BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

Department of Market Regulation,	DECISION
Complainant,	Complaint No. CMS030181
v.	Dated: June 9, 2005
Respondent.	

Hearing Panel found that complainant failed to establish that respondent harassed, coerced, intimidated or otherwise attempted improperly to influence another member or person associated with a member in violation of Rule 2110 and IM-2110-5. Held, Hearing Panel decision is reversed.

Appearances

For Department of Market Regulation: NASD Regional Counsel

For Respondent: Respondent Attorneys

DECISION

I. INTRODUCTION

The NASD Department of Market Regulation ("Market Regulation") appealed a 2004 Hearing Panel decision, which granted a motion for summary disposition filed by Respondent. In its complaint, Market Regulation alleged that Respondent "harassed, coerced, intimidated, or otherwise attempted improperly to influence another member or person associated with a member in violation of NASD Conduct Rule 2110 and IM-2110-5." In granting Respondent's motion for summary disposition, the Hearing Panel held that IM-2110-5 required a showing that the conduct was anticompetitive. The Hearing Panel found that the conduct of the parties against whom Respondent took action was not competitive and that, therefore, Respondent's conduct was not anticompetitive.

We find that the Hearing Panel erred in holding that IM-2110-5 requires a showing that the conduct at issue was anticompetitive. We also find, based on undisputed facts, that Respondent violated Rule 2110 and IM-2110-5 as alleged in the complaint. We impose a $1,000 fine.

II. FACTUAL AND PROCEDURAL HISTORY

From October 1999 through March 2003, Respondent was associated with NASD member Firm 1 as a general securities representative and a general securities principal. From February 2000 through March 2003, he also was registered with Firm 1 as an equity trader. He is currently associated with another NASD member in those same capacities.

This case centers on Respondent's actions as a Firm 1 trader on three dates in 2001 when Firm 1 was a market maker in Cisco Systems, Inc. ("CSCO") and Applied Materials, Inc. ("AMAT"). At the time, Respondent was Firm 1's trader responsible for those securities, both of which were traded on the Nasdaq stock market. Both stocks had dozens of market makers, were highly liquid and traded in large volumes.

On January 16, 2001, between 10:29:15 a.m. and 10:29:59 a.m. (a 44-second period), Firm 1 received 44 sell orders for CSCO through SelectNet[1] from NASD member Firm 2, which was a day trading firm, not a market maker. The orders were round-lot orders (e.g., each order was to sell 100 shares). A firm placing an order through SelectNet could either "broadcast" the order to the market or "preference" the order to a specific market maker chosen by the order entry firm. In this case, Firm 2 preferenced all 44 orders to Firm 1.

Of the 44 Firm 2 orders, 42 were at prices away from Firm 1's published bid (quote to buy); the other two were at Firm 1's bid. Firm 2 canceled 42 of the 44 orders, including the two orders that were at Firm 1's bid, within seconds. Respondent believed that these orders were a form of harassment of Firm 1's.[2] In response to this perceived harassment, Respondent purchased one share of the two remaining 100-share orders, with the intention of discouraging the persons responsible for placing the orders from sending Firm 1 orders through SelectNet that were away from Firm 1's published quotes. After Respondent executed the two one-share purchases, Firm 2 canceled the remaining 99 shares of each order.

On April 23, 2001, between 10:11:01 a.m. and 10:13:22 a.m. (a period of two minutes and 21 seconds), Firm 1 received 16 preferenced buy or sell orders for AMAT, through SelectNet, from NASD member Firm 3, an electronic communication network that does not

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[1] SelectNet was "an electronic screen-based order routing system that allow[ed] market participants to negotiate securities transactions in Nasdaq securities through computer communications, rather than relying on the telephone." *NASD Notice to Members 00-30* (May 2000). Since the period relevant to this proceeding, SelectNet has been subsumed into Nasdaq's SuperMontage trading platform. *See* Exchange Act Rel. No. 43863 (Jan. 19, 2001), 66 Fed. Reg. 8020, 8022 (Jan. 26, 2001).

[2] Respondent contends that Firm 2's conduct was wrongful and uncompetitive because Firm 2 (or its customer) was attempting to "game" the process, which Respondent described as placing orders away from Firm 1's bid hoping that Respondent would unintentionally execute one or more of the orders.

trade for its own account. Of the 16 orders, 10 were at prices away from Firm 1's published market for AMAT. Respondent, once again believing that Firm 1 was being harassed, partially executed eight of the orders, in each case buying one share of a 300-share sell order. He intended the partial executions to discourage the persons responsible for placing the orders from sending Firm 1 orders through SelectNet that were away from Firm 1's published quotes. Firm 3 canceled each of the other orders, including the six orders that had been placed at Firm 1's published market price, prior to execution. Firm 3 also canceled the remaining 299 shares of the eight orders that Respondent had partially executed.[3]

On June 15, 2001, between 3:07:49 p.m. and 3:09:00 p.m. (a period of one minute and 11 seconds), Firm 1 received 48 preferenced orders from Firm 2, through SelectNet, to purchase CSCO. Of the 48 orders, 45 were at prices away from Firm 1's published market for CSCO. Respondent, again believing Firm 1 was being harassed, executed just one share of a 100-share order, intending to discourage the persons responsible for placing the orders from sending Firm 1 SelectNet orders that were away from Firm 1's published quotes. Firm 2 canceled each of the other orders, including those placed at Firm 1's market, before they were executed. Firm 2 also canceled the remaining 99 shares of the order that Respondent partially executed.

The parties stipulated that one-share transactions are not disseminated to the marketplace. They also stipulated that, when he executed the one-share transactions, Respondent knew or should have known that he had no obligation to respond to any SelectNet order that was away from Firm 1's published market.

Neither Respondent nor Firm 1 lodged a complaint with NASD regarding any of the SelectNet messages referenced above, and Market Regulation indicated that it was not aware of any complaint from any other market participant. Respondent's multiple odd-lot executions[4] came to Market Regulation's attention as a result of its surveillance of market activity. Market Regulation did not conduct any investigation to learn the identity of the persons who placed the orders through Firm 2 and Firm 3 or to determine the reasons for the orders.

On August 8, 2003, Market Regulation filed a complaint charging that Respondent's actions violated Rule 2110 and IM-2110-5. Respondent filed an answer in which he contested the charges and requested a hearing. Market Regulation and Respondent subsequently filed cross-motions for summary disposition, pursuant to NASD Procedural Rule 9264. The parties relied on joint stipulations in arguing their motions. The Hearing Panel heard oral argument on

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[3] For unexplained reasons, the complaint cites only five of the eight one-share executions on April 23, 2001, in support of the charges.

[4] Although a round lot order traditionally is an order to buy or sell 100 shares of a stock, the securities industry generally recognizes that any order for quantities involving multiples of 100 is a round lot. Any trade for less than 100 shares (or in an amount not divisible by 100) typically is considered an odd lot. Here, Respondent executed one share of each of the round-lot orders (some of the round-lot orders were for 100 shares, while others were for 300 shares).

the motions on March 3, 2004. On April 2, 2004, the Hearing Panel issued a decision granting Respondent's motion for summary disposition and denying Market Regulation's motion. This appeal followed.

III. DISCUSSION

The parties do not dispute the core facts. What the parties do dispute is the breadth of the coverage of IM-2110-5. That provision reads in relevant part as follows:

> It is conduct inconsistent with just and equitable principles of trade for any member or person associated with a member . . . to engage, directly or indirectly, in any conduct that threatens, harasses, coerces, intimidates, or otherwise attempts improperly to influence another member or person associated with a member. This includes, but is not limited to, any attempt to influence another member or person associated with a member to adjust or maintain a price or quotation, whether displayed on any facility operated by NASD or otherwise, or refusals to trade or other conduct that retaliates against or discourages the competitive activities of another market maker or market participant. . . . Nothing in this interpretation respecting coordination of quotes, trades, or trade reports shall be deemed to limit, constrain, or otherwise inhibit the freedom of a member or person associated with a member to [among other things] . . . take any unilateral action or make any unilateral decision regarding the market makers with which it will trade and the terms on which it will trade unless such action is prohibited by . . . this Interpretation.

IM-2110-5. The main issue we must decide on appeal is whether IM-2110-5 requires a showing that the harassing or retaliatory conduct was anticompetitive. For the reasons set forth below, we find that it does not.

A. The Scope of IM-2110-5

The Hearing Panel interpreted IM-2110-5 narrowly and dismissed the action. Although Respondent contends that the Hearing Panel correctly decided this matter, he offers some additional arguments in support of the dismissal. We will address the Hearing Panel's holdings and Respondent's arguments in turn.

1. The Hearing Panel Decision

The Hearing Panel determined that IM-2110-5 requires a showing that the conduct at issue was anticompetitive. The Hearing Panel stated that the IM "was intended to proscribe anticompetitive conduct, but was not intended to restrict a member firm's right to make unilateral decisions regarding with whom to trade, so long as those decisions are not anticompetitive." The Hearing Panel then found that the orders transmitted by Firm 2 and Firm 3 were not competitive and that, therefore, Respondent's conduct could not have been anticompetitive. The Hearing Panel found it particularly important that (1) the orders were preferenced rather than broadcast, (2) the orders were outside the market and involved highly liquid securities, (3) there was no evidence that Respondent backed away from Firm 1's published quotes, and (4) Respondent's actions were unilateral—there was no allegation or evidence that Respondent was influenced by or attempted to influence any other market maker or even communicated his actions to other market makers. The Hearing Panel concluded that Respondent did not violate the IM because "[h]is actions were not intended to retaliate against or discourage competitive activities on the part of any market participant, and there is no evidence that they had or could have had any such effect."[5]

The Hearing Panel thus focused on whether the orders were competitive, under its narrow interpretation of that term, rather than on whether Respondent's odd-lot executions were harassing, retaliatory or otherwise contrary to the IM.[6] Distilled to its essence, the Hearing Panel's decision would allow an associated person to harass or retaliate against the sender of an order if the order was not competitive, which the Hearing Panel strongly implied would be the case any time an order is preferenced (rather than broadcast) and outside the market (or at least outside the market by a certain, undefined margin). We disagree with the Hearing Panel's interpretation.

We find that NASD need not show that the party being harassed was engaged in competitive activity (or that the respondent who harassed the other party was engaged in anticompetitive conduct). The relevant part of IM-2110-5 states that a member or associated person may not "engage, directly or indirectly, in any conduct that threatens, harasses, coerces,

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5 Clearly, the IM does not require that the prohibited conduct have actually resulted in market or economic impact because the IM uses language such as "attempts," "discourage" and "intended to influence another."

6 The Hearing Panel dismissed this case because it found that the orders were not competitive, rather than dismissing it on the grounds that there was a lack of evidence to prove that the orders were competitive. The Hearing Panel found important that these were preferenced orders regarding highly liquid stocks at prices that were away from the market. We find the Hearing Panel's analysis to be somewhat problematic. The Hearing Panel did not explain how near the market an order must be for it to be considered competitive or whether factors other than those it identified could or should be analyzed. The Hearing Panel, for instance, did not address whether the orders were competitive from the perspective of the parties who placed the orders. Nor did the Hearing Panel indicate whether factors such as the size of the order, the volatility of the security, news announcements related to the issuer or other information could be considered. SelectNet, it must be remembered, was intended to facilitate the communication of trading interest between members and the negotiation of orders with the possibility of price improvement. Various types of information not considered by the Hearing Panel could impact whether a particular order is competitive. Thus, we question whether the Hearing Panel could determine whether the orders at issue in this case where uncompetitive based on the record. However, we need not decide this issue because, as discussed below, we find that IM-2110-5 and Rule 2110 do not require a showing that an order was competitive or that the conduct in response to the order was anticompetitive.

intimidates, or otherwise attempts improperly to influence another member or person associated with a member" (the "anti-harassment provision"). The plain language does not require a showing that the party being harassed was engaged in competitive activity or that the harassing party was engaged in anticompetitive activity. Imposing such limitations, moreover, would be illogical because it essentially would condone harassing or retaliatory conduct whenever the other party's action could be viewed as uncompetitive or wrongful.

The Hearing Panel justified its holding, in large part, on the basis of certain statements in the rule-making history indicating that the IM generally was created to combat anticompetitive activity.[7] However, these general statements in the rule-making history do not lead to the conclusion that NASD is required to prove that the party that was harassed or retaliated against was engaging in competitive activity. The plain language of the pertinent provision in the IM does not require such a showing. Moreover, it is not surprising that the rule-making history would include references to anticompetitive activity because the genesis for the IM originally was a settlement between NASD and the SEC based on the SEC's findings that certain market makers had engaged in anticompetitive activity.[8] However, the fact that NASD and the SEC

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[7] The SEC's order approving the IM explained that the IM prohibits members and associated persons from engaging in the following:

> [C]onduct that threatens, harasses, coerces, intimidates or otherwise attempts improperly to influence another member in a manner that interferes with or impedes the forces of competition among member firms in the Nasdaq Stock Market. This part of the prohibition is intended to reach conduct that goes beyond legitimate bargaining among member firms. This conduct may include, among other things, refusals to trade, improper systems messages, trading in odd lots, and other conduct intended to influence a member to engage in improper market activity or refrain from legitimate market activity. However, . . . this language would not prohibit a member from taking unilateral action in selecting with whom to trade and under what terms, based on legitimate market and commercial criteria (e.g., credit exposure).

SEC Order Approving IM-2110-5, Exchange Act Rel. No. 38845 (July 17, 1997), 62 Fed. Reg. 39564, 39564 (July 23, 1997).

[8] In 1996, NASD entered into a consent order with the SEC. *See In re NASD*, 52 S.E.C. 875 (1996). The SEC alleged that "Nasdaq market makers have engaged in conduct which has resulted in artificially inflexible spreads between dealer price quotations for many Nasdaq securities and unduly disadvantageous prices to investors trading in those securities. A number of Nasdaq market makers have also taken action to discourage competition." The SEC also alleged that NASD "did not comply with certain of its rules or satisfy its obligations under the Exchange Act to enforce its rules and the federal securities laws." Without admitting or denying these allegations, NASD consented to entry of an order that committed NASD to, among other things, "propose a rule or rule interpretation for Commission approval which expressly makes

[Footnote continued on next page]

wanted to combat such activity does not mean that NASD and the SEC were not also concerned about other types of misconduct, including, as we find, harassment and retaliation, regardless of the other party's conduct.

It also is likely that the references in the rule-making history to anticompetitive activity were simply an attempt to underscore that, under certain limited circumstances, a firm is permitted to reject an order for legitimate business purposes (e.g., credit exposure). Again, however, these statements do not alter the actual language of the IM or otherwise lead to the conclusion that NASD must prove that the party being harassed was engaged in competitive activity.[9]

2. Respondent's Arguments

Although, as mentioned above, Respondent generally supports the Hearing Panel's interpretation, he also argues that, in this case, NASD may not rely on the anti-harassment provision (prohibiting "conduct that threatens, harasses, coerces, intimidates, or otherwise attempts improperly to influence another member or person associated with a member") because that provision only applies if the harassing conduct was directed to another member or associated person.[10] According to Respondent, Firm 2 is a day trading firm and Firm 3 is an ECN that does not trade for its own account and it is therefore likely that the persons who actually placed the orders were customers or subscribers, not members or associated persons.[11] Respondent

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[cont'd]

unlawful the coordination by or among market makers of their quotes, trades and trade reports, and which prohibits retribution or retaliatory conduct for competitive actions of another market maker or other market participant." *Id.* at 880-81.

[9] In addition to relying on the rule-making history, the Hearing Panel found that the language in the IM that provides an exception to the IM's requirements supports its view that an order must be competitive before the IM is triggered. We respectfully disagree. The Hearing Panel correctly noted that the IM does not limit, constrain or otherwise inhibit the freedom of a member or associated person to "take unilateral action or make any unilateral decision regarding the market makers with which it will trade and the terms on which it will trade…." However, the Hearing Panel failed to address the rest of the exception's language, which states that a member can take such unilateral action only if the unilateral action is not otherwise prohibited by the IM or other rules or laws (e.g., if it is not harassing, retaliatory). The exception, by its explicit terms, is very narrow. The example that NASD and the SEC provided in the rule-making history of conduct that would be allowed by the exception was a unilateral decision not to trade based on credit exposure. The exception does not support the notion that the IM only applies if the conduct was anticompetitive.

[10] The Hearing Panel declined to address this issue.

[11] The record does not indicate whether the orders were sent on behalf of members, associated persons or customers. As discussed *infra*, however, it makes no difference.

continues by claiming that, because the customers or subscribers were almost certainly not members or associated persons, NASD is limited to bringing an action based on a provision in the IM that covers harassment directed to a "market participant." The sentence in the IM on which Respondent relies (what we will call the "market-participant provision") states in pertinent part, "This includes, but is not limited to, . . . refusals to trade or other conduct that retaliates against or discourages the competitive activities of another market maker or market participant."[12] According to Respondent, the market-participant provision explicitly requires a showing that the harassing conduct was anticompetitive, which Respondent claims cannot be proved because the parties against whom he took action were engaged in wrongful conduct that was itself anticompetitive.[13]

We disagree with Respondent's analysis for a number of reasons. As an initial matter, the market-participant provision is not necessarily a distinct section with its own requirements. The sentence directly follows the anti-harassment provision and begins with the introductory phrase

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12 The parties agree that the term "market participant" is broad enough to include the customer behind the order. The term is used in various contexts by NASD and the SEC. Although we agree that, in general, the term "market participant" is construed more broadly than the term "member," we note that the exact confines of the former term are unclear.

13 As discussed previously, Respondent now contends that the other parties' conduct was wrongful and uncompetitive because they were attempting to "game" the process, which he described as placing orders away from Firm 1's bids or offers hoping that Respondent would unintentionally execute one or more of the orders. Respondent previously also had claimed that the parties who sent the orders were engaged in "spoofing." Spoofing is a form of market manipulation that occurs primarily in thinly traded securities. The manipulator submits to one member firm a limit order to buy or sell a security. The limit order is designed to change the public quotation for the security by either raising the inside, or best available, bid quotation for that security, or lowering the inside, or best available, offer quotation for the security. Virtually simultaneously, the manipulator places with a different member firm an order to sell the same security at the artificially inflated inside bid price or to buy the security at the artificially depressed offer price established by the manipulator's initial limit order. Once the second member firm executes the order at the artificial inside bid or offer price, the manipulator quickly cancels the initial limit order to prevent its execution and the inside bid or offer returns to its former level.

During oral argument, Respondent acknowledged that the senders of the orders in this case likely were not engaged in spoofing. Unlike a typical spoofing case, the parties here placed orders in actively, not thinly, traded securities, making it difficult for a spoofing attempt to succeed. Moreover, spoofing requires a change in the public quotation for the security, which did not occur here. As the parties stipulated, the orders at issue had no impact on the public quotations for CSCO and AMAT. In any event, NASD need not show that the conduct of the harassed party was competitive or legitimate. NASD's rules do not permit members or associated persons to take matters into their own hands.

"[t]his includes, but is not limited to." This introductory phrase makes clear that the sentence merely provides some examples of the types of conduct that the anti-harassment provision generally prohibits. The fact that one addresses misconduct directed to members and associated persons while the other addresses misconduct directed to market makers and market participants is inapposite. The sentence is simply illustrative.

Moreover, it is well settled that an "NASD firm is ultimately responsible for all orders entered, whether entered by the firm or by a sponsored customer or non-member, even if such firm is using the services of a vendor to facilitate the entry of such orders." *NASD Notice to Members 04-66* (Sept. 2004). NASD also has stated that "[a]ny member that provides its customers with access to SelectNet should understand that the member remains responsible for honoring all executions that may occur" and for ensuring compliance with SEC and NASD rules. *NASD Notice to Members 98-66* (Aug. 1998). Consistent with these notions, the conduct prohibited by the anti-harassment provision includes harassing or retaliatory action against a member's customer who is using SelectNet (or a similar service or trading system) to enter orders because the member ultimately is responsible for the orders. Moreover, as a practical matter, a nonmember market participant can only communicate with the marketplace through a member. There is no rational basis or justification for prohibiting harassing or retaliatory conduct directed at a member but allowing the same behavior to be directed at a member's customer.[14]

In sum, IM-2110-5 prohibits harassing and retaliatory conduct directed at members, associated persons or customers. There is no limitation based on the status of the other party or on whether the other party might have been engaged in uncompetitive or wrongful activity.

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[14] Furthermore, even assuming, *arguendo*, that Respondent is correct that the anti-harassment and market-participant provisions are distinct requirements (a contention with which we disagree), we reject Respondent's claim that under the market-participant provision NASD must find that the retaliation was anticompetitive. Contrary to Respondent's assertion, a correct reading of the market-participant provision is as follows, with the language relevant to this case being underlined: "<u>This includes, but is not limited to</u>, . . . refusals to trade or <u>other conduct that retaliates against</u> or discourages the competitive activities of <u>another market maker or market participant</u>. . . ." The phrase "retaliates against" is separate from the phrase "discourages the competitive activities of." Respondent's creative reading of the IM—that the retaliation must be against the competitive activities of another—would require us to accept an awkward and illogical use of the word "retaliate." In standard usage, one retaliates <u>*against actors*</u> (e.g., persons, groups, market makers or market participants) and one retaliates <u>*for or because of actions*</u> (e.g., bombings, vandalism, competitive activity). Obviously, the object of the verb phrase "retaliates <u>*against*</u>" is "another market maker or market participant." Thus, the clearer reading is that the IM defines "other conduct" as either retaliating against another market maker or market participant or discouraging the competitive activities of another market maker or market participant.

B. The Scope of Rule 2110 and the Interplay Between Rule 2110 and IM-2110-5

Market Regulation also alleged in its complaint that Respondent violated Rule 2110, which prohibits a member or associated person from engaging in a broad range of unethical conduct.[15] As with IM-2110-5, Rule 2110 is not limited to situations where both parties are members or associated persons; it requires members to adhere to ethical standards when dealing with other members or associated persons, customers, and the public at large.[16] The rule,

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[15] The decision below, which did not address Rule 2110 as a separate violation, stated:

> [T]he Hearing Panel is not holding that Respondent's actions were justified, appropriate or benign, but simply that they were not anticompetitive, in violation of Rule 2110 and IM-2110-5. . . . [B]ecause Market Regulation charged, briefed and argued the case on the theory that Respondent' actions amounted to anticompetitive harassment in violation of Rule 2110 and IM-2110-5, the Hearing Panel had no occasion to consider whether Respondent' actions could have been charged as violations of Rule 2110's broad requirement that members and associated persons "observe high standards of commercial honor and just and equitable principles of trade" under some other theory not articulated in the Complaint.

We do not agree with the Hearing Panel's conclusion that Market Regulation pleaded and argued this case solely under a theory that Respondent's actions were violative only because they were anticompetitive. The complaint states, "Respondent harassed, coerced, intimidated, or otherwise attempted improperly to influence another member or person associated with a member in violation of NASD Conduct Rule 2110 and IM-2110-5." The complaint, which alleges violations of both IM-2110-5 and Rule 2110, does not on its face rely on a theory that Respondent's actions were anticompetitive. Although Market Regulation argued at various times that the orders transmitted by Firm 2 and Firm 3 were competitive and that Respondent's actions were anticompetitive, Market Regulation did not rely solely on such theories. As such, we find that Respondent had fair notice that Market Regulation was alleging that he had violated both IM-2110-5 and Rule 2110, regardless of whether the orders were competitive or his responses thereto were anticompetitive.

[16] *See, e.g.*, *Alderman v. SEC*, 104 F.3d 285, 288-89 (9th Cir. 1997) (upholding violation of NASD Rule 2110 where associated person failed promptly to return client funds); *Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996) (upholding violation of NASD Rule 2110 where associated person, while serving as treasurer, misappropriated funds from the Houston Young Professional Republicans Club); *James A. Goetz*, 53 S.E.C. 472, 477-78 (1998) (upholding violation of NASD Rule 2110 where associated person obtained a donation from his member firm for his daughter's private high school, through his member firm's matching gifts program, by misrepresenting that he had contributed, as required, personal funds in the same amount); *Donald M. Bickerstaff*, 52 S.E.C. 232, 235-36 (1995) (upholding violation of NASD Rule 2110 where associated person forged customer's signature).

moreover, is not confined to conduct related to securities transactions. *See Vail v. SEC*, 101 F.3d 37, 38-39 (5th Cir. 1996). Nor is it limited to rules of legal conduct. *See Timothy L. Burkes*, 51 S.E.C. 356, 359 n.16 & 360 n.21 (1993), *aff'd*, 29 F.3d 630 (9th Cir. 1994) (table format). As the SEC explained, "NASD's rule requiring the observance of just and equitable principles of trade . . . implement[s] the congressional mandate expressly set forth in Section 15A," *Benjamin Werner*, 44 S.E.C. 622, 624 (1971), and NASD is thus statutorily required to enforce "compliance by its members not only with legal standards but also with ethical concepts applying to dealings with both the public and other professionals in the securities business." *Lile & Co*., 42 S.E.C. 664, 670 n.12 (1965).

Rule 2110 has long been interpreted as prohibiting harassing, threatening and retaliatory conduct. The SEC's decision in *Jay Frederick Keeton*, 50 S.E.C. 1128 (1992), is illustrative. In that case, Jay Frederick Keeton, an associated person, believed that a non-member company, Spacehab, Inc., owed him commissions in relation to an outside business venture. When Spacehab refused to give him the commissions he felt he was owed, Keeton threatened Spacehab with negative publicity. The Commission stated:

> It is possible that Keeton deserved compensation. Nevertheless, in a dispute over a commission, it was hardly necessary to threaten to place a company's reputation and financial position at risk. Keeton should have focused on the normal consequences that would flow from pursuing the merits of his cause, not on Spacehab's vulnerable position. Instead of trying to resolve his claim in an appropriate forum, he irresponsibly attempted to coerce payment from Spacehab by threatening adverse publicity, which could have had a substantially negative impact on Spacehab's capital-raising efforts. We agree with the NASD that the use of such tactics in the securities industry violates high standards of commercial honor and just and equitable principles of trade.

Id. at 1134-35.

Similarly, in *Stephen B. Carlson*, 53 S.E.C. 1017 (1998), the SEC found that Stephen B. Carlson, an associated person, violated Rule 2110 when he used threats, coercion and intimidation in an attempt to obtain the stock of Teletek, Inc., at below-market prices. Carlson, who had a short position in Teletek, believed that Larry Erber, who had previously pled guilty to manipulation and wire fraud, was promoting and manipulating the price of Teletek stock. Carlson threatened to take steps to have Teletek delisted from Nasdaq unless he received discounted Teletek shares. Carlson also told Erber that, if Erber failed to comply with his demand for cheap stock, he would expose Erber's role as an undisclosed owner of a broker-dealer, which would have violated a federal court order restricting Erber's participation in the securities industry. Despite his threats, Carlson did not take any action against Erber, and he eventually covered his short position on the open market. The SEC held that Carlson's conduct was "highly unethical and therefore actionable under NASD [Rule 2110]." *Id.* at 1021.

A finding that Rule 2110 has been violated based on harassment (or any other type of unethical conduct) does not turn on whether the party being harassed was a member or was engaged in competitive activity. As the *Keeton* and *Carlson* decisions demonstrate, members and associated persons may not take matters into their own hands simply because they believe that the other party has engaged in wrongful or anticompetitive conduct. Indeed, the axiom that two wrongs do not make a right obviously applies here.

We also find that the principles articulated in Rule 2110, of which IM-2110-5 is an interpretation, support our reading of the IM. That is, one must read IM-2110-5 in the context of the rule it is interpreting. As the SEC emphasized in its order approving the IM, "[a]lthough the behavior prohibited under the interpretation has continually been violative of NASD Rule 2110 and the federal securities laws, the Commission believes that the interpretation will clearly highlight for members that such conduct is a serious violation of NASD Rules." SEC Order Approving IM-2110-5, Exchange Act Rel. No. 38845, 62 Fed. Reg. at 39565.

Respondent's—and the Hearing Panel's—overly narrow interpretation of the IM is at odds with the broad reach of Rule 2110. Taken to its logical conclusion, Respondent's position would permit an associated person to harass or retaliate against a market participant with impunity as long as the associated person believed that the market participant's activity giving rise to the dispute was itself wrongful or uncompetitive. Contrary to Respondent's argument, Rule 2110 and the overall regulatory scheme do not permit members and associated persons to engage in vigilante justice.

If members or associated persons believe that they have been victimized by wrongful conduct, they have many lawful avenues to seek redress, including notifying NASD or the SEC.[17] Even if Respondent did not want to notify a regulator about the activity at issue, he could have simply allowed the orders to time out (which he was permitted to do because the orders were away from his firm's quotes). He is not, however, permitted to harass or retaliate against the other parties.

IM-2110-5 and Rule 2110 prohibit a member or associated person from threatening, harassing, coercing, intimidating, retaliating against or otherwise attempting to improperly influence another member, associated person or market participant. It makes no difference whether the harasser believes that the person being harassed had engaged in wrongful or anticompetitive conduct. Nor does it matter whether the person being harassed was another member's customer.

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[17] Respondent argues that NASD has no ability to investigate a day-trading firm's customers or an ECN's subscribers or customers because NASD has no jurisdiction over them. Respondent's argument misses the point. NASD has jurisdiction over all NASD members—including member firms Firm 2 (a day trading firm) and Firm 3 (an ECN)—through which customers can place orders. Again, members that provide their customers with access to SelectNet (or a similar service) are responsible for the orders and for compliance with NASD rules and the securities laws. *See* NASD Notice to Members 04-66 (Sept. 2004); NASD Notice to Members 98-66 (Aug. 1998). We note, as well, that the SEC can investigate a firm's customers.

C. Respondent's Violations of IM-2110-5 and Rule 2110

Because the core facts are undisputed, we find that it is appropriate to determine on appeal whether Respondent violated IM-2110-5 and Rule 2110. We find that he did. When Respondent received the SelectNet preferenced orders at issue, he was not required to take any action. He could have let the orders time out because they were away from Firm 1's quotes.[18] Respondent, however, responded with eight odd-lot (one-share) partial executions. As the SEC has noted, an odd-lot execution in response to a round-lot order, as occurred here, often signals harassing or retaliatory conduct. *See* SEC Order Approving IM-2110-5, Exchange Act Rel. No. 38845 (July 17, 1997), 62 Fed. Reg. 39564 (July 23, 1997). Most trading occurs in round lots and, therefore, it can be extremely difficult to trade out of a position that is not divisible by 100. Indeed, Respondent admits that he intended the one-share execution to discourage the persons responsible for the preferenced SelectNet messages from sending Firm 1 SelectNet messages to buy or sell securities at prices that were away from Firm 1's published quotes for the securities. During oral argument, moreover, Respondent's counsel acknowledged that Respondent's action "was intended to have economic harm to the person placing orders…." No more need be proved to find that Respondent violated both IM-2110-5 and Rule 2110.

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[18] Respondent claims that his situation is similar to that of certain market makers discussed in a July 16, 1997 SEC staff letter ("SEC Letter") regarding the SEC's "Firm Quote Rule," SEC Rule 11Ac1-1, which requires a market maker to execute an order presented to it at a price at least as favorable as its published quotation up to its published quotation size. That letter discussed whether a market maker should be charged with backing away from the Firm Quote Rule where an order entry firm sends it multiple orders with the intention of canceling the orders to prevent their execution. SEC staff stated, "Although market makers have a responsibility to stand behind their published quotations …, in the situations where order entry firms are deliberately deterring execution of these orders, the market maker should not be held in violation of the Firm Quote Rule. Nonetheless, because of the serious problems involving unwarranted backing away by market makers in the past, the NASDR must ensure that a market maker's allegations of order entry firms 'gaming' in response to a backing away complaint be substantiated." SEC Letter. Respondent claims that, like the situations discussed in the SEC Letter, NASD must look to the actions of both parties regarding the applicability of IM-2110-5. We disagree.

As an initial matter, the SEC Letter addressed SEC Rule 11Ac1-1, not IM-2110-5. More importantly, the SEC Letter involved market makers' potential liability for failing to act when required to do so. Conversely, Respondent acted when not required to act. Respondent had no obligation to execute the orders because they were away from Firm 1's quotes. Respondent could have simply allowed the orders to time out. Moreover, the SEC Letter indicated that the activity in question could be manipulative. Here, the Firm 2 and Firm 3 orders did not affect the public quotations for CSCO or AMAT and there is no reason to suspect manipulation. In addition, the orders could have resulted in trades that were economically beneficial to Firm 2 and Firm 3 (or their customers). That is, unlike the situation discussed in the SEC Letter, Firm 2 and Firm 3 (or their customers) likely wanted Firm 1 to execute the orders.

D. Respondent's Due Process Argument

Respondent argues that NASD would violate notions of "due process" and "fundamental fairness" if it found him in violation of IM-2110-5 and Rule 2110 without having investigated both sides of the trades. Respondent claims that due process and fundamental fairness require NASD to perform "an investigation of the actions of both the order entry party (to determine, *inter alia*, if its orders were commercially bona fide) and the responding market maker, as well as the economic affect [*sic*] of the transactions." Respondent's argument, however, presupposes that IM-2110-5 and Rule 2110 require a showing either that the other party was a member or associated person or that the other party was engaged in competitive activity. As we explained above, IM-2110-5 and Rule 2110 do not require any such showings and we, therefore, reject Respondent's claim. That is, even assuming, for purposes of argument, that Firm 2 and Firm 3 (or their customers) acted improperly or placed orders that were not competitive, Respondent's harassing and retaliatory action nonetheless violates IM-2110-5 and Rule 2110.[19]

In any event, the Exchange Act's "fairness" requirements have been met here.[20] Pursuant to those requirements, NASD must notify respondents of specific charges, provide them with the opportunity to defend against such charges before a neutral hearing panel and keep a record of the proceedings. Market Regulation notified Respondent of the charges against him, Respondent responded to those charges and the parties filed cross-motions for summary disposition based on stipulated facts.[21] A neutral hearing panel resolved the matter after oral argument, issued a decision and maintained a record of the proceeding, which we have before us on appeal.

Moreover, Respondent could have sought to obtain additional evidence on his own or by means of NASD Procedural Rule 9252, which allows a respondent to request that NASD invoke

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[19] To the extent that Respondent's fairness argument relates to the determination of appropriate sanctions, we address it in the sanctions section by assuming, *arguendo*, that there is some merit to Respondent's belief that Firm 2 and Firm 3 (or their customers) were improperly trying to "game" the system.

[20] Respondent claims that the "due process clause" requires NASD to investigate both sides of the trades. We note that self-regulatory organizations ("SROs"), such as NASD, are not government actors and constitutional principles thus do not apply to their proceedings. However, the Exchange Act requires that SROs provide for fair procedures. *See William J. Gallagher*, Exchange Act Rel. No. 47501, 2003 SEC LEXIS 599, at *9 (Mar. 14, 2003) (explaining that, although SROs "are not subject to the due process provisions of the U.S. Constitution, Exchange Act Section 15A(b)(8) requires that SROs provide 'fair procedures'").

[21] Respondent does not challenge the sufficiency of the complaint. Nonetheless, we have analyzed the issue in response to a statement in the Hearing Panel decision. We find that Respondent had fair notice of the factual and legal bases for these proceedings. *See supra* note 15.

Rule 8210 to compel the production of documents or testimony. Respondent did neither. Under these circumstances, we find that the proceedings have been fair.

E. Sanctions

The NASD Sanction Guidelines for anti-harassment violations under Rule 2110 and IM-2110-5 recommend imposing a fine of $1,000 to $50,000. NASD Sanction Guidelines (2001 ed.) at 54. In egregious cases, the Guidelines recommend considering a fine in excess of $50,000 and imposing a suspension for a period of 10 business days to two years. *Id.* The Guidelines list the following principal considerations: (1) whether the behavior was collusive or part of a larger manipulation; (2) whether the behavior attempted to affect or actually affected publicly disseminated quotes or otherwise inhibited market transparency; (3) whether the behavior attempted to or actually resulted in late or inaccurate trade reporting; (4) whether the behavior attempted to or actually altered market prices; (5) in the case of intimidation or harassment, the nature and content of respondent's speech, communications, and/or harassing behavior; (6) the general effect of the behavior on the fair and efficient operation of the securities markets; and (7) whether the behavior was repetitive or a single impulsive action. *Id.*

There is no indication that Respondent's behavior was collusive, attempted to affect publicly disseminated quotes, resulted in late or inaccurate trade reporting or attempted to or actually altered market prices. Moreover, Respondent essentially claims that he was provoked because Firm 2 and Firm 3 sent him multiple orders that were away from Firm 1's quotes in what he believes was the hope that he would mistakenly execute the orders. In light of the posture of this case, and only for the purposes of determining appropriate sanctions, we shall assume, *arguendo*, that Respondent's claim is accurate.[22] Taken together, these factors support imposition of sanctions at the low end of the range of sanctions recommended by the applicable guideline.

Nonetheless, a sanction clearly is warranted. Respondent's multiple odd-lot executions in response to round-lot orders, which occurred on three days and harassed and retaliated against the senders of the orders, violated IM-2110-5 and Rule 2110. We impose on Respondent a $1,000 fine.

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[22] As discussed above, for purposes of determining sanctions, we have assumed, *arguendo*, that Respondent's claim that Firm 2 and Firm 3 (or their customers) engaged in wrongful conduct may have had some merit. We emphasize, however, that we have done so here both because this is the first litigated case involving IM-2110-5 and because we are making findings of violation and imposing sanctions on appeal of a case that had been summarily dismissed. Going forward, members and associated persons will have the burden of showing that the other party to a transaction had engaged in anticompetitive or wrongful misconduct in order for such conduct to be taken into consideration for purposes of determining sanctions, as appropriate (such a showing, of course, would not be a defense to a violation, but could potentially demonstrate mitigation). In this regard, we reiterate that it is a respondent's obligation to marshal the evidence in support of his or her claim of mitigation.

III. CONCLUSION

IM-2110-5 and Rule 2110 prohibit harassing, intimidating and retaliatory conduct directed at members, associated persons or customers. Neither the IM nor the rule requires a showing that the conduct was anticompetitive. Respondent, who effected multiple odd-lot executions in retaliation against senders of buy or sell messages at prices away from his firm's published quotes, violated both IM-2110-5 and Rule 2110. We impose on Respondent a $1,000 fine.[23]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

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23 Pursuant to NASD Procedural Rule 8320, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanctions, after seven days' notice in writing, will summarily be revoked for non-payment. We note, as well, that we have considered and reject without discussion all other arguments advanced by the parties.