



Mary L. Schapiro  
President

December 28, 2000

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. Surveillance Efforts to Detect "Spoofing"

Dear Congressman Dingell:

As you requested in your letter dated February 23, 2000, the following is a status report of NASD Regulation Inc.'s ("NASDR") actions to address the market conduct commonly known as "spoofing." As previously discussed, the theory of spoofing involves the display and prompt withdrawal of a large quote 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 the result of a flash quote to sell, and vice versa).

The Market Regulation Department of NASDR 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 trading and reporting that may have a negative impact on the market. Following initial development, the spoofing scenario was put into experimental release in May 2000, and regular production in September 2000.<sup>1</sup> The scenario seeks to identify instances in which a large sized quote is displayed briefly, followed by a material market movement (upward for "flash" bids and downward for "flash" offers).<sup>2</sup> The identification of such an instance will result in a surveillance alert.

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<sup>1</sup> 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 breaks 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 breaks produced; and (3) production, which involves full implementation of the review as part of regular surveillance procedures.

<sup>2</sup> This surveillance scenario encompasses Nasdaq issues with an average daily volume up to 1 million shares, since such stocks are generally more susceptible to market movement than higher volume issues. Nonetheless, it is anticipated that higher volume issues would be included in the "Phase II" initiative discussed below.

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Since the "spoofing" scenario went into production, there have been over 80 alerts, most of which have been closed as non-problematic after analyst review. Additionally, the Market Regulation Department has received five complaints regarding spoofing. The major reasons for closing breaks or complaints so far have included: (1) the same market participant has posted better priced quotes for a longer duration following its subject large quote; (2) the market was already moving in the given direction of the subject quote; (3) there were no trades during, nor in the wake of, the market movement; (4) there was a full or partial execution of the subject quote (resulting in the quotes' withdrawal or revision of its price and/or size); and (5) one or more block trades occurred during the pertinent time frame that may have precipitated the market movement. The staff has initiated a number of spoofing investigations, but it is premature at this point to predict their conclusions.

For later phases of spoofing detection, NASDR is evaluating a scenario that will detect large sized orders placed in electronic communication networks ("ECNs") away from the inside market that are only seen internally in ECNs and not the Nasdaq market. This initiative is conditioned upon the integration of OATS data into the spoofing detection patterns in ADS, which we expect to occur in mid 2001.

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 Steve Luparello, Executive Vice President for Market Regulation at 240/386-5060.

Sincerely,



Mary L. Schapiro  
President

cc: Steve Luparello