BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of	
Market Regulation Committee,	DECISION
Complainant,	Complaint No. CMS960247
vs.	Market Regulation Committee
Respondent Firm 1,	Dated: December 23, 1997
Respondent.	

The National Business Conduct Committee ("NBCC") called this matter for review pursuant to NASD Procedural Rule 9310. The Market Regulation Committee ("MRC") dismissed all allegations of violations of the Short Sale Rule and various record keeping rules in a decision dated July 21, 1997. For the reasons stated below, we affirm the MRC's dismissal.

Factual Background

Respondent Firm 1 has been a registered broker/dealer since approximately 1971 and is headquartered in a town in New Jersey. Respondent Firm 1 participates in the Small Order Execution System ("SOES") as an order entry firm. Nasdaq established SOES to permit small orders in Nasdaq stocks to be executed automatically at the inside quotes. Respondent Firm 1 stated in its answer to the complaint that a substantial portion of its business involves promoting SOES trading.

Discussion

Substantive Issues - Factual Findings. The complaint alleged that Respondent Firm 1: executed a 1,000-share short sale on a down bid for a customer's account in the stock of Company 1, a Nasdaq National Market stock; failed to mark the ticket as a short sale; failed to make an affirmative determination as to the availability of stock; and failed to report the trade to the Automated Confirmation Transaction Service ("ACT") with a short sale indicator, in contravention of NASD Conduct Rules 3350, 3110(b)(1) and 3370(b)(4) and Marketplace Rule 6130(d)(6) (formerly Article III, Sections 48 and 21(b)(1) of the Rules of

Fair Practice, an Interpretation of the Board of Governors regarding Prompt Receipt and Delivery of Securities, and ACT Rule (d)(4)(F), respectively).[1]

Respondent Firm 1 admitted that on April 27, 1995, it executed on SOES an agency sale of 1,000 shares of Company 1 stock to Firm B at $78 per share. The trade was reported at 13:52:38. The previous best inside bid was a down bid from $78 1/4 to $78 at 13:52:29. Respondent Firm 1 contended that, after appropriate inquiry, it believed the sale to be long and entered it as such. The order ticket for the trade indicated that the securities were in the customer's account in good, deliverable form. At 13:50, the United States Department of Justice announced that it would not approve a merger between Company 1 and Company 2. Within five minutes of the announcement, the price of Company 1 stock declined approximately 11 percent. Thereafter, trading was halted with an inside bid of $72 3/4. Respondent Firm 1 stated that the error was detected shortly after the trade (and after commencement of the trading halt) when the sale could not be matched with a long position that erroneously was believed to have been entered earlier. A hand-written notation on the order ticket for the trade read "Taken from customer - short sale in error."

On April 28 at 8:30 a.m., trading in Company 1 resumed with an opening bid of $65 3/4. Respondent Firm 1 covered the short sale at 12:07 at $69 per share. Respondent Firm 1 argued that, in 1995, Firm B and Respondent Firm 1 did not have the type of relationship (since Respondent Firm 1 was a SOES firm) that would have allowed for communication and negotiation between them regarding breaking the trade.

A Market Regulation examiner, Examiner 1, testified that the NASD commenced its investigation of this matter after receiving complaints about improper short sales of Company 1 on SOES. Respondent Firm 1 was one of 17 firms investigated. Examiner 1 first contacted Respondent Firm 1 on April 28, 1995. In response to questioning from the MRC hearing panel, Examiner 1 testified that Respondent Firm 1 consistently contended throughout the course of the investigation that the trade was an unintentional error and that staff had no evidence that the trade was intentionally marked "long" incorrectly. He also indicated that Market Regulation staff did not attempt to contact the customer, review the customer's account records, or interview any Respondent Firm 1 trading personnel.

The Short Sale Rule. Section (c)(3) of Conduct Rule 3350 provides that section (a) of the rule, which prohibits a short sale on a down bid, does not apply to sales by a member, for an account in which the member has no interest, pursuant to an order to sell which is marked "long" in which the member does not know, or have reason to know, that the

[1] The content of several of the rules alleged to have been violated has changed significantly since the time of the transaction at issue. None of the rule changes affected the sections of the rules at issue in this matter.

beneficial owners of the account have, or as a result of such sales would have, a short position in the security. Respondent Firm 1 contended throughout the course of this proceeding that it believed, in good faith and after appropriate inquiry, that the customer was long in Company 1. There is no evidence in the record to contradict Respondent Firm 1's assertion in this regard. Furthermore, Respondent Firm 1's position has been consistent throughout the course of this investigation, and the Firm's trade blotter and order ticket support this position. The MRC concluded that Respondent Firm 1 was entitled to a presumption that it had proceeded in good faith with a sale that it reasonably believed to be long. Given the dearth of evidence to the contrary, we see no reason to disturb the MRC's finding.

On review, Market Regulation staff argued that Respondent Firm 1 never produced evidence that it proceeded with a mistaken but good faith belief that the trade was long. We disagree with this assertion. While we concur with Market Regulation staff that the burden of establishing that subsection (c)(3) applies to a trade rests with the party raising it as a defense, we do not concur that the record is devoid of evidence that Respondent Firm 1 acted in good faith. The only evidence in the record regarding the circumstances of this trade is Respondent Firm 1's responses to staff requests for information. These responses contain a credible explanation of the circumstances surrounding the trade (that the error was detected shortly after the trade when the sale could not be matched with a long position that erroneously was believed to have been entered earlier), and Market Regulation staff did not offer any contradictory evidence or question Respondent Firm 1 personnel to test Respondent Firm 1's contention in this regard. Indeed, as the MRC noted in its decision, Market Regulation staff produced no evidence regarding the circumstances surrounding the error. Examiner 1 testified that Market Regulation staff made no inquiry of either the customer or Respondent Firm 1 as to why Respondent Firm 1 initially believed that the sale was long or what caused Respondent Firm 1 later to determine that its initial belief was erroneous. Absent evidence to rebut Respondent Firm 1's contention that it acted in good faith, the MRC concluded that Respondent Firm 1's assertion was credible and dismissed the complaint.

We further concur with the MRC's conclusion that Question and Answer No. 17 in NASD Notice to Members ("NTM") 94-68, while not dispositive, is instructive in this instance. NTM 94-68 states that, if a firm adheres to its established procedures for determining intra-day whether it has a net long or short position, and, as a result, believes in good faith that it holds a long position in the stock when it effects the sale, the NASD would not consider the sale to be a violation if it were later determined that the firm's good faith belief was wrong and the firm's position was short.[2] The NTM further states that a pattern

[2] The record did not contain any evidence that suggested that Respondent Firm 1 did not follow its established procedures.

of such transactions would militate against the conclusion that the firm was acting in good faith when it effected the sale.[3]

Like the MRC, we find no evidence that Respondent Firm 1 either knew or should have known that the trade was short. There is no evidence in the record that it did not follow its established procedures, there is no evidence to contradict the Firm's explanation of the trade, and there is no evidence that the Firm engaged in a pattern or has any history of Short Sale Rule violations.

Affirmative Determination, Record Keeping and Reporting Requirements. When Respondent Firm 1 executed the order, it contended (and the MRC found) that it reasonably believed the order to be long, thereby making the requirements of subsection (b)(4)(A) of Rule 3370 applicable. Under subsection (b)(4)(A), the affirmative determination requirements apply only to long sales described under subsection (b)(1)(C) (long sales in which the securities are not in the customer's account with the member). The MRC reasoned that this requirement is separate and distinct from the requirement under subsection (b)(1)(B) to determine that the customer has the securities in its account with the member. Respondent Firm 1's order ticket for the transaction at issue indicated that the sale would not have involved the delivery to Respondent Firm 1 of the securities sold, but rather that the securities were in the customer's account in good deliverable form. The MRC thus concluded that the long sale requirements contained in subsection (b)(4)(A) did not apply and dismissed the alleged violation of subsection (b)(4).

At the MRC hearing and on appeal, Market Regulation staff argued that the appropriate subsection to apply is (b)(4)(B) (affirmative determination requirements for short sales) because the trade in question was, in fact, a short sale. Respondent Firm 1 clearly did not satisfy the requirements of this subsection, since it did not believe that the trade was short. For the reasons discussed below, based on the limited facts of this case, we affirm the MRC's dismissal of this allegation.

Subsection (b)(1) of Conduct Rule 3110 states that associated persons must mark order tickets "long" or "short." Respondent Firm 1 argued that it was inappropriate for the MRC to allege that it had violated this section, since the requirement to mark order tickets

---

[3] Respondent Firm 1 has no history of violations of the NASD's Short Sale Rule. Respondent Firm 1 signed a Letter of Acceptance, Waiver and Consent ("AWC") in 1995 in which it accepted, without admitting or denying, the entry of findings that Respondent Firm 1 executed 232 short sale transactions for customers through SOES in violation of Section (c)(3)(D) of the SOES Rules. At the time of the transactions at issue, Rule (c)(3)(D) stated that no short sale should be entered in SOES. The AWC did not involve alleged violations of the Short Sale Rule.

rests with associated persons, not member firms. We reject this argument. Subsection (a) of Rule 3110 requires each member to keep and preserve records in conformity with all applicable laws, rules, regulations and statements of policy promulgated by the NASD. Thus, the requirement in (b)(1) to mark order tickets also applies to the member firms that employ the associated persons marking the order tickets.

The MRC dismissed the allegation of a violation of Rule 3110(b)(1) because the evidence did not demonstrate that Respondent Firm 1 was negligent in marking the order ticket "long" instead of "short." The MRC reasoned that the "scant" evidence presented demonstrated that this was a single inadvertent mistake and that Respondent Firm 1 reasonably believed that the trade was long and therefore dismissed the allegation. Although we do not concur with the MRC's conclusion that NASD Regulation must demonstrate negligence before it can prove a violation of Conduct Rule 3110, for the reasons discussed below, based on the limited facts of this case, we affirm the MRC's dismissal of this allegation.

Marketplace Rule 6130(d)(6) requires that each ACT report contain a symbol indicating whether the transaction is a buy, sell, sell short, sell short exempt, or cross. Member firms do not report separately in ACT -- any trade reported in SOES automatically is included in ACT reporting. Since Respondent Firm 1 did not designate this trade as "short," the ACT reporting for the trade was inaccurate, in that it did not designate the trade as short.

The MRC dismissed this allegation because it dismissed the alleged short sale violation. The MRC concluded that this alleged violation was derivative of the short sale violation. Although we do not concur with the MRC that this allegation necessarily is derivative of the Short Sale Rule allegation, for the reasons discussed below, based on the limited facts of this case, we affirm the MRC's dismissal of this allegation.

We find that Respondent Firm 1 acted in good faith with respect to marking the order ticket short. Similarly, we conclude that the Firm attempted in good faith to comply with the requirements of Rules 3370, 3110 and 6130. Given the undisputed evidence of Respondent Firm 1's attempted compliance with these rules and the dearth of evidence of systemic problems at Respondent Firm 1, we affirm the MRC's dismissal of these allegations. We find that these record keeping and reporting failures on this one trade were technical and isolated and that the original error in marking the trade ticket long was inadvertent. Based on the limited facts and circumstances of this case, we have determined to uphold the MRC's dismissal of these allegations.

Procedural Issues. Although our decision to dismiss all allegations of the complaint makes Respondent Firm 1's procedural objections moot, we will address the procedural arguments briefly.

Respondent Firm 1 objected to the MRC's exercise of jurisdiction in this matter, since the now defunct Market Surveillance Committee had issued the complaint. We reject this argument. The NASD Regulation Board of Directors enacted an enabling resolution for the MRC in January 1997 which permitted the MRC to complete disciplinary actions commenced by the Market Surveillance Committee. Thus, the MRC had jurisdiction to proceed with this matter.

Respondent Firm 1 also objected to the content of the MRC hearing panel. Respondent Firm 1 argued that neither member of the hearing panel was a current member of the MRC as of the date of the hearing. A panel member was a member of the MRC as of the date of the MRC hearing. At the time of the MRC hearing, NASD Procedural Rule 9223(b) stated that the MRC could appoint a hearing panel consisting of two or more persons, all of whom must be persons associated with members or issuers and one of whom must be a member of the MRC. Thus, the make-up of the MRC hearing panel complied with the requirements of the NASD's Code of Procedure.

Respondent Firm 1 also argued that it was the victim of selective prosecution by the NASD, since it is an active SOES participant. In this regard, Respondent Firm 1 cited the SEC's Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market ("21(a) Report"). Respondent Firm 1 argued that the SEC's findings in the 21(a) Report indicated that the NASD engaged in selective prosecution of the SOES community. We reject this argument. In order to prove selective prosecution, Respondent Firm 1 must prove that in this matter it was singled out for enforcement action while others who were similarly situated were not and that this enforcement action was motivated by arbitrary and unjust considerations. In re George H. Rather, Jr., Exchange Act Rel. No. 36688 (January 5, 1996). Respondent Firm 1 has not established these facts. Indeed, Examiner 1 testified that Respondent Firm 1 was one of 17 firms that were the subject of the NASD's investigation in this matter. Respondent Firm 1 has not demonstrated that its was the victim of selective prosecution.[4]

[4] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Sanctions. In light of our dismissal of the allegations of the complaint, we impose no sanctions.

On Behalf of the National Business Conduct Committee,

_____

Joan C. Conley, Corporate Secretary