

NASD NOTICE TO MEMBERS 97-88

SEC Approves Amendment To Three Quote Rule Granting Staff Exemptive Authority; Effective Immediately

Suggested Routing

- Senior Management
- Advertising
- Continuing Education
- Corporate Finance
- Government Securities
- Institutional
- Insurance
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registered Representatives
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training
- Variable Contracts

Executive Summary

On October 22, 1997, the Securities and Exchange Commission (SEC or Commission) approved an NASD Regulation, Inc. (NASD RegulationSM) proposed amendment to National Association of Securities Dealers, Inc. (NASD[®]) Rule 2320 (Three Quote Rule) that provides the staff of NASD Regulation's Office of General Counsel authority to grant exemptions, under certain circumstances, from the provisions of the Three Quote Rule (SEC Rel. No. 34-39266).

Questions concerning this *Notice* may be directed to David A. Spotts, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8071.

Background

NASD Rule 2320(g) (the Three Quote Rule or Rule) originally was adopted on May 2, 1988,¹ as an amendment to the NASD's best execution interpretation ("Interpretation of the Board of Governors—Execution of Retail Transactions in the Over-the-Counter Market") under Article III, Section 1 of the NASD's Rules of Fair Practice (currently NASD Rules).² The amendment expanded a member's best execution obligation to customers by setting forth additional requirements for customer transactions in non-Nasdaq securities. In particular, the amendment requires members that execute transactions in non-Nasdaq securities on behalf of customers to contact a minimum of three dealers (or all dealers if three or less) and obtain quotations in determining the best inter-dealer market. Under the best execution interpretation, each member is generally required to use reasonable diligence to ascertain the best inter-dealer market for a security, and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.³

The Three Quote Rule was adopted in connection with the NASD's efforts to develop a nationwide automated market surveillance program for non-Nasdaq, over-the-counter securities (commonly referred to as "pink sheet" stocks). Concurrent with these activities, the NASD proposed and the Commission approved new Schedule H to the NASD's By-Laws, which established an electronic system of mandatory price and volume reporting for the over-the-counter non-Nasdaq securities.⁴ The Three Quote Rule was designed to create a standard to help assure that members would fulfill their best execution responsibilities to customers in non-Nasdaq securities, especially transactions involving relatively illiquid securities with non-transparent prices.

Application Of The Three Quote Rule

Some members who are active dealers in the non-Nasdaq market have questioned the value of the Three Quote Rule in various situations in which it is claimed that adherence to the requirement may not assure the satisfaction of the best execution obligation and, in fact, may hinder satisfaction of the obligation because of the time delays involved in contacting and collecting quotations from three separate dealers. In particular, questions have been raised about the application of the Three Quote Rule to the execution of customer transactions in securities that are traded on certain foreign exchanges, but not U.S. exchanges. Because the Three Quote Rule applies to transactions in all non-Nasdaq securities,⁵ which are defined to exclude securities traded only on a "national securities exchange," the rule by its terms applies to transactions effected on any foreign exchange.⁶ For example, where a member firm's customer places an agency order to buy or sell a foreign

security listed on a foreign exchange, the Three Quote Rule would require that the member broker/dealer contact at least three dealers and obtain quotations prior to executing the agency trade.⁷ In some circumstances, it is argued, the exchange market may constitute the best market for the securities that are listed on that market, and the time delay involved in contacting three dealers in advance of a customer transaction could hinder obtaining the best execution for the customer.

NASD Regulation believes that general exemptive authority under the Rule may be appropriate to provide some flexibility to respond to changing market conditions and particular fact situations. NASD Regulation has not yet determined, however, whether any particular class of transactions should be exempted. Considerations in determining whether to grant an exemptive request could include: (1) the number of firms publishing firm quotations and the period of time during which such quotations were published; (2) the size of the customer order in relation to the minimum size of the market makers' quotations; (3) the transaction volume of the security in question; and (4) the number of dealers publishing quotations through an electronic quotation medium in comparison to dealers in the security that do not publish such quotes.

The nature of particular classes of customers may be another factor in determining whether an exemption is appropriate. In some circumstances, for example, an institutional customer may prefer not to inform or broadcast to other intermediaries or market professionals of its particular intent to buy or sell a particular non-Nasdaq security. Under these circumstances, when a member broker/dealer contacts three other

dealers in collecting quotations, as required by the Rule, in certain markets this activity may trigger or invite additional market activity by the parties contacted or others that may affect the market price of the subject security.

Procedures In Exercising Exemptive Authority

It is important to note that the grant of an exemption to the Three Quote Rule will not limit members' best execution obligation. The staff expects that the range of circumstances in which exemptions may be granted will be limited to those circumstances in which it can be shown that the Three Quote Rule would in fact hinder a member's best execution obligation, and that approval of exemption requests generally would be infrequent.

The Office of the General Counsel of NASD Regulation will be responsible for strict compliance with discharging this exemptive authority. Member broker/dealers are instructed to submit all requests for exemptions to the Office of General Counsel, NASD Regulation, and will be required to limit the requests to actual contemplated transactions or situations. The staff will not provide exemptions in response to hypothetical situations or transactions. The request should be detailed and include all relevant information necessary for the staff to reach a determination on the request. If a particular exemption involves a particular class of transactions or class of customers that may be relevant to other member broker/dealers, the staff will also publish such results to the membership through a *Notice to Members* or similar publication or broadcast. Staff determinations will be subject to review by the National Business Conduct Committee.

Endnotes

¹ See SEC Rel. No. 34-25637 (May 2, 1988).

² The Best Execution Interpretation in Article III, Section 1 of the NASD's Rules of Fair Practice was converted to rule form into new NASD Rule 2320 in connection with the NASD's Manual revision project. See SEC Rel. No. 34-36698 (January 11, 1996).

³ See NASD Rule 2320(a).

⁴ New Schedule H of the By-Laws required NASD members executing principal transactions in non-Nasdaq securities to report price and volume data for the days on which their sales or purchases exceeded 50,000 shares or \$10,000. In 1993, member obligations under Schedule H were modified or eliminated as a result of the NASD adopting real-time reporting of transactions for non-Nasdaq securities. See SEC Rel. No. 34-32647 (July 16, 1993).

⁵ "Non-Nasdaq security" is defined in NASD Rule 6710 as: "any equity security that is neither included in the Nasdaq Stock Market nor traded on any national securities exchange..."

⁶ The term "national securities exchange" is not defined in NASD rules, but the requirements to qualify are set forth in Sections 6(a) and 19(a) of the Securities Exchange Act of 1934.

⁷ If a transaction is subject to the Three Quote Rule (NASD Rule 2320(g)), then for books and records purposes, NASD Rule 3110(b)(2) requires that "a person associated with a member shall indicate on the memorandum for each transaction in a non-Nasdaq security ... the name of each dealer contacted and the quotation received to determine the best inter-dealer market."

© 1997, National Association of Securities Dealers, Inc. (NASD). All rights reserved.