



National Association of Securities Dealers, Inc. ■ 1735 K Street, NW ■ Washington, DC 20006-1500 ■ 202-728-8000

July 7, 1997

Dr. Richard Lindsey
Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Dr. Lindsey:

This letter requests the Commission's interpretive views regarding the application of Rule 11Ac1-1 under the Securities and Exchange Act ("Firm Quote Rule") to orders received through the Nasdaq Stock Market's Selectnet System. We appreciate very much the attention the Commission staff has already given to this issue as well as the constructive suggestions you personally have made regarding longer term system and NASD rule changes that might relieve the present Firm Quote compliance burdens. Nevertheless, we believe that a response to the interpretive questions set forth below will be extremely helpful in clarifying the application of the Firm Quote Rule and thereby enhancing the ability of NASDR to enforce compliance with the Rule.

First, the Commission has previously stated that orders sent through the Selectnet System are "presented" to a market maker at the time the Selectnet order is displayed on its terminal. The Commission has further stated that the fact an order quickly scrolls off a market maker's trading screen does not excuse traders from complying with the Firm Quote Rule. We would appreciate the Commission's views as to the application of the Firm Quote Rule in the following example. The market maker receives on its terminal a preferenced Selectnet buy order at its quoted offer price at 10:10:00. Before the market maker becomes aware of the Selectnet order it executes a second order over the telephone, its proprietary execution system or SOES at 10:10:15. At 10:10:20 the market maker becomes aware of the Selectnet order. Is the market maker obliged by the Firm Quote Rule to execute the Selectnet order? Would the response to this question be different if the market maker had executed an order over the telephone or through its proprietary execution system at 10:09:55 but had not yet updated its quotation when it became aware of the Selectnet Order at 10:10:20? Would the answer to either of these fact scenarios change if the market maker was displaying a customer limit order as its quotation and had no interest in trading for its proprietary account at that price?

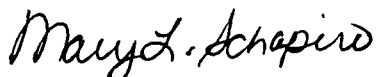
Second, we would appreciate the Commission's staff view as to whether a market maker's obligation under the Firm Quote Rule is affected in any way by the cancellation of a Selectnet order. For example, assume again that a market maker received a Selectnet buy order at its quoted offer price at 10:10:00. Assume further that the market maker states that it had not become aware of the Selectnet order prior to the time that the order was cancelled. Does the market maker's failure to execute the Selectnet order prior to cancellation violate the Firm Quote Rule? If the answer to this question is yes, what is the legal obligation which requires the market maker to respond prior to the system expiration time? Is there some period of time (e.g., 15-30 seconds), during which the market maker's failure to respond prior to a cancellation would not constitute a violation? Finally, would a market maker who becomes aware that a preferenced order has scrolled off a screen and timed out, meet its firm quote obligations if it then executed the transaction without involvement of NASDR or a complaint from the order entry firm?

Third, we would appreciate the Commission's staff view as to whether the order entry firm's conduct in entering and cancelling multiple orders through the Selectnet system is relevant to the fact situation discussed above. For example, if an order entry firm entered seven broadcast buy orders and three preferenced buy orders into the Selectnet system between 10:09:50 and 10:10:10 and then, after receiving an execution of one broadcast order at 10:10:15 cancelled all (or most) of its other Selectnet orders, have the market making firms who received the three preferenced Selectnet orders violated the Firm Quote Rule even though the order entry firm appeared to succeed in its strategy?

Finally, is it relevant in any of the backing away fact situations discussed above that the market making firm can demonstrate that on numerous occasions in the past it has executed Selectnet preferenced orders received from the same and other order entry firms.

We appreciate very much your response to these questions and look forward to continuing to work with you to ensure that the Firm Quote Rule is fully and fairly enforced.

Sincerely yours,


Mary Schapiro


Richard Ketchum *by mks*



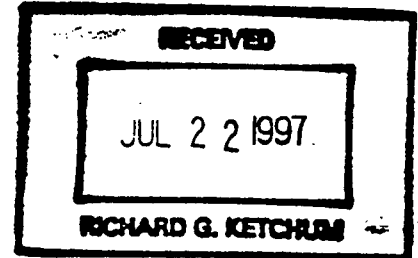
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

July 16, 1997

Mr. Richard G. Ketchum
Executive Vice President & Chief Operating Officer
National Association of Securities Dealers, Inc.

Ms. Mary L. Schapiro
President
NASD Regulation
1735 K Street, N.W.
Washington, D.C. 20006-1506



Dear Mr. Ketchum and Ms. Schapiro:

In the undertakings specified in the Commission's administrative proceeding against the NASD,^{1/} the NASD committed to substantially upgrade its capability to enforce Rule 11Ac1-1 under the Securities Exchange Act of 1934 ("Firm Quote Rule"). NASD efforts to date include the establishment of a real-time procedure for resolving backing away complaints, and new draft parameters and protocols for processing such complaints.

In your letter of July 7, 1997, you indicated that you would like more guidance on what types of activity may be deemed backing away under the Firm Quote Rule.^{2/} You have requested the Division's views regarding this conduct so as to enhance NASDR's ability to enforce compliance with the Firm Quote Rule.

Many of your questions involve a market maker's duty to honor its quote when the market maker receives two or more orders in close conjunction via Nasdaq's SelectNet System and the Small Order Execution System ("SOES") or the telephone.^{3/}

^{1/} See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD, the Nasdaq Market, and Nasdaq Market Makers, Securities Exchange Act Release No. 37542 (August 8, 1996).

^{2/} See Letter from Richard G. Ketchum, Executive Vice President & Chief Operating Officer, NASD, and Mary L. Schapiro, President, NASDR, to Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated July 7, 1997.

^{3/} The double execution problem arising from Nasdaq providing two automated order delivery systems could be eliminated by integrating these two systems.

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The Division acknowledges that the receipt of simultaneous orders in SOES, SelectNet and over the telephone raises questions regarding firm quote compliance for market makers.^{4/} Nonetheless, it is not feasible in this context to articulate a "bright-line" test on what conduct constitutes backing away. Instead, NASDR should examine the particular facts and circumstances surrounding a market maker's conduct to determine if a market maker violated its firm quote obligations.

For example, when an order entry firm cancels its order quickly after presentment in SelectNet,^{5/} NASDR should analyze that

^{4/} For example, some market makers claim that other market participants are (1) sending a market maker a preferenced SelectNet order at the market maker's quote; (2) cancelling the order quickly before the market maker can fill it; and (3) filing a backing away complaint against the market maker. Another alleged practice is for a firm to send a preferenced SelectNet order virtually contemporaneously with a similar order via SOES. In this situation, the SelectNet order arrives shortly before the market maker receives confirmation of an automatic execution in SOES. The order entry firm then will file a backing away complaint if the market maker does not honor the SelectNet order. Market makers are concerned that this practice subjects them to double executions.

^{5/} Although a market maker may often be able to react within 10 seconds of presentment of a SelectNet order, the 10 second cancellation prohibition is not meant to establish a per se backing away time threshold. See Securities Exchange Act Release No. 38185 (January 21, 1997), 62 FR 3935 (January 27, 1997) (approving a ten second minimum life for a preferenced SelectNet order). As an initial matter, the Division believes that an order entry firm that directs multiple SelectNet orders to a market maker within a relatively brief time, with the intent of cancelling these orders shortly after entry for the purpose of deliberately deterring order execution, could be in violation of the federal securities laws and should be examined under the appropriate NASD rules. Although market makers have a responsibility to stand behind their published quotations when receiving order flow from order entry systems, in the situations where order entry firms are deliberately deterring execution of these orders, the market maker should not be held to be 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

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market maker's pattern of execution for orders it receives via SelectNet. On one hand, if the analysis reveals that the market maker generally executes orders from market makers or other firms within a few seconds of presentment, a backing away violation may be indicated where the market maker waits significantly longer to execute orders from the order entry firm involved in the complaint. On the other hand, if a market maker can show that it generally fills most SelectNet orders promptly and in a non-discriminatory fashion, failure to fill a particular SelectNet order cancelled quickly after presentment may not rise to the level of backing away, depending on the facts and circumstances of a particular case.

A similar analysis should be employed for the SOES/SelectNet double hit question. There should be no "bright line" test that would excuse a market maker from executing the SelectNet order without violating its obligations. The determination would have to be made on a facts and circumstances basis.^{6/} Of course, the Firm Quote Rule does not allow a market maker to decline to fill an order based on the receipt of a subsequent order. Therefore, in deciding a backing away complaint, the NASD should determine the time the SOES order was entered by factoring in the time it takes a market maker to receive the execution confirmation from the point of order entry.

NASD policy is that firms with timely backing away complaints may receive a contemporaneous trade execution. The Division notes, however, that the fact that a market maker gives a customer a fill in response to a complaint or otherwise reimburses the customer is not determinative of whether a violation has occurred. Although it may be appropriate to consider contemporaneous fills as a mitigating factor for individual violations, it would not be conclusive for market makers that have demonstrated a pattern of backing away violations.

Finally, some market makers have complained that the large volume of SelectNet orders may cause preferenced orders to rapidly scroll off the screen before a trader can see them, subjecting the firm to backing away complaints. The Division does not believe that a firm should escape Firm Quote Rule responsibility based on

entry firm "gaming" in response to a backing away complaint be substantiated.

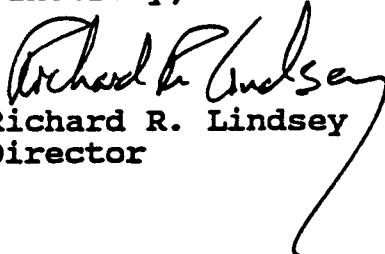
^{6/} Some factors to consider include the times that the orders were entered and whether both orders were sent by the same firm.

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claims that a trader failed to see a SelectNet order due to the "scrolling effect." The Division understands that many market makers now are able to separate the SelectNet preferenced orders from general broadcast orders on their individual screens, which would reduce the scrolling problem.

The Division reiterates that improved backing away surveillance is integral to the NASD's ability to satisfy its self-regulatory obligations. If you have additional questions regarding this matter, please do not hesitate to contact me.

Sincerely,


Richard R. Lindsey
Director