NASD® REGULATION
An NASD Company

Mary L. Schapiro
President

July 10, 2001

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

Re: NASD Regulation Inc. Regulatory Program for "Spoofing"

Dear Congressman Dingell:

Your letter dated January 10, 2001 requested a six-month update on actions by NASD Regulation Inc. ("NASDR") to address the market conduct commonly known as "spoofing." The traditional definition of spoofing involves the display and prompt withdrawal of a large quote or order with the intention of triggering a market movement from which a market participant may benefit by trading on the contra-side (i.e., buying at an unduly low price created as a result of a flash quote to sell, and vice versa). Recently, the definition of spoofing has been broadened to include any placement of an order or quote to be displayed for the purpose of gaining improper market advantage.

As I indicated in my letter to you dated December 28, 2000, NASDR's Market Regulation Department has developed a surveillance scenario for the detection of spoofing using its Advanced Detection System ("ADS"). ADS is an automated market break detection system designed to monitor exceptions in quotation, trading and trade reporting that may have a negative impact on the market or violate NASD rules or the federal securities laws. The ADS spoofing scenario was put into experimental release in May 2000, and regular production in September 2000.[1] The spoofing scenario identifies instances in which a large sized quote is displayed, or "flashed" briefly, followed by a material market movement (upward for "flash" bids and downward for "flash" offers). The identification of such an instance results in a surveillance alert.

The ADS spoofing scenario has produced a number of alerts, 13 of which were identified for a more formal review. On May 18, 2001, NASDR referred the results of 2 of these formal reviews to the Securities and Exchange Commission, because the conduct involved individual investors who do not fall under the jurisdiction of NASDR. For 5 of these reviews, the staff has determined that the conduct involved was not actionable and thus the matters were closed without action. The staff continues to pursue the remaining 6 formal reviews.

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[1] The routine stages regarding the implementation of a new automated surveillance scenario are (1) initial development, during which the elements of the targeted conduct are defined, preliminary surveillance review parameters are set, and a computer program is written; (2) experimental release, during which sample alerts are reviewed to test the program's internal logic and conformity with the defined parameters, as well as the parameters themselves in connection with the volume and quality of alerts produced; and (3) production, which involves full implementation of the review as part of regular surveillance procedures. Alerts produced during the experimental phase of development will be investigated fully if they reveal evidence of violative conduct.

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NASDR also has been working to enhance its spoofing detection system through the integration of Order Audit Trail System ("OATS") data. Specifically, using OATS data, the staff has developed an additional scenario for our ADS program that identifies the market participants behind large "flash" orders placed in electronic communication networks ("ECNs") at prices away from the inside market. This scenario is currently undergoing testing and is expected to go into production on an experimental basis later this summer.

You also may be aware that on May 3, 2001, the SEC announced the settlement of In re Monski, an administrative proceeding involving a case in which an individual investor entered a small "flash" order into an ECN which narrowed the inside market.[2] This individual did so to take advantage of broker-dealer systems that provide automatic executions up to a certain size at that newly created inside price.

NASDR referred the Monski case to the SEC as a result of our active surveillance and enforcement program that monitors orders of all sizes and which has been in place since 1997. To date, our Market Regulation Department has made 21 formal referrals to the SEC for this type of conduct. Additionally, NASDR has brought four such cases against registered representatives, which have imposed suspensions, fines, and the payment of restitution.[3] NASDR is currently investigating 11 such cases involving other registered representatives.

NASDR continues to be vigilant in its detection of market manipulation in its varied forms, and is committed to the aggressive pursuit of such activity in its mission to protect customers and preserve market integrity. If you should have any questions or concerns, please contact me at 202/728-8140 or Stephen Luparello, Executive Vice President for Market Regulation at 240/386-5060.

Sincerely,

Mary L. Schapiro

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President

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[2] In the Matter of Robert J. Monski, SEC No. 34-44250 (May 3, 2001)("Monski Case"). The SEC imposed a civil penalty of $10,000 and required Monski to pay disgorgement of $15,000.

[3] Alan L. Goldstein, NASD Case #CMS000131 (October 2000) (3-month suspension, $17,500 fine, and $12,817 restitution payment); Paul Kazak, NASD Case #CMS010073 (May 2001) (6-month suspension, $15,000 fine, and $23,730 restitution payment); Mark M. Krist, NASD Case #CMS010051 (May 2001) (2-month suspension, $25,000 fine, and $1,794 restitution payment); and Fredric N. Gabler, NASD Case #CMS010064 (May 2001) (2-week suspension, $75,000 fine, and $6,513 restitution payment).