UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

July 16, 1997

Mr. Richard G. Ketchum
Executive Vice President & Chief Operating Officer
National Association of Securities Dealers, Inc.

Ms. Mary L. Schapiro
President
NASD Regulation
1735 K Street, N.W.
Washington, D.C. 20006-1506

Dear Mr. Ketchum and Ms. Schapiro:

In the undertakings specified in the Commission's administrative proceeding against the NASD,[1] the NASD committed to substantially upgrade its capability to enforce Rule 11Ac1-1 under the Securities Exchange Act of 1934 ("Firm Quote Rule"). NASD efforts to date include the establishment of a real-time procedure for resolving backing away complaints, and new draft parameters and protocols for processing such complaints.

In your letter of July 7, 1997, you indicated that you would like more guidance on what types of activity may be deemed backing away under the Firm Quote Rule.[2] You have requested the Division's views regarding this conduct so as to enhance NASDR's ability to enforce compliance with the Firm Quote Rule.

Many of your questions involve a market maker's duty to honor its quote when the market maker receives two or more orders in close conjunction via Nasdaq's SelectNet System and the Small Order Execution System ("SOES") or the telephone.[3]

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[1] See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD, the Nasdaq Market, and Nasdaq Market Makers, Securities Exchange Act Release No. 37542 (August 8, 1996).

[2] See Letter from Richard G. Ketchum, Executive Vice President & Chief Operating Officer, NASD, and Mary L. Schapiro, President, NASDR, to Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated July 7, 1997.

[3] The double execution problem arising from Nasdaq providing two automated order delivery systems could be eliminated by integrating these two systems.

The Division acknowledges that the receipt of simultaneous orders in SOES, SelectNet and over the telephone raises questions regarding firm quote compliance for market makers.[4] Nonetheless, it is not feasible in this context to articulate a "bright-line" test on what conduct constitutes backing away. Instead, NASDR should examine the particular facts and circumstances surrounding a market maker's conduct to determine if a market maker violated its firm quote obligations.

For example, when an order entry firm cancels its order quickly after presentment in SelectNet,[5] NASDR should analyze that market maker's pattern of execution for orders it receives via SelectNet. On one hand, if the analysis reveals that the market maker generally executes orders from market makers or other firms within a few seconds of presentment, a backing away violation may be indicated where the market maker waits significantly longer to execute orders from the order entry firm involved in the complaint. On the other hand, if a market maker can show that it generally fills most SelectNet orders promptly and in a non-discriminatory fashion, failure to fill a particular SelectNet order cancelled quickly after

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4 For example, some market makers claim that other market participants are (1) sending a market maker a preferenced SelectNet order at the market maker's quote; (2) cancelling the order quickly before the market maker can fill it; and (3) filing a backing away complaint against the market maker. Another alleged practice is for a firm to send a preferenced SelectNet order virtually contemporaneously with a similar order via SOES. In this situation, the SelectNet order arrives shortly before the market maker receives confirmation of an automatic execution in SOES. The order entry firm then will file a backing away complaint if the market maker does not honor the SelectNet order. Market makers are concerned that this practice subjects them to double executions.

5 Although a market maker may often be able to react within 10 seconds of presentment of a SelectNet order, the 10 second cancellation prohibition is not meant to establish a per se backing away time threshold. See Securities Exchange Act Release No. 38185 (January 21, 1997), 62 FR 3935 (January 27, 1997) (approving a ten second minimum life for a preferenced SelectNet order). As an initial matter, the Division believes that an order entry firm that directs multiple SelectNet orders to a market maker within a relatively brief time, with the intent of cancelling these orders shortly after entry for the purpose of deliberately deterring order execution, could be in violation of the federal securities laws and should be examined under the appropriate NASD rules. Although market makers have a responsibility to stand behind their published quotations when receiving order flow from order entry systems, in the situations where order entry firms are deliberately deterring execution of these orders, the market maker should not be held to be in violation of the Firm Quote Rule. Nonetheless, because of the serious problems involving unwarranted backing away by market makers in the past, the NASDR must ensure that a market maker's allegations of order entry firm "gaming" in response to a backing away complaint be substantiated.

presentment may not rise to the level of backing away, depending on the facts and circumstances of a particular case.

A similar analysis should be employed for the SOES/SelectNet double hit question. There should be no "bright line" test that would excuse a market maker from executing the SelectNet order without violating its obligations. The determination would have to be made on a facts and circumstances basis.[6] Of course, the Firm Quote Rule does not allow a market maker to decline to fill an order based on the receipt of a subsequent order. Therefore, in deciding a backing away complaint, the NASD should determine the time the SOES order was entered by factoring in the time it takes a market maker to receive the execution confirmation from the point of order entry.

NASD policy is that firms with timely backing away complaints may receive a contemporaneous trade execution. The Division notes, however, that the fact that a market maker gives a customer a fill in response to a complaint or otherwise reimburses the customer is not determinative of whether a violation has occurred. Although it may be appropriate to consider contemporaneous fills as a mitigating factor for individual violations, it would not be conclusive for market makers that have demonstrated a pattern of backing away violations.

Finally, some market makers have complained that the large volume of SelectNet orders may cause preferenced orders to rapidly scroll off the screen before a trader can see them, subjecting the firm to backing away complaints. The Division does not believe that a firm should escape Firm Quote Rule responsibility based on claims that a trader failed to see a SelectNet order due to the "scrolling effect." The Division understands that many market makers now are able to separate the SelectNet preferenced orders from general broadcast orders on their individual screens, which would reduce the scrolling problem.

The Division reiterates that improved backing away surveillance is integral to the NASD's ability to satisfy its self-regulatory obligations. If you have additional questions regarding this matter, please do not hesitate to contact me.

Sincerely,

Richard R. Lindsey
Director

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6 Some factors to consider include the times that the orders were entered and whether both orders were sent by the same firm.