

INFORMATIONAL

Three Quote Rule

SEC Approves Proposed Changes To The NASD Three Quote Rule And Related Recordkeeping Requirements;
**Effective Date:
November 24, 2000**

SUGGESTED ROUTING

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

KEY TOPICS

- Best Execution
- NASD Rule 2320
- NASD Rule 3110
- Trading

Executive Summary

On September 21, 2000, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rules 2320(g) and 3110(b), which:

- 1) require that members executing a customer order in a non-Nasdaq® security contact and obtain quotations from three dealers (or all dealers if three or fewer) to determine the best inter-dealer market for the security, unless two or more priced quotations are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis (such as the OTC Bulletin Board® (OTCBB) or the electronic pink sheets);
- 2) require that members displaying priced quotations for the same non-Nasdaq security in two or more quotation mediums that permit quotation updates on a real-time basis display the same priced quotations for the security in each quotation medium;
- 3) no longer require that a member indicate on the order ticket for each transaction in a non-Nasdaq security the name of each broker/dealer contacted and the quotations received if two or more priced quotations are displayed and NASD Regulation has access, on a historical basis, to the quotation data; and
- 4) define the terms “inter-dealer quotation system” and “quotation medium” for the purposes of the proposed rule change.¹

The amendments become effective on November 24, 2000. The amendments to Rules 2320 and 3110 are provided in Attachment A.

Questions/Further Information

Questions concerning this *Notice* may be directed to the Legal Section, Market Regulation Department, NASD Regulation, Inc. (NASD RegulationSM), at (240) 386-5126; or Stephanie M. Dumont, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background And Discussion

Rule 2320(g) (Three Quote Rule) originally was adopted on May 2, 1988,² as an amendment to the NASD's best execution interpretation. As originally adopted, the Three Quote Rule required 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 fewer) and obtain quotations in determining the best inter-dealer market.³

The Three Quote Rule is intended to create a standard to help ensure that members fulfill their best execution responsibilities to customers in non-Nasdaq securities, particularly in transactions involving relatively illiquid securities with non-transparent prices. The Three Quote Rule is a minimum standard, and compliance with the rule, in and of itself, does not mean a 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.⁴

Since the adoption of the Three Quote Rule, the market for non-Nasdaq securities has changed dramatically. For example, from 1996 to 1999, the OTCBB has experienced growth of 72 percent in market maker positions, 421 percent in average daily share volume, and 65 percent in average daily dollar volume. Because of the rapid growth in the market for non-Nasdaq securities, in some instances, the existing Three Quote Rule has hindered, rather than furthered, investor protection by causing significant delays in obtaining executions of customer orders.

Rule Amendments

Accordingly, the amendments to Rule 2320(g) will require members to obtain quotations from three dealers (or all dealers if three or fewer) only when there are fewer than two priced quotations displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis (such as the OTCBB or the electronic pink sheets). The amendments define the term "inter-dealer quotation system" as any system of general circulation to broker/dealers that regularly disseminates quotations of identified broker/dealers. Quotations by the same dealer in more than one inter-dealer quotation system are considered one quotation for the purposes of this rule. As with the existing rule, the amendments do not limit or change a member's general best execution obligations.

In addition, Rule 3110(b)(2) currently requires that members indicate on the order ticket for each transaction in a non-Nasdaq security the name of each dealer

contacted and the quotations received to determine the best inter-dealer market. Under the amendments, members are not required to note such information on the order ticket if two or more priced quotations are displayed in an inter-dealer quotation system and NASD Regulation has access to the quotation data. As a result, members are relieved of certain recordkeeping burdens in which NASD Regulation can validate and confirm compliance with applicable requirements directly through its internal historical data. Currently, NASD Regulation has access to such data with respect to the OTCBB securities; however, it does not have access to historical quotation data for the electronic pink sheets.⁵

Finally, the amendments require members that display priced quotations for the same security in two or more quotation mediums that permit quotation updates on a real-time basis to display the same priced quotations in each system. This obligation exists even where the quotation displayed represents a customer limit order. "Quotation medium" is defined as any inter-dealer quotation system or any publication or electronic communications network (ECN) or other device that is used by broker/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.

NASD Regulation believes that members that display different priced quotations in different quotation mediums for the same security can be confusing and misleading to other market

participants and, more importantly, to public investors. Moreover, requiring that members display consistent priced quotations in multiple quotation mediums will enhance the ability of other market participants to ascertain the best inter-dealer market for a security.

Endnotes

¹ See Securities Exchange Act Release No. 43319 (September 21, 2000), 65 Fed. Reg. 58589 (September 29, 2000) (File No. SR-NASD-00-20).

² See Exchange Act Release No. 25637 (May 2, 1988).

³ If three firm quotations are displayed, a broker/dealer is not required to call the three market makers to verify the firm quotations that are displayed on the screen. A broker/dealer need only note on the order ticket the identity of the broker/dealers and the firm quotations displayed.

⁴ See NASD Rule 2320(a).

⁵ NASD Regulation has filed a proposed rule change with the SEC that generally would require members to record their quotation data in the electronic pink sheets or similar quotation systems and report such data to NASD Regulation. See Exchange Act Release No. 43367 (September 27, 2000), 65 Fed. Reg. 59482 (October 5, 2000) (File No. SR-NASD-00-42). Where priced quotations are displayed in an inter-dealer quotation system for which NASD Regulation does not have access to historical quotation information, although the member is not required under Rule 2320(g) to call the market maker to verify the firm quotation that is displayed, the member is required to note on the order ticket the identity of the broker/dealer, the firm priced quotation displayed, and the inter-dealer quotation system in which the quotation was displayed.

ATTACHMENT A

Text Of Rule Changes

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

Rule 2320. Best Execution and Interpositioning

(a) through (f) No Change

(g)(1) Unless 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, [I]in any transaction for or with a customer pertaining to the execution of an order in a non-Nasdaq security [(as defined in the Rule 6700 Series)], 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) For purposes of this paragraph, the term "inter-dealer quotation system" means any system of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers.

(4) For purposes of this paragraph, the 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.

(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.

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Rule 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 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.

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