



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

December 20, 1999

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:

In your letter dated November 19, 1998, you asked for a follow-up report by the end of the year on the NASD's progress in resolving all open matters identified in the Commission's August 20, 1998 report regarding the remedial actions undertaken by the NASD. Your letter identified six items in our August report as outstanding matters or continuing deficiencies. The attached memorandum, prepared by my staff, provides an update regarding each of these items. We understand that the Department of Justice is providing its response under separate cover.

Overall, I believe that the remedial actions undertaken by the NASD, coupled with the Commission's Order Handling Rules, have significantly enhanced the Nasdaq Stock Market to the benefit of investors. The NASD has committed substantial resources to fulfill the fourteen undertakings required by the Commission in its 1996 enforcement action. Although I have been very satisfied with the NASD's progress to date, my staff will continue to monitor their efforts.

Thank you for your interest in the NASD's efforts. If you have questions or comments, please do not hesitate to contact me or Annette L. Nazareth, Director of the SEC's Division of Market Regulation, at (202) 942-0090.

Sincerely,

A handwritten signature in black ink, appearing to be "A. Levitt", written in a cursive style.

Arthur Levitt

Enclosure

## NON-PUBLIC MEMORANDUM

**To:** Chairman Arthur Levitt

**From:** Annette L. Nazareth, Director  
Division of Market Regulation

**Date:** December 17, 1999

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

This memorandum responds to Representative Dingell's request to update the Commission's comprehensive report, dated August 20, 1998, on the National Association of Securities Dealers, Inc.'s ("NASD") progress in fulfilling the fourteen undertakings required by the Commission in its 1996 order ("SEC Order"). Congressman Dingell's November 19, 1998 letter enumerates six items identified in our August 20, 1998 report as outstanding matters or continuing deficiencies. This memorandum is intended to provide follow-up information about each of these items. For a complete discussion of the actions taken by the NASD, please refer to our August, 1998 report.

In responding to Congressman Dingell's inquiry, we have relied upon the representations of NASD staff and the July 19, 1999 report issued by Frederick M. Werblow ("1999 Werblow Report"), the independent consultant hired by the NASD to review the NASD's compliance with the SEC Order.

1. The SEC Order required the NASD to provide for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries. In August 1998, we reported that the requirements of this undertaking had been fulfilled with respect to investigative and prosecutorial authority and the regulatory autonomy of NASD Regulation, but we described the insulation of the regulatory staff from the commercial interests of NASD members and Nasdaq as "still evolving."

Update. The NASD has not yet fully completed implementing its restricted list, which would identify those Nasdaq equity securities that cannot be purchased by NASD, NASD Regulation, and Nasdaq employees during a specified time period. According to the NASD's General Counsel's office, the restricted list should be fully implemented by year-end. The last set of quarterly account statements is expected to be input into the system by mid-December and will then be compared with the restricted list. The NASD has hired a consultant to update the system on a quarterly basis.

Due to the Y2K blackout on systems modifications imposed by the NASD, the

necessary systems changes cannot be put in place to monitor compliance with the NASD's "No Net Short" and 90-day holding period requirements, which prohibit NASD, NASD Regulation, and Nasdaq employees from holding short positions in Nasdaq equities and from selling Nasdaq securities that have been held for less than 90 days. The necessary systems changes are expected to be completed by the end of the first quarter of next year.

2. The SEC Order required the NASD to promulgate and apply on a consistent basis uniform standards for regulatory and access issues and to institute safeguards to ensure fair and even-handed access to NASD services and facilities. At the time of our August 1998 report, we had not yet received a draft proposal that fully described Nasdaq listing and delisting procedures.

Update. On May 4, 1999, the Commission approved a proposed rule change submitted by the NASD delineating the procedures by which issuers may be denied listing on, or be delisted from, the Nasdaq Stock Market. Securities Exchange Act Release No. 41367, 64 FR 25942 (May 13, 1999) (order approving File No. SR-NASD-98-88). The new rules provide multiple layers of review to help ensure that the standards are applied consistently. Adverse decisions may be appealed to the Commission.

3. The SEC Order required the NASD to establish an independent internal audit staff to review all aspects of NASD's operations, including its regulatory function and disciplinary process. In our initial report, we noted that although the NASD had established the required internal audit department, high staff turn-over had, to some extent, hampered the audit committee in carrying out its responsibilities.

Update. According to the 1999 Werblow Report, the audit staff of the Internal Review ("IR") department has increased from 19 to 26 since last year and the number of vacant positions in the IR department has decreased from 5 to 1. In addition, the part-time IR Counsel position has been replaced by a full-time attorney. Finally, as of November 30, 1999, reports have been issued for 75% percent of the audits included in the 1999 Audit Plan. Field work has been completed on an additional 8% of the audits and the IR Department anticipates that 100% of the reports will be issued by February 15, 2000.

4. The SEC Order required NASD to develop an order audit trail sufficient to enable the NASD to reconstruct markets promptly, effectively surveil them, and enforce its rules. On March 6, 1998, the Commission approved the NASD's Order Audit Trail System ("OATS") rules, which set forth a two-year implementation schedule, with final implementation scheduled for July 31, 2000.

Update. The NASD's implementation of OATS is ongoing. The implementation

of Phase II, which required the reporting of all electronic orders to OATS, began on August 2, 1999 and was completed by the end of September. According to NASD Regulation, as of November 19, 1999, OATS is receiving approximately 11 million order event reports per day and the data received is being used by its Market Regulation staff to surveil limit order handling, trade reporting, and the activities of electronic communications networks. The implementation of Phase III, which will require all orders to be reported to OATS, is scheduled for July 31, 2000.

5. The SEC Order required the NASD to improve substantially its surveillance and examination of order handling. In our August 1998 report, the Commission noted that the NASD's systems for surveilling market maker compliance with the order handling rules could be improved by inclusion of a feature that automatically notifies the NASD that a violation has occurred. We further noted that the Trading and Market Maker Surveillance ("TMMS") examination unit had been crippled by staff turnover of more than 50 percent and the TMMS exam cycle was behind schedule. The TMMS supervisory structure, budget, and resources were found to be inadequate to allow TMMS staff to properly accomplish the unit's objectives.

Update. As discussed in the 1999 Werblow Report, NASD Regulation's Advanced Detection System ("ADS"), implemented in 1998, is designed to detect possible best execution violations under four separate scenarios: retail trading during open market hours, dealer-to-dealer trades executed during open market hours, after-close retail trades, and after-close dealer-to-dealer trades. The 1999 Werblow Report also noted that since August 1998, TMMS examination staff turnover has been reduced to 32% of authorized staffing levels--down from 50% in the prior year. In addition, one supervisor position and one assistant director position have been added to the program and, as of June 30, 1999, the TMMS examination staff had increased by six. Although staff turnover appears to be declining somewhat, the TMMS examination staff continue to have a backlog of unresolved examinations from 1998. Commission staff will continue to monitor the TMMS program and discuss possible areas of improvement with the NASD.

6. In its 21(a) Report, the SEC noted that the NASD's trade reporting surveillance procedures were deficient and were hampered by insufficient automated surveillance reports. As of August 1998, the NASD had expanded and improved its capabilities but needed to take steps to further refine and improve its surveillance of trade reporting.

Update. The NASD has taken a number of steps to further improve its surveillance of trade reporting. NASD Regulation relies on sweeps to surveil for compliance with the trade reporting rules and its Advanced Detection System ("ADS") to surveil for possibly intentional late trade reporting. In

addition, the ongoing implementation of OATS is expected to improve surveillance in this area.