

**ACTION REQUESTED BY
JANUARY 11, 2001**

Three Quote Rule

NASD Regulation
Requests Comment On
A Proposed Amendment
To NASD Rule 2320(g)
To Exclude Certain
Transactions In
Foreign Securities;
**Comment
Period Expires
January 11, 2001**

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Operations
- Trading and Market Making

KEY TOPICS

- Three Quote Rule
- NASD Rule 2320(g)

Executive Summary

NASD Regulation, Inc. (NASD Regulation®) requests comment from members, investors, and other interested parties on a proposed amendment to NASD Rule 2320(g) (the “Three Quote Rule”) to exclude transactions in foreign securities effected by a National Association of Securities Dealers, Inc. (NASD®) member as agent or riskless principal on a foreign market that is the primary market for the security. Under the proposal, primary market would be defined as either: (1) the market with at least 50 percent of the worldwide trading volume in the particular foreign security during the three-month period preceding the date of the transaction in question; or (2) any market whose quotations are part of a consolidated quotation system that includes quotations from the market that had at least 50 percent of the worldwide trading volume in the particular foreign security during the three-month period preceding the date of the transaction in question.

Included with this *NASD Notice to Members* are Attachment A (the text of the proposed rule change) and Attachment B (specific questions on which NASD Regulation requests comments from members and interested parties).

Action Requested

NASD Regulation is seeking comment on a proposed amendment to NASD Rule 2320(g) (the “Three Quote Rule”) to exclude transactions in foreign securities effected by an NASD member as agent or riskless principal on a foreign

market that is the primary market for the security. NASD Regulation encourages all members, investors, and other interested parties to comment on the proposed rule change. Comments must be received by, January 11, 2001.

Comments should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com

Important Note: The only comments that will be considered are those submitted in writing or by e-mail.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission (SEC) following further public comment.

Questions/Further Information

As noted, written comments should be submitted to Joan C. Conley. Questions concerning this *NASD Notice to Members—Request for Comments* may be directed to the Legal Section, Market Regulation Department, at (240) 386-5126; or Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

Members have raised concerns regarding the potential adverse impact on obtaining best execution of customer orders in foreign securities as a result of the Three Quote Rule.¹ Specifically, members have indicated that the application of the Three Quote Rule to customer transactions in foreign securities executed on a foreign market is unnecessary and potentially harmful to the customer's best interests when a member, using reasonable diligence, has determined that the best market for a foreign security is a foreign market and sends the customer order to that market as agent or riskless principal for execution.

In this regard, the staff previously has granted exemptions from the requirements of the Three Quote Rule relating to transactions in foreign securities pursuant to its exemptive authority under Rule 2320(g)(5).² For example, the staff granted exemptive relief to a member firm for customer transactions in Canadian securities executed on a Canadian exchange, under the following conditions:

(1) the member periodically monitors and reviews customer executions to assure that the member is achieving best execution under NASD Rule 2320; and

(2) the customer transactions in Canadian securities are handled on an agency or riskless principal basis.³

The exemption granted was based on representations that executions on a Canadian exchange at the exchange price ordinarily result in customers obtaining best execution of their orders. In its letter seeking exemptive relief, the member stated that a recent analysis of dealer prices compared to

exchange prices indicated that, in virtually all cases, the exchange had the best price. The member, therefore, concluded that, under these circumstances, the function of contacting and obtaining quotes from three dealers would result in significant delays and would be a hindrance to achieving best execution for the customer.⁴

Proposed Rule

To address these concerns, NASD Regulation is soliciting comment on a proposed rule change that would exclude from the Three Quote Rule's coverage transactions in foreign securities effected by an NASD member as agent or riskless principal on a foreign market that is the primary market for the security.

Under the proposal, primary market would be defined as either: (1) the market with at least 50 percent of the worldwide trading volume in the particular foreign security during the three-month period preceding the date of the transaction in question; or (2) any market whose quotations are part of a consolidated quotation system that includes quotations from the market that had at least 50 percent of the worldwide trading volume in the particular foreign security during the three-month period preceding the date of the transaction in question.

Among other issues, NASD Regulation staff is soliciting comment on whether the proposed definition of "primary market" adequately addresses the concerns raised in this area. For example, do active foreign markets exist, whereby no single market contains 50 percent of the worldwide trading volume, but where the transaction may be appropriate for exclusion from the requirements of the Three Quote Rule?

As under the current requirements, compliance with the Three Quote Rule, in and of itself, does not mean the member has met its best execution obligations. Best execution requires each member 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.

Endnotes

1 The Three Quote Rule 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, unless two or more firm quotations are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis.

2 The SEC, in its approval order granting NASD Regulation exemptive authority with respect to the Three Quote Rule, specifically indicated that exemptive relief may be appropriate for transactions executed on a foreign exchange. The SEC stated that exemptive relief may be appropriate in such circumstances because the foreign exchange market may constitute the best market for securities that are listed on that market and the time delay involved in contacting three dealers in that market may, therefore, hinder a member from obtaining best execution for the customers. See Securities Exchange Act Release No. 39266 (Oct. 22, 1997), 62 Fed. Reg. 56217 (Oct. 29, 1997).

3 See letter dated May 29, 1998 to Mr. Kenneth W. Perlman, General Counsel, Mayer & Schweitzer, Inc. from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, Inc.

4 The proposed rule change, if approved, would not supersede any exemptions that previously have been granted relating to the application of the Three Quote Rule to transactions in foreign securities. Further, the staff will continue to have exemptive authority with respect to the Three Quote Rule under Rule 2320(g)(5).

ATTACHMENT A

Proposed Rule Language

(Note: New language is underlined; deletions are in brackets.)

2320. Best Execution and Interpositioning

(a) through (f) No Change.

(g)(1) Except as provided in subparagraph (3) below, [u]nless two or more priced quotations for a non-Nasdaq security (as defined in the Rule 6700 Series) are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis, in any transaction for or with a customer pertaining to the execution of an order in a non-Nasdaq security, a member or person associated with a member, shall contact and obtain quotations from three dealers (or all dealers if three or less) to determine the best inter-dealer market for the subject security.

(2) Members that display priced quotations on a real-time basis for a non-Nasdaq security in two or more quotation mediums that permit quotation updates on a real-time basis must display the same priced quotations for the security in each medium.

(3) In any transaction for or with a customer pertaining to the execution of an order in a non-Nasdaq security of a foreign issuer that is traded on a foreign securities market, a member or person associated with a member may execute the transaction without obtaining quotations from three deal-

ers, provided that the member executes the transaction on an agency or a riskless principal basis in a foreign market that is the primary market for the security, as defined herein.

(4) Definitions

For purposes of this paragraph (g):

(A) T[t]he term “inter-dealer quotation system” means any system of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers.

(B) [For purposes of this paragraph] T[t]he term “quotation medium” means any inter-dealer quotation system or any publication or electronic communications network or other device that is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.

(C) The term “primary market” means either:

(i) the market that had a minimum of 50% of the worldwide trading volume in the security during the three-month period preceding the date of the transaction; or

(ii) any market whose quotations are part of a consolidated quotation system that includes quotations from the market that had at least 50% of the worldwide trading volume in the security during the three-month period preceding the date of the transaction.

(5) Pursuant to the Rule 9600 Series, the staff, for good cause shown, after taking into consideration all relevant factors, may exempt any transaction or classes of transactions, either unconditionally or on specified terms, from any or all of the provisions of this paragraph if it determines that such exemption is consistent with the purpose of this Rule, the protection of investors, and the public interest.

3110. Books and Records

(a) No Change

(b)(1) No Change

(b)(2) A person associated with a member shall indicate on the memorandum for each transaction in a non-Nasdaq security, as that term is defined in the Rule 6700 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market; however, the requirements of this subparagraph shall not apply if (A) two or more priced quotations for the security are displayed in an inter-dealer quotation system, as defined in Rule 2320(g), that permits quotation updates on a real-time basis for which NASD Regulation has access to historical quotation information; or (B) the transaction is effected in compliance with Rule 2320(g)(3).

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NASD Notice to Members 00-84—Request For Comment

ATTACHMENT B

Request for Comment Checklist

The following list of questions provides a quick and easy means to comment on some of the provisions contained in the proposal. This list of questions does not cover all of the changes contained in the proposal; therefore, we encourage members and other interested parties to review the entire proposal and to comment separately on all aspects of the proposal.

Instructions

Comments must be received by **January 11, 2001**. Members and interested parties can submit their comments using the following methods:

- mailing in this checklist
- e-mailing written comments to pubcom@nasd.com
- mailing in written comments
- submitting comments online at the NASDR Web Site (www.nasdr.com)

The checklist and/or written comments should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Proposed Amendment To NASD Rule 2320(g) To Exclude Certain Transactions In Foreign Securities

1. Do you support the proposed rule change described in the *Notice*?

☐ Yes ☐ No ☐ See my attached written comments

2. To what extent, if any, does compliance with the Three Quote Rule hinder, rather than further, best execution with respect to customer transactions in foreign securities executed on a foreign market?

☐ See my attached written comments

3. Does the proposed definition of "primary market" adequately address the concerns raised with respect to excluding certain transactions in foreign securities from the requirements of the Three Quote Rule?

☐ Yes ☐ No ☐ See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

☐ An NASD Member

☐ An Investor

☐ A Registered Representative

☐ Other: _____