execution times on order tickets violates Rule 17a-3 promulgated under the Exchange Act, 17 C.F.R. § 240.17a-3 (1995).

<sup>99</sup> 17 C.F.R. § 240.17a-4 (1995).

<sup>100</sup> The structure of the Nasdaq market contributes to trade reporting problems. In a dealer market, each market maker must install and maintain a trade reporting capability on its premises. By comparison, on an exchange, the trade reporting process is installed and maintained by the exchange, and the physical presence of key market participants on the exchange floor makes the trade reporting system easier to administer. The dispersion of vital parts of the trade reporting system in the Nasdaq market places added responsibility on market makers for monitoring their trade reporting systems. Particular attention must be paid to the personnel at trading desks, who are the human element in trade reporting, and cause delays in the submission of trade reports. Market makers must commit the resources necessary to ensure the soundness of their trade reporting systems to overcome the complications posed by the dispersed structure of the Nasdaq market.

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trade reporting violations was accorded low priority and was ineffective.<sup>101</sup> The NASD lacked sufficient procedures to identify and follow-up on patterns of trade reporting errors by particular firms.<sup>102</sup> Automated reviews designed to identify trades that may have been reported late were deficient, erroneously eliminating or ignoring potential late trades. This failure occurred despite the fact that the NASD identified the "lack of adequate exception reports" for late trade reports as an internal weakness in the 1992/1993 Market Surveillance Business Plan.

Although the NASD periodically generated a report of all trades designated as late, it did not review these reports on a regular basis, despite the large percentage of late trades reported. NASD examination programs for trade reporting were too limited in scope to detect adequately non-compliance with trade reporting requirements.<sup>103</sup> As a result of these deficiencies in the surveillance and examination programs, various trade reporting problems went undetected.<sup>104</sup>

The NASD's investigations of trade reporting violations have also proven inadequate. There have been delays in both conducting reviews and issuing sanctions, which were often insufficient and inconsistent with the NASD's penalty guidelines.<sup>105</sup> Prior to October 1994,

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<sup>101</sup> A trade report task force had been formed in 1993 to review member firm compliance with trade reporting rules, but the project was not given high priority, and its implementation was delayed, because a sharp increase in backing away complaints diverted Market Surveillance resources and the NASD did not provide additional resources.

<sup>102</sup> In addition, the NASD did not generate automated surveillance reports designed to identify trades that are reported late but not marked ".SLD" in accordance with Schedule D of the By-Laws. NASD Manual, Schedule D to the By-Laws, Part X, § 2 (CCH) ¶ 1867 (1995).

<sup>103</sup> For example, the NASD exam modules were designed to identify only trades more than two minutes late, even though the NASD By-Laws define a late trade as one occurring more than ninety seconds after the trade is executed. In addition, examiners selected sample sizes too small to detect patterns of trade reporting problems at individual firms.

<sup>104</sup> For example, the NASD failed to notice that certain high volume market making firms never properly reported after hours trades as occurring outside normal market hours as required by the NASD By-Laws.

<sup>105</sup> The NASD's published Sanction Guidelines state that for Trade Reporting violations monetary fines ranging from \$1,000 to \$100,000 may be imposed. In the period July 1990 through June 1994, of the 367 trade reporting cases that resulted in sanctions, only 34, or less than ten percent, resulted in any fine being imposed, and 20 of these resulted in fines of \$500 or less, notwithstanding the minimum \$1,000 fine set forth in the NASD Sanction Guidelines. None of the cases resulted in fines in excess of those described in

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the NASD had not sanctioned any member firms for a pattern of excessive late trade reports.<sup>106</sup> When the NASD detected trade reporting violations, it had insufficient procedures to ensure that the deficiencies were corrected.

Examinations by Commission staff revealed that the NASD also failed to monitor and enforce rigorously trade reporting compliance by NASD members trading exchange-listed securities in the OTC market. Certain exchange-listed securities are traded by NASD members in the OTC market, much the same way that they trade Nasdaq stocks: prices are quoted on Nasdaq workstations, and trades are executed over the telephone, SelectNet, or Instinet and reported through the NASD's ACT system. The NASD has rules requiring prompt and accurate trade reporting by market makers in exchange-listed securities comparable to those for market makers in Nasdaq securities, and the NASD is responsible for surveillance and enforcement of these rules.<sup>107</sup>

The Commission's examinations reviewed 329 complaints received by the NASD between January 1994 and June 1995 from exchanges that had detected trades reported by NASD members at prices outside the best bid or offer displayed in the market ("trade-throughs"). In many cases, the apparent trade-throughs were attributable to trade reporting errors by the NASD member, including late trade reports not marked late, and trades reported with incorrect prices. The NASD staff typically resolved such complaints by correcting the trade reports. However, the Commission's examinations found that the NASD staff did not refer any of these complaints for further investigation, including situations where best execution concerns were raised. Furthermore, the NASD had no formal procedures for identifying and referring trade reporting errors for further review. As a result, none of these complaints were analyzed for patterns indicating abuse, and no disciplinary actions were taken for repeated violations.

The deficiencies in the NASD's program for monitoring trade reporting compliance were highlighted in a subsequent cause examination by Commission staff of a firm that had been identified as responsible for a disproportionate number of violations during the examination period. The Commission's examination found extensive trade reporting violations in exchange-listed securities traded OTC, including late trades that were not marked late, trade reports marked late that were not late, and trades erroneously reported twice. The Commission's

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<sup>105</sup>(...continued)

the NASD Sanction Guidelines. The balance of the cases resulted in warning letters or letters of caution.

<sup>106</sup> Since October 1994, the NASD has taken action to improve its program to detect, investigate, and discipline member firms for trade reporting violations. The Department of Market Surveillance of the NASD implemented procedures to identify firms with excessive late trade reports and initiated actions that resulted in fines and a reduction in the percentage of late trade reports.

<sup>107</sup> NASD Manual, Schedule G to the By-Laws (CCH) ¶¶ 1917-22 (1995).

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examination also revealed that for a number of exchange-listed securities traded OTC, the firm failed to report trades representing significant percentages of total market volume for those securities. For example, in one security, over a period of three days, the firm failed to report trades representing 11% of total market volume in the security. On another day, the firm failed to report trades representing 12.9% of the total market volume in the security.

In some instances, when incorrect trade reports were brought to the attention of the NASD staff, their response was to correct the trade report or ask the firm making the report to submit a corrected report. The NASD did not take disciplinary action against the violators in these cases. A tape obtained during the investigation reflects one instance in which an NASD Market Surveillance supervisor inappropriately instructed a trader to submit an inaccurate trade report. The trader, who disclosed to the supervisor that a trade had occurred during a trading halt, was advised that it could be remedied by changing the reported time of the trade to make it appear to have been done prior to the trading halt. The same supervisor explained to another trader that the NASD efforts to make "corrections" to trade reports showing execution times during trading halts arose out of criticism of the NASD in the press.<sup>108</sup>

In sum, the NASD has failed to enforce adequately its trade reporting rules. It did not fully appreciate the significance of late trade reporting attributable to systems problems until after the Commission's investigation began, even though late trade reporting due to systems problems can significantly distort the appearance of the market. By bringing few disciplinary actions for late or inaccurate trade reporting, and imposing unduly light sanctions, the NASD put too little regulatory pressure on market makers to ensure timely reporting of trades, and thus did not serve the investors' interest in a full and accurate picture of transactions in the market.<sup>109</sup>

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<sup>108</sup> In advising the trader to modify a report of a trade reflected as occurring during a trading halt, the supervisor stated:

The only reason we are going to such great lengths is all the ripping that we've taken from the press. And frankly we've had a phone call from Dow Jones, from the Wall Street Journal, and they are doing a story on it, and that is one of the things they are asking about - - all these trades that are going through after the halt. They all look like they are being executed during the halt.

<sup>109</sup> One reason advanced by the NASD for its inattentiveness to enforcement of trade reporting requirements was that staff members were diverted by the filing of numerous backing away complaints by SOES activist firms in 1994. This does not explain the lack of enforcement of trade reporting in prior time periods, nor does it address inadequacies in the examination process. This contention may, however, point to inadequacies in the resources committed by the NASD to the enforcement process. The Rudman Committee report recommended increasing the resources devoted to enforcement. The findings of this investigation provide further support for that recommendation. However many resources are applied to the problem, the NASD must conduct a thorough evaluation of  
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## C. The Firm Quote Rule

### 1. The Importance of Firm Quotes

Under the Commission's "firm quote" rule,<sup>110</sup> a market maker is required to execute any order presented to it to buy or sell a security at a price at least as favorable to the buyer or seller as the market maker's published bid or offer and up to its published quotation size.<sup>111</sup> NASD rules also require that market makers honor their quotations.<sup>112</sup> The Commission has emphasized that SROs need to enforce strict compliance with the firm quote rule to ensure that investors receive best execution and that the market receives reliable quotation information.<sup>113</sup> As stated in the 1963 Special Study of the Securities Markets:

By quoting ostensibly firm markets over the telephone or wire dealers represent that a unit of trading can actually be bought or sold at the prices quoted. Upon the basis of these quotations, professionals check competing markets and prices and make their trading decisions. Broker-dealers also obtain these quotations in connection with their retail activities, so that investment decisions of customers and the quality of executions for customers may depend on them. In these and other respects, backing away from quotations impairs a basic mechanism on which orderly operation of over-the-counter markets depends.<sup>114</sup>

There are two exceptions to the firm quote rule under which market makers can reject orders. The first exception occurs when, prior to the receipt of the order, the market maker has communicated to its exchange or association a revised quotation size or revised bid or offer. The second exemption applies when, prior to the receipt of the order, the market maker is in the process of effecting a transaction in a security when an order in the same security is

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<sup>109</sup>(...continued)

personnel and training to assure the NASD's strict adherence to its obligations as an SRO.

<sup>110</sup> Exchange Act Rule 11Ac1-1, 17 C.F.R. § 240.11Ac1-1 (1995).

<sup>111</sup> A market maker who fails to meet his firm quote rule obligations is said to have "backed away" from its quote.

<sup>112</sup> NASD Manual, Schedule D to the By-laws, Part V, § 2(b) (CCH) ¶ 1819 (1995).

<sup>113</sup> See In re: Philadelphia Stock Exch., Inc., Admin. Proc. File No. 3-5890, 1980 SEC LEXIS 1891 (Philadelphia Stock Exchange censured for failure to enforce firm quote rule).

<sup>114</sup> Staff of Special Study of the Securities Markets, 88th Cong., 1st Sess., Report of the Special Study of Securities Markets, pt. 2 at 573 (Comm. Print 1963).

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presented, and immediately after the completion of such transaction, the market maker communicates to its exchange or association a revised quotation size or revised bid or offer (hereinafter referred to as the "trade-ahead" exception).

Market makers have a fundamental obligation to honor their quotations. Market maker quotations are one of the foundations of the Nasdaq market and the national market system. The reliability of quotations is essential to investor confidence and to an efficient process of price discovery. Failure to honor quotations deprives investors of the liquidity market makers advertise they will provide, and diminishes the credibility of the market. When quotations are not firm, investors seek other means for order execution, which results in market fragmentation.<sup>115</sup>

## 2. Failure to Honor Quotes

A significant number of market makers have failed to comply consistently with their firm quote obligations. Tapes of traders' telephone lines reviewed during the investigation include numerous conversations of market makers declining to transact at their quotes for seemingly spurious reasons. In addition, the tapes of market maker telephone calls and market maker testimony disclose that they often instructed other market makers to "give me ahead," i.e., use the name of the first market maker to claim a trade-ahead exception if a third market maker asks the second to complete a trade. The latter tactic may be utilized in reprisal for a perceived incident of backing away by the third market maker at some earlier point in time. Such a request may also be made if the market makers are competing for the same order flow<sup>116</sup> or

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<sup>115</sup> For example, one options market maker informed the staff that over the years he has directed approximately 95% of his trading in Nasdaq stocks to Instinet and stated that most traders use Instinet because they believe it has better prices and firm quotes. This options market maker stated that Nasdaq quotes are rarely firm and Nasdaq market makers would not display his bids between the inside spread.

<sup>116</sup> The following audio taped telephone conversation is between two Nasdaq traders at different firms.

Trader 1: I saw [stock] get a little weaker. I went out and hit [firm 3], and he told me [firm 4] ahead.  
Trader 2: Oh really?  
Trader 1: If [firm 4] comes in to you, give me ahead.  
Trader 2: OK.  
Trader 1: I just don't like the way . . . I don't like the stock. I got a feeling that my seller is going to come back and sell more.  
Trader 2: I got you.  
Trader 1: But I don't want to get you in trouble in the thing, either.  
Trader 2: Oh, it doesn't matter. I made some sales yesterday. I'm long 8  
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if a market maker moves its quotes in a manner that harms the requesting market maker.

### 3. Selective Refusal to Trade

Certain market makers have backed away from orders presented to them by firms that the market makers "dislike" or perceive to be overly competitive. Some market makers preferred not to trade with firms that they considered to be "professional traders," such as options market makers,<sup>117</sup> firms that act as block positioners,<sup>118</sup> exchange members with

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<sup>116</sup>(...continued)

now.  
Trader 1: Yeah. It's that I don't want to see you get hurt, so.  
Trader 2: Look.  
Trader 1: Stay put if you'd like, if you want. And, you know, then give me ahead or tell them you've got me tied up. Why don't we do that? Maybe we'll be able to make some more sales. I'm long about 5.  
Trader 2: OK.

<sup>117</sup> In the following audio taped telephone conversation, a market maker calls another market maker to inquire about consummating a trade in order to avoid trading with an options market maker.

Trader 1: [T]he option guys are trying to \*\*\*\*\* whack me [hit his bid].  
Trader 2: Oh.  
Trader 1: So I was like, \*\*\*\*, you know, I'd rather buy your. . . . If you don't want to sell your stock, that's fine.  
Trader 2: No, I already sold them. I sold them on Instinet at 1/4.  
Trader 1: Oh, you did?  
Trader 2: Yeah, I'm all right.  
Trader 1: All right, so there's a 1/4 print on the machine. That's all I care. . . .

<sup>118</sup> An audio taped telephone conversation discloses that, after being told by his trading assistant that his firm had sold stock to a block positioning firm, a trader made the following comments to the trading assistant.

Trader: I do not like [block positioner]. I do not want to trade with him, period. I know he's a non-market maker. He's brokering.  
Aide: OK.

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unlisted trading privileges for Nasdaq stocks,<sup>119</sup> and SOES firms. The evidence indicates that some market makers wanted to avoid trading with such firms because the trading "styles" of such firms may leave market makers at a disadvantage.<sup>120</sup> For instance, some market makers have testified that they believe that these firms will "front run" market makers orders<sup>121</sup> or

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<sup>118</sup>(...continued)

Trader: I am not interested in being short. . . . It's very important for me to make money this month. . . . I don't need this \*\*\*\*. It's very simple, no prints to anybody.

\* \* \* \*

Trader: I told you very specifically I did not want to be short the stock. I do not trade with [block positioner]. He is a scumbag in the stock. . . . I am not here to accommodate him, that's it, end of discussion.

<sup>119</sup> An exchange member may trade a security with unlisted trading privileges as if it were listed on the exchange. See Exchange Act § 12(f), 15 U.S.C. § 78l (1994).

<sup>120</sup> In the following audio taped telephone conversation, two traders at the same firm are discussing an order from an exchange member that makes a market in Nasdaq securities that traded on an exchange pursuant to Unlisted Trading Privileges.

Trader 1: Listen to me [name of Trader 2]. Listen to me. I took around four calls in here already that came in looking for that because they were paying for size looking for fast money. All these guys want to do the same thing. OK, now [name of UTP trading firm] is on the options floor. He watches Instinet. He sees what's going on. He is not a legitimate customer per se.

Trader 2: There are two out there. There are two [name of UTP trading firm]s. I've been telling you this once before. One is on the options floor. The other one is a retail call. They're upstairs at one of the buildings. They are not on the floor and that's where that order came from. . . . It's legitimate [name of UTP trading firm]. If it comes from the other call, I'd say no. But that one — I have two keys at [name of UTP trading firm]. I have a legitimate key and a \*\*\*\*\* key.

<sup>121</sup> In this context, the term "front running" is used to describe a practice of entering orders immediately after learning information that could affect the market for a given security. For example, a market maker might enter a 20,000 share order to sell in Instinet or  
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"pick off" market makers who are slow to update their quotes following news announcements. Such practices are considered "unprofessional" or "unethical" as between market makers and are discouraged within the market maker community.

The selective refusal of certain market makers to trade with these firms further erodes the underpinnings of the firm quote rule, and is unfair and inconsistent with the concept of a free and open market. It also hinders the development of the national market system. The options markets cannot operate efficiently if options market makers' trading in the underlying stock is hampered. The competitive benefits of permitting trading through Unlisted Trading Privileges are diminished if market makers can avoid trading with exchange specialists. The firm quote rule is vitiated if market makers can pick and choose the parties with whom they will trade. Refusals to trade contribute to market fragmentation, and thereby impair pricing efficiency and fairness to investors.

#### 4. The NASD's Enforcement of the Firm Quote Rule Was Inadequate

The NASD is responsible for ensuring that market makers comply with the firm quote rule. The policies and practices of the NASD were insufficient to detect and deter backing away by market makers. The NASD did not generate automated surveillance reports designed to identify potential instances of backing away. NASD examination modules did not address potential non-compliance with the firm quote rule by market makers. The NASD's oversight of compliance with the firm quote rule was limited to responding to complaints against market makers. However, there has been limited incentive to filing backing away complaints because a successful complainant was not awarded a trade execution. The only sanctions imposed by the NASD were fines against offending firms. This practice differs from many of the exchanges, where a floor official will instruct a specialist who improperly backed away to fill the order.<sup>122</sup> The lack of an adequate remedy acted as a disincentive to the filing of backing away complaints by aggrieved parties.

Even if a firm did file a backing away complaint, the NASD's procedures for processing complaints were deficient. Prior to 1994, the NASD required firms to submit written backing away complaints. The accused market maker would be given a copy of the complaint and told to respond within five days. Analysts in the Market Surveillance Department would review records and contact the traders involved. If the Market Surveillance staff felt that further action

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<sup>121</sup>(...continued)

SelectNet. Another firm may see this large order and try to sell short immediately and cover at a lower price after the larger order is executed.

<sup>122</sup> See NYSE Guide, Rules of Board-Dealings & Settlements, Rule 75 (CCH) ¶ 2075 (1996); Amex Guide, General & Floor Rules, Rule 126(h) (CCH) ¶ 9276.02 (1996). The NASD's sanction practices are also in contrast to the handling of trade-through complaints in the Intermarket Trading System ("ITS"). A prevailing ITS trade-through complainant is awarded a prompt fill at the quotation traded through.

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was warranted, the matter would be referred to the Market Surveillance Committee. The entire process could take months to complete.

Beginning in late January 1994 and just after the NASD limited access to SOES through the interim SOES rules, SOES firms began using SelectNet for much of their trading. Unlike SOES, which provided for automatic execution, SelectNet is an order delivery system that allows market makers to accept or reject orders. Immediately after the interim SOES rules went into effect, the NASD began receiving large numbers of backing away complaints from SOES firms.<sup>123</sup> The orders involved in these backing away complaints were mostly directed SelectNet orders.<sup>124</sup> The submission of large numbers of backing away complaints led the NASD to modify its existing procedures to facilitate a more expeditious review. The NASD's new procedures for processing and evaluating backing away complaints had the effect of favoring the market makers accused of backing away by eliminating complaints for reasons not set forth in, and inconsistent with, the Commission's and the NASD's firm quote rules. In connection with the investigation, the Commission staff reviewed a large number of backing away complaints filed with the NASD in 1994.<sup>125</sup> Although the NASD took no enforcement action in most of these cases, the Commission staff's review found that a significant number of these complaints were eliminated from consideration for disciplinary action even though they may well have violated the firm quote rule.

On March 10, 1994, the NASD issued a notice to its members that cited the increase in the volume of SelectNet backing away complaints and reiterated the obligation that market makers honor their quotes.<sup>126</sup> The March 10th Alert also set forth the procedures to file and respond to a backing away complaint. The complaining firm was instructed to contact the market maker within five minutes of the incident. If the complaint was still unresolved after

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<sup>123</sup> Over 4,700 backing away complaints were filed in 1994. In comparison, the NASD received 41 backing away complaints in 1993. The NASD had learned no later than 1991, however, that SOES firms had difficulty in executing phone orders through market makers. See *infra* note 188, and accompanying text.

<sup>124</sup> A firm entering a SelectNet order to buy or sell a Nasdaq security can direct its order to a single market maker (referred to as a "directed" or "preferenced" order). Directed SelectNet orders trigger the market maker's obligation to honor its quotes, assuming the order is priced at the market maker's quotes. SelectNet orders can also be broadcast to all market makers. SelectNet orders remain on the Nasdaq workstation for three minutes (unless the order entry firm specifies a longer time period), after which time the order automatically expires.

<sup>125</sup> The SEC staff reviewed a sample consisting of 1,616 complaints filed against 16 market makers.

<sup>126</sup> NASD Special Regulatory Alert, "NASD Reiterates Members' Firm Quote Obligations" (Mar. 10, 1994) [hereinafter "Alert"].

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such contact, the complaining firm had to contact the NASD's Market Surveillance Department within 15 minutes after the alleged backing away. An "official" backing away complaint form had to be filed in writing within 24 hours.

The Compliance Subcommittee of the NASD Market Surveillance Committee was responsible for ruling on the validity of backing away complaints and determining the appropriate sanctions for violations of the rule. In early 1994, the Compliance Subcommittee became concerned about its ability to process the increased number of backing away complaints and directed the Market Surveillance Department staff to develop guidelines for processing complaints. After reviewing and commenting upon the staff-generated criteria, the Compliance Subcommittee authorized on March 10, 1994 the use of new SelectNet backing away procedures to review complaints, even though certain of these criteria were not consistent with the Commission's and the NASD's rules regarding firm quotations.<sup>127</sup> Under these procedures, a market maker was entitled to the trade-ahead exception to the firm quote rule if (1) a trade was reported through the Automated Confirmation Transaction Service system ("ACT")<sup>128</sup> and the market maker's quotations were revised by the firm within two minutes of the SelectNet order; (2) a trade was reported within one minute prior to a SelectNet order and quotations were revised within ten seconds after the order; (3) a trade was executed through SOES within thirty seconds before an order and quotations were revised within ten seconds of the SelectNet order or within thirty seconds after the SOES execution; or (4) a trade was executed through SOES within thirty seconds after an order and quotations were revised within thirty seconds after the SOES execution. Additionally, the backing away procedures dictated that a complaint would be dismissed if the SelectNet order was cancelled before three minutes (when orders are automatically cancelled by the SelectNet system) by the complaining firm or if the complaint itself was deficient (e.g., filed late or lacked sufficient detail).<sup>129</sup> Any complaints that were

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<sup>127</sup> The criteria adopted by the Compliance Subcommittee went beyond the scope of the relevant factors outlined in the Alert. Although staff of the Commission's Division of Market Regulation had reviewed drafts of the Alert prior to its issuance, the staff was not apprised of all of the criteria adopted by the NASD for processing backing away complaints until it began an inspection of the NASD in July of 1994. The staff of the Division of Market Regulation did not approve the specific criteria adopted by the NASD for reviewing backing away complaints.

<sup>128</sup> The ACT system is an automated system for trade reporting and clearing owned and operated by NASD Market Services Inc.

<sup>129</sup> The Alert advised members that their "cancellation of preferenced SelectNet orders before a market maker has declined the order or before the order 'times out' will generally be deemed conduct evidencing a lack of an intent to trade, thus precluding the member from raising a valid backing away complaint." [Emphasis added.] The procedures adopted by the Compliance Subcommittee went beyond the guideline expressed in the Alert, making a cancellation prior to the expiration of three minutes an absolute bar to the filing of a backing away complaint.

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not resolved by application of the procedures were to be presented to the Compliance Subcommittee for further review.<sup>130</sup>

The backing away procedures nullified many valid complaints for reasons not permitted by the firm quote rule. All complaints involving orders that were cancelled by the order entry firm before they automatically expired after three minutes should not have been rejected.<sup>131</sup> Some of these cancellations were entered after the market maker moved its quotation without responding to the SelectNet order. Other orders were cancelled after the order entry firm completed the transaction through some other means. An order entry firm should not be required to bear the risk of continuing to expose its order to pursue a backing away complaint. A market maker's obligation to fill an order begins when the order is presented, and not upon the expiration of the three minute time period.

The NASD's backing away procedures also gave a market maker a trade-ahead exemption if it reported a trade and changed its quote within two minutes. The apparent logic behind the two minute time period was that a market maker was required to report a trade in ninety seconds and the extra thirty seconds represented an additional "cushion." Working backwards in time, a market maker was presumed to have been in the process of effecting that transaction when the directed SelectNet order was presented.<sup>132</sup> The many automated trading systems now in use, however, would have allowed the NASD, in evaluating backing away complaints, to determine whether such orders in fact preceded a directed SelectNet order. Instead, the NASD adopted an approach that had the effect of favoring the market makers by allowing any order within two minutes to qualify as a trade-ahead exception.

The backing away procedures also permitted a trade-ahead exemption for any SOES executions received within thirty seconds after the directed SelectNet order. Because SOES executions are automatic and instantaneous, a market maker could not have been in the process of executing a SOES order that was received after a SelectNet order. Such transactions clearly should not have qualified as trade-ahead exceptions.

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<sup>130</sup> The SelectNet backing away parameters and procedures were not published or generally disclosed to the NASD's members.

<sup>131</sup> The requirement imposed by the NASD that the SelectNet order had to be outstanding for a full three minutes for a backing away complaint to be valid effectively created a third exception to the firm quote rule, permitting market makers in these circumstances to avoid honoring their quotes where an order was validly presented to them.

<sup>132</sup> In using the time the other trade was reported (rather than the time of entry or execution), the NASD recognized the inadequacy of member firms' records for use in reconstructing trades. For telephone trades, most firms did not create records that evidenced the time that telephone orders were presented or executed. The lack of such records made it more difficult to analyze backing away complaints properly.

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In handling these complaints, the NASD staff applied the criteria of the protocol unevenly. The complaining firms were held to the letter of each requirement, while market makers were at times given the benefit of the doubt. For example, a complaint based on a SelectNet order which was displayed for a period of almost but not quite three minutes would be eliminated. However, a market maker who reported a trade and updated its quotations two minutes and a few seconds after the complainant's order was placed would sometimes be excused from having to execute that order.

Even where a market maker violated the terms of the protocol, often the NASD staff and Market Surveillance Committee failed to impose sanctions. In some instances, the staff of the Market Surveillance Department did not refer backing away complaints to the Compliance Subcommittee even though the complaints met the criteria of the backing away procedures. Valid complaints were also not forwarded due to the use by the Market Surveillance Department of the wrong trading data in evaluating the complaints and the expansion of the time periods for the trade-ahead exception. Examinations by the SEC staff indicated that at least an additional 76 complaints in the SEC sample should have been sent to the Compliance Subcommittee for review.

The Compliance Subcommittee also screened out certain complaints that satisfied the backing away parameters and had been forwarded by the Market Surveillance Department. Although the rationale of most of the Compliance Subcommittee's decisions was not memorialized in writing, it appears that these rulings were based on expanded time periods for a trade-ahead exception, or by a market maker's assertion that it was not aware of the directed SelectNet order, that its subsequent offer to execute a trade was refused, or that the order entry firm did not contact it about the incident. At least 29 complaints in the SEC sample that appeared valid under the terms of the procedures were dismissed without sanctions by the Compliance Subcommittee.<sup>133</sup>

The firm quote rule is triggered when an order is "presented" to the market maker. Because all directed SelectNet orders are delivered electronically to a particular market maker, the presentment of an order is readily ascertainable. In responding to backing away complaints, some market makers argued that if a directed SelectNet order to them scrolled off the SelectNet order screen and they did not observe it, then their inattentiveness relieved them of their firm quote obligations. In some cases, the Compliance Subcommittee of the Market Surveillance

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<sup>133</sup> The 76 complaints that should have been sent to the Compliance Subcommittee for review and the 29 complaints that should have been treated as valid by the Compliance Subcommittee (which total 105 complaints) are likely to understate the number of backing away complaints that were improperly tabled in the NASD's review process. These 105 complaints were instances in which the NASD staff or the Compliance Subcommittee did not follow the NASD's protocol, which was unduly lenient. Had more reasonable criteria been used to identify meritorious backing away complaints, the number of valid complaints would have been higher.

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Committee used the same logic to dismiss backing away complaints. The fact that SelectNet orders may have scrolled off the most frequently used screen on the Nasdaq workstation terminal does not excuse traders from complying with the firm quote rule.<sup>134</sup> It does illustrate, however, a defect in the NASD's trading systems that fostered non-compliance. After market makers raised the issue of orders scrolling off the trading screen, the NASD should have addressed, among other things, this design flaw in the Nasdaq workstation.

Even if a backing away complaint was found to be meritorious, the NASD did not always follow its own guidelines in imposing sanctions. The NASD's sanction guidelines set forth certain minimum penalties based on the number of violations committed within a twelve month period.<sup>135</sup> The NASD combined separate incidents of backing away by a market maker and counted them as one violation. The fines imposed on the market makers were thus often smaller than those set forth in the guidelines because of the consolidation of violations. The NASD's policies and practices with respect to backing away complaints consistently favored the market makers and did not act as a sufficient deterrent to market makers' non-compliance with the firm quote rule.

In sum, the NASD's lack of commitment to enforcing the firm quote rule was evident in its handling of the 1994 backing away complaints. Thus, it failed to secure for investors the liquidity that firm quotations provide and failed to dispel the false appearance of the market that illusory quotations project.<sup>136</sup>

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<sup>134</sup> Market makers claim that directed SelectNet orders often scrolled off their trading screens in a brief time span, especially in periods of high market volatility. SelectNet orders appear on the screen of the Nasdaq workstation terminal and a trader can adjust the number of SelectNet orders that would appear on the first page of the Nasdaq display. SelectNet orders that scrolled off the first page could be accessed on another page of the Nasdaq display, but traders rarely checked this page for active SelectNet orders. Instead, traders usually relied on phone calls from the order entry firm to alert them to these orders.

<sup>135</sup> The sanction guidelines set forth the following sanctions:

First violation	—	Letter of Warning
Second violation	—	Letter of Caution
Third violation	—	Acceptance, Waiver and Consent proceeding ("AWC") and \$1,000 fine
Fourth violation	—	AWC and \$2,500 fine
Fifth violation	—	AWC and \$5,000 fine
Sixth violation	—	AWC or Formal Complaint

<sup>136</sup> It should be noted that the deliberations of the Market Surveillance Committee and the reasons for its decisions on whether or not to authorize charges were poorly documented. (continued...)

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## II. THE NASD'S REGULATORY DEFICIENCIES

### A. The SOES Controversy

#### 1. Origin of the SOES Controversy<sup>137</sup>

SOES was established by Nasdaq in 1984 to permit small orders in Nasdaq stocks to be automatically executed at the inside quotes.<sup>138</sup> Since 1988, significant controversy has revolved around the SOES system and its use. There are two types of participants in SOES: SOES market makers and SOES order entry firms. A SOES participant must belong to the NASD and be registered as either a SOES market maker or SOES order entry firm in a particular stock. A dealer cannot be both a SOES market maker and a SOES order entry firm in the same security.

SOES was intended to achieve the timely and efficient processing of small trades, by providing automatic execution of a market order at the inside quotes for a required minimum

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<sup>136</sup>(...continued)

The committee's records are generally unclear regarding what discussion the committee engaged in and what basis the committee had for its decisions. Of particular concern are the cases which satisfied the parameters used by the NASD staff for a valid backing away complaint, but which the committee did not authorize for action. While the Commission's settlement with the NASD requires, among other things, that the Market Surveillance Committee shall no longer have a grand jury function, the activities of NASD disciplinary bodies should be thoroughly documented at all stages, in order to ensure compliance with the NASD's obligation to maintain a fair procedure for the disciplining of members and persons associated with members, as required by Section 15A(b)(8) of the Exchange Act.

<sup>137</sup> The NASD has a statutory obligation to oversee the Nasdaq market and to enforce its rules and regulations as to all member firms in an evenhanded and impartial manner. The record in the investigation suggests the undue influence of market makers and a lack of vigor and balance in the NASD's enforcement activities with respect to such firms that is inconsistent with its obligations. Section 19(g)(1)(B) of the Exchange Act, 15 U.S.C. § 78(l)(1)(B). The Report and Appendix should not be read to suggest any conclusion by the Commission on the merits of any specific enforcement action or inspection by the NASD of any SOES firm.

<sup>138</sup> NASD Notice to Members 88-43, June 22, 1988 (adopting amendments to the Rules of Practice and Procedures for the NASD Small Order Execution System).

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size, even during periods of heavy volume.<sup>139</sup> During the market break of October 1987, however, many SOES market makers withdrew from the SOES system, which forced SOES-eligible customers to attempt to obtain execution of their orders by telephone.<sup>140</sup> As a result of the October 1987 market break, the NASD took steps to ensure that investors would have access to the SOES system even in periods of high volume. On June 30, 1988, SOES was changed to require all Nasdaq market makers to participate in SOES and the penalty to market makers for unexcused withdrawals of quotations from the Nasdaq system was increased.<sup>141</sup>

After SOES became mandatory for all Nasdaq market makers in NMS securities, there was an increase in trading by customer accounts at SOES order entry firms whose primary, if not exclusive, business line was promoting SOES trading ("SOES firms"). These firms, sometimes referred to as "SOES bandits," "SOES activists," "day traders," or "SOES abusers," developed trading strategies based on the automatic execution capabilities and firm quotes available in the system, which involved entering orders for customer accounts in response to changes in market conditions or promptly after the announcement of news or other relevant market information, but before a market maker updated its quote.<sup>142</sup> The position established in the customer accounts would be closed out after market makers had updated their quotations. This style of trading was commonly referred to as "picking off" a market maker.

Considerable acrimony developed between the market makers and the SOES firms.<sup>143</sup>

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<sup>139</sup> Because SOES reports trade data automatically, a trader would not have to spend time processing trade related paperwork. Additionally, SOES trades can be completed without having to make a telephone call to another market maker. SEC Division of Market Regulation, The October 1987 Market Break, Feb. 1988, p. 9-13 [hereinafter referred to as "The October 1987 Market Break Report"].

<sup>140</sup> The October 1987 Market Break Report, pp. 9-14 and 9-15. Telephonic access to dealers was already difficult during the market break, due to the high volume of orders.

<sup>141</sup> After the rule changes, a market maker was subject to a twenty business day suspension for unexcused withdrawal from the Nasdaq system. NASD Notice to Members No. 88-43, June 22, 1988. Previously, the penalty for an unexcused withdrawal was a two-day prohibition. The October 1987 Market Break Report, p. 9-13, n.40. But see, infra Part II.B.1., for discussion of NASD's failure to adequately discipline members for unexcused withdrawals.

<sup>142</sup> See NASD Notice to Members No. 91-67, Oct. 16, 1991.

<sup>143</sup> For example, interviews with persons at SOES firms disclose that certain market makers frequently made obscene remarks to such persons during telephone calls. Review of SelectNet text messages uncovered other harassing messages directed by market makers at SOES firms, although the use of obscenities on SelectNet is prohibited by the NASD. (continued...)

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Market makers viewed SOES firms as market professionals who were profiting from rapid fire trading on a system not designed for such activity. Market makers asserted that this activity resulted in their institutional customers receiving inferior prices. For their part, the SOES firms asserted that automatic execution was the best way to complete a trade, because market makers often "backed away" from any telephone orders placed by SOES firms.

Because SOES executions do not require the specific agreement of the market maker to the order, the market makers could not preclude the trading activities of the SOES firms without withdrawing from the market. Market makers turned to the NASD to urge that it limit the impact of SOES.

The market makers sought to deal with the competitive problems posed by SOES by enlisting the support of the NASD in three areas: (1) rulemaking and interpretation; (2) the aggressive investigation of SOES firms and enforcement of the SOES rules; and (3) the restriction of admissions and an increase in conditions to NASD membership. In each of these areas, the NASD took steps to constrain the activities of SOES firms.

## **2. SOES Rulemaking in Response to Market Maker Complaints**

### **a. Limiting Access to SOES**

Four significant modifications have been made to the SOES rules since the system became mandatory in 1988. Each of these modifications limited the access to the SOES system of SOES firms and their customers, or decreased the obligation of market makers to execute SOES orders.<sup>144</sup> The market makers pressed these changes to the SOES rules through lobbying efforts, majority participation in NASD committees, and, in certain instances, influence with the NASD staff.

Amendments to the SOES rules typically originated with either the NASD's Trading Committee or the Market Surveillance Committee. The rules proposed by the committees were

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<sup>143</sup>(...continued)

At the 1991 annual meeting of the Security Traders Association, "SOES Sucks" buttons were distributed to general acclaim.

<sup>144</sup> For example, the volume which market makers were obligated to trade on SOES has ranged from a high of 5,000 shares in 1988 to a low of 500 shares in 1993. In 1995, notwithstanding the NASD's efforts to hold market makers' size obligation on SOES to 500 shares, the Commission restored a minimum of 1,000 shares. Exchange Act Release No. 35535 (Mar. 27, 1995), 60 Fed. Reg. 16690 (Mar. 31, 1995).

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approved by the NASD Board of Governors<sup>145</sup> and ultimately by the Commission. During the relevant time period, a significant majority of Trading and Market Surveillance Committee members were associated with firms that made markets.<sup>146</sup> Additionally, a significant number of NASD committee members also were officers of market maker trade associations. Some were from STA, while others were from a regional affiliate of STA, the Security Traders Association of New York, Inc. ("STANY").<sup>147</sup> Of 61 individuals who have served as officers, directors, or governors of the STA or STANY between 1988 and 1994, about half (29) have also served on significant NASD boards, committees, or subcommittees,<sup>148</sup> in most cases (24) simultaneously with their service at STA or STANY.<sup>149</sup>

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<sup>145</sup> The Board did not modify or reject any of the proposed amendments. The conduct of the Board in this regard is consistent with the Rudman Report's finding that the Board acted "primarily as a 'referee' in the rulemaking process," Rudman Report at IV-3, and that "the Trading Committee wields significant power in the NASD's regulation of the Nasdaq market." Rudman Report at IV-6.

<sup>146</sup> From 1987 to 1994, 39 out of 49 members of the Trading Committee came from firms that made markets. During the same time period, 36 of 39 members of the Market Surveillance Committee also worked for firms engaged in market making. Not one was affiliated with a firm generally considered to be a SOES firm.

Appointments to the Trading Committee and Market Surveillance Committee have been controlled by senior NASD officials. Members of the Trading Committee were selected by a three-person panel consisting of the NASD President, the outgoing Chairman of the NASD Board of Governors, and the incoming Chairman of the NASD Board of Governors. Members of the Market Surveillance Committee were selected by a nominating committee consisting of the two past chairs of the Market Surveillance Committee and three members of the Board of Governors.

<sup>147</sup> See, e.g., Letter from STANY to Jonathan Katz, Secretary of the Commission, dated May 28, 1991 ("STANY represents more than 1200 individuals in the greater New York metropolitan area, the majority of whom are NASDAQ market makers.").

<sup>148</sup> These boards, committees, and subcommittees include the NASD Board of Governors, the NASD Executive Committee, the NASD National Nominating Committee, the National Business Conduct Committee, the Market Operations Review Committee, the Market Surveillance Committee (including its Compliance and Investigations Subcommittees), the SOES Users Committee, the Trading Committee (including its Quality of Markets, SelectNet/SOES, and SOES Tier Size Review Subcommittees), and the various District Committees of the NASD.

<sup>149</sup> This is not to suggest that market makers may not, directly or through their trade associations, lobby their regulators or participate in the governance structure of the  
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The first significant modification to SOES occurred in August 1988, when the NASD issued a rule interpretation relating to the maximum order size in SOES.<sup>150</sup> The rule interpretation concerned the "order splitting" provision of the SOES rules.<sup>151</sup> This provision set a maximum size for SOES orders<sup>152</sup> and prohibited the division of larger orders into smaller parts to avoid the size limitations. The August 1988 rule interpretation provided that in certain circumstances trades of different customers should be aggregated in determining non-compliance with the order splitting rule. The NASD redefined "split orders" to include trades done on a discretionary basis by a single trader.<sup>153</sup>

The August 1988 rule interpretation resulted from concerns expressed by the SOES Users Committee, an NASD committee consisting largely of market makers, and recommendations made by the market makers through the STA and its regional affiliates.<sup>154</sup> The STA stated in a July 27, 1988 letter to the President of the NASD, that its members were "extremely concerned" about rapid-fire SOES executions. The STA suggested, among other things, that orders in discretionary accounts be combined for purposes of the order splitting rule. The

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<sup>149</sup>(...continued)

NASD. However, the undue influence of market makers diminished the objectivity and effectiveness of the NASD. This contributed to the failure of the NASD to enforce its rules evenhandedly.

<sup>150</sup> NASD Notice to Members 88-61, Aug. 25, 1988.

<sup>151</sup> NASD Manual, SOES Rule c(3)(C) (CCH) ¶ 2460 (1995).

<sup>152</sup> There are three tiers (1,000, 500, or 200 shares) depending on the trading characteristics of the security involved.

<sup>153</sup> According to the rule interpretation, if two or more trades flowed from a "single investment decision," then those trades were aggregated. A single investment decision was presumed if the trades occurred within a five minute period in accounts controlled by either a customer or a person associated with the SOES firm. Control would be inferred if the customer or associated person exercised discretion over the account, was granted a power of attorney, or if the account was the personal account of the customer or associated person (including the immediate family of the associated person). NASD Notice to Members 88-61, Aug. 25, 1988.

<sup>154</sup> NASD employees and committee members drafted the actual text of this and other amendments to the SOES rules. The NASD staff was prompted by the SOES Users Committee in June 1988 to examine the use of SOES by persons associated with member firms who had discretionary authority over customer accounts. In general, the NASD committees worked with the NASD staff to develop ideas to alter the existing regulatory framework.

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NASD's rule interpretation, issued less than one month later, incorporated the STA's recommendation.

In crafting the rule interpretation to include trades where there was a common associated person, such as a trader or broker, and not just a common customer, the NASD was able to classify a large part of the business of SOES firms as split orders. At the time of the rule interpretation, the NASD believed that many SOES trades were made on a discretionary basis. The effect of the rule interpretation was to reduce the volume of trading by SOES firms. The interpretation of "order splitting" served as the basis for a number of NASD disciplinary actions, including cases against SOES firms.

The NASD further amended the SOES rules in December 1988 by adopting the professional trading account ("PTA") rule. This rule permitted the NASD to designate a customer's account as a PTA if certain criteria were met.<sup>155</sup> Once the account was classified as a PTA, no SOES trades could be executed for that account, which in effect disqualified the account from access to the SOES system. Market makers initiated the rule change. An August 8, 1988 memo from NASD staff members to the SOES Users Committee<sup>156</sup> listed proposed restrictions to access on SOES and stated "[t]he above proposals were suggested by members who have complained about the abuse of SOES by certain order entry firms." STANY supported further denial of access to "day traders," and the NASD advanced the proposal.

The third major group of modifications of the SOES rules occurred in October 1991. These modifications followed from the complaints of member firms to the NASD staff about the activities of SOES firms in the spring of 1990. The Trading Committee and Market Surveillance Committee, both of which consisted largely of representatives of firms that made markets, considered possible rule changes proposed by the NASD to broaden the definition of a PTA at meetings in June and July 1990, respectively. A letter dated October 31, 1990 from STANY to the Chairman of the NASD's Trading Committee advocated changes to the SOES rules and recommended three solutions to the problem of SOES abuse, including expanding the definition of a PTA. These recommended solutions also included the use of a time delay between SOES

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<sup>155</sup> Using a two-prong test, the NASD defined a professional trading account as an account in which (1) five or more day trades (buy and sell in same security on same day) via SOES were made; or (2) there was a professional trading pattern as evidenced by a pattern of day trades, a high volume of day trades as compared to longer term transactions, or a high volume of day trades in relation to amount and value of securities in the account. NASD Notice to Members 88-103, Dec. 19, 1988.

<sup>156</sup> Like the Trading Committee and the Market Surveillance Committee, the SOES Users Committee (which was eliminated in 1990) consisted largely of representatives of firms that made markets. See Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors, p. IV-25, n.56 (Sept. 15, 1995).

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executions by a market maker.<sup>157</sup> Testimony confirms that the suggestion for a time delay came directly from the market makers.

The change in the definition of a PTA expanded the types of activity that could be used to classify an account as a PTA.<sup>158</sup> The amendments to the PTA definition were challenged as overly burdensome and vague, and this rule was ultimately repealed after being criticized by the U.S. Court of Appeals for the D.C. Circuit in Timpinaro v. SEC.<sup>159</sup>

The October 1991 SOES rule amendments as filed with the Commission also allowed for the modification of the SOES operating software to provide for a fifteen-second delay between executions by a particular market maker. The purpose of this delay was to give the SOES market maker an opportunity to update its quotations after receiving a report of a trade executed through SOES. In fact, the NASD implemented an effective delay of twenty seconds, which reduced the ability of SOES users to obtain executions.<sup>160</sup> The purported rationale for the additional five-second delay was to allow for the time taken for the electronic transmission of

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<sup>157</sup> The third proposal suggested in the October 31, 1990 letter was to ban all short selling on SOES. This suggestion was later adopted in the so-called interim SOES rules, which became effective on a pilot basis in January 1994. See NASD Special Notice to Members 94-1, Jan. 5, 1994.

<sup>158</sup> Day trading was redefined to include using SOES on only one side of a buy and sell transaction. Under the 1988 version of the PTA rules, day trading required the use of SOES on both sides of the transaction. Under the second prong of the test, the 1991 amendments permitted the use of additional factors in considering whether an account was a PTA. These criteria included: (1) excessive frequency of short-term trading; (2) excessive frequency of short-sale transactions; (3) trading of discretionary accounts; and (4) direct or physical access to Nasdaq quotation screens or SOES terminals. NASD Notice to Members 91-67, Oct. 16, 1991.

<sup>159</sup> 2 F.3d 453 (D.C. Cir. 1993). The NASD did not publish any guidelines as to what frequency of short term trades or short sale trades was "excessive." Thus, even the NASD analysts and supervisors responsible for selecting accounts for possible PTA designation did not have objective criteria for distinguishing between excessive and acceptable trading. Contemporaneous notes and testimony concerning a June 27, 1990 meeting of the Trading Committee indicate that the Committee believed that excessive trading should not be defined quantitatively and a "[y]ou know it when you see it" standard should be used.

<sup>160</sup> The Release by the Commission approving the proposed rule changes explicitly noted that the delay function was set at fifteen seconds and stated that "[a]ny change in the time period must be submitted to the Commission for review pursuant to Section 19(b) of the [Exchange] Act." Exchange Act Release No. 29810 (Oct. 10, 1991), 56 Fed. Reg. 52098 (Oct. 17, 1991), n.10. The NASD has never made any such submission.

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execution reports and quote updates. According to internal NASD studies, however, any delays in transmission occurred only at the opening of busy trading days and the vast majority of any such delays were no more than two to three seconds in length. The NASD should have set forth in its filings with the Commission seeking approval for the delay that the time between executions had been set at twenty seconds, but did not do so. The existence of the additional five second delay was discovered by the Commission staff during the investigation.

The final change to the SOES system involved the interim SOES rules and the proposed N\*PROVE system, both of which were part of a single initiative to reform SOES. The stated purpose of N\*PROVE was to replace SOES's immediate automatic execution with an order delivery system. The proposed N\*PROVE system allowed a market maker fifteen seconds to accept or decline an incoming order, before the order was executed by the system.<sup>161</sup> The N\*PROVE system was proposed by the NASD as a replacement for SOES, but was ultimately withdrawn by the NASD without any formal action by the Commission.

The interim SOES rules were a series of modifications designed to alleviate market maker concerns about SOES "abuse" until N\*PROVE became operational. The interim SOES rules included provisions for the reduction of the maximum SOES order size from 1,000 shares to 500 shares,<sup>162</sup> a reduction in the number of times that a market maker would be exposed to SOES executions from five to two with a fifteen-second interval between the two executions,<sup>163</sup> the authorization for Nasdaq to offer an automated quote update feature that would move a market maker's quote away from the inside quote after a SOES execution of an order in the maximum SOES order size,<sup>164</sup> and a prohibition on short sales in SOES.

As before, market makers (both on and off the NASD's Trading Committee) initiated these further restrictions on SOES trading. A market maker who was an STA officer (as well

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<sup>161</sup> A market maker could refuse a N\*PROVE order only if a valid exception to the firm quote rule, 17 C.F.R. §240.11Ac1-1(c) (1995), was available.

<sup>162</sup> This reduction was made even though market maker quotes in many Nasdaq NMS stocks must be valid for at least 1,000 shares under the firm quote rule.

<sup>163</sup> The reduction in maximum order size and the reduction in number of executions effectively reduced a market maker's exposure on SOES from 5,000 to 1,000 shares, after which the market maker had five minutes in which to refresh its quotations.

<sup>164</sup> Some individual broker-dealers already had auto-quote update systems in place, which they had designed themselves. These programs, sometimes referred to as "bandit systems," updated a quotation upon receipt of a SOES execution, but only if specified SOES order entry firms were involved. Generally, the firms identified by such systems were ones believed to be sponsoring active SOES trading. The Nasdaq Stock Market's auto-quote update system did not permit the market maker selectively to update quotes based on the identity of the order entry firm.

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as a NASD committee member) testified that he conceived of the reduction in the maximum SOES order size to 500 shares. The STA was also a source for the proposal to reduce the number of times a market maker was exposed to SOES executions. As noted above, STANY had previously suggested a ban on SOES short selling. The market makers also supported the conversion of SOES into an order delivery system, because this gave them a measure of control over whether or not to enter into a given transaction.

The Commission approved the interim rules in December 1993, but limited the rules to a one-year pilot program to provide an opportunity to test the claims that active trading on SOES impaired market quality.<sup>165</sup> One year later, the NASD sought to extend the interim rules, arguing that the rules indeed had resulted in decreased spreads and volatility in Nasdaq. For example, in filings with the Commission, the NASD asserted that "the interim SOES rules have been associated with positive market developments in terms of lower spreads on Nasdaq"<sup>166</sup> and that "spreads in Nasdaq securities experienced a decline in the immediate period following implementation" of the interim rules.<sup>167</sup> These positions were inconsistent with statements and data presented by the NASD at the Bear Stearns Meeting on May 24, 1994 that spreads had not narrowed following adoption of the interim rules.<sup>168</sup>

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<sup>165</sup> Exchange Act Release No. 33377, (Dec. 23, 1993), 58 Fed. Reg. 69419, 69424 and 69429 (Dec. 30, 1993).

<sup>166</sup> Exchange Act Release No. 35077 (Dec. 9, 1994), 59 Fed. Reg. 65105, 65107 (Dec. 16, 1994).

<sup>167</sup> Exchange Act Release No. 35080 (Dec. 9, 1994), 59 Fed. Reg. 65109, 65110 (Dec. 16, 1994). In support of its proposal to extend the interim rules, the NASD submitted an econometric study purporting to show a decrease in spreads as a result of the interim rules. The NASD also submitted an economic study by an outside consulting firm that purported to show "a statistically significant improvement in effective spreads for the top 100 Nasdaq stocks (based on dollar volume) during the three month period following implementation of the rules." Letter from NASD to Securities and Exchange Commission, at 15 (Jan. 12, 1995).

<sup>168</sup> See *supra* notes 39-40 and accompanying text. The NASD has continued to argue in its Commission filings that active trading on SOES was responsible for wide spreads. See, e.g., letter from NASD to Securities and Exchange Commission, at 2-3, 8-9 (Mar. 22, 1995) (SOES rules "have been associated with narrower spreads"); Exchange Act Release No. 36154 (Aug. 31, 1995), 60 Fed. Reg. 45502 (Aug. 31, 1995) ("the NASD continues to believe that concentrated bursts of SOES activity by active order-entry firms contribute to increased short-term volatility, wider spreads, and less market liquidity on Nasdaq").

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b. **Commission Action on SOES Rules Amendments**

The Commission's approval of the various modifications to SOES was based on its assessment of the apparent costs and benefits of the amendments. From the outset, the NASD, the STA, and individual market makers raised serious concerns that the manner in which SOES orders were entered by certain firms could "impose substantial additional costs and risks on SOES market makers" that "could cause market makers to reduce substantially the number of securities for which they make a market."<sup>169</sup> Opponents of the NASD's modifications to SOES challenged the theory that SOES orders produced the harms alleged and argued that the changes were discriminatory and anticompetitive.

The Commission's role in approving the NASD's rule changes was first, to evaluate whether certain types of SOES use that were claimed to be abusive did indeed threaten the efficient functioning of the NASDAQ market, and second, whether the response to that threat was rational and measured.<sup>170</sup> While the underlying rationale of the system of self-regulation requires the Commission to accord deference to the expertise and knowledge of the self-regulatory organizations for the markets it regulates, the Commission must carefully consider all comments received, and independently evaluate the facts. Each time the Commission engaged in this weighing process from 1988 to 1993, it determined that the balance of expected harm outweighed the restrictive effects on order entry firms. In approving the rule changes, the Commission balanced its predictive judgment against "the relative difficulty of generating any meaningful empirical studies on the effects of professional trading."<sup>171</sup>

The Commission first undertook to consider empirical evidence in evaluating the effects of SOES on market quality when the PTA rules were remanded to the Commission by the U.S. Court of Appeals for the D.C. Circuit in 1993.<sup>172</sup> The court noted that while the Commission's approval of the rules was based on a "sound theory of market behavior," the Commission should have explored whether it was possible to determine these issues through empirical analysis of trading data.<sup>173</sup> Accordingly, in evaluating subsequent NASD proposals

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<sup>169</sup> Exchange Act Release No. 26361 (Dec. 15, 1988), 53 Fed. Reg. 51605, 51605 (Dec. 22, 1988).

<sup>170</sup> Exchange Act Release No. 33377, (Dec. 23, 1993), 58 Fed. Reg. 69419, 69420 (Dec. 30, 1993).

<sup>171</sup> Exchange Act Release No. 32092, (Apr. 1, 1993), 58 Fed. Reg. 18279, 18281 (Apr. 8, 1993).

<sup>172</sup> Timpinaro v. SEC, 2 F.3d 453 (D.C. Cir. 1993).

<sup>173</sup> Id. at 458-60. After the Timpinaro case, the NASD chose to withdraw the PTA rules, in part because they had not been particularly successful in limiting the use of SOES, and  
(continued...)

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to modify SOES, the Commission focused on whether active SOES trading produced a quantifiable impact on market quality that would justify restricting access to the system.

In this regard, the Commission examined the validity of arguments about the effects of active SOES trading when it considered the NASD's interim rules proposal. In particular, the Commission reviewed a study submitted by the NASD attributing wide spreads and increased volatility to SOES trading. Based on its own analysis as well as comments received, the Commission found that the study was inconclusive and did not establish the purported result.<sup>174</sup> In the absence of any conclusive empirical analysis, the Commission limited approval of the rule changes to a one-year pilot program to provide an opportunity for the Commission and the NASD to assess the impact of the rules on spreads and volatility.<sup>175</sup> Although the Commission noted its concern over the lack of reliable statistical analysis, it approved the rules, among other reasons, because of the limitation on their duration and the commitment to monitor the rules' effect.<sup>176</sup>

One year later, the NASD sought to extend the interim rules, arguing that the rules had limited the effects of active SOES trading in Nasdaq, resulting in decreased spreads and volatility. However, based on its review of the NASD's arguments and analyses, the Commission determined that the NASD had not made the requisite showing that the interim rules resulted in decreased spreads and volatility.<sup>177</sup> Accordingly, the Commission indicated that an extension of the interim rules beyond a 60-day phase-out period could not be justified under the applicable statutory standard.<sup>178</sup>

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<sup>173</sup>(...continued)

submitted new rules (the interim rules are discussed supra notes 162-68 and accompanying text).

<sup>174</sup> Exchange Act Release No. 33377, (Dec. 23, 1993), 58 Fed. Reg. 69419, 69424 (Dec. 30, 1993).

<sup>175</sup> Id. at 69424 and 69429.

<sup>176</sup> Exchange Act Release No. 35275 (Jan. 25, 1995), 60 Fed. Reg. 6327, 6327-28 (Feb. 1, 1995).

<sup>177</sup> Id. at 6328-29.

<sup>178</sup> Id. Accordingly, the prohibition on short selling through SOES was allowed to expire on January 25, 1995, Exchange Act Release No. 35077 (Dec. 9, 1994), 59 Fed. Reg. 65105 (Dec. 16, 1994), and the reduction in the SOES maximum order size to 500 shares was allowed to expire on March 28, 1995. Exchange Act Release No. 35535 (Mar. 27, 1995), 60 Fed. Reg. 16690 (Mar. 31, 1995). The Commission has extended the remaining two components of the interim SOES rules.

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Although the NASD learned over time that factors other than SOES likely contributed to the width of spreads on Nasdaq, such information was not adequately made known to the Commission as the NASD sought further amendments to the SOES rules.<sup>179</sup> The process by which the NASD proposed and implemented the SOES rules illustrates the extent to which the NASD allowed itself to advocate the interests of market makers.

**c. Effect of SOES Rules Amendments**

The changes to the SOES rules from 1988 through 1994 consistently favored the interests of the market makers over those of the SOES firms. These rule changes largely evolved from concepts developed by market makers, who proposed them to the NASD staff. The resulting rule changes were approved through the NASD's rule making process, which was unduly influenced by firms that made markets. The NASD should have ensured that other interested member firms, investors, and issuers received adequate consideration in the rule making process. The NASD staff was institutionally constrained from advocating in a balanced way the interests of all its constituencies.

**3. The NASD's Focus on the Examination and Disciplining of SOES Firms**

The NASD made enforcement of the SOES rules a priority.<sup>180</sup> Planning documents of the District offices expressly identified as a goal the "aggressive enforcement of SOES rules," and various Market Surveillance Department staff members devoted substantial time and effort to enforcement of the SOES rules.<sup>181</sup> The Market Surveillance Department established a

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<sup>179</sup> See supra notes 39-40 and accompanying text and Part I.A.2.

<sup>180</sup> The institution of a NASD disciplinary action typically followed from an investigation by the NASD's staff. If a matter appeared to warrant formal disciplinary action, the staff brought it before a NASD committee for review. District office inquiries were reviewed by the District Business Conduct Committee ("DBCC") and investigations by the Market Surveillance Department were reviewed by the Market Surveillance Committee. If the respective Committee decided to bring a formal disciplinary action, a hearing was held in accordance with the NASD's Code of Procedure. A decision adverse to the respondent could be appealed to the National Business Conduct Committee ("NBCC"), then to the NASD Board of Governors and ultimately to the Commission. A decision adverse to the staff could not be appealed.

<sup>181</sup> The enforcement of the SOES rules was largely, though not exclusively, within the domain of the Market Surveillance Department and the Market Surveillance Committee. The District offices could investigate and prosecute violations of the SOES rules, and they also provided assistance to any inquiries being conducted by Market Surveillance. Such assistance usually took the form of conducting examinations of member firms, accumulating and analyzing documents, and testifying at subsequent disciplinary hearings.

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dedicated telephone line listed in the NASD Manual through which market makers and others could register complaints about specific SOES transactions.<sup>182</sup> Logs maintained by the NASD reflect that market makers lodged hundreds of complaints regarding alleged violations of the SOES rules. Many of these complaints related specifically to trading by SOES firms and some were relied upon as the basis for instituting investigations by the NASD staff.<sup>183</sup> Complaints made by market makers to other individuals at the NASD were also passed on to Market Surveillance for possible review.<sup>184</sup> Senior Nasdaq officers ensured that Market Surveillance followed up on the complaints of market makers.

In a 1992 memorandum, a senior NASD executive wrote that the market makers are "extremely frustrated and angry. Unless they get some immediate relief the subject of SOES abuse is going to come back to haunt us." One "possible measure" identified in the memorandum is "immediate prosecution of SOES violations with simultaneous suspension from

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<sup>182</sup> In contrast, no such effort was taken specifically for complaints about late trade reporting or market makers not honoring their quotations.

<sup>183</sup> Two examples illustrate the NASD's responsiveness to market maker complaints about SOES. In June 1994, a market maker complained to senior officers of the Nasdaq market that a large number of SOES trades in a single stock had been executed against it by a particular SOES firm. NASD officials in Washington, D.C. directed examiners at District 10 to conduct a highly unusual same day examination. Moreover, all of the trades were cancelled by the NASD as "clearly erroneous," pursuant to NASD Uniform Practice Code § 70. NASD Manual, Uniform Practice Code, § 70 (CCH) ¶ 3570 (1995).

A January 1991 report of the examination of another SOES firm noted that "[t]he staff has continuously received complaints from member firms that [name of SOES firm] is abusing the Small Order Execution System (SOES). Many of the firms allege that they had received SOES orders from [name of SOES firm] in fast moving markets and were disadvantaged by these orders." An examination of the SOES firm was conducted even though the complaints did not necessarily indicate illegal activity. No evidence of wrongdoing was uncovered and the matter was filed without action.

<sup>184</sup> Market makers lobbied the NASD to take disciplinary action against SOES activists. An April 1995 memo from the NASD Liaison Committee of the STA reads:

There is considerable consternation in the Street over what is perceived as the NASD's inability to discipline "SOES firms" for obvious violations of the Short Sale Rule. The senior staff of Market Surveillance, the Chairman of the Market Surveillance Committee and the NASD President have been informed of this growing resentment. Look for the NASD to take some severe action in the near future or else face a difficult situation with its market makers.

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SOES. I can't emphasize how important this is. Even if we bring a precise, abbreviated complaint that can get immediate relief, following up with a full investigation with all i's dotted and t's crossed." This memorandum was distributed to, among others, the two top NASD executives with responsibility for the disciplinary process.

The NASD made substantial efforts to identify the SOES firms and closely monitor their trading activity. SOES firms were generally subjected to routine examination every year.<sup>185</sup> At least one market maker provided an NASD officer with a list of "SOES bandits" and this officer forwarded the list to the Market Surveillance Department. A senior Market Surveillance officer wrote the market maker to thank him for the list and assured him that the NASD was familiar with the names on the list. The letter encouraged the market maker to support the 1991 proposed rule amendments designed to limit SOES "abuse."<sup>186</sup>

At various times, the NASD conducted a coordinated series of exams at SOES firms to look for potential SOES rule violations. Such "SOES sweep exams" were often, but not exclusively, made soon after amendments to the SOES rules. Thus, comprehensive SOES sweep exams were conducted in January 1991, December 1991, August 1992, and February 1994.<sup>187</sup>

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<sup>185</sup> Routine examinations were conducted on one (Level 1), two (Level 2) or three or more (Level 3) year cycles. Firms were classified as Level 1, 2, or 3 depending on various characteristics of the firm and its business. SOES firms, along with other types of firms, were considered Level 1 firms.

<sup>186</sup> The Market Surveillance Department began compiling its own list of SOES firms in 1993. Firms were placed on the list if computer generated reports reflected that they frequently placed multiple SOES orders in the same security within a short time frame and that such orders were at or near the maximum SOES tier size. These lists were generated roughly every quarter during 1994. The SOES firm lists were distributed to the supervisors within the Market Surveillance Department who were responsible for the enforcement of the SOES rules, as well as to all supervisors in the District Offices. The NASD staff used the lists to identify firms for which special SOES "sweep" exams were conducted. NASD examiners would also examine firms for compliance with the SOES rules during other special or routine examinations if the firm's name appeared on a SOES firm list. The Market Surveillance Department did not utilize its data bases or computerized surveillance capabilities to create lists of market makers that were frequently late in reporting trades or had possibly failed to honor their quotations with respect to preferenced SelectNet orders. Market Operations personnel did not maintain records sufficient to allow the creation of lists of market makers that frequently requested excused withdrawals. Moreover, during the relevant period the NASD did not conduct sweep examinations of market makers with respect to compliance with the trade reporting, firm quote, or excused withdrawal rules.

<sup>187</sup> Sweep exams are an effective tool to ensure rule compliance and the Commission has effectively used such exams in the past.

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In addition, other special SOES exams were conducted from time to time at individual firms suspected of SOES rule violations.

The SOES sweep examinations in January 1991 were scheduled to coincide with the beginning of the Persian Gulf war because the NASD staff believed that the commencement of hostilities might result in a severe market downturn. Examiners from District 10 in New York City were dispatched to five SOES firms<sup>188</sup> to look for improper short sale violations. Although the examinations did not uncover any breach of the SOES rules, the exam report discussed the trading habits of SOES firms. The report noted that:

One common scenario is to sell short through SOES and cover through SELECTNET. The SELECTNET leg is advantageous to the firm because when an initial bid or offer is placed into the system, the identity of the firm is not disclosed until the trade is consummated. Since some of these firms [the SOES firms] have created "enemies" on the street, they might otherwise have difficulty executing transactions with the same market makers they may have previously "picked off" through SOES.

The report reflects that it was distributed to senior supervisors in District 10 and the Market Surveillance Department. While the exam report indicated that some market makers were apparently backing away from their quotes, no follow-up investigation of such backing away was ever instituted.

A second SOES sweep examination was conducted in December 1991 to detect violations of the recent amendments to the SOES rules which broadened the definition of a professional trading account. District 10 examined nine SOES firms selected by the Market Surveillance Department. The comprehensive examination and subsequent analysis of documents consumed a great deal of District 10's examination resources during the relevant time period. These examinations ultimately led to the designation of PTAs at three SOES firms.<sup>189</sup>

In one instance, the NASD instituted an accelerated enforcement proceeding against a SOES firm. A senior NASD enforcement officer sent a congratulatory letter to the Market Surveillance Department staff members who worked on this proceeding which stated that "there

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<sup>188</sup> These firms were described in a NASD memorandum as "potential SOES rules violators."

<sup>189</sup> One of the accounts designated as a PTA was that of Geraldine and William Timpinaro. It was this designation which led to the litigation challenging the validity of the PTA rules and their subsequent repeal.

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is no better service quality we could have provided to our market maker customers and the individual investor." (Emphasis added.)<sup>190</sup>

The NASD conducted another SOES sweep examination in February 1994, concentrating on compliance with the recently enacted interim SOES rules. A list of SOES firms created by the Market Surveillance Department, distributed to prepare for a January 1994 planning meeting at the NASD's District 10 offices, was used to select the six firms examined by NASD staff. Disciplinary actions for violations of the short sale prohibitions of the SOES rules were brought against four of these firms.

In addition, the NASD designated a number of PTAs arising out of special examinations of individual firms. In all such cases, the accounts designated were maintained at SOES firms. The NASD did not conduct special examinations of any non-SOES firms for possible PTA designation.

The Market Surveillance Department did not have objectively defined benchmarks or guidelines with which to determine if an account was a PTA.<sup>191</sup> In addition, the Chairman of the Market Surveillance Committee (a trader who made markets on Nasdaq) was responsible for approving all proposed PTA designations. The identity of the firm where the accounts in question were maintained was disclosed in every case to the Chairman during his deliberations.<sup>192</sup> A procedure of this type creates the potential for disparate treatment.

In sum, the NASD placed substantial emphasis on enforcement of the SOES rules. At the same time, rules applicable to market makers were enforced with considerably less vigor and scrutiny. The NASD should have ensured a better balance in its enforcement activities and

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<sup>190</sup> This emergency remedial proceeding was only one of two such proceedings ever brought by the NASD.

<sup>191</sup> In its release approving the amendment of the PTA rule, the Commission addressed the issue of the generality of the rule by stating that "[w]hile the NASD will have discretion to determine exactly what is 'excessive' and to determine based upon these factors which accounts are professional trading accounts, the NASD is required to act fairly and reasonably." Exchange Act Release No. 29,809 (Oct. 10, 1991). The facts uncovered in the Commission's investigation indicate that this discretion appears not to have been properly exercised.

<sup>192</sup> The deficiencies in these procedures were compounded by participation in the process of a market maker with an economic interest in the outcome. In another matter, the Commission reversed an NASD disciplinary proceeding because the presiding panel included individuals whose employer firms were involved in certain of the transactions at issue in the proceeding. In the Matter of Datek Securities Corp. and Sheldon Maschler, Exchange Act Release No. 32,560 (June 30, 1993).

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maintained evenhandedness consistent with its obligation to employ a fair procedure for disciplining its members.

#### 4. Application of Standards and Criteria for Admission to Membership

The NASD, particularly District 10 in New York, used the admissions process to limit the admission and activities of potential SOES firms.<sup>193</sup>

Applications for membership by new SOES firms did not become a major concern of the NASD until 1993. Before 1993, admissions to membership were handled by the various District Committees, with the assistance of the District staff. For example, in District 10, there was a staff pre-membership section composed of several examiners and a staff supervisor devoted to processing applications for membership.<sup>194</sup> The prospective member was required to submit financial and other information to the pre-membership section and a pre-membership interview ("PMI") was held.<sup>195</sup> After the PMI, the application and the staff's recommendation were submitted to the full District Committee for final approval.<sup>196</sup>

In May 1993, District 10 created an ad hoc PMI Subcommittee and delegated to it full authority from the District Committee to make the final determination on membership applications.<sup>197</sup> The minutes of the May 19, 1993 District Committee meeting note that one of the principal reasons for the creation of the new PMI Subcommittee was to provide for "enhanced review" of new applications. In a September 29, 1993 meeting of the District

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<sup>193</sup> This District Committee consisted largely of representatives of firms that made markets.

<sup>194</sup> Between 1993 and 1995, approximately three-quarters of all SOES firms were situated in District 10, according to NASD lists of SOES firms.

<sup>195</sup> See NASD Manual Section C to the By-Laws, Part I, § (1), (CCH) ¶ 1783 (1995).

<sup>196</sup> Before 1994, there was a conflict between Article III of the NASD's By-Laws and Schedule C to the By-Laws as to whether the District Committee or the NASD staff made the initial determination to admit or deny membership. Article III of the By-Laws invested such authority in the District Committee, while Schedule C implied that the staff made the initial decision. The common practice of the NASD before 1993 was for the District Committee to make the ruling. The conflict was resolved by amendments to the By-Laws and Schedule C effective July 20, 1994, that gave such power to the District Committee or to a pre-membership subcommittee, if the District Committee designated such a subcommittee. NASD Notice to Members 94-22, Apr. 1994.

<sup>197</sup> The denial of membership can be appealed to the District Committee, the NBCC, the NASD Board of Governors, and then to the Commission. NASD Manual, Schedule C to the By-Laws, Part I, § (2) (CCH) ¶ 1783 (1995) and Exchange Act, § 19(d)(2), 15 U.S.C. § 78s(d)(2) (1994).

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Committee, several members of the Committee expressed an interest in finding out under what circumstances an application could be rejected. The NASD staff was asked to prepare a set of guidelines for the denial of membership in the association and a District 10 supervisor developed a one page set of guidelines.

The guidelines were distributed and discussed at the November 17, 1993 meeting of the District Committee. At the meeting, the staff member who drafted the guidelines stated that he was trying to capture the concerns previously expressed by the Committee. One of the proposed guidelines would have denied membership to:

Owners, control persons or principal officers who have been recently employed by a known SOES activist and who have indicated an interest in being a SOES activist themselves. This interest would be evidenced by conducting business predominately on a retail agency basis and the request to have pieces of equipment with SOES capabilities that is close in number to RR's [registered representatives] that the firm intends to employ.

While there was a general consensus at the meeting that this and other guidelines were a good idea, and should be used by the PMI Subcommittee, an NASD lawyer opined that this guideline went beyond the provisions noted in Schedule C to the By-Laws regarding the denial of membership.<sup>198</sup> The director of District 10 did not authorize the use of this guideline, based on the attorney's advice. Even though not adopted as official policy, a copy of the guidelines was provided to the supervisor of the PMI section of District 10 without an explanation of the attorney's advice, and the supervisor applied this particular SOES-related guideline to new applicants along with the other guidelines in identifying issues for the PMI Subcommittee to consider.<sup>199</sup>

The minutes of the September 29, 1993 District Committee meeting note that the director of District 10 suggested that the PMI Subcommittee take "an aggressive posture" with respect to membership applications. This "aggressive posture" manifested itself, in part, in the

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<sup>198</sup> The other guidelines were unrelated to SOES.

<sup>199</sup> Less than one month after the November 17, 1993 District Committee meeting, the one page set of guidelines was faxed to a meeting of the NASD's Advisory Council (which consists of members of all the District Committees and provides general recommendations to the Board of Governors on various issues) at the request of a District 10 Committee member attending the Advisory Council meeting. Among other issues, the Advisory Council discussed Schedule C to the By-Laws and the need for uniform criteria for NASD membership. The guidelines distributed to the Advisory Council meeting still included SOES activism as grounds for denial of membership, and there was no indication that an NASD attorney had advised against the use of this criterion. The Advisory Council made no recommendation that this guideline be adopted as official policy.

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identification of applicants who were perceived as potential new SOES firms, the undue delay of some of these membership applications, and the imposition of a variety of restrictions on their SOES trading.

A number of perceived likely SOES firms were effectively hindered or delayed in their efforts to seek NASD membership. At the direction of the PMI Subcommittee, the District 10 staff created a list of applicants that were of "regulatory concern." The PMI Subcommittee's belief that the applicant intended to be a SOES firm was a reason for including the firm on the "regulatory concern" list.<sup>200</sup> Some applicants perceived as likely SOES firms who were placed on the list experienced lengthy delays in the processing of their membership applications,<sup>201</sup> and at least one applicant abandoned the process due to a lengthy delay. Other applicants perceived as likely SOES firms included in the "regulatory concern" list were often required to accede to various limitations on their SOES trading activities.

The PMI Subcommittee curtailed the ability of certain firms to use the SOES system. The NASD expressly conditioned membership on certain firms' acceptance of substantial limitations on its SOES trading activity. These restrictions included, in certain circumstances, outright prohibitions on the use of SOES, limitations on the number of SOES terminals available to the firm, and restatement in the membership agreement of the order splitting<sup>202</sup> and professional trading account rules.<sup>203</sup>

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<sup>200</sup> Likely SOES usage was generally not the only reason for placing a particular applicant on the regulatory concern list and many applicants were placed on the list for reasons other than likely SOES usage. Even though the Regulatory Concern List did not include only potential SOES firms, the identification of likely SOES usage in the application process and the inclusion of SOES-related restrictions in the restriction agreements of certain applicants was inappropriate, as is discussed further in the text.

<sup>201</sup> Lengthy delays are contrary to the provisions of Schedule C, Part I § 1(b) of the By-Laws, which requires a reasonable review period. NASD Manual, Schedule C to the By-Laws, Part I, § 1(b) (CCH) ¶ 1783 (1995).

<sup>202</sup> For some firms, the time period in which orders would be aggregated was expanded beyond five minutes provided by NASD rule to, for example, seven minutes.

<sup>203</sup> The inclusion of the PTA rules in members' restriction agreements had the effect of increasing the sanctions that could be imposed for violations of the rules. Violations of the PTA rules now subjected the firms to potential loss of their NASD membership, a greater sanction than any set forth in the NASD Sanction Guidelines. Without such provisions in the restriction agreements, violations of the PTA rules would only prevent the customer account involved from further SOES trading. Particularly troubling is the fact that PTA restrictions were retained in restriction agreements as much as eighteen months after the PTA rules were repealed.

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Established SOES firms which sought modification of existing restriction agreements also faced obstacles. The NASD applied an informal policy to prevent firms from seeking modifications of any restrictions by conditioning membership on the requirement that the firm forbear from seeking modifications for six months to one year, despite NASD rules permitting a firm to seek a modification at any time.<sup>204</sup> NASD documents indicate that all SOES-related restrictions had to be approved by a District 10 subcommittee (unlike other restrictions) and that no changes in SOES related restriction agreements were granted in late 1993.

The restrictions discussed above were inconsistent with the NASD's rules concerning the membership application process.<sup>205</sup> Furthermore, Sections 15A(b)(3) and 15A(g) of the Exchange Act<sup>206</sup> together prescribe the bases on which membership or access to services may be denied by the NASD, and require that certain standards for denial, such as those applied to potential SOES firms, be defined in the rules of the NASD. Some of the criteria applied to potential SOES firms were not defined in the NASD's rules, nor were they set forth in any filing with the Commission for notice and comment pursuant to Section 19(b)(2) of the Exchange Act,<sup>207</sup> as would be required for the adoption of a rule.

Although the NASD may have had concerns over potential rule compliance or disciplinary history issues with respect to certain applicants, the use of the SOES system, by itself, was legally permissible and could not serve as the basis for heightened regulatory scrutiny. Restriction agreements cannot be used to subject member firms to potential loss of their membership for violations of the Professional Trading Account or other rules simply because these firms are believed to be likely to sponsor use of the SOES system. Applicants are permitted to seek to modify or remove restrictions upon written application under Schedule C of the NASD By-laws, and cannot be denied that opportunity as a condition to NASD membership. The imposition of the restrictions described herein and the *ad hoc* manner in which they were applied was an inappropriate exercise of regulatory discretion by the NASD, and underscores the need for structural change of the membership application process.

The NASD's staff should have the sole authority to handle approval of membership applications and the conditions and limitations that can be placed thereon. Written standards for denial or limitation of membership applications should be promulgated and filed with the Commission pursuant to Section 19(b) of the Exchange Act. The PMI Subcommittee, and its parent, the District Committee, should no longer have any involvement in individual membership

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<sup>204</sup> NASD Manual, Schedule C to the By-Laws, Part I, § 3, (CCH) ¶ 1783 (1995).

<sup>205</sup> 15 U.S.C. § 78s(g) (1994). The NASD rules governing membership applications are set forth in the NASD By-Laws. NASD Manual, Schedule C to the By-Laws, Part I (CCH) ¶ 1783 (1995).

<sup>206</sup> 15 U.S.C. §§ 78o-3(b)(3) and 78o-3(g) (1994).

<sup>207</sup> 15 U.S.C. § 78s(b)(2) (1994).

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applications, as prevailing practices have too readily allowed for the interjection of improper criteria into the membership application process.

## **B. The NASD's Laxity in Rule Enforcement**

The NASD has been lax in enforcing rules applicable to market makers and other significant constituents. This is illustrated by its inadequate enforcement of the firm quote rule and the trade reporting rules discussed earlier, and is further exemplified by the following.

### **1. The NASD's Failure to Enforce the Excused Withdrawal Rules**

NASD rules require each member firm to enter and maintain two-sided quotations on a continuous basis for every Nasdaq security in which the member firm is registered as a market maker.<sup>208</sup> The NASD has failed to enforce adequately the mandatory suspension penalties applicable to Nasdaq market makers that do not maintain continuous quotations in accordance with these rules.

Under the rules, a member firm that withdraws its quotations in a particular security must also withdraw as a market maker in that security for a twenty-day period. An exception may be granted if the market maker obtains excused withdrawal status from the NASD prior to withdrawing its quote.<sup>209</sup> Excused withdrawals may be granted only for the specific reasons enumerated in the rule.<sup>210</sup> In addition, a market maker that does not "refresh" its quote in a security within a five-minute period after its SOES exposure limit has been exhausted will be deemed to have withdrawn as a market maker in that security for twenty-business days (a "SOES withdrawal").<sup>211</sup> The SOES rules provide that a market maker that obtains excused withdrawal status from the NASD, prior to withdrawing from SOES, is not subjected to the twenty-day SOES suspension.<sup>212</sup>

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<sup>208</sup> See NASD Manual, Schedule D to the By-Laws, Part V, § 2(a) (CCH) ¶ 1819 (1995).

<sup>209</sup> See NASD Manual, Schedule D to the By-Laws, Part V, § 8 (CCH) ¶ 1824 (1995).

<sup>210</sup> The reasons include (1) physical circumstances beyond the market maker's control, such as computer problems, bomb threats, or fires; (2) demonstrated legal or regulatory requirements, such as trading restrictions pursuant to Rule 10b-6 of the Exchange Act or in cases in which the market maker is in possession of material nonpublic information; (3) religious holidays; or (4) vacation.

<sup>211</sup> See NASD Manual, Rules of Practice and Procedure for the Small Order Execution System, Rule c(2)(G) (CCH) ¶ 2460 (1995). See also Exchange Act Release No. 25791 (June 9, 1988), 53 Fed. Reg. 22594 (June 16, 1988) n.9.

<sup>212</sup> See NASD Manual, Rules of Practice and Procedure for the Small Order Execution System, Rule c(2)(H) (CCH) ¶ 2460 (1995).

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The NASD began routinely to grant waivers for SOES withdrawals for reasons outside the scope of the rules. This practice has allowed market makers that failed to refresh their quotes after their SOES exposure was exhausted to avoid the requisite twenty-day suspension. Until 1995, the practice of Nasdaq Market Operations<sup>213</sup> was to grant SOES withdrawal waivers as a matter of course without inquiring into the reasons for the withdrawals.<sup>214</sup> A market maker merely had to request the waiver and Nasdaq Market Operations granted it. Beginning in 1995, Nasdaq Market Operations started to make some inquiry into the reasons for the SOES withdrawals, granting waivers based upon an examination of four factors.<sup>215</sup> These factors, however, are not generally relevant to the acceptable reasons, as articulated in the rules, for granting excused withdrawal status.<sup>216</sup> Nor were these factors included in any filing made by the NASD with the Commission pursuant to Section 19(b) of the Exchange Act, as amendments or interpretations of its rules. The NASD has continued to grant waivers for

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<sup>213</sup> Nasdaq Market Operations is responsible for processing excused withdrawals and waivers.

<sup>214</sup> A taped conversation between an operations clerk in Nasdaq Market Operations and a trader exemplifies this practice:

Trader: Hey it's [trader's name] from [firm]. How you doing?  
Clerk: Alright. Yourself?  
Trader: Good and not so good. I got suspended in Apple. The trader's assistant's out and we're a little short on the desk, I'm calling from [firm name].  
Clerk: [firm symbol]?  
Trader: Yeah.  
Clerk: Okay, I'll put you back in.  
Trader: And I'm, I'm going to update it so it's, so it's a greater amount.  
Clerk: [unclear] See, the thing is not what you're doing as far as upping. The thing is, somebody's got to watch out, because . . . the thing is, we're not supposed to be doing this.  
Trader: Right, Right.

<sup>215</sup> The factors are (1) the timeliness of the market maker's call to Market Operations; (2) the volatility of the stock; (3) the liquidity of the market and the number of market makers in the stock; and (4) the number of Nasdaq terminals at the market maker to which the orders could be routed (which was relevant in cases where the market maker requested an excused withdrawal due to mechanical or electronic failure of a Nasdaq terminal).

<sup>216</sup> See NASD Manual, Schedule D to the NASD By-Laws, Part V, § 8(b) (CCH) ¶ 1824 (1995), which states in part: "[t]he withdrawal of quotations because of pending news, a sudden influx of orders or price changes, or to effect transactions with competitors shall not constitute acceptable reasons for granting excused withdrawal status."

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reasons other than those listed in the applicable rules,<sup>217</sup> allowing market makers to avoid suspension penalties.

There are other significant problems with the NASD's excused withdrawal program. The NASD has not maintained appropriate databases to record waivers and excused withdrawals, compromising its ability to identify market makers that make excessive requests or to supervise its own staff to determine if they are properly granting excused withdrawals. It did not consistently verify the validity of the excuses offered by market makers requesting the excused withdrawal or waiver, and lacked any mechanism to track market makers who frequently made such requests. In numerous instances, market makers requested and were granted such withdrawals without providing the notice to the NASD required by the rules.<sup>218</sup>

The NASD's failure to enforce its excused withdrawal rules has fostered an environment that allowed market makers to avoid their responsibilities to maintain continuous quotes in the securities in which they made markets. Market makers were able to withdraw voluntarily from SOES beyond the permitted five-minute window, or otherwise withdraw from the market during periods of volatility without substantial risk that the NASD will enforce a twenty-day suspension.<sup>219</sup> This undermines a fundamental premise of the dealer market: that market makers stand willing to buy and sell securities at all times. Allowing market makers to evade this responsibility reduces liquidity in the market and threatens the ability of investors to execute trades.

The NASD did not place administration of the excused withdrawal rule in its enforcement or regulatory staff, but rather in its Market and Trading Services staff. That laxity in the application of market making rules occurred in an area other than the NASD's enforcement or regulatory staff is indicative that the NASD's ongoing efforts to reform should extend to all employees who may affect the self-regulatory process.<sup>220</sup>

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<sup>217</sup> For example, market makers were granted waivers after their SOES exposure was exhausted because they were away from their desk, working another order, or covering another trader's stocks.

<sup>218</sup> The rules require five days advance notice to the NASD for excused withdrawal requests for religious holidays and twenty days advance notice for excused withdrawal requests for vacation.

<sup>219</sup> The suspension was increased from two to twenty days in the aftermath of the 1987 market break because of findings by the Brady Commission, the SEC, and the NASD that market makers simply withdrew from the market. *See supra* note 141.

<sup>220</sup> Relegating the administration of the excused withdrawal rule to the NASD's Operations staff in its Trumbull, Connecticut facility raises certain issues. Although the excused withdrawal rule relates to the operation of the market, it is nevertheless a rule and should  
(continued...)

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The failure of the NASD to enforce the letter and spirit of the excused withdrawal rules made it possible for market makers routinely to avoid their responsibilities to make markets and provide liquidity, without being penalized. This approach to enforcement of the excused withdrawal rules was inappropriate in light of the NASD's responsibilities to maintain the integrity of the Nasdaq market.

## 2. The NASD's Inadequate Enforcement of MSRB Rule G-37

The results of an inspection by the Commission staff of the NASD's enforcement of Municipal Securities Rulemaking Board Rule G-37 ("Rule G-37") further highlight the lack of balance in the NASD's self-regulatory activities. Rule G-37 was adopted in April 1994, and prohibits any broker, dealer, or municipal securities dealer from engaging in municipal securities business with a municipal securities issuer if it or certain persons associated with or controlled by it contributes more than \$250 (a "relevant contribution") to any person who can influence the award of municipal securities business with that issuer.<sup>221</sup> The NASD is responsible for overseeing compliance with Rule G-37 by its members.<sup>222</sup> An SEC inspection of the NASD's program to oversee compliance with Rule G-37 identified several deficiencies in the program.

The MSRB's rule changes were controversial and highly publicized, and results of the inspection indicated that the NASD did not implement in a timely and effective manner Rule G-37 examination modules, procedures, and sanction guidelines. Examination modules and procedures were distributed to the District Offices charged with conducting examinations up to ten months after Rule G-37 went into effect. Specific sanction guidelines were given to District Offices approximately 17 months after the Rule's effective date. The examination modules for

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<sup>220</sup>(...continued)

be administered from a regulatory standpoint. All rules, whether categorized as disciplinary or operational, must be administered objectively and impartially. The persons administering the operational rules must be especially mindful of the need to be evenhanded and dispassionate, since these rules are administered with fewer procedural safeguards than the disciplinary rules (e.g., investors injured by a reduction in liquidity due to non-enforcement of the excused withdrawal rule have no means of learning of violations or seeking relief). As is the case with the regulatory staff, the persons administering operational rules must have regulatory training and must follow regulatory procedures.

<sup>221</sup> The prohibition lasts for two years after the relevant contribution. See Exchange Act Release No. 33868 (Apr. 7, 1994), 59 Fed. Reg. 17621 (Apr. 13, 1994).

<sup>222</sup> Section 15B(c)(7) of the Exchange Act. 15 U.S.C. § 78o-4(c)(7) (1994).

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Rule G-37 reviews were inadequate.<sup>223</sup> For example, the modules were confined to a review of the examined firm's books and records. Individual contributions by associated persons of a firm may not be revealed by such a limited exam.<sup>224</sup>

The NASD's surveillance program to detect non-compliance with Rule G-37 also was deficient. It did not include any effective mechanisms to identify firms that failed to file requisite forms,<sup>225</sup> firms that engaged in municipal securities underwriting business within two years of a relevant contribution, or municipal finance professionals that made political contributions. In addition, the NASD's computerized complaint system did not classify complaints related to the Rule, making it difficult to track and investigate such complaints.

When violations of the Rule were presented to the NASD, it failed to take sufficiently strong action against members who violated Rule G-37. The NASD allowed a grace period for firms to comply with the Rule, and permitted firms to file late Form G-37 filings and revise inadequate written supervisory procedures prior to the close of examinations, thereby avoiding even informal sanctions. In addition, the NASD construed the exemptive relief provisions of the Rule too broadly and granted such relief inappropriately.<sup>226</sup> No minutes were prepared for the meetings of the Executive Committee of the NASD Board at which exemptions were granted. Thus, the bases for such exemptions were inadequately documented.

Rule G-37 was adopted over the objections of numerous municipal securities underwriters. The NASD, whose members include the nation's leading municipal securities underwriters, failed to implement its enforcement of the Rule adequately. This failure reinforces concerns that the NASD is reluctant to enforce rules against the major constituencies of its membership.

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<sup>223</sup> The modules cover recordkeeping and filing requirements related to the Rule, written supervisory procedures, procedures for the use of consultants, and bans on municipal activity or exemptions from the Rule.

<sup>224</sup> Outside sources of information would include lobbying registration reports filed with state authorities, PAC filings, minutes of meetings held by issuers of municipal bonds underwritten by the firm, and campaign and election records.

<sup>225</sup> Rule G-37(e)(i) requires all brokers, dealers, or municipal securities dealers to file with the Municipal Securities Rulemaking Board quarterly reports of political contributions on Form G-37.

<sup>226</sup> On June 3, 1994, Rule G-37 was amended to provide procedures for dealers to seek exemptive relief from the Rule. Exchange Act Release No. 34160 (June 3, 1994), 59 Fed. Reg. 30376 (June 13, 1994).

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## C. Other Areas of Regulatory Concern

### 1. Authority of District Business Conduct Committees

Much of the ability of market makers to influence disciplinary actions was attributable to their participation in the District Business Conduct Committees ("DBCC's"). The DBCC's have a dual role in the disciplinary process. First, they have a "grand jury" function, in which the NASD staff must seek their authorization before it can proceed with an enforcement action. Secondly, they serve as an adjudicatory body, deciding the outcome of litigated enforcement actions and approving settlements. The grand jury function is of particular concern, because it provides firms that make markets with a preliminary opportunity to influence the process. As described above, such firms have inappropriately used their influence on the NASD's committee structure to advance their interests. Meaningful self-regulation does not require that industry representatives have a grand jury function. The adjudicatory role of the DBCC provides them with a powerful and central role in the operation of the NASD. In order to promote the objectivity and impartiality of the disciplinary process, the DBCC's should no longer have a grand jury function. Similarly, the Market Surveillance Committee, which has had a similar grand jury function with respect to actions proposed by the staff of the NASD's Market Surveillance Department, should no longer retain that function.

### 2. The Excess Spread Rule

As discussed above, one initiative undertaken by the NASD to address the issue of wide spreads on Nasdaq was to implement a rule against excessive market maker spreads. This measure, however, has had certain undesirable effects. The "excess spread" rule requires that market makers input quotes with dealer spreads no greater than 125% of the average dealer spread of the three market makers having the narrowest dealer spreads in each security listed in Nasdaq.<sup>227</sup> The maximum width of a market maker's spread in a particular security is thus dependent upon the spreads quoted by other market makers in the stock. The interdependence of quotes mandated by the rule may deter market makers from narrowing their dealer spreads, because, once the spread is tightened, the rule in some instances precludes a market maker from widening the spread to earlier levels.

For example, if a stock is uniformly quoted with 3/4 of a point dealer spreads, and a market maker narrows its dealer spread from 3/4 of a point to 1/2 of a point, and two other dealers match the 1/2 of a point dealer spread, no market maker in the stock can enter a dealer spread greater than 5/8 of a point. Thus, the market maker that initiated the narrower spread

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<sup>227</sup> A market maker is not required to quote less than a 1/4 spread in any security. NASD Manual, Schedule D to the By-Laws, Part V, § 2(c) (CCH) ¶ 1818 (1995).

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cannot return to quoting the stock with a 3/4 of a point dealer spread.<sup>228</sup> In these circumstances, a market maker may refrain from initiating a narrower dealer spread in order to avoid being locked in at a 1/2 of a point dealer spread.

In addition, the interdependence of dealer spreads created by the excess spread rule establishes an economic incentive for market makers to discourage one another from narrowing their dealer spreads.<sup>229</sup> Market makers may be required to narrow their dealer spreads, not because they believe it to be economically appropriate, but because the excess spread rule forces them to follow the lead of other market makers.<sup>230</sup> Rather than follow the lead of a market maker that narrows its spread, market makers may attempt to convince that market maker to widen its spread back out.

The stated purpose of the rule was to prevent market makers from disseminating quotations that were always outside the inside spread and receiving a certain amount of order flow at little risk to themselves. However, it has had undesirable effects, creating incentives for market makers to avoid narrowing the quotes and to urge other market makers to avoid narrowing the quotes. Thus, the excess spread rule may interfere with the free flow of prices in the market and impede attempts by the market to reach the optimal competitive spread. It may also create incentives for market makers to collaborate, which is particularly undesirable in light of the evidence of inappropriate collaboration described herein. Hence, the Commission has sought and obtained the NASD's commitment in the settlement of the enforcement action brought concurrently with the issuance of the Report, to modify the rule to eliminate its undesirable effects, or to repeal it.

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<sup>228</sup> In a taped conversation between two Nasdaq traders, one trader discussed the narrowing of spreads following the Bear Stearns meeting and the problems created by the excess spread rule:

Nightmare, you know. The one thing, too is that if people close them up and now with these new . . . excessive spread things and there's there is no way to open them back up again. . . . So now you've closed them up and we can't, and there's no way to open them up again. So everyone's  
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<sup>229</sup> The NASD recognized the possibility that the rule could encourage collusion among market makers. See *supra* note 60 and accompanying text.

<sup>230</sup> In one conversation, one trader tells another trader:

Two years ago [before the excess spread rule was changed], 3 guys did it [broke the spread], it didn't matter, 'cause we'd all stay at 3/4. Now, we have no choice, we have to follow them.

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### 3. The Contested Election Process

In the Report issued by the Rudman Committee in its review of the NASD's operations, the Committee discussed the NASD's District Nominating Committee and made particular reference to a contested election in 1994 in District 10.

The Rudman Committee stated:

[The NASD] addressed issues that arose on an ad hoc basis, and generally handled the election inappropriately — particularly insofar as NASD staff appeared to take sides in the matter. NASD officials have acknowledged that the election was mishandled.<sup>231</sup>

The gist of the Rudman Committee's concerns arose out of two letters sent by the District 10 Nominating Committee, the first of which was on NASD letterhead, endorsing the candidacy of one person over the challenger. In addition, volunteers recruited by the NASD's District Nominating Committee actively campaigned in support of the successful candidate.

The NASD's By-Laws only specifically authorize the Nominating Committee to select the regular candidate. The NASD, its committees and its staff should not in any way exhibit favoritism or partiality in such elections.

### 4. The Audit Trail

In the course of the investigation, the Commission staff encountered significant difficulties reconstructing activity in the Nasdaq market. Broker-dealer order tickets, among the most fundamental of records, were too often unavailable or inconvenient to retrieve. Timestamping was often unreliable for the purposes of determining compliance with applicable rules, such as the firm quote rule and limit order protection rules.<sup>232</sup>

A further difficulty was the inadequate documentation of telephone orders received at OTC trading desks. As noted above, order tickets, if they were available at all, were not always reliably timestamped. Having reliable and accurate records of telephone orders is crucial to evaluating a market maker's compliance with the firm quote rule and trade reporting rule. Because telephone orders and transactions are a significant part of the activity in the Nasdaq market, the documentation of these orders and transactions is essential to adequate surveillance and compliance in the market.

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<sup>231</sup> Rudman Report at III-16.

<sup>232</sup> At one firm, the timestamping did not include seconds, which particularly frustrated the Commission's ability to reconstruct the market.

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The NASD has automated surveillance capabilities with respect to its current audit trail, although it has not consistently maintained adequate routine automated surveillance capabilities over the audit trail. Its surveillance and enforcement responsibilities with respect to market conduct have increased substantially in recent years. The adoption of limit order protection rules in 1994 and 1995, and the frequency of backing away from quotations and late trade reporting revealed by this investigation, all indicate the need for an improved surveillance capability. In light of the high volume of trading on today's Nasdaq market and the dispersed nature of that market, these rules cannot be efficiently enforced through current NASD examination techniques, such as time consuming on-site inspections and analysis of hard copies of order tickets and other records. Automated surveillance is essential if these rules are to be effectively enforced. This surveillance capability can only be implemented with an improved audit trail.

Hundreds of millions of shares trade every day on Nasdaq, and effective regulation of this market requires a comprehensive centralized and computerized recordkeeping system. Surveillance methods employed in this market must keep pace with the rapidity of trading done with computer technology. A comprehensive audit trail, beginning with the time an order is placed and continuing to record the life of the order through the process of execution, is essential to maintaining the integrity of the Nasdaq market. Such an audit trail would feature the computerized recordation of the time and terms of an order, and of the sequence of steps taken to execute the order. By providing these details, the enhanced audit trail would allow for prompt surveillance on a scale that cannot be attained with traditional methods of examination. It would greatly facilitate the ability of the NASD and the Commission to protect the interests of investors and promote the best execution of their orders. In view of the deficiencies in the Nasdaq market uncovered in this investigation, substantial improvement to the audit trail is crucial to market reform. As set forth in the NASD's undertakings in the concurrent administrative proceeding, and as discussed in the Report, the NASD has undertaken to design and implement an audit trail sufficient to reconstruct markets promptly, surveil them effectively and enforce its rules.

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