SPECIAL NASD NOTICE TO MEMBERS 97-67

NASD Regulation Institutes Firm Quote Compliance

Suggested Routing

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To ensure that members fully comply with Securities and Exchange Commission (SEC) Rule 11Ac1-1 (Rule 11Ac1-1 or the firm quote rule), NASD Regulation, Inc., has developed an automated surveillance system (the Firm Quote Compliance System or FQCS) to permit the resolution of backing-away complaints on a real-time basis. FQCS will also, in the absence of complaints, identify firms that demonstrate a pattern of non-response to SelectNet℠ liability orders. By utilizing the Firm Quote Compliance System, NASD Regulation℠ is able to address backing-away complaints on a real-time basis with the intent of resolving such complaints with a contemporaneous trade execution, if warranted, and will look, on a historical basis, for patterns of behavior indicative of potential violations of Rule 11Ac1-1.

A backing-away occurs when a member firm is not complying with its obligations under Rule 11Ac1-1(c). This rule 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. A market maker's obligation to fill an order begins at the time the order is "presented," regardless of how the order is transmitted to the market maker. Exceptions to Rule 11Ac1-1 exist only if: (i) the market maker revises its quoted price or size to The Nasdaq Stock Market℠ prior to presentation of an order; or (ii) the market maker has effected or is in the process of effecting a transaction at the time an order is presented and, immediately upon completion of that transaction, communicates a revised quotation to The Nasdaq Stock Market. Violations of Rule 11Ac1-1 may also violate Conduct Rule 3320 and Marketplace Rule 4613(b), which require a market maker to trade at its quotation and up to its quotation size when presented with an order.

In light of the establishment of the Firm Quote Compliance System, NASD Regulation's Market Regulation Department has instituted procedures to immediately address complaints during the trading day. Any potential backing-away complaint should be brought to the attention of the Market Regulation Department within five (5) minutes of the alleged backing-away by calling (800) 925-8156. If a complaining firm does not contact the staff within five (5) minutes, it will be difficult for the staff to obtain a contemporaneous trade execution, if warranted, from the market maker. Firms also are encouraged, but not required, to contact the other firm to seek resolution of their complaint. Firms that contact the other side first will not be held to the five- (5) minute time period of contacting the Market Regulation Department. However, they must contact the other side within five minutes and, if there is no resolution, they must contact the Market Regulation Department *immediately* after their contact with the other firm. Also, although the staff will review and investigate complaints which are faxed or received by telephone after the five- (5) minute period, the staff may not be able to assist in obtaining a contemporaneous trade execution for those complaints. **Failure of the complaining firm to contact the market maker or the staff within five (5) minutes of the alleged backing-away is not, and has never been interpreted by NASD Regulation as, a defense to a backing-away violation.**

In processing the alleged backing-away complaints and other potential rule violations identified by the Firm Quote Compliance System, NASD Regulation will not pursue immediate disciplinary action for an individual backing-away complaint in which a contemporaneous trade execution is obtained or offered. However, the staff will keep a record of, and gather information concerning, such incidents to determine if a firm has demonstrated a pattern of non-compliance with the firm quote rule. Thus, these violations could result in disciplinary action. **The staff will investigate individual instances of backing-away and consider disciplinary action if the staff believes that a contemporaneous execution is warranted, but the market maker refuses to provide the fill upon the staff's request.**

Members are also encouraged to carefully read the applicable sections of the SEC Section 21(a) report, which contains a discussion of a market maker's obligations under Rule 11Ac1-1 as well as specific situations which the SEC considers to be violations of the firm quote rule. Following are some guidelines that market makers should be aware of:

1. Cancellation of Preferenced SelectNet Liability Orders. The fact that a preferenced SelectNet order is canceled by the order entry firm before the three-minute time period does not eliminate a firm's firm quote obligation with respect to that order while it was "live." Patterns of delay in filling liability orders may indicate non-compliance with Rule 11Ac1-1. A market maker's obligation to fill an order begins when the order is presented, not upon expiration of the three-minute time period.

2. Failure to Act on a Preferenced SelectNet Liability Order. The fact that preferenced SelectNet liability orders may have scrolled off the screen on the Nasdaq Workstation terminal is not an exception to Rule 11Ac1-1. Members should take whatever steps they deem appropriate to ensure that preferenced liability orders received through SelectNet are monitored and responded to in conformance with the firm quote rule.

3. No Trade-Ahead Exception for SOES Executions Received After a Preferenced SelectNet Liability Order. A trade-ahead exception will not be permitted for Small Order Execution System℠ (SOES℠) executions received after presentment of a preferenced SelectNet liability order. As stated in the SEC's Section 21(a) report, "[b]ecause SOES executions are automatic and instantaneous, a market maker could not have been in the process of executing a SOES order that was received after a SelectNet order."

4. No Automatic Trade-Ahead Exception. A trade-ahead exception for trades that are reported after the presentment of a liability order will not be permitted if a market maker executes a trade absent proof, such as the time of order entry, that the market maker was in the process of executing the order prior to presentment of the preferenced SelectNet liability. Additionally, the market maker must immediately update its published quotation subsequent to the execution.

5. Late quote update. A quote update without any accompanying trade report must occur prior to, or simultaneous with, the presentment of a SelectNet liability order or telephone order to be considered an exception to Rule 11Ac1-1.

6. System Problems, Extreme Weather, Flood of SelectNet Liability Orders. Situations such as firm system problems, extreme weather conditions, and a flood of other SelectNet orders surrounding a SelectNet liability order may be viewed as mitigating factors, but not exceptions, to Rule 11Ac1-1.

On July 16, 1997, the SEC sent a letter to the National Association of Securities Dealers, Inc. (NASD®) and NASD Regulation providing guidance on a variety of firm quote compliance issues. (The NASD's July 7, 1997 inquiry and the SEC's July 16, 1997 letter in response are attached to this *Notice*.) Based on the guidance provided in the SEC's letter dated July 16, 1997, the staff will continue to analyze the SOES/SelectNet "double-hit" issue on a facts-and-circumstances basis and will continue to review firms that demonstrate a pattern of non-responsiveness to SelectNet liability orders *after presentment*. In addition, the SEC's letter implicitly reiterates the SEC staff's position that a preferenced SelectNet order is deemed to be presented to the recipient of that order for purposes of Rule 11Ac1-1 upon delivery of that order to the firm. Indeed, the SEC's letter reaffirms statements made in the SEC's Section 21(a) report that, **"[t]he firm quote rule is triggered when an order is 'presented' to the market maker. Because all directed SelectNet orders are delivered electronically to a particular market maker, the presentment of an order is readily ascertainable."**

Member firms should discuss the items set forth in this *Notice* and the SEC's letter dated July 16, 1997, with their traders and remind them of their obligations under Rule 11Ac1-1. Member firms should also implement adequate written supervisory procedures to detect and deter potential firm quote violations. Failure to have an adequate supervisory system in place may result in disciplinary action. In addition, firms should ensure that they have adequate staff and/or systems technology to immediately respond to SelectNet orders. In the near future, NASD Regulation will publish a *Notice to Members* to provide firms with general guidance on implementing supervisory procedures relating to the firm quote rule and other areas.

Questions regarding this *Notice* may be directed to NASD Regulation's Market Regulation Department, at (800) 925-8156.