



THE CHAIRMAN

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

August 20, 1998

The Honorable John D. Dingell  
Ranking Member  
Committee on Commerce  
U.S. House of Representatives  
2322 Rayburn House Office Building  
Washington, D.C. 20515-6115

Dear Congressman Dingell:

I am pleased to respond to your letter dated January 14, 1998, in which you asked for an evaluation of the remedial actions undertaken by the National Association of Securities Dealers as a result of the Commission's 1996 enforcement action. I have attached an analysis, prepared by my staff, which I believe provides the information you requested. We understand that the Department of Justice is providing its response under separate cover.

In the two years since the SEC's historic enforcement action, the NASD has adopted an unprecedented number of changes to improve the fairness and efficiency of its operations. These improvements have significantly changed the way the NASD does business.

In particular, at the SEC's direction, the NASD has applied the principle of balanced public representation to its Board of Governors and the Boards of its subsidiaries, the Nasdaq Stock Market and NASD Regulation, as well as key committees. These changes should help to ensure that future NASD decisionmaking is fairer and more even-handed.

The NASD has also made fundamental changes to the way it carries out its regulatory functions. These include:

- Restructuring the NASD into three distinct Boards, thereby separating market and enforcement functions;
- Developing an order audit trail system, which should greatly improve the NASD's surveillance and enforcement capabilities; and
- Developing other automated surveillance systems and enhancing enforcement efforts, which should reduce incidences of backing away behavior and market-maker intimidation and coordination.

The NASD has already spent tens of millions of dollars to implement the improvements discussed above, and before the process is complete, that number will rise to \$100 million. But more importantly, throughout this process the NASD and its staff have shown a genuine commitment to improving the way the NASD functions. Certainly, our work here is not done. In particular, the NASD needs to devote more resources to its examination

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program. But we will continue to work with the NASD to realize the goals envisioned at the time of our enforcement settlement.

I want to specifically address one concern you raised in your letter -- a recent study by two researchers purporting to show that Nasdaq market makers are avoiding quoting stock prices in odd sixteenths of a dollar. Like you, we were concerned about the conclusions in this study and asked the NASD to conduct its own study to determine whether there is an absence of odd sixteenth quotations among Nasdaq firms that cannot be explained by normal business-related choices. In addition, the Commission's Office of Economic Analysis ("OEA") conducted a spot review of the use of odd sixteenths in a sample of 20 Nasdaq securities.

The NASD's findings are discussed in the enclosed staff report, as are OEA's generally consistent observations. In short, while the NASD's study showed that Nasdaq market makers do quote in odd sixteenths, albeit in fewer than half of all Nasdaq market maker quotes. As the NASD observed in its study, there are a number of legitimate, business-related reasons why at any given time a market maker would not quote in odd sixteenths. Please be assured that we and the NASD will continue to monitor this situation and will take appropriate measures should we identify a regulatory problem.

Thank you for giving us the opportunity to apprise you of the status of the NASD's remedial efforts. If you have questions or comments, please do not hesitate to contact me or Richard R. Lindsey, Director of the SEC's Division of Market Regulation at (202) 942-0090.

Sincerely,



Arthur Levitt

Enclosure

cc (w/o Enclosure): The Honorable Tom Bliley, Chairman  
Committee on Commerce

The Honorable Michael Oxley, Chairman  
Subcommittee on Finance and Hazardous Materials

The Honorable Thomas J. Manton, Ranking Member  
Subcommittee on Finance and Hazardous Materials

Mr. Frank G. Zarb, Chairman and CEO  
National Association of Securities Dealers, Inc.

## NON-PUBLIC MEMORANDUM

**To:** Chairman Arthur Levitt

**From:** Richard R. Lindsey, Director  
Division of Market Regulation 

**Date:** August 19, 1998

**Subject:** Status and Effectiveness of NASD Actions Since the 21(a) Report

### I. Introduction

This memorandum responds to Representative Dingell's request to report on the National Association of Securities Dealers, Inc.'s ("NASD") progress in fulfilling the fourteen undertakings ("Undertakings") required by the Commission in its 1996 order ("SEC Order").<sup>1</sup> In conducting our review, we considered NASD rule changes, both adopted and proposed, that directly respond to the Undertakings. We also considered other measures taken by the NASD in the past two years, which, although not specifically required by the SEC Order, still helped to improve the regulation and operation of the Nasdaq Stock Market ("Nasdaq"). In addition, we met with NASD staff as well as with Frederick M. Werblow, the independent consultant hired by the NASD (as required by the SEC Order) to review the NASD's compliance with the Undertakings. Finally, we included preliminary findings from the Commission's Office of Compliance Inspections and Examinations' ("OCIE") ongoing inspections of the NASD's market surveillance and regulatory programs.

### II. Summary of Findings

The SEC Order was issued in response to the Commission's findings that, among other things, the NASD had failed to adequately enforce its rules.<sup>2</sup> As described in the SEC Order, the NASD agreed to comply with the requirements of the fourteen enumerated Undertakings within a specified period of time.<sup>3</sup> The Undertakings were designed to address the deficiencies identified in the Commission's 21(a) Report, which discussed the failings of the NASD, and in an earlier report issued by the NASD's Select Committee on Structure and Governance, chaired by former United States Senator Warren Rudman.<sup>4</sup>

Our review of the NASD's efforts indicates that the NASD has substantially complied with each of the enumerated Undertakings. The NASD also has undertaken a number of other remedial measures to address deficiencies in the areas of surveillance, examination, enforcement and internal audit identified in the 21(a) Report. The NASD has already spent over \$66 million in performing these regulatory and systems enhancements and is committed to spend \$100 million in total on these improvements.

We believe that these changes have improved the operation of the NASD and have made Nasdaq fairer for market participants generally.

The NASD continues to make substantial efforts to implement the improvements directed by the Commission. Many parts of this process are ongoing. For instance, the NASD's Order Audit Trail System ("OATS") is not due to be fully implemented until July 31, 2000. Moreover, many of the systems changes that have been implemented in this process, including OATS, will need to be continually assessed in light of changing market conditions.

In some areas the NASD has been hampered in its efforts to make the required improvements by turnover of experienced professional staff. This problem has been particularly acute in the examinations and surveillance areas. The NASD states that it will redouble its efforts to address this problem by, among other ways, allocating additional resources to help recruit and retain experienced staff. Like the independent consultant, we view this as critical to the NASD's continuing efforts to make the improvements we still believe are needed in the NASD's surveillance and examination programs.

Although improvements are ongoing and the regulatory environment of the NASD is dynamic, we were encouraged that we did not find any evidence of the types of systemic problems, including discrimination against classes of NASD members, that were detailed in the 21(a) Report. We will continue to work with the NASD to build on the achievements that have been made over the past two years.

### III. Status of Undertakings

#### A. Corporate Governance

The Commission's 21(a) Report identified a number of problems with the NASD's corporate governance, including a lack of independence of the self-regulatory organization ("SRO") function from the commercial interests of Nasdaq.<sup>5</sup> The Commission found in its investigation that the NASD Board was unduly influenced in its regulatory decisionmaking by NASD market maker members.<sup>6</sup> The Commission also found that the NASD failed to process certain membership applications within a reasonable time, required some applicants to satisfy criteria not enumerated in its rules, placed improper restrictions on those firms' activities as a condition to membership, and prevented such members, once admitted, from seeking modifications to their membership agreements as permitted by the NASD's rules.<sup>7</sup>

To remedy these problems, the Commission required that: (1) the Boards of the NASD, NASD Regulation, Inc. ("NASDR"), and Nasdaq, and certain committees, include at least 50% independent public and non-industry members; (2) NASDR be delegated primary day-to-day responsibility for the regulation, surveillance, examination and disciplining of NASD member firms and registered persons; (3) the

NASD use professional hearing officers to preside over disciplinary proceedings; (4) the regulatory staff of the NASD and those of its operating subsidiaries be granted autonomy and independence to carry out their respective SRO responsibilities; and (5) the NASD promulgate uniform standards for access and other regulatory issues and apply them consistently to ensure that market participants receive fair and even-handed access to all of the NASD's services and facilities.<sup>8</sup>

1. Composition of Boards and Committees (Undertaking #1)

In the SEC Order, the Commission required the NASD to implement and maintain at least 50% independent public and non-industry membership in the NASD Board of Governors.<sup>9</sup> The Commission also required equal public representation on the Boards of Directors of all the NASD's subsidiaries and affiliates that exercise or have delegated self-regulatory functions, as well as certain committees.<sup>10</sup>

The requirements of Undertaking #1 have been fulfilled. Beginning in 1996, the NASD filed and the Commission approved a series of interim and final rule proposals amending the NASD's corporate governance documents<sup>11</sup> to require that at least 50% of the participants on the governing boards and the specified committees come from outside the securities industry.<sup>12</sup> In particular, less than half of the participants presently on the governing boards of the NASD, NASDR, and Nasdaq are broker-dealers or others that earn their livings in the securities industry. The same is true for the National Adjudicatory Council (formerly the National Business Conduct Committee), as well as for the following committees: National Nominating, Audit, Arbitration, Quality of Markets, Market Regulation (formerly Market Surveillance) and Management Compensation. Moreover, most of these entities, with the exception of two highly technical committees,<sup>13</sup> are also required to have individuals employed outside the financial services arena. The most recent report issued by the independent consultant confirmed these findings and recommended several measures to ensure continued compliance.<sup>14</sup>

2. NASDR's Delegated Responsibilities (Undertaking #2)

The Commission also required the NASD to provide NASDR with primary day-to-day responsibility for regulating, surveilling, examining and disciplining member firms and registered persons.<sup>15</sup> In carrying out its duties, NASDR is to have full access to the records of the Nasdaq market.<sup>16</sup>

The requirements of Undertaking #2 have been fulfilled. The corporate restructuring needed to address these requirements was among the first changes submitted by the NASD and approved by the Commission, as noted in the 1997 Werblow Report.<sup>17</sup> Specifically, the Delegation Plan expressly confers on NASDR the authority to take necessary or appropriate actions to assure compliance with the federal securities laws and NASD rules through examination, surveillance, investigation, enforcement, disciplinary and other programs.<sup>18</sup> Also, the Delegation Plan was

amended in July 1998 to expressly state that the “books and records of Nasdaq shall be subject at all times to inspection and copying by [NASDR].”<sup>19</sup> The 1998 Werblow Report confirmed that this Undertaking has been completed.<sup>20</sup>

### 3. Disciplinary Proceedings (Undertaking #3)

The Commission required the NASD to use professional hearing officers that are attorneys with appropriate experience and training to preside over disciplinary proceedings.<sup>21</sup> This requirement arose from the Commission’s findings in the 21(a) Report that market makers had unduly exerted their influence over the disciplinary process through their participation in the District Business Conduct Committees.<sup>22</sup>

The requirements of Undertaking #3 have been fulfilled. The amendments to the NASD’s Code of Procedure, implementing the Hearing Officer program and setting out respondents’ rights, were approved by the Commission in 1997.<sup>23</sup> An Office of Hearing Officers has been established, and a Chief Hearing Officer, Deputy Chief Hearing Officer and seven Hearing Officers, all with appropriate qualifications, have been engaged. Today, all members subject to NASD disciplinary procedures are guaranteed the right to a hearing before the Office of Hearing Officers, the rulings of which may then be reviewed by the National Adjudicatory Council.<sup>24</sup> The 1998 Werblow Report also concluded that, with the Commission’s approval of the Code of Procedure, this Undertaking has been fulfilled.<sup>25</sup>

### 4. Independence of Regulatory Staff (Undertaking #4)

The Commission required the NASD to provide for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries.<sup>26</sup> Specifically, the Commission required that the regulatory staff, subject only to the supervision of the NASD Board of Governors and the Boards of Directors of NASDR and Nasdaq: (1) have sole discretion as to what matters to investigate and prosecute; (2) have sole discretion to handle regulatory matters such as approval of applications for membership and the conditions and limitations that may be placed on membership; (3) prepare rule proposals, rule interpretations and other policy matters (with fair and even-handed consultation with all interested NASD constituencies); and (4) be generally insulated from the commercial interests of NASD members and Nasdaq.<sup>27</sup>

Undertaking #4 explicitly prohibits any involvement in disciplinary proceedings by the District Business Conduct Committees and the Market Surveillance Committee (now the Market Regulation Committee). In particular, this Undertaking proscribes any involvement by the District Committees in the review or approval of applications for membership in the NASD. However, the Undertaking permits the regulatory staff of the NASDR engaged in the disciplinary process, solely on its own initiative, to inform itself on matters of market or other securities industry expertise by consulting with representatives of member firms or committees of the NASD or its subsidiaries.

(a) Investigative and Prosecutorial Discretion

The requirements of Undertaking #4 have been fulfilled with respect to investigative and prosecutorial authority. Discretion as to what matters to investigate and prosecute is conferred on NASDR through the NASD corporate governance documents and the Delegation Plan.<sup>28</sup> Initial versions of these documents were approved by the Commission in early 1996.<sup>29</sup> Final versions became effective in January of 1998.<sup>30</sup> In addition, a Case Authorization Unit was created within the Enforcement section of NASDR.<sup>31</sup> This unit authorizes the filing of complaints for cases developed within the NASD districts. NASDR's Office of Disciplinary Policy authorizes complex Enforcement and Market Regulation cases. The amended Rules of the NASD that relate to the functions of these offices were approved by the Commission in August 1997.<sup>32</sup> Thus, the District Business Conduct Committees and the Market Regulation Committee do not have any formal involvement in disciplinary proceedings. Before consulting with members of these committees on its own initiative, the enforcement staff is required to first clear it with the NASDR's Office of Disciplinary Policy.<sup>33</sup>

(b) Regulatory Discretion

The requirements of Undertaking #4 also have been fulfilled with respect to regulatory matters, such as membership application autonomy issues. NASD rule changes approved by the Commission specifically delegate to NASDR the SRO responsibilities related to the establishment and interpretation of rules and regulations, and exemptions.<sup>34</sup> NASDR also is responsible for fees, membership requirements and arbitration procedures.<sup>35</sup> For example, the District Business Conduct Committees no longer approve membership applications. The Rule 1010 Series, as approved by the Commission, provides that the NASDR staff, rather than the District Business Conduct Committees, must make the initial decision on membership applications. Moreover, applicants may now appeal a staff decision to the National Adjudicatory Council, whose decision then is subject to discretionary review by the NASD Board.<sup>36</sup>

(c) Regulatory Autonomy

The requirements of Undertaking #4 have been fulfilled with respect to the regulatory autonomy of the NASDR. The Delegation Plan grants NASDR authority to determine NASD policy, through the rule filing process, relating to a full range of NASD matters.<sup>37</sup>

(d) Insulation from Commercial Interests

The requirements of Undertaking #4 with respect to insulation from Nasdaq members' commercial interests have been fulfilled largely through the separation of the NASDR and Nasdaq subsidiaries. Yet several areas are still evolving.<sup>38</sup> For example, a new NASD Code of Conduct for employees went into effect February 1, 1998, which

emphasizes the broad policies of maintaining the highest integrity and avoiding even the appearance of impropriety. As the 1998 Werblow Report noted, however, the NASD currently does not have a "restricted list" in place, which would identify those Nasdaq equity securities that cannot be purchased by NASD, NASDR, and Nasdaq employees during a specified time period.<sup>39</sup> Moreover, as the 1998 Werblow Report noted, there are currently no procedures in place to monitor compliance with the NASD's "No Net Short" and 90-day holding period requirements, which prohibit NASD, NASDR, and Nasdaq employees from holding short positions in Nasdaq equities and from selling Nasdaq securities that have been held less than 90 days.<sup>40</sup> The NASD plans to implement these procedures by September 30, 1998.

##### 5. Uniform Standards for Regulatory Issues (Undertaking #5)

In the 21(a) Report, the Commission found that the NASD failed to process certain membership applications within a reasonable time, required some applicants to satisfy criteria not enumerated in its rules, and placed improper restrictions on those firms' activities as a condition to membership.<sup>41</sup> It also prevented such members, once admitted, from seeking modifications to their membership agreements as permitted by the NASD's rules.<sup>42</sup> As a result, the Commission required the NASD to promulgate and apply on a consistent basis uniform standards for regulatory and other access issues (such as admission to the NASD as a member firm and conditions placed on market makers) and institute safeguards to ensure fair and even-handed access to all NASD services and facilities.<sup>43</sup>

The requirements of Undertaking #5 with regard to membership and market maker standards have been fulfilled. Amendments to the Membership and Registration Rules were approved by the Commission in August 1997.<sup>44</sup> These membership rules set forth more detailed, comprehensive, and objective standards to be used to determine whether applicants should be admitted to membership. Additional procedural rights are also afforded to applicants to ensure that applications are processed fairly and expeditiously. These procedures also specify the amount of time the NASD has to issue membership decisions.

In addition, we are discussing revised Nasdaq issuer listing and delisting procedures with the NASD. The proposed rules would significantly supplement the protections afforded applicants for use of Nasdaq services and more completely define the procedures involved and the standards applied in the listing and delisting process. Although we hope that changes to these procedures will be proposed for comment in the fall, we are concerned about the length of time it has taken for the NASD to finalize its proposal. Specifically, we have reviewed earlier drafts and met with representatives of the NASD on several occasions to discuss those drafts over the past several months. Nevertheless, we have yet to receive a draft proposal that fully describes the NASD's processes. The NASD has informed us that it is committed to working with us to finalize its proposal in the near future.

Finally, as emphasized in the 1997 Werblow Report, the various NASD websites provide a wide range of information regarding NASD services and facilities, and the Office of Ombudsman continues to provide a means for investigating and resolving complaints regarding alleged unfair practices or disparate treatment by the NASD.<sup>45</sup> In response to a recommendation in the 1998 Werblow Report, the NASD has agreed to add a hyperlink to the NASD websites describing the availability of the Office of Ombudsman as a channel for confidential complaints.

## B. Internal Controls

The deficiencies cited in the 21(a) Report indicated a lack of effective internal controls within the NASD. For example, the Commission faulted the NASD for failing to satisfy its statutory SRO responsibilities, noting that the NASD's inaction contributed to wide-spread, potentially illegal conduct by market makers.<sup>46</sup> Consequently, a number of the requirements of the Undertakings were designed to address weaknesses in internal controls. Specifically, the Undertakings required the NASD to: (1) establish an internal audit department to report directly to an independent audit committee of the NASD Board; (2) implement a comprehensive order audit trail system; (3) improve the surveillance and examination of order handling; and (4) enhance the surveillance, examination and enforcement of trade reporting.<sup>47</sup>

### 1. Internal Audit Staff (Undertaking #6)

Under the SEC Order, the NASD was required to establish an independent internal audit staff to review all aspects of the NASD's operations, including its regulatory function and disciplinary process.<sup>48</sup> This staff also would be responsible for reviewing the Nasdaq market and its systems.<sup>49</sup> The internal audit staff was to report directly to an audit committee of the NASD Board of Governors.<sup>50</sup> The SEC Order required that the audit committee be composed of a majority of public and non-industry Governors and be chaired by a public Governor.<sup>51</sup>

The formal requirements of Undertaking #6 have been fulfilled. The audit committee composition is established in the NASD By-Laws and the Delegation Plan, as is the requirement that the Senior Vice President and the staff of the Internal Review ("IR") Department report directly to the audit committee.<sup>52</sup> The audit committee currently has five members, and is composed as required (including the requirement that its chair be a public Governor of the NASD). Over the past several months, the IR Department has undertaken a number of important initiatives. For example, according to the 1998 Werblow Report, the IR Department has created an inventory of all securities related laws, regulations or rules to which the NASD or its subsidiaries are subject for compliance or regulatory purposes.<sup>53</sup> This data base identifies the responsibilities that the various NASD departments have with respect to each particular rule. Each item in the data base has been matched to an auditable entry. The IR Department also has undertaken a number of operational audits to ascertain compliance with a number of the Undertakings. In addition, the IR Department has performed an

inventory of all Nasdaq systems as part of a risk assessment to determine how resources should be allocated in the future.

To some extent high turn-over has hampered the audit committee in carrying out its responsibilities. As described in the 1998 Werblow Report, the IR Department has encountered significant difficulties in retaining qualified staff.<sup>54</sup> Consequently, it has been difficult for the IR Department to accomplish its identified objectives. The NASD also recognizes this problem and has agreed to address employee retention and hiring issues. In particular, the NASD has agreed with the independent consultant's recommendation to have an independent party study how to retain staff. In addition, the NASD has committed to continue to work through its Human Resources Department to find ways to address retention issues across the NASD and particularly in the IR Department and the examination programs.

## 2. Order Audit Trail System (Undertaking #7)

In its 21(a) Report, the Commission noted that in its investigation, Commission staff had "encountered significant difficulties reconstructing activity in the Nasdaq market."<sup>55</sup> The Commission noted that, given the high volume of trading and the frequency of backing away from quotations and late trade reporting discovered in the Commission's investigation, the NASD's rules and federal securities laws cannot be effectively enforced through current NASD examination techniques.<sup>56</sup> As a result, the SEC Order required the NASD to develop an order audit trail sufficient to enable the NASD to reconstruct markets promptly, effectively surveil them, and enforce its rules.<sup>57</sup> The audit trail was required to include, at a minimum, an accurate time-sequenced record of orders and transactions, beginning with the receipt or origination of an order through its execution.<sup>58</sup> The SEC Order also required marketwide synchronization of clocks used in connection with the audit trail.<sup>59</sup>

The requirements of Undertaking #7 have been fulfilled. On March 6, 1998, the Commission approved the NASD's new OATS rules.<sup>60</sup> The OATS rules require NASD member firms to capture and record specific information related to the handling or execution of orders for equity securities in Nasdaq.<sup>61</sup> Firms then must report that information to the NASD through OATS.<sup>62</sup>

The Commission and the NASD have agreed to a phased roll-out of OATS to enable NASD members to make the necessary systems changes in an efficient manner.<sup>63</sup> Specifically, OATS is scheduled to be implemented over the next two years, with final implementation of all orders by July 31, 2000.<sup>64</sup> The NASD is continuing to improve and refine OATS prior to its full implementation. The technical specifications for OATS were revised on June 30, 1998. On July 10, 1998, the OATS application software was installed in a production environment for a month of production acceptance testing. The NASD will implement a pilot version of OATS in August 1998. Additional modifications are expected as testing of the system continues.

### 3. Order Handling Surveillance and Examination (Undertaking #8)

The Commission also required the NASD to improve substantially its surveillance and examination of order handling.<sup>65</sup> In its 21(a) Report, the Commission criticized the NASD's surveillance and examination practices.<sup>66</sup> As discussed above, the Commission's investigation uncovered the NASD's laxity in enforcing certain rules, including the firm quote rule and trade reporting rules.<sup>67</sup>

On August 29, 1996, the Commission adopted Rule 11Ac1-4 ("Display Rule") and amendments to Rule 11Ac1-1 ("Firm Quote Rule") under the Securities Exchange Act of 1934 (collectively, "Order Handling Rules").<sup>68</sup> The implementation of the Order Handling Rules, completed in October 1997, has significantly improved individual investors' access to the best available prices.

The NASD has issued a number of Notices to Members to educate member firms about their obligations with respect to the handling of customer orders.<sup>69</sup> In addition, the NASD has enhanced its surveillance capabilities and has created a new examination module to assist its examiners in reviewing market maker trading activity. However, we believe that the NASD's automated systems for surveilling market maker compliance with the Order Handling Rules could be improved. In particular, the NASD's automated system for surveilling violations of the Display Rule does not have a feature that automatically notifies the NASD that a violation has occurred. The NASD relies instead on examinations to detect violations. We believe that an automatic "kick-out" function could greatly enhance the NASD's ability to detect violations. Accordingly, OCIE has been working with the NASD to determine the feasibility of modifying its current system to include such a function.

While the NASD has devoted resources to developing surveillance techniques to monitor compliance with these rules, effective fulfillment of the requirements of this Undertaking has been hampered by an unusually high level of surveillance and examination staff turn-over in the Market Regulation Department.<sup>70</sup> Due to staffing problems, the Trading and Market Making Surveillance ("TMMS") examination staff has been unable to achieve its examination goals. According to the 1998 Werblow Report, the TMMS exam cycle is behind schedule for the second year in a row.<sup>71</sup> The 1998 Werblow Report also noted that TMMS' supervisory structure, budget, and resources are inadequate to allow TMMS staff to properly accomplish its objectives.<sup>72</sup>

The NASD acknowledges these problems and has agreed to find ways to address employee retention issues. The Commission staff will continue to monitor the NASD's examination and surveillance programs and is working with the NASD to help ensure that the examination deficiencies cited in the Werblow Report are addressed in a timely manner. The NASD also has committed to undertake a careful review of staffing needs in the upcoming 1999 budget process.

#### 4. Enhancement of Trade Reporting (Undertaking #9)

The Commission further directed the NASD to improve substantially the reliability of trade reporting through, among other things, enhancement of surveillance, examination, and enforcement.<sup>73</sup> In its 21(a) Report, the Commission noted that the “NASD’s trade reporting surveillance procedures were deficient and were hampered by insufficient automated surveillance reports.”<sup>74</sup> The Commission further stated that NASD examiners “relied on antiquated methodologies” that significantly impeded the NASD’s ability to enforce the trade reporting rules.<sup>75</sup>

As mentioned above, the NASD has undertaken to expand and improve its surveillance capabilities and its examination and enforcement efforts. The 1998 Werblow Report cited an internal NASD memorandum indicating that these efforts have resulted in a sharp reduction in the instances of late trade reports in the second half of the period from June 23, 1997 to May 8, 1998 compared to the first half.<sup>76</sup> However, the NASD needs to take steps to further refine and improve its surveillance of trade reporting. The NASD has agreed to the independent consultant’s recommendation to make these improvements. For example, the NASD has agreed that, by the end of the third quarter of 1998, the Team Leader for its Trading Analysis section will develop a management report that highlights late trade reporting case reviews of member firms that are aged more than six months. These reports will be discussed with the Assistant Director for the Trading Analysis Section at least twice per month. This required supervisory check should help to ensure that late trade reporting complaints are addressed in a timely manner.

#### C. Market Maker Practices

The Commission’s 21(a) Report identified a number of areas in which the NASD’s surveillance of abusive trading practices by some NASD members and enforcement of NASD rules and the federal securities laws were substantially deficient. The Commission cited deficiencies in the NASD’s enforcement of the Firm Quote Rule, as well as its failure to adequately address market maker collusion.<sup>77</sup> The Commission required the NASD to: (1) better enforce the Firm Quote Rule; (2) promulgate a rule prohibiting coordination among market makers; (3) enhance market maker competitiveness through better enforcement of the NASD Rules of Fair Practice; and (4) redefine or repeal the excess spread rule.<sup>78</sup>

##### 1. Enforcement of the Firm Quote Rule (Undertaking #10)

The 21(a) Report identified deficiencies in the NASD’s enforcement of compliance with the Firm Quote Rule.<sup>79</sup> The Firm Quote Rule requires a market maker to execute an order presented to it at a price at least as favorable as its published quotation up to its published quotation size.<sup>80</sup> As a result of the cited deficiencies, the Commission directed the NASD to implement a process for handling complaints about

Nasdaq market makers backing away from their quotes so that valid complaints could be satisfied with a contemporaneous trade execution, or other appropriate action.<sup>81</sup>

While this Undertaking has been partially fulfilled, improvements are ongoing. To upgrade its capability to enforce the Firm Quote Rule, the NASD has developed the Firm Quote Compliance System ("FQCS").<sup>82</sup> Once indications of backing-away have been identified, the FQCS has the ability to identify firms that fail to respond to liability orders they receive through Nasdaq's SelectNet service (i.e., fail to execute orders they receive through SelectNet at the market maker's displayed quote).<sup>83</sup> In addition, NASDR has instituted a toll-free hotline to receive backing away complaints from members as soon as the complaint arises.<sup>84</sup> The NASD's enhanced capability to review backing-away complaints enables its staff to require contemporaneous trade executions, when warranted.<sup>85</sup>

The 1998 Werblow Report noted that of 5,027 complaints received from January 1, 1998 to May 31, 1998, about 32% were either filled or offered to be filled.<sup>86</sup> The Report also noted, however, that the existing technology was not designed to handle the volume of complaints that the FQCS has received.<sup>87</sup> Consequently, the system has experienced some delays in responding to complaints. In light of the high number of backing-away complaints that the NASD continues to receive, we believe the NASD should substantially upgrade the FQCS. The NASD is committed to upgrading the FQCS to improve the system's performance and capacity.

## 2. Anti-Coordination Rule (Undertaking #11)

The Commission required the NASD to propose a rule or interpretation explicitly prohibiting coordination among market makers of their quotes, trades and trade reports.<sup>88</sup> The NASD also was directed to prohibit retribution or retaliation by market makers in response to competitive actions by other market makers.<sup>89</sup>

The requirements of this Undertaking have been fulfilled. On July 17, 1997, the Commission approved an Interpretation of NASD Conduct Rule 2110 that prohibits members from: (1) coordinating quotations, prices, trades, and trade reporting; (2) directing or requesting another member to alter prices or quotations; and (3) threatening, harassing, coercing, intimidating, or otherwise attempting improperly to influence another member in a manner that interferes with or impedes the forces of competition among member firms.<sup>90</sup> The NASD's surveillance capabilities in this area have been enhanced by its Advanced Detection System ("ADS"). One noteworthy feature of the ADS is its "best execution" break browser, which permits the NASD to surveil for possible order handling abuses. The break browser is used to generate alerts when Nasdaq market makers are effecting trades that are 1/8th or more away from the inside market. These alerts for Tier I market makers are being included in Best Execution Report Cards that are being sent to those members. In addition, the NASD's Best Execution and Locked and Crossed Markets Section of its Trading Practices unit has sent 62 Wells Letters requesting information from members regarding best

execution alerts generated from November 1997 through January 1998 and from February through April 1998. These responses were sent out in June and July of 1998, and the NASD is reviewing the responses it has received to date. In addition, the Commission's Order Handling Rules, as discussed above, should make coordination among market makers more difficult.

### 3. Enhancing Market Maker Competitiveness (Undertaking #12)

The Commission also directed the NASD to enforce the NASD Rules of Fair Practice to enhance market maker competitiveness.<sup>91</sup> Specifically, the Commission directed the NASD to eliminate: (1) anticompetitive or unlawful pricing conventions (and to discipline market makers for harassing others who narrow the displayed quotations); (2) coordination between or among market makers of quotes, trades and trade reports; and (3) concerted discrimination and concerted refusals to deal by market makers.<sup>92</sup>

As discussed above, the NASD's adoption of an Interpretation to NASD Conduct Rule 2110 explicitly prohibits such anti-competitive conduct by market makers.<sup>93</sup> The NASD has taken a number of other steps to enhance market competitiveness, as well. For example, the NASD has substantially enhanced its market surveillance capabilities, which should be further improved by the implementation of OATS. The NASD also has implemented formal procedures for reviewing complaints and adopted a new registration category and examination for equity traders, which includes questions about prohibited conduct (see discussion of the Series 55 Examination below). (See also discussion of disciplinary proceedings under Undertaking #3, above.)

However, the 1998 Werblow Report recommended that the NASD undertake to increase the quality of members' written supervisory procedures with respect to issues arising from the 21(a) Report and the NASD's monitoring of members' implementation of such procedures.<sup>94</sup> The NASD agrees with this recommendation and has drafted two Notices to Members with respect to supervisory procedures, which it expects to issue this fall.

### 4. Redefine or Repeal the Excess Spread Rule (Undertaking #13)

In its 21(a) Report, the Commission noted its concerns regarding the NASD's Excess Spread Rule, which at the time required 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 Nasdaq security.<sup>95</sup> The Commission was concerned that the Excess Spread Rule created an economic incentive for market makers to discourage one another from narrowing their quotes, thereby interfering with the pricing mechanism of the market.<sup>96</sup> Consequently, the NASD was directed to refine or repeal the excess spread rule to eliminate any disincentive to narrow the displayed quotations.<sup>97</sup> The NASD allowed the Excess Spread Rule to lapse

on October 13, 1997.<sup>98</sup> Therefore, the requirements of this Undertaking have been completely satisfied.

#### D. Independent Consultant (Undertaking #14)

Finally, the NASD was required to hire an independent consultant to provide an initial report within six months of August 8, 1996 (the date the SEC Order was issued) and on the anniversary of that date for three consecutive years.<sup>99</sup>

In response to this requirement, as discussed above, the NASD retained independent consultant Frederick M. Werblow. The first three Werblow reports have been received and reviewed by Commission staff.<sup>100</sup> Findings from the most recent report, dated July 23, 1998, have been incorporated into this report. The requirements of this Undertaking will be fulfilled upon the filing of the final report, due on August 8, 1999.

#### IV. Other Remedial Measures

In addition to its efforts to address the Undertakings enumerated in the SEC Order, the NASD has undertaken to implement certain other remedial measures to address deficiencies noted in the 21(a) Report. A brief description of the NASD's efforts is provided below.

##### A. The 17-Second Rule

In its 21(a) Report, the Commission criticized the NASD for adding, without the Commission's knowledge or approval, an additional five-second delay to the pre-existing 15-second delay between the time a Nasdaq market maker executes one unpreferenced market order or marketable limit order through the Nasdaq's Small Order Execution System ("SOES") and the time the market maker is required to execute another such order.<sup>101</sup> The NASD claimed that the additional five-second delay was needed to allow for the time taken for the electronic transmission of execution reports and quote updates.<sup>102</sup> The Commission found that the additional delay was longer than reasonably necessary.<sup>103</sup> The Commission also found that this additional delay further restricted the ability of SOES users to obtain executions.<sup>104</sup>

The Commission directed the NASD to determine the actual time it takes to transmit an execution report and update a quote. The NASD concluded that most execution reports are transmitted within two seconds. Subsequently, on December 24, 1997, the Commission approved an NASD proposal to change NASD Rule 4730(b)(1).<sup>105</sup> Under the revised rule, once an unpreferenced market order or a marketable limit order is executed against a SOES market maker, that market maker is not required to execute another unpreferenced SOES order at the same bid or offer in the same security until 17 seconds have elapsed, absent a quotation update by the market maker within that 17-second period.<sup>106</sup> The Commission determined that a two-

second period was sufficient to permit a market maker to electronically transmit an execution report and update its quote.

#### B. Excused Withdrawals

In the 21(a) Report, the Commission criticized the NASD's handling of excused withdrawal requests and the reinstatement of market makers that had been "SOESed out of the Box" (see discussion below).<sup>107</sup> Specifically, the Commission found that the NASD was lax in holding market makers to their quotation obligations.<sup>108</sup> The NASD routinely granted waivers for SOES withdrawals for reasons not permitted by the rules and failed to keep adequate records of the excused withdrawals it granted, which would have enabled the NASD to detect excessive requests by particular market makers.<sup>109</sup> Prior to 1995, the NASD regularly granted SOES suspension waivers as a matter of course without inquiring into the reasons for the withdrawals.<sup>110</sup> The Commission found that the NASD's failure to enforce the excused withdrawal rule undermined the requirement that market makers provide investors with a continuous market as required by the federal securities laws and NASD's rules.<sup>111</sup>

In response, the NASD proposed changes to NASD Rules 4619 (excused market maker withdrawals), 4620 (voluntary termination of market maker registrations, "20-Day Rule"), and 4730 (reinstatement of market makers that have been "SOESed out of the Box"). Under these rules, a Nasdaq market maker will be suspended from SOES if its bid or offer size has been reduced to zero, due to SOES executions. If this occurs, the market maker will be permitted a 5-minute grace period to restore a two-sided quote in that security. This suspension is referred to as being "SOESed Out of the Box." Failure to revise and reinstate its quotes results in suspension of market maker status in the affected security for twenty days. The NASD may grant an exception to the 20-Day Rule if a market maker obtains an excused withdrawal from the NASD prior to withdrawing its quotes. The NASD's rules provide that excused withdrawals may be granted only for certain specific reasons. On December 10, 1997, the Commission approved proposed amendments to these rules that are intended to ensure that market makers will be relieved of their market making obligations only for legitimate reasons.<sup>112</sup> Waivers of the "20-Day Rule" will be made only when Nasdaq has determined that the market maker receiving the waiver is not attempting to avoid its market making obligations.<sup>113</sup>

#### C. Clearly Erroneous Trades

In the 21(a) Report, the Commission questioned the NASD's excessive level of responsiveness to market maker complaints about SOES.<sup>114</sup> In one example, the Commission found that a market maker complained to senior Nasdaq officials that a large number of SOES trades in a single stock had been executed against it by a particular SOES firm.<sup>115</sup> The NASD officials directed examiners to conduct a highly unusual same-day examination, following which all of the trades were canceled by the NASD as "clearly erroneous."<sup>116</sup>

On January 14, 1998, the Commission approved an NASD proposal to change NASD Rule 11890, governing the review and resolution of clearly erroneous transaction complaints.<sup>117</sup> These amendments, particularly the provision permitting an appeal to the NASD's Market Operations Review Committee, should make the process for resolving clearly erroneous transaction complaints fairer and more efficient and help to ensure that Nasdaq does not unfairly discriminate between customers, issuers, brokers, or dealers.

D. SOES Orders When There Is No Market Maker At The Inside Quote

In its 21(a) Report, the Commission noted its general concern with NASD actions taken to limit SOES access.<sup>118</sup> Subsequently, in the course of implementing Order Handling rules, a new problem developed. Specifically, an inside quote by an unlisted trading privileges ("UTP") participant or an electronic communications network ("ECN") effectively halted SOES executions when the ECN or UTP participant was the only one quoting at that price (referred to as being "alone at the inside"). Since SOES orders could not be executed against ECNs, pending SOES orders were rejected. As a result, the ECN customer entering that order essentially could control the inside price and potentially create an advantage in SOES for itself by jumping ahead of other SOES orders that might have executed first in that issue if they had not been rejected. An ECN sometimes changed its quotes almost immediately, before it could be accessed through SelectNet or the ECN's own internal system. Once this quote disappeared and a new dealer inside was established, new SOES orders entered the system and displaced pending SOES orders at the old inside price.

On February 10, 1998, the Commission published an NASD proposal to address this issue.<sup>119</sup> The proposal, which became effective upon filing, operates when an ECN or UTP participant is alone at the inside in a Nasdaq National Market System ("NMS") security. In this situation, executable SOES orders that are in queue or received at that moment will be held for a specified period of time. This "hold time," initially set at 90 seconds, is the maximum life of an order. Holding the queued orders for 90 seconds will give other market makers time to adjust their quotes to create a new inside, join the ECN at its quote, or allow the ECN to move away from the inside. If one of these conditions is met and the order is still executable, it will execute. If none of these conditions occurs, however, the order will time out, under normal time-out processing, and be returned to the entering firm after 90 seconds.

E. Creation Of Series 55 Exam For Equity Traders

On January 2, 1998, the Commission approved an NASD proposal requiring each registered representative who engages in proprietary or agency trades of equities, preferred securities, or convertible debt securities, or who directly supervises such activities, to register as a limited representative-equity trader.<sup>120</sup> To register as a limited representative-equity trader, the representative must be registered as a general securities representative or as a limited representative-corporate securities, and must

pass the Series 55 examination. The exam covers four areas: (1) the Nasdaq market and market maker activities; (2) automated execution and trading systems; (3) trade reporting requirements; and (4) securities industry regulations. Although not specifically raised as a concern in the 21(a) Report, the creation of the Series 55 designation is intended to ensure that all Nasdaq equity traders have attained a certain level of knowledge and expertise regarding the NASD's rules and the federal securities laws beyond merely passing the general Series 7 examination.

F. Mandated \$100 Million Expenditure on Surveillance and Enforcement

As part of its settlement with the Commission, the NASD agreed to commit \$100 million over five years to enhance its systems for market surveillance, including the development and implementation of an enhanced audit trail, and to increase its staffing in the areas of examination, surveillance, enforcement, and internal audit.<sup>121</sup>

According to the NASDR, in 1996 and 1997, the NASD spent \$11.7 million<sup>122</sup> and \$35.6 million, respectively, to address deficiencies identified in the Commission's 21(a) Report. Specifically, the NASD spent these funds to enhance its market surveillance systems and to increase staffing in the examination, surveillance, and enforcement areas, as well as for technological projects, including OATS and FQCS. According to the NASDR, through May 31, 1998, the NASD has spent an additional \$18.9 million. The independent consultant is monitoring these expenditures.

G. Aggregation of Fines

As discussed above, the 21(a) Report details the Commission's findings that, among other things, market makers exerted undue influence on the NASD's disciplinary process<sup>123</sup> and that the NASD's enforcement of trade reporting and firm quote rules was inadequate.<sup>124</sup> To address these concerns, the NASD modified its Sanction Guidelines. The amendments clarify that the NASDR may treat several violative acts or transactions as one "violation" for purposes of determining sanctions, only in certain delineated situations. The modifications describe the circumstances in which the NASDR may batch violations, which would allow the NASDR to mete out appropriate sanctions using consistent, published guidelines.

V. Allegations Concerning Odd-Sixteenth Quotes

Finally, Representative Dingell requested that we discuss the implications of a study by David Whitcomb and Yusif Simaan ("Whitcomb-Simaan Study").<sup>125</sup> That Study examined the use of odd-sixteenth quotes in Nasdaq since June of 1997 and reviewed quoting patterns after the Commission's Order Handling Rules were implemented in January of 1997. The Whitcomb-Simaan Study concluded that market makers used odd-sixteenths significantly less than half the time and that ECNs quote in odd-sixteenths more frequently than market makers. We requested that the NASD

analyze the Whitcomb-Simaan Study and conduct its own study on the issue, and provide its findings to us.

Like the Whitcomb-Simaan Study, the NASD's study also found that odd-sixteenths were represented in less than 50% of market maker quotations. In its study, the NASD identified several possible legitimate business-related reasons that could account for this result. The Division and the Commission's Office of Economic Analysis ("OEA") worked with the NASD to develop the parameters of the study. OEA also reviewed the use of odd-sixteenths in a sample of 20 Nasdaq stocks for the month of April 1998 and for a week in June 1997.

A. Incidence of Odd-Sixteenths Varied By Characteristics of Stocks and Throughout the Trading Day

The NASD study indicated that the incidence of odd-sixteenths varied across stocks. Specifically, the NASD study indicated that, at the inside (*i.e.*, the best) bid and offer on a stock, use of odd-sixteenths increased when either the price or volatility of the stock was lower or when the level of trading activity was higher. The NASD verified that quotes on New York Stock Exchange ("NYSE") stocks followed the same patterns, although use of odd-sixteenths was generally greater than that found on Nasdaq.<sup>126</sup>

The NASD study also found that the use of odd-sixteenths increases throughout the trading day. The NASD noted that the same trend existed in NYSE stocks, as well. OEA's analysis similarly found that the use of odd-sixteenths increased from 22.5% in the first hour of trading to approximately 27% later in the trading day in April 1998, the longer and more recent of the two periods OEA reviewed. The NASD cites two plausible reasons. First, market makers may be more reluctant to quote in odd-sixteenths (which often results in a narrowing of a market maker's spread) until the market is given an adequate opportunity to digest news that may have come out after the previous day's close that could adversely impact the price of a particular stock. This is referred to as "adverse selection risk." Second, market makers may be more inclined to quote in odd-sixteenths as the day goes on to reduce inventory in a particular stock before the day's close. This is called "inventory risk." As the NASD noted, the fact that market makers quote more aggressively as the day goes on does not imply that they were not quoting competitively earlier in the day.

Based on these findings, the NASD preliminarily concluded that the quotation increment for a particular stock could be driven by economic factors, rather than by the lowest increment available to the market maker or specialist. In light of the market discipline that the Order Handling Rules impose on market makers, we agree that it is reasonable to conclude that market makers may weigh a number of legitimate business factors (including a stock's price, volume, and volatility, as well as adverse selection risk and inventory risk) in determining whether to price a particular stock at the lowest pricing increment available.

## B. Market Maker Quotes Compared to Those of ECNs

The NASD also examined the discrepancy found in the Whitcomb-Simaan Study in the use of odd-sixteenths between market makers and ECNs. (Any such comparison is difficult because the orders placed in ECNs are anonymous, and so they may represent either dealer orders or institutional orders.)

The NASD's analysis found that the prevalence of odd-sixteenths among the best market maker bids and offers was higher than among market maker quotes in general.<sup>127</sup> In many instances, use of odd-sixteenths among the best market maker bids and offers was equal to that of Instinet. In addition, the NASD found that the best market maker quotes displayed a greater frequency of odd-sixteenths than the quotes from Island, the second most active ECN. The NASD believes that this is an important finding because the quotes from Island may represent the best orders among those placed by active day-traders.

The NASD ultimately found that for a group of 25 stocks with active Instinet use, the best market maker quotes exhibited an odd sixteenth use of approximately 26%, as opposed to 32% for Instinet.<sup>128</sup> In its review of a group of 20 stocks, OEA found that in April 1998 25.9% of all market-maker bid quote updates were in odd sixteenths as opposed to 37.3% for ECNs. In June 1997 the numbers were 11.1% for all market makers compared to 28.1% for ECNs. It is perhaps noteworthy that OEA reviewed all market maker quotes rather than the best market maker quotes, which, as the NASD postulates, are more likely to contain odd sixteenths than are the quotes of market makers generally. Even in this group, the OEA review found that use of odd sixteenths was clearly present and their use has increased significantly from June 1997 (shortly after the markets moved to sixteenths as the minimum pricing increment) to April 1998. It is also worth noting that OEA's review of all ECN quotes shows use of odd sixteenths among ECNs well below 50% in both sample periods. Perhaps more importantly, OEA's review could suggest that the trend in odd sixteenths use over time may be significantly higher for all market makers than for ECNs. Indeed, while use of odd sixteenths has increased only 33% for ECNs from June 1997 until April of 1998 (28.1% to 37.3% = 33% increase), use among all market makers has more than doubled in the same stocks over the same period (11.1% to 25.9% = 133% increase).

Moreover, the NASD postulates that differences in use of odd sixteenths between market makers and ECNs could be explained by the difference between a quote, which is what a market maker displays on Nasdaq, and an order, which is what any subscriber, including a market maker, displays on an ECN. The NASD observes that "a quote persists throughout the day representing 'routine' liquidity supply, while an order represents a more discrete investment decision." The NASD's analysis suggests that orders placed by dealers on Instinet are more aggressive than quotes in the same security placed on Nasdaq.

The NASD identifies two other possible reasons for this discrepancy--the anonymity provided by Instinet and the size restrictions on Nasdaq quotes that existed at the time of the study. ECNs permit market participants to enter orders into the system anonymously. Nasdaq does not.<sup>129</sup> A dealer's order in an ECN is anonymous to all subscribers of the ECN, and to the Nasdaq market. Many market participants enter anonymous orders into ECNs to reduce the market impact that the same order might have if placed under that participant's name in the Nasdaq quote. In addition, the 1,000 share minimum size restriction, which, until recently, applied to Nasdaq market maker quotes in many Nasdaq securities, did not apply to Instinet orders, and Instinet orders were frequently for fewer than 1,000 shares.<sup>130</sup> We believe that the differences between Nasdaq and ECNs in place at the time of the respective studies (e.g., anonymity and minimum size requirements) are possible reasonable explanations for the disparity in odd-sixteenths between the competing markets.

#### C. Impact of Order Handling Rules

We further believe that the possibility of there being any impact of a pricing convention would be diminished greatly by the SEC's Order Handling Rules, which were implemented in January of 1997. Those rules require that market makers display customer limit orders, if the customer does not direct otherwise, and require that the best market maker orders transmitted to ECNs be displayed in the public quote. The rules, which permit customers to make public their limit orders, have resulted in narrower spreads overall. In addition, they have resulted in some of the best orders, which were previously available only to a limited number of market participants on ECNs and other private trading systems, being made available to all investors. We believe that the enhanced competition from customer orders that the Order Handling Rules have brought about makes it highly unlikely that any disparities in odd-sixteenths use are due to dealer collusion in the Nasdaq market.

#### D. Conclusion

Permitting a market maker to quote in a particular trading increment does not mean that it necessarily will quote in that increment. Many factors, including any one or a combination of those suggested by the NASD and discussed above, may drive the pricing decision. The frequency of any particular quotation cannot, in and of itself, be considered evidence of collusive or coordinated behavior. At the time the pricing convention existed, eighths were the smallest increment available for quotation, and the use of odd-eighths among Nasdaq market makers was virtually non-existent in certain stocks; this pricing convention was sustained through threats and coercive actions. A similar situation has not been found in the Whitcomb-Simaan Study, the NASD's research, OEA's spot review of the frequency of odd-sixteenths, current NASDR and SEC examinations, or any of the Commission staff's conversations with market participants. For those reasons, we believe that the frequency of odd-sixteenth quotes are due to a combination of various economic factors, as discussed above. Nevertheless, we have asked the NASD to continue to monitor the use of odd-

sixteenths if patterns of usage change in a manner that suggests possible price coordination. We will do the same.

## Endnotes

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<sup>1</sup> See In the Matter of National Association of Securities Dealers, Inc., Securities Exchange Act Release No. 37538, August 8, 1996; Administrative Proceeding File No. 3-905.

<sup>2</sup> See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Securities Exchange Act Release No. 37543, August 8, 1996 (“21(a) Report”); Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (“Appendix to 21(a) Report”).

<sup>3</sup> See SEC Order, supra note 1, at 6-9.

<sup>4</sup> See Report of the NASD Select Committee on Structure and Governance, September 15, 1995.

<sup>5</sup> See 21(a) Report, supra note 2, at 39.

<sup>6</sup> Id. at 40-41.

<sup>7</sup> Id. at 41-42.

<sup>8</sup> See SEC Order, supra note 1, at 6-7.

<sup>9</sup> Id. at 6.

<sup>10</sup> Id. These committees include the National Nominating Committee, the Trading/Quality of Markets Committee, the Arbitration Committee, the Market Surveillance Committee, the National Business Conduct Committee, the Management Compensation Committee, and any successors. The names of some of these committees have changed since the issuance of the SEC Order.

<sup>11</sup> Such materials include the certificates of incorporation and the by-laws of the NASD, its subsidiaries and affiliates, and the Delegation Plan.

<sup>12</sup> See Securities Exchange Act Release No. 39326 (November 14, 1997) 62 FR 62385 (November 21, 1997) (File No. SR-NASD-97-71).

<sup>13</sup> The Division of Market Regulation recognized that, due to the technical nature of the issues dealt with by these two committees, it may be difficult for the NASD to find qualified individuals with no ties to the industry. See Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to T. Grant Callery, Senior Vice President and General Counsel, NASD, dated January 13, 1998.

<sup>14</sup> For example, the 1998 report issued by the independent consultant recommended that committee classifications be certified to ensure that the specified participation criteria have been satisfied. A conflicts of interest database based on information obtained pertaining to the activities of Board and Committee members was also recommended. See Report of Independent Consultant Frederick M. Werblow on the Status of Implementation of Undertakings, dated July 23, 1998 (“1998 Werblow Report”), at 91-92.

<sup>15</sup> See SEC Order, supra note 1, at 6.

<sup>16</sup> Id.

<sup>17</sup> See Securities Exchange Act Release Nos. 37106 (April 11, 1996) 61 FR 16944 (April 18, 1996) (File No. SR-NASD-96-02); 37107 (April 11, 1996) 61 FR 16948 (April 18, 1996) (File No. SR-NASD-96-16); 37282 (June 6, 1996) 61 FR 29777 (June 12, 1996), (File No. SR-NASD-96-20); 37425 (July 11, 1996) 61 FR 37518 (July 18, 1996) (File No. SR-NASD-96-29); see also Report of Independent Consultant Frederick M. Werblow on the Status of Implementation of Undertakings, dated July 25, 1997 (“1997 Werblow Report”), at 6.

<sup>18</sup> See Securities Exchange Act Release No. 39326, supra note 11.

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<sup>19</sup> See Securities Exchange Act Release No. 40252 (July 23, 1998) 63 FR 40759 (July 30, 1998) (File No. SR-NASD-98-46).

<sup>20</sup> See 1998 Werblow Report, supra note 14, at 9.

<sup>21</sup> See SEC Order, supra note 1, at 6.

<sup>22</sup> See 21(a) Report, supra note 2, at 35 n.91.

<sup>23</sup> See Securities Exchange Act Release No. 38908 (August 7, 1997) 62 FR 43385 (August 13, 1997) (File No. SR-NASD-97-28).

<sup>24</sup> See the Rule 8000 and 9000 Series of the Rules of the NASD, which contain the disciplinary procedures of the NASD, as implemented by NASDR.

<sup>25</sup> See 1998 Werblow Report, supra note 14, at 9.

<sup>26</sup> See SEC Order, supra note 1, at 7.

<sup>27</sup> Id.

<sup>28</sup> See 1997 Werblow Report, supra note 17, at 8; see also Securities Exchange Act Release No. 39326, supra note 11.

<sup>29</sup> See Securities Exchange Act Release Nos. 37106, 37107, 29777, and 37425, supra note 17.

<sup>30</sup> See Securities Exchange Act Release No. 39483 (December 22, 1997) 63 FR 117 (January 2, 1998) (File No. SR-NASD-97-70).

<sup>31</sup> See 1997 Werblow Report, supra note 17, at 8.

<sup>32</sup> See Securities Exchange Act Release No. 38908, supra note 23.

<sup>33</sup> See 1998 Werblow Report, supra note 14, at 24-25.

<sup>34</sup> See Securities Exchange Act Release No. 39326, supra note 11.

<sup>35</sup> Id.

<sup>36</sup> Membership application rules setting forth staff responsibilities in the membership application process were approved by the Commission in August 1997. See Securities Exchange Act Release No. 38908, supra note 23.

<sup>37</sup> See Securities Exchange Act Release No. 39326, supra note 11.

<sup>38</sup> See Securities Exchange Act Release No. 40252, supra note 19. For example, the NASD recently amended the Delegation Plan to codify NASDR's access to the books and records of Nasdaq.

<sup>39</sup> See 1998 Werblow Report, supra note 14, at 97-99. Included on the restricted list, for example, would be Nasdaq securities which had been the subject of initial or secondary public offerings within the previous 30 days.

<sup>40</sup> Id. at 99-100.

<sup>41</sup> See 21(a) Report, supra note 2, at 41.

<sup>42</sup> Id.

<sup>43</sup> See SEC Order, supra note 1, at 7.

<sup>44</sup> See Securities Exchange Act Release No. 38908, supra note 23.

<sup>45</sup> See 1997 Werblow Report, supra note 17, at 9.

<sup>46</sup> See 21(a) Report, supra note 2, at 34.

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<sup>47</sup> See SEC Order, supra note 1, at 7-8.

<sup>48</sup> Id. at 7.

<sup>49</sup> Id.

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> See 1997 Werblow Report, supra note 17, at 10.

<sup>53</sup> See 1998 Werblow Report, supra note 14, at 42-46.

<sup>54</sup> Id. at 42.

<sup>55</sup> See Appendix to 21(a) Report, supra note 2, at A-83.

<sup>56</sup> Id. at A-84.

<sup>57</sup> See SEC Order, supra note 1, at 7-8.

<sup>58</sup> Id.

<sup>59</sup> Id.

<sup>60</sup> See Securities Exchange Act Release No. 39729, 63 FR 12559 (March 13, 1998) (File No. SR-NASD-97-56).

<sup>61</sup> Id.

<sup>62</sup> Id.

<sup>63</sup> Id. We note that Mr. Werblow (at the direction of the NASD Audit Committee) did not perform any work on OATS in connection with his 1998 Report. See 1998 Werblow Report, supra note 14, at 3.

<sup>64</sup> See Securities Exchange Act Release No. 39729, supra note 60.

<sup>65</sup> See SEC Order, supra note 1, at 8.

<sup>66</sup> See 21(a) Report, supra note 2, at 45.

<sup>67</sup> Id. at 36-39.

<sup>68</sup> See Securities Exchange Act Release No. 37619A, 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

<sup>69</sup> See e.g., NASD Notices to Members 96-65 (October, 1996), 97-49 (August, 1997) and 97-57 (September, 1997).

<sup>70</sup> According to the 1998 Werblow Report, since August 1997, the TMMS Examination Program has experienced staff turnover of more than 50%. See 1998 Werblow Report, supra note 14, at 51.

<sup>71</sup> Id.

<sup>72</sup> Id.

<sup>73</sup> See SEC Order, supra note 1, at 8.

<sup>74</sup> See 21(a) Report, supra note 2, at 38.

<sup>75</sup> Id.

<sup>76</sup> See 1998 Werblow Report, supra note 14, at 57.

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<sup>77</sup> See 21(a) Report, supra note 2, at 30-38.

<sup>78</sup> See SEC Order, supra note 1, at 8-9.

<sup>79</sup> See 21(a) Report, supra note 2, at 36.

<sup>80</sup> See Securities Exchange Act Release No. 37619A, supra note 68; Special NASD Notice to Members 97-67 (October 1997).

<sup>81</sup> See SEC Order, supra note 1, at 8.

<sup>82</sup> See Special NASD Notice to Members 97-67 (October 1997).

<sup>83</sup> Id.

<sup>84</sup> Id.

<sup>85</sup> Id.

<sup>86</sup> See 1998 Werblow Report, supra note 14, at 63.

<sup>87</sup> Id.

<sup>88</sup> See SEC Order, supra note 1, at 8.

<sup>89</sup> Id.

<sup>90</sup> See Securities Exchange Act Release No. 38845, 62 FR 39564 (July 23, 1997) (File No. SR-NASD-97-37).

<sup>91</sup> See SEC Order, supra note 1, at 8.

<sup>92</sup> Id. at 8-9.

<sup>93</sup> See Securities Exchange Act Release No. 38845, supra note 90.

<sup>94</sup> See 1998 Werblow Report, supra note 14, at 88-89.

<sup>95</sup> See Appendix to 21(a) Report, supra note 2, at A-81.

<sup>96</sup> Id.

<sup>97</sup> See SEC Order, supra note 1, at 9. To address the Commission's concerns, the NASD proposed to revise the Excess Spread Rule on a pilot basis through July 1, 1997. See Securities Exchange Act Release No. 38180 (January 16, 1997) 62 FR 3725 (January 24, 1997) (File No. SR-NASD-96-50). The pilot was extended twice, to September 30, 1997 (Securities Exchange Act Release No. 38804 (July 1, 1997) 62 FR 36855 (July 9, 1997) (File No. SR-NASD-97-46)) and October 13, 1997. See Securities Exchange Act Release No. 39120 (September 23, 1997) 62 FR 51170 (September 30, 1997) (File No. SR-NASD-97-70).

<sup>98</sup> The NASD notified the Commission, by letter dated September 25, 1997, that Nasdaq's Board of Directors approved a resolution, subsequently ratified by the NASD's Board of Governors, to allow the Excess Spread Rule to lapse as of October 13, 1997.

<sup>99</sup> See SEC Order, supra note 1, at 9.

<sup>100</sup> See 1998 and 1997 Werblow Reports, supra notes 14 and 17.

<sup>101</sup> See Appendix to 21(a) Report, supra note 2, at A-62-63.

<sup>102</sup> Id.

<sup>103</sup> Id.

<sup>104</sup> Id.

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<sup>105</sup> See Securities Exchange Act Release No. 39490 (December 24, 1997) 63 FR 897 (January 7, 1998) (File No. SR-NASD-97-50).

<sup>106</sup> Id.

<sup>107</sup> See 21(a) Report, supra note 2, at 38-39; Appendix to 21(a) Report, supra note 2, at A-76-79.

<sup>108</sup> Id.

<sup>109</sup> Id.

<sup>110</sup> Id.

<sup>111</sup> Id.

<sup>112</sup> See Securities Exchange Act Release No. 39423 (December 10, 1997) 62 FR 66160 (December 17, 1997) (File No. SR-NASD-97-04).

<sup>113</sup> Id.

<sup>114</sup> See Appendix to 21(a) Report, supra note 2, at A-68 n. 183.

<sup>115</sup> Id.

<sup>116</sup> Id.

<sup>117</sup> See Securities Exchange Act Release No. 39550 (January 14, 1998) 63 FR 4333 (January 28, 1998) (File No. SR-NASD 96-51).

<sup>118</sup> See 21(a) Report, supra note 2, at 40-41.

<sup>119</sup> See Securities Exchange Act Release No. 39637 (February 10, 1998) 63 FR 8242 (February 18, 1998) (File No. SR-NASD-98-05). The rule change became effective immediately pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and Rule 19b-4(e)(5) thereunder.

<sup>120</sup> See Securities Exchange Act Release No. 39516 (January 2, 1998) 63 FR 1520 (January 9, 1998) (File No. SR-NASD-97-21); see also Securities Exchange Act Release No. 40137 (June 26, 1998) 63 FR 36462 (July 6, 1998) (File No. SR-NASD-98-43) (extending the grace period in which equity traders can register for the Series 55 exam).

<sup>121</sup> See SEC Order, supra note 1, at 5.

<sup>122</sup> Of that amount, \$153,000 was paid to the independent consultant for his services in 1996. According to the NASDR, the independent counsel was not paid out of these funds in 1997.

<sup>123</sup> See 21(a) Report, supra note 2, at 36-39.

<sup>124</sup> See Appendix to 21(a) Report, supra note 2, at A-38-55.

<sup>125</sup> Professors Yusif Simaan and David K. Whitcomb, "The Quotation Behavior of ECNs and Nasdaq Market Makers," Fifth Draft, December 31, 1997.

<sup>126</sup> The NASD noted that the affirmative obligations placed on NYSE specialists to maintain depth and price continuity as a possible explanation of the difference between odd-sixteenths on the NYSE and Nasdaq. See NASD Study, at 3.

<sup>127</sup> The NASD's review did not compare the quotes transmitted by Instinet, the largest of the ECNs, with the quotes transmitted by all market makers, as had the Whitcomb-Simaan Study. Instead, the NASD compared the quotes transmitted by Instinet with the quotes of the best market-maker quote on Nasdaq. The NASD chose to use this measure rather than the one used by Whitcomb and Simaan because Instinet quotes transmitted to Nasdaq represent the best among the dealer orders currently on Instinet's book, just as the best market maker quote on

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Nasdaq represents the best among the market makers' and ECNs' quotes. We believe that it was reasonable for the NASD to review only the best market maker quotes rather than using the Whitcomb and Simaan methodology.

<sup>128</sup> By way of comparison, the study that gave rise to the NASD investigation regarding the avoidance of odd-eighths found almost no use of odd-eighths by Nasdaq market makers. See William G. Christie and Paul H. Schultz, Why Do NASDAQ Market Makers Avoid Odd Eighth Quotes?, 49 J. Fin. 1813-40 (1994).

<sup>129</sup> The NASD has proposed a new system that would, among other things, permit anonymous display of orders. See Securities Exchange Act Release No. 39718 (March 4, 1998) 63 FR 12124 (March 12, 1998) (File No. SR-NASD-98-17). The proposal is still pending with the Commission.

<sup>130</sup> On July 15, 1998, the Commission approved an NASD proposal to permit Nasdaq market makers to quote in 100 share increments. See Securities Exchange Act Release No. 40211, 63 FR 39322 (July 22, 1998) (File No. SR-NASD-98-21). Prior to that time Nasdaq market makers were required to quote in sizes greater than 100 shares (up to 1000 shares) for many Nasdaq stocks.