CARRIE DWYER

Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market

FINAL PRINTING

United States
Securities and Exchange Commission

August 8, 1996

**REPORT PURSUANT TO SECTION 21(a)
OF THE SECURITIES EXCHANGE ACT OF 1934
REGARDING THE NASD AND THE NASDAQ MARKET**

TABLE OF CONTENTS

I. INTRODUCTION AND SUMMARY 1

II. CONCURRENT COMMISSION ENFORCEMENT ACTION 4

III. REMEDIAL MEASURES IMPLEMENTED BY THE NASD 4

IV. SELF-REGULATION IN THE OTC MARKET 6

A. The NASD and the OTC Market 6

B. The Nasdaq Stock Market 7

C. Commission Oversight of the NASD 8

D. Governance of the NASD 8

1. The Pre-Investigation Structure of the NASD 8

2. The Rudman Committee's Review 9

V. THE COMMISSION'S INVESTIGATION 11

VI. PROBLEMS OF THE NASDAQ STOCK MARKET 12

A. Impediments to Price Competition 12

1. Importance of Competition 12

2. Price Quotations in Nasdaq 12

3. The Nasdaq Pricing Convention 14

4. The Nasdaq Size Convention 21

5. Effect of the Pricing and Size Conventions 22

B. Coordination of Quotations, Trades, and Trade Reports 22

C. The Exchange of Proprietary Information 26

D. Collaboration in the Nasdaq Market 27

E. Failure to Honor Quotations 28

F. Late Trade Reporting 29

VII. THE NASD'S PERFORMANCE AS AN SRO 30

A. The NASD's Awareness of the Nasdaq Pricing Convention 30

1. Events in 1990 30

2. Events in 1992 31

3. Post-1992 Developments 32

B. The NASD's Regulatory Deficiencies 35

1. Market Maker Influence 35

2. The Undue Influence of Market Makers in the Disciplinary Process 36

a. Enforcement Emphasis on SOES Activity 36

b. The NASD's Laxity in Enforcing the Firm Quote Rule . . . 36

c. The NASD's Laxity in Enforcing Trade Reporting Rules . . 38

d. Failure to Enforce the Excused Withdrawal Rules 38

e. The NASD's Imbalance in Enforcement of Its Rules 39

3. The Undue Influence of Market Makers in the Regulatory Process 40

a. Market Maker Influence 40

b. Application of Standards and Criteria for Membership . . . 41

4. The NASD's Corporate Goals 42

VIII. CONCLUSION 42

A. Settlement with the NASD 42

B. Commission Rule Proposals 46

C. Summation 47

APPENDIX

TABLE OF CONTENTS . . . . A-i

REPORT PURSUANT TO SECTION 21(a) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET

I. INTRODUCTION AND SUMMARY

The Commission staff has conducted an investigation of the operations and activities of the National Association of Securities Dealers, Inc. ("NASD") and of market making activities in the Nasdaq Stock Market ("Nasdaq market"). The investigation uncovered a number of matters of fundamental concern about the operations and structure of the NASD and the Nasdaq market, as set forth herein. The Commission believes that significant changes to the NASD and the Nasdaq market are warranted. The Commission has deemed it appropriate to issue this Report of Investigation ("Report") pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act") in order to discuss the matters uncovered in the investigation and, in particular, deficiencies in the NASD's oversight of the Nasdaq market and its failure to enforce compliance with the NASD's rules and the requirements of the federal securities laws.[1]

Based on the results of the investigation, the Commission finds that the NASD violated Section 19(g) of the Exchange Act by failing adequately to comply with certain NASD rules and, without reasonable justification or excuse, to enforce compliance with the Exchange Act and the rules and regulations thereunder, including Sections 10(b), 11A, and 15(c) and Rules 10b-5, 11Aa3-1(c), 11Ac1-1(c), and 15c1-2, and its own rules, including Article III, Section 1 of the NASD's Rules of Fair Practice and Schedule C of the NASD's By-Laws. The NASD has consented to the issuance of this Report without admitting or denying any of the findings set forth herein.

A primary focus of the investigation was whether the NASD had adequately carried out its obligation under the Exchange Act to oversee the Nasdaq market and the conduct of its members. The investigation identified a number of serious deficiencies in the NASD's performance of its duties as a self-regulatory organization ("SRO"), especially as they relate to oversight of the Nasdaq market. The NASD failed over a period of time to conduct an appropriate inquiry into an anticompetitive pricing convention among Nasdaq market makers,

[1] The findings made in the Commission's Report are solely for the purpose of the Report and are not binding on any other person or entity named as a respondent or defendant in any other proceeding. In addition to describing conduct directly evidencing the NASD's violation of Section 19(g) of the Exchange Act, the Report describes conduct of the NASD and its members that has problematic implications for the Nasdaq market and the manner in which the NASD carries out its self-regulatory functions. The issuance of this Report and the concurrent enforcement action against the NASD do not preclude further enforcement actions against other persons or entities arising from activities uncovered in the investigation.

even though the NASD knew of facts and circumstances evidencing such matters by 1990. In addition, the NASD failed to enforce vigorously significant rules applicable to its market maker members. These rules included the firm quote rule[2] and the trade reporting rule,[3] both of which are crucial to the fair operation of the Nasdaq market.

The investigation revealed that the Nasdaq market has not always operated in an open and freely competitive manner. Nasdaq market makers have engaged in a variety of abusive practices to suppress competition and mislead customers.[4] The investigation found the following abusive practices:

- Nasdaq market makers widely followed a pricing convention pursuant to which many securities were quoted only in even-eighth prices.[5] Adherence to this practice, as detailed in this Report, was not the result of natural economic forces and often increased the transaction costs paid by investors.[6] Certain market makers also discouraged other market makers from narrowing the displayed quotes for smaller orders. Market makers that failed to follow these conventions were sometimes subjected to harassment and an unwillingness to trade by other market makers who were attempting to enforce compliance with the conventions.

- Numerous market makers collaborated without disclosure to their customers in ways that misled and disadvantaged their customers and other market participants. These market makers coordinated their price quotations, their transactions in securities, and their trade reports. For example, the investigation found that some market makers have displayed quotations at prices at which they did not intend to trade in order to help another market maker trade, have orchestrated artificial increases or decreases in prices of trades, and have improperly delayed the

---

[2] See infra note 68.

[3] See infra note 73.

[4] The record varies as to the degree of participation of particular market makers in the specific activities described in this Report.

[5] For example, prices will be quoted in intervals such as \$20 1/4, \$20 1/2, \$20 3/4, or \$21, but not \$20 1/8, \$20 3/8, \$20 5/8, or \$20 7/8. The pricing convention is described herein at VI.A.3.

[6] The Commission is not suggesting that parallel pricing behavior, standing alone, is necessarily a violation of the securities laws. However, such conduct may well raise serious questions that regulators should investigate and evaluate. When a pricing convention results from a reciprocal understanding among market makers, is maintained by a reciprocal understanding, or is enforced through harassment or other means, it raises serious anticompetitive concerns.

reporting of trades to the Nasdaq market for their benefit or that of another market maker.

- Some market makers, without disclosure to their customers, shared information with each other about their customers' orders, including the size of the order and, on occasion, the identity of the customer. They also shared information about their inventory positions, trading strategies, and the prices they planned to quote.

- Numerous market makers frequently have failed to honor their price quotations in violation of Commission and NASD rules requiring firm quotations and prohibiting misleading or fictitious quotations. Certain market makers have also refused to honor their firm quote obligations in a selective and discriminatory fashion as a means of punishing certain market participants. This conduct was anticompetitive, inconsistent with the operation of a free and open market, and resulted in unfair discrimination between and among market participants.

- Many market makers have not consistently reported their trades to the Nasdaq market on time or appropriately designated as required by NASD rules. As a result, the sequence of trades publicly reported by Nasdaq has been inaccurate.

These practices by market makers directly harmed the Nasdaq market, other market participants, and large and small investors.[7] Adherence to the pricing convention often affected the prices reflected in the Nasdaq quotes, thereby impacting the fairness and accuracy of quotation information disseminated in the market and interfering with the economically efficient execution of transactions. The convention also impaired the ability of investors to ascertain the best market for their trades, increased the costs of transactions, and resulted in unfair discrimination among classes of market participants. The undisclosed activities of market makers that coordinated price quotations, transactions in securities, and the timeliness and sequence in which they reported trades, misled market participants and customers, impaired disclosure of the quotations and prices at which dealers were actually willing to buy and sell, and lessened the ability of investors and other market participants to obtain competitive prices.

---

[7] While the Commission is describing the behavior of market makers in the Nasdaq market in discussing the conduct of the NASD, the Commission is not making specific findings in this Report with regard to the conduct of any individual market making firm. The investigation of trading in the Nasdaq market recently conducted by the Department of Justice's Antitrust Division found no evidence that the pricing convention described herein resulted from "an express agreement reached among all of the market makers in a smoke-filled room." Competitive Impact Statement of the U.S. Department of Justice Antitrust Division at 15, United States v. Alex. Brown & Sons., et al., (S.D.N.Y. July 17, 1996). Although the findings of the Commission's investigation are consistent with that conclusion, one need not determine that the pricing convention arose out of explicit "collusion" to find that the convention had anticompetitive consequences and was harmful to the interests of investors.

The interests of market participants in accurate, fair, and reliable pricing were not served. Moreover, the duties that those market makers owed to their customers were compromised by undisclosed sharing of customer information and the repeated failure to honor quotes or report trades promptly or with appropriate designations.

The NASD's failure to investigate and pursue aggressively clear indications of possible violations seriously undermined its ability to ensure compliance with the NASD's own rules as well as the requirements of the federal securities laws. As discussed below, the consequences for the Nasdaq market of this failure were exacerbated by the undue influence exercised by Nasdaq market makers over various aspects of the NASD's operations and regulatory affairs. This influence made vigorous enforcement by the NASD even more essential to the fair operation of the Nasdaq market.

II. CONCURRENT COMMISSION ENFORCEMENT ACTION

Along with the issuance of this Report, the Commission has today instituted proceedings against the NASD pursuant to Section 19(h) of the Exchange Act.[8] The Order Instituting Proceedings in that action alleges that the NASD failed to comply with certain NASD rules and, without reasonable justification or excuse, failed to enforce compliance with the Exchange Act, the rules and regulations promulgated thereunder, and its own rules, in violation of Section 19(g) of the Exchange Act. The Order finds, among other things, that the NASD failed to take appropriate action to investigate effectively and to address adequately violations and potential violations of the federal securities laws and the NASD's rules. Without admitting or denying the allegations of the Order, the NASD consented to the entry of the Order, which censured the NASD and ordered it to comply with certain undertakings designed to address the problems alleged in the Order.[9]

III. REMEDIAL MEASURES IMPLEMENTED BY THE NASD

The Commission notes that the NASD has taken and will take significant remedial steps relating to its governance and regulatory structure. Combined with the undertakings which the NASD has agreed to as part of the resolution of the concurrent administrative proceeding instituted by the Commission, these measures are intended to address many of the issues and concerns discussed in this Report.

The NASD reorganized to provide for a Board of Governors which includes a majority of non-industry members. The NASD also created two new subsidiaries: (a) NASD Regulation, Inc. ("NASDR"), which has primary responsibility for regulatory matters, and (b) The Nasdaq

---

[8] On September 29, 1995, the Commission also proposed new rules and rule amendments intended to improve order handling and transparency in both exchange and dealer markets ("Order Handling Rules"). See discussion infra Part VIII.B.

[9] A description of the undertakings appears infra Part VIII.A.

Stock Market, Inc., which has primary responsibility for operating The Nasdaq Stock Market. Both of these subsidiaries have Boards of Directors consisting of equal numbers of industry and non-industry members. Members of all three of these Boards were carefully selected to represent a wide range of the NASD's constituencies. Importantly, the concept of balance, of industry and non-industry, or, in some cases, majority non-industry members, has been extended to certain important committees of the NASD or its subsidiaries. These include the NASD Audit Committee, the NASDR Executive Committee, the NASDR National Business Conduct Committee, the NASDR National Arbitration and Mediation Committee, the Nasdaq Executive Committee, and the Nasdaq Quality of Markets Committee. These steps represent significant changes in the NASD's self-regulatory process.

The NASD has also commenced affirmative steps to address the regulatory issues discussed in this Report. The NASDR Board of Directors has authorized a 7% increase in NASDR staff for positions principally in the Enforcement, Examination, and Market Regulation programs. The NASD has instituted measures to enhance the enforcement of the trade reporting, firm quote, customer limit order handling, and other market making rules, and has begun the development of an enhanced audit trail. The NASD is in the process of taking additional remedial measures to ensure the fair review and disposition of applications for membership and to change its disciplinary processes to include hearing officers and add procedures aimed at achieving greater efficiency and fairness. The NASD is also enhancing its systems for trading and market surveillance, including compliance with late trade reporting and various other NASD trading rules. The NASD has created two new offices, the Office of Individual Investor Services and the Office of the Ombudsman, to more fully serve the interests of investors and other NASD constituents.

The NASD has represented that in conjunction with the undertakings set forth in the Order Instituting Proceedings and other remedial measures it has taken and will take, the Board of Governors of the NASD and the Board of Directors of NASDR have authorized $25 million and have committed to expend an additional $75 million over the next five years, to enhance its systems for market surveillance, including the development and implementation of an enhanced audit trail, and to increase its staffing in the areas of examination, surveillance, enforcement, and internal audit.[10]

[10] These funds are in addition to 1995 funding levels for these activities. If, over the course of this time period, the Board of Governors of the NASD and the Board of Directors of NASDR believe that the $100 million expenditure is not achievable or feasible, the NASD may, by application to the Commission, seek modification of this commitment.

IV. SELF-REGULATION IN THE OTC MARKET

A. The NASD and the OTC Market

When the Maloney Act was adopted in 1938, its principal purpose was to provide for a means of regulating the over-the-counter ("OTC") market. To that end, the NASD was organized in 1939, incorporating the concept of industry self-regulation which had received federal recognition in the Exchange Act. Under the Exchange Act, the NASD, as an SRO, must be organized and have the capacity to comply with and enforce compliance with the Exchange Act and rules thereunder. The NASD's rules must be designed to prevent fraud and manipulation, to promote just and equitable principles of trade, and to protect investors and the public interest. Its rules may not unfairly discriminate among customers, brokers, dealers, or issuers, fix minimum profits, or regulate matters not related to the purposes of the Exchange Act. The rules are required to provide fair procedures both for disciplining members and for denying access to services. Because of the vital public interest in the fairness and integrity of quotations, the NASD is specifically required by the Exchange Act to have rules designed to ensure that quotes are fair and informative and to prevent fictitious or misleading quotations. The Exchange Act mandates that the NASD vigilantly safeguard the integrity of its market by striving to meet these goals.

Historically, Nasdaq market makers have not been subjected to the restrictions on trading activity that were imposed on exchange specialists by Section 11(b) of the Exchange Act and Exchange Rules. Because the OTC market was structured to provide for multiple competing dealers, Congress and the Commission saw less need to limit proprietary trading or to otherwise address the conflicts that arise from the combined role of broker and dealer. Vigorous inter-dealer competition was seen as assuring efficient price discovery, narrow spreads, absence of collusive opportunity, and the self-enforcing effects for which self-regulation strives.

The 1963 Special Study of the Securities Markets ("Special Study") reiterated that "[t]he ultimate safeguard for the integrity of interdealer markets is often said to be the factor of competition among dealers."[11] The Special Study identified a number of anticompetitive and manipulative practices in the OTC markets of the day: failure to honor quotations, trading ahead of customers, "hand holding" (friendliness among traders ranging from sharing customer trade information to secretly investing in joint accounts), blackballing, nontransparent pricing, and wide spreads set by committees of members, among others. The Special Study concluded that "competition in these markets may at times be impaired, resulting in an appearance of competition that may not always accord with reality."[12] Moreover, the Special Study found that:

---

[11] Staff of Special Study of the Securities Markets, 88th Cong., 1st Sess., Report of Special Study of the Securities Markets, pt. 2, 661 (Comm. Print 1963).

[12] Id. at pt. 2, 577.

the appearance of several dealers' active interest in a security may not be a reliable indication of a competitive market, either because most of them are in fact appearing for one and thus making a single market or because "holding hands" or similar practices may restrain actual competition. Regulatory measures appropriate for genuinely competitive markets may thus be quite inappropriate or inadequate for those where competition is lacking, whether this fact is readily apparent or is disguised under an appearance of competition.[13]

To address these issues and in the wake of Congress's 1975 mandate for a national market system, the Commission pursued various initiatives toward the creation of greater transparency and reliability for OTC quotations: consolidation and public dissemination of the market-wide best bid and offer, firm quote obligations, and designated market maker status. Timely last sale reporting and surveillance capabilities sufficient to police compliance with trade reporting rules were other initiatives designed to provide a greater level of disclosure of market information, which in turn was seen as a means to enhance the level of competition in the OTC markets. Each of these changes has given the Nasdaq market greater visibility and enhanced investor confidence in its essential fairness.

Notwithstanding the inherent potential for self-regulation to favor the interests of the securities industry over those of the investing public, self-regulation has been viewed as having certain advantages over direct governmental regulation. Industry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry and thereby should be able to respond quickly to regulatory problems. Self-regulation supplements the resources of the government and reduces the need for large government bureaucracies. In addition, SROs can adopt and enforce compliance with ethical standards beyond those required by law.

The benefits of self-regulation, however, can be realized only if, among other things, the SRO fully informs itself of the nature and purposes of the full range of activities occurring in the market. The SRO must vigilantly surveil and investigate the activities of market participants and take appropriate action as warranted under the facts and as required by law.

B. The Nasdaq Stock Market

Nasdaq is the second largest stock market in the United States. Founded in 1971, the Nasdaq market has experienced remarkable growth in the twenty-five years of its existence. Today nearly 6,000 issues trade on Nasdaq and total capitalization exceeds $1 trillion. Daily trading volume of 400 million shares is commonplace and, in recent months, has exceeded 600 million shares at times. The Nasdaq composite index has risen from 100 in 1971 to over 1,000 today.

---

[13] Id. at pt. 2, 661-62.

The NASD owns and operates Nasdaq and also serves as the Nasdaq market's primary regulator. This dual role requires the NASD to subordinate its commercial interests as the owner of the market to its public interest mandate as an SRO to protect investors. The Securities Act of 1933 ("Securities Act") and the Exchange Act were both adopted, in part, based on the recognition that the securities markets are imbued with the public interest. Nasdaq, as a facility of the NASD, a self-regulatory organization, cannot operate in all respects like a private enterprise. Both the NASD and Nasdaq must be governed and operated in accordance with the obligations of an SRO as set forth in the Exchange Act and the NASD's rules.

C. Commission Oversight of the NASD

The Commission recognizes its responsibility to oversee the NASD and, ultimately, to ensure compliance with the federal securities laws. The Commission's investigation of this matter has been lengthy and thorough and it believes that the resulting undertakings of the NASD will facilitate a more open and competitive over-the-counter market. Notwithstanding this, and the obligation of the NASD as an SRO to enforce compliance with its rules as well as the rules and regulations of the Exchange Act, the concept of self-regulation is, of course, a partnership between industry and government. Therefore, the Commission acknowledges that it too has responsibility for overseeing the market with a view to preventing the conduct described in this Report. In this regard, both the NASD and the Commission will have to commit greater and ongoing vigilance in oversight if self-regulation is to be effective.

D. Governance of the NASD

1. The Pre-Investigation Structure of the NASD

The NASD is governed by a structure of national and regional bodies. The NASD Board of Governors ("the Board") is the ultimate governing body, but significant day-to-day authority has been vested in committees composed primarily of NASD members and NASD governors, who are generally representatives of NASD member firms. The committees have conducted virtually all of the disciplinary proceedings, with the Board having an appellate role. The committees also have regulatory functions, such as the admission or rejection of applicants to the NASD and the formulation of policy and rule proposals.

Prior to April 1996, the Board consisted of governors from each NASD regional district, a number of governors at large, and the NASD president. The Board had a certain degree of latitude to determine the composition and number of Board governors. However, the number of district governors always exceeded the number of governors not elected by the districts (i.e., Governors-At-Large and the President).[14] The NASD's By-Laws required that various constituencies, such as issuers, investors, investment company underwriters, and insurance

[14] See NASD Manual, By-Laws, Art. VII, § 4(a) (CCH) ¶ 1183 (1995).

companies, have representatives on the Board.[15] However, the By-Laws ensured that NASD member firms would always have a majority vote on the Board.

The Board worked directly with various corporate committees, advisory boards, and standing committees that advised the Board on specific areas of NASD activity. The national committees were appointed by the Board as it deemed necessary and one or more governors could sit on such committees.[16] Any committee or subcommittee that consisted of one or more Governors could exercise all the powers and authority of the Board in the management of the business and affairs of the NASD as permitted by the By-Laws or by resolution of the Board.

The NASD's district structure distinguishes the NASD from other SROs in the securities industry. To provide for local administration of the affairs of the NASD, each district elects a governing body called the District Committee. The District Committees are responsible for the local administration of the association's affairs and for providing representatives of the district to the Board of Governors. While the Board of Governors is responsible for overall management, the structure of the NASD is centralized and grants the districts broad discretionary authority. In particular, the District Committees act as the functional equivalent of a grand jury with respect to proposed disciplinary actions, conduct disciplinary proceedings, and approve or disapprove applications for membership. Thus, members sitting on the District Committees have the simultaneous responsibility to determine enforcement policy, sit in judgment of other industry members, and decide who will be admitted to the NASD as a member.

2. The Rudman Committee's Review

The NASD's system of governance has recently been the subject of analysis by the NASD Select Committee on Structure and Governance, chaired by former United States Senator Warren Rudman (the "Rudman Committee"). This committee was appointed in November 1994 by the NASD's Board of Governors with the mandate to review the NASD's governance structures and the NASD's oversight of the Nasdaq market.[17] The Rudman Committee inquired into the appropriateness of the NASD's structures for governance and for oversight and operation of the Nasdaq market, the NASD's regulatory and disciplinary processes, the extent to which the NASD provided for appropriate representation of its constituencies, and its policy

---

[15] NASD Manual, By-Laws, Art. VII, § 4(c) (CCH) ¶ 1183 (1995); cf. 15 U.S.C. § 78o-3(b)(4) (requiring that at least one director be a representative of issuers and investors).

[16] See NASD Manual, By-Laws, Art. XI, §1 (CCH) ¶ 1241 (1995).

[17] The Rudman Committee's mandate expressly excluded reviewing the matters that were the subjects of the Commission's investigation.

and rulemaking processes. The Rudman Committee submitted its report to the NASD on September 15, 1995.[18]

The Rudman Committee's report addressed a wide range of issues and recommended changes to the NASD in a number of respects. Particularly pertinent here is the Rudman Committee's conclusion that the NASD's governance structure had "blur[red] the distinction between regulating the broker-dealer profession and overseeing the Nasdaq stock market."[19] The Rudman Committee also found that the NASD would benefit from greater public representation in its governing bodies. The Rudman Committee recommended that the NASD reorganize its corporate structure such that the Nasdaq market and the NASD's regulatory functions would be in separate subsidiaries of the NASD, and that the NASD and these two subsidiaries have 50% or greater public representation on their boards of governors or directors, respectively. The NASD is now implementing, in large part, these recommendations of the Rudman Committee.

The report of the Rudman Committee noted that "[t]he NASD is still governed largely by a host of committees, each with a measure of authority to assert its own interests and one (the Trading Committee) with significant influence over the Nasdaq market and trading systems."[20] The Rudman Committee found that "the NASD Board [was] not well-suited to take a firm hand in regulating the Nasdaq market and its trading systems."[21] Moreover, the Rudman Committee observed that the void created by the inability of the NASD Board to oversee the Nasdaq market was filled by the Trading Committee, "which primarily represents the interests of Nasdaq market makers."[22]

The Trading Committee considered issues relating to market making and trading in the Nasdaq market. The Trading Committee also developed and recommended new NASD rules and amendments to existing rules that related to trading and market making. Membership on the Trading Committee has not consisted of a cross- section of NASD members.[23] As noted in the Rudman Committee report:

---

[18] Report of the NASD Select Committee on Structure and Governance (Sept. 15, 1995) ("Rudman Report").

[19] Executive Summary of Report of the NASD Select Committee on Structure and Governance 21 (Sept. 15, 1995).

[20] Rudman Report at IV-6.

[21] Id. at IV-6.

[22] Id. at IV-5.

[23] See Appendix Part II.A.2.

> The Trading Committee has significant influence in matters affecting the Nasdaq market. At the same time, however, its membership does not reflect the diverse constituencies interested in Nasdaq. It is, quite literally, a traders' committee, and more importantly, a dealers' committee.[24]

Other Standing Committees that influenced rulemaking efforts, such as the Market Surveillance Committee and the SOES Users Committee, were also composed primarily of market makers. The Rudman Committee concluded that "[t]he inescapable fact is that the NASD's structure was tailored to the relatively insignificant OTC markets of an earlier era, not the second largest securities market in the United States."[25]

V. THE COMMISSION'S INVESTIGATION

The Commission's investigation followed allegations that raised serious questions about the integrity of both the Nasdaq market and the NASD's oversight of that market. Throughout 1993, the NASD's attempts to restrict use of its SOES system generated criticism that market makers were using the NASD's regulatory process to hamper legitimate competition. In the spring of 1994, a widely publicized economic study suggested that market makers implicitly colluded to maintain artificially wide inside spreads on Nasdaq by avoiding odd-eighth quotations in many stocks.[26] Thereafter, several class action lawsuits alleging collusion were filed against Nasdaq market makers in the summer of 1994. In addition, media accounts reported widespread allegations that market makers routinely refused to trade at their published quotes, intentionally reported transactions late in order to hide trades from other market participants, and engaged in other market practices detrimental to individual investors.[27] Certain NASD member firms also alleged that the NASD had targeted them for regulatory and disciplinary action because these firms engaged in trading practices that were disliked by the market makers which dominated and controlled the NASD. The Commission opened a formal inquiry in the fall of 1994 to investigate the functioning of the Nasdaq market and to determine whether the NASD was complying fully with its obligations as an SRO.

During the investigation, the Commission staff requested and obtained documentary evidence from the NASD, Nasdaq market makers, and other market participants. The staff reviewed thousands of hours of audio tapes of traders' telephone lines, which were produced pursuant to subpoenas issued to Nasdaq dealers. The staff took the testimony of numerous

---

[24] Rudman Report at III-25 (emphasis in original).

[25] Id. at IV-6.

[26] William G. Christie & Paul H. Schultz, Why Do NASDAQ Market Makers Avoid Odd-Eighth Quotes?, 49 J. Fin. 1813-40 (1994)("Christie-Schultz Study").

[27] See, e.g., Scot Paltrow, "Inside Nasdaq: Questions about America's Busiest Stock Market," L.A. Times, Oct. 20-25, 1994.

witnesses, including traders from many Nasdaq market making firms and many of the NASD's officers, employees, and committee members. The staff conducted examinations of more than twenty Nasdaq market maker firms for compliance with certain NASD and Commission rules and inspections were performed of various aspects of the NASD's regulatory, surveillance, and enforcement programs. At the Commission staff's request, the NASD produced computer data that embodied audit trail and market maker quote reports for the entire Nasdaq market for a period of more than one year. This and other data were used in analyzing trading and pricing patterns and practices in the Nasdaq market.

VI. PROBLEMS OF THE NASDAQ STOCK MARKET

A. Impediments to Price Competition

1. Importance of Competition

The Exchange Act contemplates that the U.S. securities markets shall be "free and open"[28] with safeguards "to protect investors and the public interest."[29] Vigorous price competition is a hallmark of a free and open market and is critically important to the efficient functioning and regulation of a dispersed dealer market. Because Nasdaq market makers trade securities which are otherwise fungible, price should be a principal means of competition in the Nasdaq market. Any significant hindrance to price competition impedes the free and open market prescribed by the Exchange Act. The investigation found that certain activities of Nasdaq market makers have both directly and indirectly impeded price competition in the Nasdaq market.

2. Price Quotations in Nasdaq

The Nasdaq market is a dealer market, in which a number of broker-dealers make markets in the same security. Making a market consists of standing ready to buy and sell a security at displayed prices. The market makers in Nasdaq quote two prices: a "bid" price, at which they are willing to buy the security, and an "ask" price, at which they are willing to sell the security. In so doing, they seek to profit by buying at lower prices and selling at higher prices. A market maker's bid price will always be lower than its ask price, and the difference between the two prices is called the "dealer spread."

Market makers play an important role in financial markets. Demand for market making services generally arises because buyers and sellers of securities do not arrive at the market at the same time or with the same quantities to trade. The market maker helps provide a solution to the uneven flow of supply and demand by standing ready to buy and sell. The market maker is thus said to provide immediacy to the market. In general, market makers seek to sell to

---

[28] Exchange Act, § 6(b)(5), 15 U.S.C. § 78f(b)(5) (1994).

[29] Exchange Act, § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (1994).

buyers at prices higher than the prices at which they buy from sellers. The spread represents part of the market maker's potential compensation.

Market makers are on one or both sides of almost all trades on Nasdaq. Each issuer must have at least two market makers for its stock, but the average stock has eleven market makers. Some of the more actively traded stocks have fifty or more. As of the end of 1995, there were 512 firms registered to make markets in Nasdaq securities and 60,950 market making positions in those securities. Often these market makers display different bid and ask prices. Their quotes are displayed on the Nasdaq market's electronic quotation system. The highest bid and the lowest ask prices are also separately displayed together, as the "inside quotes," and the difference between the two is called the "inside spread." Display of the inside quotes allows a viewer to observe immediately the best prices quoted on the Nasdaq market for both buying and selling a given security.

In general, different market makers will be quoting the inside bid and the inside ask prices. This is because, at any given point in time, some market makers will want to display an interest in buying a given security and will therefore quote high bid prices, while other market makers will want to display an interest in selling the security and will therefore quote lower ask prices.[30]

Most Nasdaq market making firms not only trade as principals with other broker-dealers in their market making activities, but also accept customer orders for Nasdaq securities. When executing a customer order, market makers are required to seek the most favorable terms for the customer under the circumstances. Historically it was generally accepted among market makers that this obligation was satisfied for a customer market order[31] when it was executed at the appropriate inside quote (i.e., customer orders to buy would be executed at the inside ask price, and customer orders to sell would be executed at the inside bid price).[32] The size of the

---

[30] For example, assume there are three market makers in a stock. Market maker A quotes \$20 bid and \$20 3/4 ask. Market maker B quotes \$20 1/4 bid and \$21 ask. Market maker C quotes \$20 1/2 bid and \$21 1/4 ask. Each market maker has a \$3/4 dealer spread, but at different prices. The inside spread is only \$1/4 wide, consisting of \$20 1/2 bid (by market maker C) and \$20 3/4 ask (by market maker A).

[31] A market order is an order in which the customer does not specify any particular price, but where the broker-dealer is to execute the order at the best price available under the circumstances.

[32] The Commission's proposing release for the Order Handling Rules notes that broker-dealers must consider the opportunities for price improvement beyond the inside quote when fulfilling their obligation to obtain best execution for customer market orders in Nasdaq securities. Exchange Act Release No. 36310 (Sept. 27, 1995), 60 Fed. Reg. 52792, 52794 (Oct. 10, 1995).

inside spread therefore usually has direct cost implications for investors in the market.[33] A customer who buys at the ask price would experience a loss equivalent to the inside spread if he or she were to liquidate the position immediately at the bid price. Over the life of the investment, the spread between the ask and the bid represents a transaction cost for the investor, in addition to any other fees (such as commissions or mark-ups) that may be incurred: the wider the inside spread, the higher the transaction cost.

It is also a general practice for a Nasdaq market maker receiving a retail customer order to execute the order itself rather than to send it to another market maker, even if that other market maker is quoting the best price (i.e., the best inside bid or offer) and the executing market maker is not. The executing market maker will provide the customer with the price displayed in the inside quotes, whether or not it is quoting those prices itself.[34] By executing customer orders in-house, market makers attempt to capture the inside spread, rather than allowing another market maker to benefit from the spread.[35] Thus, market makers have a significant interest in each other's quotes because those quotes directly affect their actual trading prices. This interdependency of prices strongly affects the conduct of market makers and provides a significant economic incentive for establishing and enforcing the pricing convention described below.

3. The Nasdaq Pricing Convention

The evidence gathered in the investigation indicates that Nasdaq market makers followed and in some cases overtly enforced a pricing convention that was used to determine the

---

[33] Large institutional customers and sophisticated individual customers often attempt to negotiate for prices better than the inside quotes. The inside quotes are often important to these negotiations, however, because they may serve as a benchmark from which the negotiations proceed. Many institutional customers have access to other avenues of price discovery, including proprietary trading systems and direct telephone contact with market makers. Customers with less market power (e.g., trades of 1,000 shares or less) do not have access to such systems, generally cannot negotiate, and usually must accept the prices displayed at the inside quotes.

[34] This may reduce the incentive of market makers to try to attract order flow on the basis of incremental improvements in quotes.

[35] Many market makers pay non-market making brokerage firms to send customer orders to them for execution, a practice known as "payment for order flow." This purchased order flow is also executed at the inside quotes. For example, market maker, Firm A, may pay a non-market maker brokerage firm, Firm B, two cents per share for orders, with the understanding that Firm A will execute those orders at prices at least as good as the inside quotes regardless of whether Firm A is quoting at the inside. Firm A's profits for purchased orders will be the inside spread, less the two cents per share it pays Firm B for the orders.

increments in which they would adjust their displayed quotes.[36] This practice resulted in most stocks being quoted only in increments of $1/4. Market makers testified that under the convention, stocks in which dealers were quoting spreads of $3/4 or more were to be quoted in even-eighths (i.e., $1/4, $1/2, $3/4), thereby giving rise to a minimum inside spread of $1/4 ("even-eighth stocks"). Stocks with dealer spreads less than $3/4 could be quoted in both even and odd-eighths, thereby allowing a minimum inside spread of $1/8. The dealer spread was understood by market makers as indicating which of the two quotation increments applied to a particular security.[37] The Nasdaq pricing convention was generally treated by market makers as a pricing "ethic," "tradition," or "professional norm" that other market makers were expected to follow, and was sometimes enforced through harassment, or threatened or actual refusals to deal. This pricing convention both directly and indirectly restricted the independent pricing decisions of individual market makers, and thereby negatively impacted price competition. Pricing and quoting decisions independently arrived at by individual market participants do not, in and of themselves, raise the same anticompetitive concerns.

The existence of this pricing convention is confirmed through analysis of the price and quote data in the Nasdaq market. Prior to May 1994, more than 80% of all domestic Nasdaq NMS stocks (more than 3,200 stocks) followed the pricing convention.[38] Of the more than 1,900 domestic NMS stocks greater than $10, more than 90% followed the pricing convention and approximately 78% were even-eighth stocks.[39] Among the 100 most actively traded

---

[36] See Appendix Part I.A.1.

[37] Although Christie and Schultz (see supra note 26) observed the paucity of odd-eighth quotes in the Nasdaq market, they did not have the data that reflected the dealers' individual spreads.

[38] The Commission's data confirms widespread adherence to the convention, including substantial, albeit lesser, adherence among stocks priced under $10, which under Nasdaq rules may be quoted in increments of $1/16 or finer. The fact that approximately 20% of stocks were classified as not following the pricing convention is to a large degree attributable to two factors. First, the Commission applied conservative classification parameters (described in note 9 of the Appendix). Second, two-thirds of the stocks not classified as adhering to the convention had prices below $10 per share, which show lower levels of adherence to the pricing convention. In order to avoid a statistical bias, the Commission included all domestic stocks in its sample.

[39] After May 1994, following negative publicity about the Nasdaq market and the actions undertaken as a result of the "Bear Stearns meeting," market makers began to change their behavior. See infra note 56, and accompanying text.

domestic Nasdaq stocks, at least 96% of them followed the convention and 66% of them had dealer spreads of $3/4 or greater.[40]

This pricing convention[41] was well understood and widely observed by traders throughout the Nasdaq market.[42] According to some market makers, the pricing convention was based on tradition and represented the "professional" way to quote in the Nasdaq market. Indeed, a number of traders testified that senior traders at their respective firms trained them to follow the pricing convention. Other traders have described the practice as an "ethic," a "custom," or a "tradition."

Market makers who enforced adherence to the convention did so in a number of ways. When certain market makers attempted to violate the convention by quoting in smaller increments (such as $1/8 when the majority of dealers were quoting with dealer spreads of greater than or equal to $3/4), they were subjected to harassing telephone calls. One trader explained that the reason he called another market maker who was quoting in a manner that violated the pricing convention was "[t]o get him to get his increments and his spreads to conform to what I thought was the right thing to do."[43] There was widespread awareness among market makers of the harassing telephone calls. Traders from numerous market making firms, including traders who served on various NASD committees, testified to having received or made telephone calls complaining about or questioning quotations that violated the pricing convention. Traders testified that the telephone calls were effective in deterring market makers

---

[40] The top 100 domestic stocks constituted 57% of total NMS dollar volume and 35.4% of total NMS share volume traded on Nasdaq in the period February 1994 through May 1994.

[41] As discussed further in the text, adherence to the convention often adversely affects both the prices at which orders are executed and the starting prices from which customers negotiate with the market makers. Thus, although the convention is described in terms of quotations, it is appropriately referred to as a "pricing convention."

[42] Quoting in violation of the pricing convention was pejoratively described by traders as making a "Chinese market." Industry-wide recognition of the pricing convention is reflected in the third quarter 1989 newsletter of a securities industry trade association, Securities Traders Association of New York, which stated that "it is clearly UNETHICAL to make a Chinese Market or to run ahead of an order." (Emphasis and capitalization in original.) Facts and circumstances evidencing the existence of the pricing convention and its enforcement also were known to the NASD by 1990. (see infra Part VII.A.1.).

[43] This trader also testified that he was trained to make such calls.

from entering quotes that were inconsistent with the pricing convention and narrowed spreads.[44] In general, the mere threat of such harassment was sufficient to discourage market makers from violating the convention. In addition, market makers who broke the convention and reduced the spreads were at times subjected to refusals by other market makers to trade with them. Such conduct lends strong support to the conclusion that the pricing convention, as detailed in this Report, was not the result of natural, competitive economic forces or structural aspects of the Nasdaq market.[45]

The pricing convention limited the flexibility and competitiveness of price quotations in the Nasdaq market. For stocks in which dealers were quoting spreads equal to or greater than \$3/4, the avoidance of odd-eighth quote increments meant that the inside spread could not be narrowed to \$1/8, since the use of odd-eighth quotations violated the convention.[46] Thus, the pricing convention discouraged price competition among Nasdaq market makers.

---

[44] One trader explained why, when he was a junior trader, these telephone calls dissuaded him from narrowing spreads, stating "[b]ecause, many years ago, as a junior trader, I wanted to be accepted." Another trader who admitted that he had made calls questioning other market makers' "unprofessional quotations" explained that the calls imposed "peer pressure" on traders who violated the convention. He testified:

> no man or woman who is a trader wants to have people think you are a fool, at least not when you are working for a reputable firm, you have institutional clients out there. You don't want a reputation for leaving off such questions as legality and ethics. That's a given. Obviously, you don't want that. But you also don't want people to think you're an idiot. And that's the kind of pressure I'm talking about.

[45] When market participants enforce the avoidance of odd-eighth quote increments, the "price clustering" that results (i.e., the tendency of prices to fall on certain increments) cannot be regarded as the result of natural economic forces. Regardless of the size of the inside spread or the dealer spread, one would expect quote updates to use all possible eighth increments. Moreover, the almost total avoidance of odd-eighths in a large percentage of Nasdaq stocks is inconsistent with the degree of price clustering that occurs in other financial markets.

[46] For the 100 most active domestic stocks during the period December 1993 through May 1994, approximately two-thirds were quoted with dealer spreads of \$3/4 or greater, with odd-eighth quotes being used less than 1.6% of the time in those stocks. If the sample were extended to all domestic Nasdaq NMS stocks over \$10, during the same period, approximately 84% were quoted with dealer spreads of \$3/4 or greater, with odd-eighth quotes being used less than 2.5% of the time in those stocks. See Appendix Part I.A.1. for a discussion of the data and methodology used.

Market makers' adherence to the pricing convention often increased the transaction costs paid by customers trading Nasdaq securities. Most customer orders, particularly smaller orders, are executed by market makers at the inside spread. Because market makers primarily moved their quotations in even-eighth increments for most domestic Nasdaq NMS stocks, the inside best bid and offer for these stocks almost always moved in even-eighth increments. This often resulted in wider inside spreads, which caused trades to be executed at prices that were less favorable for investors than if there had been no pricing convention.[47] The practice also had an impact on the ability of some institutional investors to obtain favorable prices and may have placed them at a disadvantage in price negotiations.

The Commission does not mean to suggest that a $1/4 or greater inside spread could not be appropriate in a particular security, assuming that such a spread is independently determined based on the free interplay of competitive economic forces. Similarly, there may be occasions when a market maker acting independently might reasonably choose to update quotes in increments other than $1/8. There is, however, no valid economic justification for the widespread avoidance of odd-eighth quotations which resulted from adherence to the pricing convention.

Further evidence that the pricing convention was an artificial constraint on the Nasdaq market was found in the trading activity of market makers in Instinet. Instinet is a proprietary system in which Nasdaq stocks, among others, are traded.[48] Instinet is accessible only to broker-dealers and institutional investors who become participants.[49] A key feature of Instinet

---

[47] This is reflected in the testimony of a trader with 35 years experience, including service on the NASD Trading Committee, concerning the pricing convention and its enforcement:

> There is no ethical issue whatsoever. It was just the way the marketplace — I'm not sure but I can tell you, you know, having been in the business for 35 years, it existed prior to that and economically, there was no earthly good reason. I will just add but I shouldn't say that. When you start trading, if you bid a 3/4 point spread and you started trading an 1/8 point increments, the economics of the business were such that from a profit standpoint 'you were cutting off your nose to spite your face' because there was a chance when — of making 1/4 point on a trade at times which allowed you to make up for a multitude of sins. . . .

[48] Instinet currently operates as a registered broker-dealer and is an NASD member. Nothing in this Report is intended to suggest improper or illegal activity by Instinet.

[49] A large number of broker-dealers have access to Instinet, although Instinet does not allow all broker-dealers to trade on its system. Many institutional investors also have access to Instinet, although, as described in the text, they account for a relatively small part of (continued...)

is that its quotes are not displayed on Nasdaq or otherwise broadcast to the general public. Thus, the prices displayed on Instinet did not modify the inside quotes on Nasdaq, and broker-dealers did not regard prices displayed on Instinet as changing the prices at which they were obligated to execute customer orders.

Trading volume on Instinet has reached sizable proportions. More trading occurs on Instinet than on any of the organized United States stock markets other than the New York Stock Exchange and Nasdaq.[50] Market makers use Instinet extensively: for the period April through June, 1994, approximately 90% of all trading activity on Instinet involved a market maker. Approximately 85% of the quotes that market makers placed on Instinet were better than the inside quote in the Nasdaq market. Analysis of Instinet trading activity showed that market makers regularly quoted odd-eighth prices in Instinet for stocks that were quoted only in even-eighths in Nasdaq. That market maker quotations on Instinet involved the regular use of odd-eighths for stocks quoted only in even-eighths in Nasdaq supports the conclusion that natural economic forces were not freely operating in Nasdaq.[51] The clustering of quote increments in the Nasdaq market should be contrasted with the absence of clustering for exactly the same stocks by the same market makers in the quotes they place in Instinet, where even and odd-eighths are used almost equally. The disparity in market maker quoting in Nasdaq and Instinet, as well as the market maker conduct described throughout this Report, undermine price clustering as an explanation for the pricing convention.

Market makers did not follow the pricing convention when trading in Instinet, in part, because Instinet is an anonymous system. More important, however, is the fact that quoting between the spread on Instinet does not affect the inside spread on Nasdaq and therefore does not affect the prices at which market makers trade with the public. Thus, market makers did

---

[49](...continued)
the direct trading activity on Instinet. The "quotes" on Instinet consist of limit orders placed by persons having trading privileges on Instinet and are completely anonymous. Because Instinet orders express market makers' willingness to deal at stated prices, such orders may be regarded as the functional equivalent of market maker quotes, and are referred to as quotes for the purposes of the analysis in this Report.

[50] For example, in 1994, trading volume on Instinet was approximately 10.8 billion shares with an approximate dollar volume of $282 billion. By comparison, Nasdaq had approximately 74 billion shares traded, for an approximate dollar volume of $1,449 billion. (It should be noted that Instinet trade and dollar volume is included in the Nasdaq numbers.) The New York Stock Exchange volume for 1994 was approximately 76 billion shares with an approximate dollar volume of $2,841 billion.

[51] For the period April through June, 1994, the average trade size in Instinet was approximately 1,600 shares, compared to approximately 1,900 shares in Nasdaq. Thus it does not appear that the use of different quotations in Instinet can be explained by differences in order sizes.

not have the same economic incentive to prevent one another from using odd-eighth quotes on Instinet. Ultimately, the ability of market makers to attract trading interest through Instinet allowed them to trade without using odd-eighth quotes and narrowing the Nasdaq spread.[52]

The artificial nature of the Nasdaq pricing convention was further evidenced by the behavior of market makers after May 1994. Beginning in late May 1994, the Nasdaq market received considerable adverse publicity stemming from the Christie-Schultz study suggesting implicit collusion among Nasdaq market makers,[53] the filing of class action litigation against a number of market makers, and news reports in late 1994 of government investigations into the activities of market makers. Before May 1994, approximately 12% of the Nasdaq NMS stocks priced over $10 had dealer spreads less than $3/4 and were therefore routinely quoted in both even and odd-eighths. After a meeting of NASD officials and market makers at Bear Stearns in late May 1994,[54] efforts were made by some market makers to narrow the spreads of certain high profile stocks that had previously been quoted only in even-eighths. What is noteworthy is that although these market makers started quoting in odd-eighths, they generally did so by following the pricing convention, narrowing their dealer spreads from $3/4 and above to less than $3/4.[55] Throughout the remainder of 1994 and into 1995, market makers increasingly moved to quoting odd-eighths both by following the convention and narrowing their dealer spreads to less than $3/4,[56] and by quoting odd-eighths with dealer spreads of $3/4 or more. These recent changes provide additional support for the conclusion that the pricing convention was not an inherent or essential feature of pricing in the Nasdaq market.

The increased use of odd-eighths in certain stocks after the May 24, 1994 Bear Stearns meeting generally resulted in narrower spreads in those stocks. The Commission's concerns in this Report are not directed at spreads per se, but at the inflexibility in pricing that results from adherence to the pricing convention. The avoidance of odd-eighths in market maker quotations pursuant to the pricing convention inhibits price competition, while an increased usage of odd-

---

[52] The Commission's analysis showed similar use of the NASD's SelectNet system, a screen based order communication and negotiation system that is part of Nasdaq and is available only to NASD members. The data showed that most of the prices market makers placed in SelectNet improved the inside spread, and market makers regularly used odd-eighths in SelectNet for stocks that were quoted in even-eighths on Nasdaq.

[53] See supra note 26.

[54] See Appendix Part I.A.1.e.

[55] This was not particularly well received by other market makers. See Appendix Part I.A.1.e.

[56] By July 1995, approximately 22% of domestic Nasdaq NMS stocks over $10 were being quoted with dealer spreads less than $3/4.

eighths enhances price competition. Thus, the greater use of odd-eighths in market maker quotations after May 24, 1994 would be expected to result in narrower spreads. While volatility, liquidity, and the price of the security are likely to affect spreads, they do not explain the adherence to the pricing convention, nor do they explain the significant changes in quotation behavior and narrowing of spreads in various stocks following the Bear Stearns meeting and the commencement of investigations by the Department of Justice and the Commission.

4. The Nasdaq Size Convention

The investigation has also determined that many Nasdaq market makers have adhered to a convention under which they would not display a new inside quote unless they were willing to trade in an amount substantially greater than the minimum volume required by NASD rules (the "size convention").[57] The size convention required the market maker to be willing to trade in the range of two to five times the minimum NASD volume requirement when creating a new inside quote. The effect of this convention was that market makers would narrow the inside spread on Nasdaq only if they were willing to trade at the substantially larger volume required by the convention. Thus, a market maker in a stock where the minimum NASD quotation amount is 1,000 shares who narrowed the spread from $1/2 to $1/4, or from $1/4 to $1/8, was expected to trade between 2,000 and 5,000 shares. Like the pricing convention, the size convention was in some instances overtly enforced by Nasdaq market makers through intimidation, harassment or other improper conduct.

The size convention had an anticompetitive effect. It inhibited price transparency by limiting quote changes to those circumstances where a Nasdaq market maker was willing to trade in substantially greater volume than the NASD prescribed minimum. This impaired price competition in the Nasdaq market, because improved quotations to reflect orders smaller than those required by the convention were deterred. Spreads were necessarily wider because the size convention discouraged aggressive pricing. The fact that the size convention was enforced by some market makers through harassment and other similar conduct supports the conclusion that it was artificially imposed in the Nasdaq market.

---

[57] See Appendix Part I.A.1.c. NASD rules require market makers to be willing to trade at least 1,000 shares at their quoted prices for the more actively traded stocks and lesser amounts for other Nasdaq stocks. See NASD Manual, Schedule D to the By-Laws, Part V, § 2 (CCH) ¶ 1819 (1995) (prescribing minimum sizes of quotations). The Commission recognizes that an independent decision to trade in greater size than the published quote is a service that a market maker may extend to its customers. However, to the extent that the size convention became the "professional norm" that all other market makers were expected to follow or was enforced as described above, this convention was anticompetitive and resulted in artificially wide spreads.

5. Effect of the Pricing and Size Conventions

In sum, the pricing convention, the size convention, and the availability to market makers of alternative trading systems resulted in a fragmented market for Nasdaq stocks. Customers were often confronted by artificially wide, inflexible spreads, and lacked access to the markets with the best prices. Attempts by certain market makers to compete on the basis of price were discouraged through harassment and the potential loss of trading opportunities. These practices cannot be reconciled with the "free and open" market contemplated by the Exchange Act and evidence significant underlying problems in the Nasdaq market.

B. Coordination of Quotations, Trades, and Trade Reports

The investigation has determined that a number of Nasdaq market makers have coordinated quotations, trades, and trade reports with other Nasdaq market makers for the purpose of advancing or protecting the market makers' proprietary trading interests.[58] By engaging in such conduct, these market makers may have acted contrary to the best interests of their customers and created a false or misleading appearance of trading activity in the Nasdaq market.

For example, the tapes reflect numerous occasions in which market makers have asked other market makers to move their displayed quotations in a particular direction to help the requesting market maker trade (often with customers) at prices more favorable to the requesting market maker. The requesting market maker generally disclosed his or her intentions for future price movements and transactions to the cooperating market makers. Cooperating market makers acceded to these requests because of an expectation that the requesting market maker would reciprocate in the future. Such cooperative activity improperly influenced prices, often at the expense of investors, while creating an inaccurate picture of market conditions. The market makers involved in such conduct may, depending upon the facts and circumstances of each particular situation, be deemed to have engaged in unlawful manipulation of the market or otherwise violated applicable antifraud provisions of the federal securities laws or NASD rules.[59]

---

[58] See Appendix Part I.A.3.

[59] The applicable antifraud provisions could include Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1994), and Sections 10(b) and 15(c) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78o(c) (1994), and Rules 10b-5 and 15c1-2 promulgated thereunder, 17 C.F.R. §§ 240.10b-5 and 240.15c1-2 (1996), and Article III, Section 1 of the NASD Rules of Fair Practice, NASD Manual, (CCH) ¶ 2151 (1995). This Report does not purport to address the potential liability of any person or entity under other federal or state laws.

Some Nasdaq market makers have also worked improperly together in this way to fill customer orders or to reduce inventory exposure.[60] In such cases, a market maker having a sizeable customer order or an inventory imbalance called upon other market makers to coordinate their quotations and transactions with the requesting market maker.[61] The fact that

[60] Inventory exposure arises from either holding a large long position or a large short position in a given security for any significant length of time. For example, a market maker holding a long position of 50,000 shares of a security experiences a paper loss of $50,000 if the market price drops $1. In general, market makers prefer to minimize their inventory positions for this reason.

[61] The following taped conversation illustrates this type of coordination. On June 17, 1994, a market maker (Market Maker 1) in the common stock of AES Corp. (AESC) had an order to buy a quantity of AESC stock. Market Maker 1 entered a bid of $18 1/4, a quarter point above the other bids in the market, to attract sellers. Another market maker (Market Maker 2) had an order to sell AESC stock. Market Maker 2 called and asked Market Maker 1 to lower its bid because Market Maker 2 wanted to pay less for the stock it was buying (as the counterparty to the order to sell that it had received):

> MM 2: I just seen [sic] you go 1/4 bid. Without like going through a whole bunch of, you know, **** **** I know I got a bunch of these for sale at the opening. I would rather buy them at 18, if you know what I'm saying. If there's a ticket to write, I will write it with you [meaning I will sell some AESC stock to you if you are looking to buy some].
>
> MM 1: There absolutely is a ticket to write.
>
> MM 2: OK.
>
> MM 1: I can make a sale at the opening myself.
>
> MM 2: You can?
>
> MM 1: Yes.
>
> MM 2: OK, so.
>
> MM 1: As long as it's — I can go down . . . .

Trading records indicate that Market Maker 1 dropped its bid price to $18. Market Maker 2 proceeded to purchase 8,000 shares of AESC stock at $18. In the meantime, Market Maker 1 sold 16,700 shares at $18 1/2 to its customer, of which 7,500 shares were sold short. Market Maker 2 subsequently sold 6,500 shares to Market Maker 1 at

(continued...)

a market maker used these arrangements when engaged in buying or selling securities for a customer was typically not disclosed and may have violated the duties owed by the market maker to its customer.

Such undisclosed collaboration can injure the interests of both retail and institutional investors. A market maker representing a customer order is required to obtain the most favorable terms for its customer that are available under the circumstances. See, e.g., Opper v. Hancock Securities Corporation, 250 F. Supp. 668 (S.D.N.Y.), aff'd per curiam, 367 F.2d 157 (2d Cir. 1966) (broker-dealer liable for trading ahead of customer's order on an undisclosed basis). When a market maker with a customer order is helping another market maker dispose of a quantity of a security, it may not bargain hard with the other market maker in order to get the best price for its customer because it is accommodating the interests of the other market maker.[62] In these instances, the market maker's interest in helping a fellow market maker conflicts with the firm's obligation to obtain the best available terms for its customer.[63] An undisclosed arrangement between or among market makers that results in a broker-dealer acting contrary to the interests of its customer is incompatible with the firm's agency duties to its customers.[64]

The investigation also revealed instances in which some Nasdaq market makers agreed to delay reporting trades they had done with each other. The report of a trade, particularly a large trade, can affect market price. Thus, the delay of a trade report can provide an

---

[61](...continued)
$18 1/4. Market Maker 2 injured the interests of the seller by asking Market Maker 1 to lower its bid price so that Market Maker 2 could pay $18 per share, rather than $18 1/4 (a difference of $2,000 for the entire trade). Market Maker 1 was also a participant, since it changed its bid at Market Maker 2's request, to create a deceptive appearance to the market, and made it harder for the seller to observe the true level of buying interest.

[62] Such cooperative trading is evidenced by tape recordings obtained in the investigation, which showed that market makers frequently did not bargain with each other for the best prices for their customers.

[63] The Commission is not suggesting that the usage of multiple brokers to obtain executions of orders is by itself improper. The discussion in this Report is directed to the activities of market makers on the Nasdaq market who engaged in these practices to the detriment of their customers.

[64] Even in situations in which market makers trade with customers as principals, they nevertheless have duties to deal fairly with their customers. See, e.g., Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943) (broker-dealer liable for undisclosed mark-ups to customers).

information advantage to a market maker. The investigation found that cooperating market makers have agreed to withhold a trade report until one of them could inappropriately trade for the firm's own account in a market unaware of the unreported transaction. Certain Nasdaq market makers also asked other market makers to delay trade reports in order to prevent a customer from judging the quality of an order execution against substantially contemporaneous dealer-to-dealer transactions. If the dealer-to-dealer trades were reported on time, the customer might have been able to tell if its price was worse than other contemporaneous trades and then question whether it had received the best price available under the circumstances.[65] Agreeing

[65] An example of such delayed trade reporting occurred on June 22, 1994. Three market makers arranged for a sequence of four trades in the common stock of PXRE Corp., in which shares sold by Market Maker 1's customer would ultimately be bought by Market Maker 3's customer. Market Maker 3 did not want its customer to see the true sequence of trades and obtained Market Maker 2's promise to hold its trade report and asked Market Maker 2 to secure Market Maker 1's agreement to hold its trade reports. Market Maker 1 agreed to hold its trade reports for ten minutes. Market Maker 2 told Market Maker 3 that Market Maker 1 would hold his trade reports but omitted to say for ten minutes only. The trades occurred as follows:

1. MM1 bought 20,000 shares at $24 1/2 from its customer at approximately 12:15 p.m. (Trade A).
2. MM1 sold 20,000 shares at $24 9/16 to MM2 at approximately 12:18 p.m. (Trade B).
3. MM2 sold 20,000 shares at $24 19/32 to MM3 at approximately 12:23 p.m. (Trade C).
4. MM3 sold 20,000 shares at $24 11/16 to its customer at approximately 12:24 p.m. (Trade D).

These trades were reported, however, in the following sequence:

1. MM3 reported its sale of 20,000 shares at $24 11/16 to its customer at 12:24:51 p.m. (Trade D).
2. MM1 reported its purchase of 20,000 shares at $24 1/2 from its customer at 12:25:01 p.m. (Trade A).
3. MM1 reported its sale of 20,000 shares at $24 9/16 to MM2 at 12:28:00 p.m. (Trade B).

(continued...)

to withhold trade reports under the foregoing circumstances, to create a false appearance of activity in the market and possibly to deceive investors, may have violated the antifraud provisions of the federal securities laws as well as the NASD's rules requiring timely reporting of trades.

C. The Exchange of Proprietary Information

As part of coordinating their activities, various Nasdaq market makers often shared with each other customer information and other information that would normally be viewed as proprietary.[66] For example, the evidence demonstrates that these market makers regularly shared information concerning the size of customer orders and sometimes the identity of the customer. A market maker was typically expected to reveal the full extent of its customer's order when negotiating a trade with another market maker. Market makers also shared information concerning their own inventory positions, their intended trading strategies, and future quote movements. Market makers testified that this was often done with the understanding that other market makers with whom such information was shared would not use it against the disclosing market maker's interests.

Market makers involved in such information sharing have indicated that they regarded it as "professional," "ethical," or a courtesy. Frequently, market makers shared information to protect each other from price movements in the market price of a particular security. Those market makers who were unwilling to observe these practices had less access to information and trading opportunities from other market makers.

---

[65](...continued)

4. MM2 reported its sale of 20,000 shares at $24 19/32 to MM3 1:26:12 p.m. (Trade C).

None of the last three trades was reported with an ".SLD" modifier, which would have identified it as a late trade report. Because Market Maker 1 reported its lower priced trades immediately after Market Maker 3 reported its trade with its customer, Market Maker 3, in an angry frame of mind, spoke to Market Maker 2:

> MM3: So now I got ******, okay. . . . I hope I don't have to cancel the trade, but I might have to because as soon as the ******* guy [MM3's customer] sees it, you know, the ******* guy is going to start jumping up and down, okay.
>
> MM2: Were you able to sell it . . . ?
>
> MM3: I sold 'em. I mean the guy didn't get the ******* report yet, you know what I mean.

[66] See Appendix Part I.A.3.

These information sharing "courtesies" were typically not extended to customers and could conflict with the basic obligations owed by a broker-dealer to its customers. Investors may be deprived of benefits that would otherwise be available in a competitive market. Revealing the size of a customer order may be detrimental to the ability of the customer to obtain the best execution. The customer's interests often are best served by concealing the scope of its trading interest, especially if the customer is trading in large quantities. Market makers learning of the order could adjust the price and size of their quotations to force the customer to pay more or sell for less than would have been the case if the customer's confidentiality had been protected by its executing market maker.

In the situations where market makers share the customer's identity, the customer's ability to seek competitive quotations from market makers is significantly hampered. A reason that has been given by some market makers for disclosing the identity of a customer is the suspicion that the customer was doing business with more than one market maker. Traders testified that they sometimes would share the identity of a customer when they believed the customer was trading with both market makers at the same time in order to better evaluate the risks of trading with that customer. This testimony indicates that market makers may at times be tempted to overlook their obligation to deal fairly with their customers. A customer may properly deal simultaneously with more than one market maker in order to secure the best execution of its orders. This is a primary way in which the customer obtains the benefit of a dealer market. However, for a market maker to collaborate with other market participants against the interests of its customer is inconsistent with the fair dealing obligations of market makers in a free and open market.

D. Collaboration in the Nasdaq Market

The pricing convention, the size convention, the coordination of quotations, trades and trade reports, and the sharing of proprietary and customer information, by themselves, raise significant concerns. Taken together, these practices point to a broader problem: that Nasdaq market makers have had a tendency to improperly collaborate and coordinate their activities. In such an environment, the forces of competition were impeded. It is of overriding regulatory importance that Nasdaq market making not be permitted to evolve into a culture of non-competition. This inclination to collaborate has broad implications for the functioning of the Nasdaq market. In a dealer market, it is important that dealers compete aggressively with each other and that the benefits of that competition are passed on to investors. If dealers do not vigorously compete, the value to investors and the public of a dealer market is diminished. The above-described tendency of some Nasdaq market makers to protect each other without regard to the interests of their customers and other market participants underscores the need for significant market reform.[67]

[67] This is not meant to suggest that a dealer market is undesirable. The Commission continues to view dealer markets as an appropriate market structure, provided they are competitive, free, and open as required by the Exchange Act.

E. Failure to Honor Quotations

Market makers have a fundamental obligation to honor their quotations.[68] Prompt, accurate, reliable, and fair information with respect to quotations is a cornerstone of the national market.[69] The reliability of quotations is essential to investor confidence and to the efficient operation of the market. Investors have difficulty obtaining reliable price information or order executions in the absence of firm quotations. Failure to honor quotations deprives investors of the liquidity that market makers advertise they will provide and injures the credibility of the market as a whole.

The investigation revealed numerous violations of the firm quote rule by Nasdaq market makers.[70] Certain market makers at times did not honor their quotations for those with whom they preferred not to trade and "backed away" from their quotes as reprisal for, among other reasons, perceived prior backing away by other market makers. Certain market makers have also variously refused to trade with order entry firms,[71] certain other market makers, and market participants they "dislike," such as options market makers.[72] Market makers at times backed away from their trading obligations to avoid unwanted orders placed when they coordinated their quotations with other market makers. The incidence of backing away in the marketplace has contributed to market fragmentation and has weakened the pricing mechanism in Nasdaq. Nasdaq market makers must consistently honor their quotes to safeguard the integrity of Nasdaq as a viable dealer market.

---

[68] The firm quote rule is set forth in Exchange Act Rule 11Ac1-1, 17 C.F.R. §240.11Ac1-1 (1996). See also NASD Manual, Schedule D to the By-Laws, Article V, § 2(b) (CCH) ¶ 1819 (1995).

[69] Exchange Act Release No. 14416 (Jan. 26, 1978), 43 Fed. Reg. 4354 (Feb. 1, 1978).

[70] See Appendix Part I.C.

[71] Order entry firms are broker-dealers that route customer orders to market makers for execution. Some order entry firms execute small customer orders through the SOES system, which provides automated execution of small orders. Certain order entry firms that are active users of SOES are disliked by market makers.

[72] Options market makers on the various options exchanges make markets in standardized common stock options on Nasdaq and exchange-listed stocks. An options market maker needs to be able to execute trades in the security underlying the option in order to hedge the option's risk.

F. Late Trade Reporting

Market makers and certain other broker-dealers are required to report trades in Nasdaq stocks within 90 seconds of the transaction.[73] Trades that are reported late are required to be specifically identified with the designation "SLD" so that market participants will know that these reports are being reported more than 90 seconds after the execution. Timely trade reporting and the accurate designation of late trade reports with the "SLD" designation are essential to providing investors and other market participants with an accurate picture of Nasdaq market activity.

Numerous market makers repeatedly failed to report Nasdaq transactions on an accurate and timely basis.[74] Calculations by the Commission staff indicate that at least 3.6% of all Nasdaq trades in the period February through December 1994 were reported late.[75] During the same time period, late trades accounted for only .09% of reported trades on the New York Stock Exchange. In addition to trades reported more than 90 seconds late and marked "SLD," approximately 6.7% of trades between broker-dealers in a sample of 1994 transactions examined by the staff were reported late, but were not marked late by the reporting market maker as required by NASD rules.[76] The staff's analysis revealed that for both marked and unmarked late trades, the percentage of larger trades reported late was significantly higher than for smaller trades. Because reports of larger trades are more likely to be market sensitive, market makers seeking to fill an order or cover a position may have a greater incentive to report large trades

---

[73] Pursuant to Exchange Act Rules 11Aa3-1 and 11Aa3-2, the NASD adopted a transaction reporting plan for National Market System securities in 1982. Exchange Act Release No. 18590 (Mar. 24, 1982), 47 Fed. Reg. 13617 (Mar. 31, 1982). A pattern or practice of late reporting without exceptional circumstances may be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Article III, Section 1 of the NASD Rules of Fair Practice. NASD Manual, Schedule D to the By-Laws, Part X, § 2(a)(8) (CCH) ¶ 1867 (1995).

[74] See Appendix Part I.B.1.

[75] This figure includes trades reported through systems such as SOES, SelectNet, and ACES, which automatically report trades and generally eliminate the possibility of late trade reports. When trades on these systems are excluded, late trades account for approximately 4.5% of all reported trades for the period. As discussed in the Appendix, the NASD began to take action to improve its program for enforcing trade reporting rules in late 1994. The percentage of trades reported late on Nasdaq fell in 1995. See Appendix Part I.B.1 and note 101.

[76] This analysis was based on a sample that represented approximately 20% of all NMS trades from February through December 1994 and included all trades between broker-dealers containing both a trade report time and a counterparty time and that were not executed through SOES, SelectNet, or ACES.

late. The higher percentage of large trades reported late raises a concern that a portion of these late reports may be the result of intentional reporting delays rather than negligence or computer errors. In testimony, traders have admitted that they sometimes deliberately delayed reporting trades, and examinations of a cross-section of Nasdaq market makers by the staff confirmed an unacceptable frequency of late trade reporting. The examinations revealed numerous other inaccurate trade reports including trades executed after the market closed and not identified accordingly; trades identified as late that were not submitted late; trades reported incorrectly as executed after the market closed; trades not reported; and inaccurate execution times submitted in trade reports.

Many Nasdaq market makers did not treat trade reporting as a priority and in some cases used inadequate trade reporting systems. Late and inaccurate trade reporting by Nasdaq broker-dealers undermines the integrity of the Nasdaq market. Accurate and timely transaction reports provide critical information to investors, issuers, and brokers and dealers trading Nasdaq securities, as well as options and other derivative products. Trade reporting problems also hamper the ability of investors, firms, and regulators to monitor broker-dealer compliance with a variety of investor protection rules, including limit order protection and rules prohibiting excessive markups. The scope of the trade reporting problem shown to exist on Nasdaq compels the conclusion that corrective action was warranted.

VII. THE NASD'S PERFORMANCE AS AN SRO

The Exchange Act requires the NASD to enforce its rules and the federal securities laws vigorously and in an evenhanded and impartial manner. Moreover, the NASD has an affirmative obligation to be vigilant in surveilling, evaluating, and effectively addressing potential violations of the federal securities laws and its rules, as well as conduct that could adversely affect the competitiveness or integrity of the Nasdaq market.

A. The NASD's Awareness of the Nasdaq Pricing Convention

1. Events in 1990

By 1990, the NASD was aware of facts and circumstances evidencing the pricing convention, actions undertaken by market makers to enforce it, and the rigidity of Nasdaq spreads.[77] In August 1989, the New York Stock Exchange ("NYSE") sent a letter to a Nasdaq listed company which contended that Nasdaq spreads were wider than NYSE spreads for comparable securities and urged the company to transfer its listing to the NYSE. This letter, together with facts evidencing the pricing convention, its enforcement, and the rigidity of Nasdaq spreads, were the topics of discussion at a June 27, 1990 meeting of the NASD's Trading

[77] See Appendix Part I.A.2.

Committee.[78] At this meeting, a committee member urged that the NYSE letter reflected competitive pressure and that Nasdaq market makers should narrow their spreads or face the loss of "clients" and "product." The pricing convention was described by one committee member as an "ethic" in the Nasdaq market, part of which was not to close the spreads or make "Chinese markets." Two other committee members stated that attempts to break the spreads would prompt telephone calls asking about the reason for the narrowed spreads. The committee concluded that it was inadvisable to legislate spreads and that the "ethic" was an "internal" matter which the Security Traders Association of New York, an industry trade association, should address. The NASD took no action following this meeting to investigate the existence of the pricing convention or address the detrimental effects it could have on competition and the interests of investors.

The NASD, by its inaction in 1990, failed to satisfy its responsibilities as an SRO. The NASD viewed the pricing convention and, to a great extent, spreads, as commercial issues pertaining to its competitive standing with the New York Stock Exchange, instead of significant regulatory problems. Because of the effect of the pricing convention on the competitiveness and fairness of the Nasdaq market, the NASD should have acted promptly and vigorously to investigate indications that its market maker members were potentially violating the Exchange Act or the NASD's rules. The use of substantial enforcement and other resources to investigate these issues would have been fully warranted. The NASD's regulatory policies failed to address these concerns. In particular, by not reacting to the issues raised at this committee meeting, the NASD was effectively deferring to the securities industry and its trade organizations in responding to these allegations of potentially illegal practices. This placed responsibility for the problem in the hands of the persons with the least incentive to address the issues effectively and change the status quo. There was little likelihood that the securities industry and its trade associations would voluntarily take sufficient corrective measures to deal with the problems, particularly when any corrective action was likely to directly affect the proprietary interests of the NASD's market maker members.

2. Events in 1992

In 1992, the fundamental elements of the pricing convention were brought to the attention of the NASD's executive management.[79] In early 1992, a senior NASD executive was assigned the task of obtaining a better understanding of spreads on Nasdaq and identifying possible means of reducing spreads. He undertook an evaluation and analysis and consulted with the NASD

---

[78] The NASD staff attending this meeting included representatives of the Office of General Counsel, the Market Surveillance Department, and the Market Operations Department.

[79] See Appendix Part I.A.2.

Quality of Markets Subcommittee of the Trading Committee.[80] At a March 24, 1992 meeting of the Quality of Markets Subcommittee, this senior executive and committee members discussed the issue of widening spreads, "Chinese markets," the quoting patterns dictated by the pricing convention, and the intimidation of market makers. The senior executive prepared a memorandum dated June 30, 1992 (the "June 1992 Memo") which reported on the analysis he had conducted of widening spreads in the Nasdaq market. The June 1992 Memo identified the stigma associated with making "Chinese markets," and noted the absence of odd-eighth quotations in stocks that typically moved in even-eighth quotes.[81] The June 1992 Memo also noted that peer pressure was applied to dealers that narrowed the spreads. The June 1992 Memo recommended that the NASD should support market makers that competed through price improvement and should protect them from harassment by other market makers. The June 1992 Memo was distributed to the NASD's executive management.

The NASD failed to take appropriate action at the time of the June 1992 Memo to address the issues raised by the pricing convention and its enforcement through market maker harassment. The NASD made no attempt to assess the impact of these market maker practices on spreads or trade executions. Despite the gravity of the behavior and the potential injury to investors, the NASD failed to investigate possible violations of law or the NASD's rules. The NASD's inaction failed to satisfy its statutory responsibilities as an SRO under the Exchange Act.

3. **Post-1992 Developments**

After June 1992, the NASD continued to receive information regarding the pricing convention and its implications.[82] While the NASD was concerned over the relatively wide spreads on Nasdaq, it pursued limited regulatory and structural measures such as the excess spread rule[83] and a trading system called N*PROVE, which were designed, in part, to narrow

---

[80] The Quality of Markets Subcommittee was formed in early 1991 to address two issues: the development of the short sale rule and the issue of spreads. The Subcommittee was composed only of representatives of market making firms.

[81] The June 1992 Memo included a substantial discussion of certain concepts for regulatory or structural change of the market as means of addressing the widening of spreads. See Appendix at p. 25.

[82] Id.

[83] The excess spread rule in substance provides that all dealer spreads for a stock must be within 125% of the average of the three narrowest dealer spreads in that stock. NASD Manual, Schedule D to the By-Laws, Part V, § 2(d) (CCH) ¶ 1819 (1995). While this rule limits the width of dealer spreads, it does not address the problem of inflexibility of pricing and the impact of such inflexibility on even the narrowest of dealer spreads.

displayed spreads. The N*PROVE proposal was submitted to the Commission as a replacement for the SOES system and its immediate automatic execution feature which was widely disliked by market makers.[84] These limited initiatives were not an adequate substitute for the NASD's duty to investigate the conduct of its market maker members or to enforce compliance with the NASD's rules and the federal securities laws.[85]

The NASD continued to receive indications of a lack of vigorous price competition in the Nasdaq market. For example, an article in the August 16, 1993 edition of Forbes reported that Nasdaq market makers were reluctant to narrow the spreads and made complaining telephone calls to market makers who did narrow the spreads.[86] Although NASD management was critical of the Forbes article because of certain perceived inaccuracies, the senior NASD executive who authored the June 1992 memo concerning spreads circulated comments regarding the article to members of the NASD's executive management stating, with respect to the complaining telephone calls, "I believe this to be true." In late 1993, the NASD conducted a

---

[84] N*PROVE was filed with the Commission on March 28, 1994. Exchange Act Release No. 34145 (June 1, 1994), 59 Fed. Reg. 29649 (June 8, 1994). N*PROVE was designed to replace SOES's immediate automatic execution system with an order delivery system that would have given Nasdaq market makers 15 seconds to decline incoming small orders rather than having the orders automatically executed against them. The N*PROVE proposal also included a limit order file which would have provided some opportunity for customer orders to interact with each other. Because the Commission had continuing concerns that N*PROVE would not provide sufficient opportunities for customer interaction without the intervention of a market maker, as well as concerns about enforcement of the firm quote rule, the N*PROVE proposal was ultimately withdrawn by the NASD without formal action by the Commission. See Exchange Act Release No. 35275 (Jan. 25, 1995), 60 Fed. Reg. 6327, 6329 (Feb. 1, 1995).

[85] The NASD and Nasdaq market makers have generally tried to blame SOES traders for the width of the spreads in the Nasdaq market. As evidence of the pricing convention and the other anticompetitive practices described herein demonstrates, there is ample reason to doubt this contention. In addition, the fact that a reduction of the market makers' exposure to SOES trading in 1994 resulted in no perceptible narrowing of spreads further undercuts such a claim. Specifically, at a May 24, 1994 meeting of market makers and representatives of the NASD at Bear Stearns & Co., an NASD senior executive pointed out that spreads had not narrowed after the SOES rules changed in January 1994 to reduce the amount of volume market makers were obligated to trade on SOES. He urged market makers to narrow their spreads in light of their reduced SOES exposure. The absence of an overall narrowing of spreads after these changes in the SOES rules is inconsistent with the argument that SOES trading was responsible for wide spreads.

[86] Gretchen Morgenson, "Fun and Games on Nasdaq," Forbes, Aug. 16, 1993, at 75-76.

survey of institutional investors, which disclosed, among other things, that certain investors were concerned about possible collusion and self- dealing by Nasdaq market makers.[87] Institutional investors cited such concerns as a reason for using trading systems other than Nasdaq-operated systems. The NASD took no action to investigate or address these concerns.

In May 1994, the media reported on the Christie-Schultz study which suggested the possibility of tacit collusion among Nasdaq market makers.[88] The Christie-Schultz study independently raised similar concerns about price rigidity as discussed in the June 1990 Trading Committee meeting and the June 1992 Memo and should have prompted the NASD to investigate objectively the issues being raised. The NASD's response, however, was to engage in public denials, to solicit support from issuers and market makers, and to undertake economic research[89] to discredit what, by June 1994, it should have recognized to be well founded.

The NASD failed to meet its statutory obligations as a result of its failure to investigate meaningfully the pricing convention and related issues. The NASD's response to these issues demonstrates a lack of the objective, proactive approach to addressing potential violations of its rules and federal law that the Exchange Act requires. Repeatedly faced with serious allegations concerning widespread, potentially illegal conduct by market makers, the NASD simply failed to confront the problem. As an SRO, the NASD is obligated by statute to monitor the Nasdaq market closely and maintain its integrity. The NASD has a statutory duty to surveil and enforce vigorously its rules and the federal securities laws against its members whenever such members act contrary to the interests of investors and the public.

---

[87] One institutional investor noted his concern that "dealers collude and share information that we don't see," while another stated the belief that "[m]arket makers are self-serving. They take care of their own accounts first, then their 'broker buddies.' We're the last ones they care about." [emphasis in original]

[88] See supra note 26 and, accompanying text.

[89] The NASD sometimes followed a result oriented approach to economic research it sponsored. For example, the NASD would from time to time conduct preliminary research in an area to ascertain likely results before commissioning an outside economist to conduct the research. In one instance, an agreement with an outside economist provided that the NASD retained the right to prevent publication of the research for a $1,000 payment. An internal NASD memorandum explained that this provision was included in the agreement "[b]ecause of the negative publicity that may be generated by poor results. . . ."

B. The NASD's Regulatory Deficiencies

1. Market Maker Influence

The NASD, like any regulator, must be cognizant of the natural tendency of a regulated industry to influence its regulator to protect the industry's proprietary interests. As an SRO, the NASD must guard against the efforts of any one segment of its membership, such as its market maker members, to assert undue influence over its regulatory functions and processes. While the NASD's market maker members have a significant and appropriate role to play in the self-regulatory process governing the Nasdaq market, the public interest must be the predominant concern.

Market makers have exerted substantial influence over the affairs of the NASD through their traditional active role in its governance.[90] Representatives of firms that make markets have constituted a majority of the Nasdaq market's Board of Directors, as well as the committees and subcommittees central to the governance of the NASD, the administration of its disciplinary process and the operation of the Nasdaq market.[91] Other less organized constituencies, such as retail and institutional investors and other broker-dealers, did not have comparable representation on those boards and committees.

---

[90] See supra note 20, and accompanying text.

[91] Changes effected in early 1996 provide for the composition of the NASD's Board of Governors to be a majority of non-industry members. Prior to this time, representatives of firms that make markets have comprised a majority or a substantial portion of the NASD's Board of Governors. Much of the market makers' influence over the disciplinary process came from their participation in the District Business Conduct Committees ("DBCCs"). The DBCCs have had a "grand jury" function, in which the NASD staff must seek DBCC authorization to initiate a disciplinary action. The DBCCs also serve as adjudicative bodies, which decide the outcome of litigated enforcement proceedings and approve settlements. The grand jury function provides the NASD's industry members with the ability to veto NASD staff enforcement recommendations and allows them to prosecute those cases they, sitting as members of the DBCC, deem appropriate. The adjudicatory role of the DBCC provides NASD members with a powerful and central role in the self-regulatory process. Meaningful self-regulation does not require that industry representatives also perform a grand jury function in the disciplinary process. The objectivity and impartiality of the disciplinary process will be advanced by removing the DBCCs from the grand jury function and the potential for abuse that such a role entails. Similarly, the Market Surveillance Committee, which has a grand jury function with respect to disciplinary actions proposed by the NASD's Market Surveillance Department, should no longer retain that function. The NASD has agreed to make these changes as part of its undertakings in the settlement of the administrative proceeding brought by the Commission concurrently with the issuance of this Report.

2. The Undue Influence of Market Makers in the Disciplinary Process

The following discussion concerns the NASD's enforcement process. Nothing herein should be interpreted to mean that the NASD should not have an active and aggressive enforcement program with respect to all member firms, including member firms that traded actively on behalf of customers on SOES ("SOES firms"), to enforce all rules and regulations of the NASD. This Report should not be read to suggest any conclusion by the Commission on the merits of any specific enforcement action or inspection by the NASD of SOES firms.

a. Enforcement Emphasis on SOES Activity

The repeated complaints of market makers, coupled with what the NASD has represented was its belief that the SOES firms were a source of serious problems in the Nasdaq market, precipitated a concerted effort by the NASD staff to bring disciplinary actions against SOES firms.[92] A telephone number was listed in the NASD directory specifically for "Small Order Execution System (SOES) — Rule Violations/Inquiries." Perceived violations of the SOES rules became an enforcement priority for the NASD staff. Firms were identified as potential violators with information provided by market makers or developed through monitoring SOES activity by the NASD's Market Surveillance Department. Certain firms were subjected to special SOES "sweep" examinations, which in some cases resulted in disciplinary actions. Substantial resources at the NASD's District 10 Office in New York City and in its Market Surveillance Department were devoted to monitoring, examining, and bringing disciplinary actions for potential violations of the SOES rules.[93]

b. The NASD's Laxity in Enforcing the Firm Quote Rule

In contrast to its aggressive enforcement of the SOES rules, the NASD was far less attentive to possible rule violations by market makers.[94] For example, the firm quote rule was enforced only if an aggrieved party filed a written complaint with the Market Surveillance Department, which initiated a disciplinary process that could take months to resolve. If a violation was found, the remedy was only to impose letters of caution or a relatively small financial penalty against the offending market maker. Even if the complainant proved its case, it could not be rewarded with an executed trade. Thus, backing away complaints were

---

[92] See Appendix Part II.A.3.

[93] This is not to suggest that these firms may not have engaged in conduct that may be violative of the NASD's rules. Even though the NASD may have believed that substantial resources were needed for SOES enforcement, it remained obligated to ensure balance in both its enforcement process and allocation of enforcement resources.

[94] See Appendix parts I.B.2., I.C.4., II.A.3., and II.B.

effectively discouraged both by an ineffective procedure for enforcing the rule and by the absence of adequate sanctions for demonstrated misconduct.[95]

In 1994, after temporary approval by the Commission of NASD rule changes limiting access to SOES, SOES firms increased their use of SelectNet to execute orders. During this period, the SOES firms filed several thousand complaints alleging that market makers failed to honor their quotes.[96] The NASD committee that reviewed the complaints excluded the large majority of these claims from consideration for possible disciplinary action on the basis of criteria that were inconsistent with the Commission's firm quote rule and the NASD's own rule requiring market makers to honor their quotes. Additionally, in certain of the cases where violations were found, the NASD committee aggregated the violations and as a result imposed sanctions less than those recommended by the NASD's Sanction Guidelines. The result was that the firm quote rule was not enforced as vigorously as it should have been, and violations were not adequately deterred. The fact that the complaining parties were widely disliked by market

[95] The small number of NASD formal disciplinary actions for market related rule violations brought against joint NYSE/NASD member firms, which would encompass the larger firms in the securities industry, illustrates the Commission's concern over the NASD's enforcement priorities:

Year	Backing Away	Excess Spread	Nasdaq NMS Trade Reporting
1991	2	4	9
1992	2	17	6
1993	0	19	4
1994	2	65	3
1995	13	44	16

This record of enforcement activity indicates that backing away complaints and trade reporting became enforcement priorities for the NASD after it learned that the Commission had significant concerns about the firmness of quotations and the accuracy of trade reporting. Similarly, enforcement of the excess spread rule escalated sharply as the width of Nasdaq spreads became the subject of increasing public controversy. As discussed further in the text, the excess spread rule has certain undesirable consequences, and the NASD is obligated under its settlement with the Commission to repeal that rule or eliminate its undesirable consequences.

[96] Three SOES firms filed the large majority of these complaints.

makers contributed to the appearance of an imbalance in the NASD's disciplinary process. The NASD's failure to enforce adequately the firm quote rule relieved market makers of their obligation to provide investors with a continuous market as required by the rules of the Commission and the NASD and created an inaccurate picture of the market.

c. The NASD's Laxity in Enforcing the Trade Reporting Rules

The NASD's enforcement of the trade reporting rules was also inadequate.[97] The NASD's trade reporting surveillance procedures were deficient and were hampered by insufficient automated surveillance reports. The NASD's examination programs relied on antiquated methodologies, such as comparing small samples of manually timestamped order tickets to the times of trade reports. In fact, an analysis by the Commission's staff of data readily available to the NASD revealed numerous violations of trade reporting rules, particularly with respect to larger orders. Some of the late trade reporting was attributable to problems with NASD members' internal systems. However, the NASD did not recognize the extent and significance of late trade reporting attributable to systems problems until after the Commission's investigation began, even though late trade reporting due to systems problems can significantly distort the appearance of the market.

Despite the high rates of late trade reporting identified by the Commission staff from NASD market data, the NASD historically has brought very few cases for late trade reporting. When it did bring cases, the NASD often imposed sanctions inconsistent with and lighter than those recommended in its Sanctions Guidelines. Additionally, it had no procedures to follow up and ensure that deficient firms undertook appropriate corrective action. Thus, the NASD put little regulatory pressure on market makers to ensure timely reporting of trades and thereby neglected the interest of investors and other market participants in having a full and accurate picture of transactions in the Nasdaq market.[98] In any market, this toleration of late trade reporting would have created conditions conducive to fraudulent trading activities such as front running and manipulation.

d. Failure to Enforce the Excused Withdrawal Rules

The excused withdrawal rules apply to the obligations of market makers to maintain two-sided quotations on a continuous basis.[99] Market makers who have transacted the minimum volume required by the SOES system have their quotes temporarily removed from Nasdaq and

[97] See Appendix Part I.B.2.

[98] Examinations by the Commission's staff also found that the NASD failed to monitor and enforce rigorously trade reporting compliance by NASD members trading exchange listed securities in the OTC market.

[99] See NASD Manual, Schedule D to the By-Laws, Part V, § 2(a) (CCH) ¶ 1819 (1995).

are given five minutes to revise and reinstate their quotations.[100] Failure to revise and reinstate their quotes results in suspension of market maker status in the affected security for twenty days. An exception to the twenty day suspension may be granted if the market maker obtains an excused withdrawal from the NASD prior to withdrawing its quotes.[101] The NASD's rules provide that excused withdrawals may be granted only for certain specific reasons.

The NASD was lax in holding market makers to their quotation obligations.[102] It routinely granted waivers for SOES withdrawals for reasons not permitted by the rules and failed to keep adequate records of excused withdrawals granted (which would have enabled it to detect excessive requests by particular market makers). Until 1995, the NASD regularly granted SOES suspension waivers as a matter of course without inquiring into the reasons for the withdrawals. Beginning in 1995, the NASD started to make some inquiry into the reasons for the SOES withdrawals, although it continued to grant excused withdrawals for reasons not permitted by the rules. The NASD's failure to enforce the excused withdrawal rule undermined the requirement that market makers provide investors with a continuous market as required by the NASD's rules.

e. The NASD's Imbalance in Enforcement of Its Rules

The NASD has a statutory obligation to oversee the Nasdaq market and to enforce its rules and regulations fairly as to all member firms. The record in the investigation suggests undue influence of market makers and a lack of vigor and balance in the NASD's enforcement activities with respect to market maker firms that is inconsistent with this obligation. See Section 19(g)(1)(B) of the Exchange Act, 15 U.S.C. § 78t(1)(B).[103] Moreover, the NASD's failure diligently to enforce its trading rules against its market maker members as described herein was detrimental to the interests of investors and the public.

---

[100] See NASD Manual, Rules of Practice and Procedure for the Small Order Execution System, Rule c(2)(G) (CCH) ¶ 2460 (1995).

[101] See NASD Manual, Schedule D to the By-Laws, Part V, § 8 (CCH) ¶ 1824 (1995).

[102] See Appendix Part II.B.1.

[103] The NASD's failure to effectively enforce Rule G-37 of the Municipal Securities Rulemaking Board, which regulates political contributions by underwriters of municipal securities, provides another example. See Appendix Part II.B.2.

3. The Undue Influence of Market Makers in the Regulatory Process

a. Market Maker Influence

During the period covered by this investigation, Nasdaq market makers in certain instances unduly influenced the NASD's regulatory process in their favor.[104] They initiated or advocated changes in the SOES rules which limited the ability to trade through SOES. The ideas for these changes often emanated from trade associations controlled by market makers, which worked closely with the NASD staff to formulate ideas for regulatory policy.[105] In other instances, the changes originated from individuals serving on the NASD's Trading Committee, which consisted largely of market makers.[106] The interests of other NASD

---

[104] See Appendix Part II.A.

[105] On a number of occasions, associated persons at NASD member firms have served simultaneously on a committee or board of a trade association and on an NASD committee. Although self-regulation presupposes that members of industry will participate in the regulatory activities of their SROs, such simultaneous service gives rise to potential conflicts of interest. An obvious example would be a trader's advocacy for the proprietary interests of market makers on the one hand, and his or her undertaking on behalf of the SRO to safeguard the interests of investors and the public. The NASD and its industry members must be sensitive to such actual and potential conflicts and strive to maintain the fact and appearance of fairness and objectivity at all times. Any uncertainty must, of course, be resolved in favor of steadfast adherence by the NASD to its obligations to the public and to investors.

[106] The NASD adopted the concept of "customer service" throughout its organization, including in its regulatory and disciplinary activities. For example, NASD managers asked member firms to evaluate the performance of specific NASD examiners. There is also evidence that the concept was applied to enforcement. Thus, when a disciplinary action was brought against a firm in 1992, a senior NASD executive issued a congratulatory memorandum to the staff assigned to the case, which stated "there is no better service quality we could have provided to our market maker customers and the individual investor."

Although any regulator may benefit from the regulated industry's input regarding such things as the competence or professionalism of the regulator's staff, the NASD's application of this approach to its regulatory and disciplinary process raises questions about the appropriate balance an SRO should strike between serving the public interest, as an aggressive regulator, and ensuring that its member "customers" are satisfied with the "services" they receive in the course of being regulated. Simply put, excessive concern about a member's dissatisfaction with regulation could undermine investor

(continued...)

constituencies received inadequate consideration in the formulation of these rule changes. The NASD staff was institutionally constrained from vigorously advocating those interests by the undue influence of market makers in the NASD's regulatory process.

b. Application of Standards and Criteria for Membership

The extent of market maker influence in the NASD's regulatory process was also reflected in the procedures for reviewing membership applications.[107] At the New York City District 10 office of the NASD, the District Committee, or a subcommittee it created called the PMI Subcommittee, played central roles in reviewing applications for NASD membership. Both committees consisted largely of individuals associated with market maker firms. Beginning in 1993, the District 10 Committee encouraged close scrutiny of applicants who appeared likely to engage in active SOES trading. This scrutiny sometimes delayed these applications substantially, even though NASD rules provide for reasonable review periods.[108] The PMI Subcommittee also encouraged the placement of restrictions on many applicants in order to limit, discourage, or prohibit use of the SOES system. The NASD also required certain applicants to satisfy criteria not enumerated in its rules and prevented such members, once admitted, from seeking modifications to their restriction agreements for a period of time. These additional restrictions were not consistent with the NASD's rules relating to the applications process.[109]

---

[106](...continued)
protection. Similarly, treating a disciplinary action against a firm as a service to market maker "customers" overlooks the fact that the SRO's disciplinary process is intended to serve the public interest, and not the proprietary interests of a powerful segment of the NASD's membership.

[107] This Report does not pass on the merits of the NASD's processing or final determination with respect to any specific membership application, and nothing in the Report should be interpreted to be a determination on any such matters.

[108] Schedule C of the NASD By-Laws requires a reasonable review period for membership applications. NASD Manual, Schedule C to the By-Laws, Part 1, § 1(b) (CCH) ¶ 1783 (1995). In addition, Section 15A(b)(8) of the Exchange Act requires the NASD to provide a fair procedure for the denial of membership. 15 U.S.C. § 78o-3(b)(8) (1996).

[109] The rules relating to membership applications are set forth in the NASD By-Laws. NASD Manual, Schedule C to the By-Laws, Part I (CCH) ¶ 1783 (1995). The NASD has represented that beginning in 1993, members of its District 10 Committee had regulatory concerns about applicants likely to engage in SOES activity. The District 10 Committee and PMI Subcommittee, however, pursued their mandate improperly by applying criteria and standards not permitted by the NASD's rules to such applicants.

4. The NASD's Corporate Goals

Since its inception in 1971, the Nasdaq market has become the second largest stock market in the United States. It has provided listing, growth opportunities, and access to capital to thousands of publicly held companies, as well as investment opportunities to millions of investors. While vigorous competition between the NASD and the exchanges is beneficial to the overall development of the U.S. securities markets, no market should allow its competitive zeal to overshadow its statutory obligations as a self-regulatory organization.

The investigation uncovered evidence suggesting that, at times, the NASD may have allowed the critical distinctions between its two functions to blur. For example, at the time the NASD first focused on the width of spreads in the Nasdaq market, its primary concern appeared to be that it perceived spreads in comparable NYSE listed stocks to be generally narrower. The NASD focused its concern on the fact that the Nasdaq market would lose listings to the NYSE and attempted to deal with the spreads issue through measures, such as the excess spread rule, or through exhortation, such as at the May 1994 Bear Stearns meeting, rather than by conducting an investigation of potential violations of the NASD's rules and the federal securities laws.[110] Viewing the issue of spreads primarily through the prism of its market-to-market competition with the NYSE, rather than as a threshold investor protection issue, appears to have contributed to the NASD's failure to respond adequately to mounting evidence that the width of the spreads could be attributable to anticompetitive conduct by Nasdaq market makers.

The investigation also disclosed an excessive emphasis on public image that is difficult to reconcile with the NASD's role as the SRO of a major capital market. The results of the Commission's investigation suggest that surveillance and enforcement and the enhancement of Nasdaq's trading system should take priority over an excessive concern with public image. This observation is directly supported by the NASD's response to the adverse publicity resulting from publication of the Christie-Schultz Study and the initiation of government investigations. Such response reflected an inappropriate emphasis on a defense of the status quo, rather than a thoughtful examination of the significant issues that had been raised.

VIII. CONCLUSION

A. Settlement with the NASD

Under Section 19(h)(1) of the Exchange Act, the Commission may impose appropriate sanctions if the Commission finds that an SRO has failed to comply with or, without reasonable justification or excuse, to enforce compliance by its members with the federal securities laws or its own rules. The Commission has determined that the NASD's conduct described herein

[110] See Appendix Part I.A.1.e.

demonstrates a failure to comply with its statutory obligations.[111] The Commission has entered into a settlement with the NASD of an administrative proceeding instituted pursuant to Section 19(h) of the Exchange Act, under which the NASD, which does not admit or deny the

[111] The Commission has exercised its authority to bring enforcement actions against SROs on four occasions in recent years: (a) Midwest Clearing Corporation ("MCC"), Exchange Act Release No. 31416 (Nov. 6, 1992), 57 Fed. Reg. 54435 (Nov. 18, 1992) (MCC and the Midwest Securities Trust Company violated, among other things, the antifraud, books and records, rule making, customer protection, and clearing agency registration requirements under the Exchange Act; MCC settled with the Commission and was censured, required to undertake certain actions generally designed to improve internal controls, permanently enjoined from violating the Exchange Act and Rules promulgated thereunder, and ordered to pay a civil penalty of $2,000,000); (b) Chicago Board Options Exchange ("CBOE"), Exchange Act Release No. 26809 (May 11, 1989) (CBOE failed to enforce certain of its rules in the face of compelling circumstantial evidence, was without "reasonable justification or excuse" in violation of the Exchange Act, and was censured and ordered to strengthen its surveillance activities and disciplinary process and address potential conflicts of interest); (c) Philadelphia Stock Exchange ("Phlx"), Exchange Act Release No. 16648 (Mar. 13, 1980) (Phlx, without reasonable justification or excuse, failed to comply with or enforce compliance by its members with the Commission's quotation rule, and was censured based on Phlx's representation that it had made and had undertaken to make extensive organizational revisions designed to strengthen its market surveillance and enforcement capabilities); and (d) Boston Stock Exchange ("BSE") and Boston Stock Exchange Clearing Corporation ("BSE Clearing Corp."), Exchange Act Release No. 17183 (Oct. 1, 1980) (violations of applicable margin, net capital, and bookkeeping requirements on the part of several BSE specialists and failure of BSE to maintain adequate surveillance procedures to ensure compliance, along with failure of BSE Clearing Corp. to fulfill its responsibility under Regulation T to monitor compliance with the applicable margin requirements, and extension by BSE Clearing Corp. of excessive credit in violation of Regulation T; resulted in BSE and BSE Clearing Corp. being censured and BSE being ordered to undertake, among other things, to reassess its corporate governance structure and surveillance procedures).

Prior to the Securities Act Amendments of 1975, the Commission had a limited arsenal of regulatory options to address an SRO's breach of its statutory responsibilities. Generally, the Commission was limited to terminating an SRO's registration or exercising its rulemaking authority to address an SRO's violations. As a result, Commission action against SROs prior to 1975 were rare. See Exchange Act Release No. 7870 (Apr. 22, 1966) (Commission proceedings pursuant to section 19(a)(1) to withdraw San Francisco Mining Exchange's registration as a national securities exchange for repeatedly failing to enforce compliance with the Exchange Act); S.E.C., Staff Rpt. on Organization, Management, and Reg. of Conduct of Members of the Am. Stock Exch. (Jan. 3, 1962).

allegations of the Commission, is censured and ordered to comply with certain undertakings, which are described below.

The NASD's settlement of the Commission's enforcement action creates a framework for the reformation of the NASD which builds, in part, on the recommendations of the Rudman Committee. While self-regulation benefits from the knowledge, insight, and expertise brought by industry participants, it must give primacy to the fundamental purpose of regulation of the securities markets: the protection of investors and the public interest.

As part of its settlement with the Commission, the NASD has agreed to perform various undertakings to address problems uncovered in the investigation. First, it has undertaken to reorganize its governance structure to provide for significantly greater involvement by representatives of the public and NASD constituencies other than the market makers.[112] These changes are intended to alter the perspectives of the NASD and infuse it with a greater sense of objectivity and impartiality. Diversified representation should instill greater awareness of the need for evenhanded treatment of all regulated persons in every aspect of the NASD's activities, including rulemaking, regulation, disciplinary processes, and operations. Increased public representation is also intended to heighten the NASD's appreciation for the needs of investors and the public interest in a free, open, and competitive market.

The NASD has undertaken to institute the participation of professional hearing officers, with legal training, to preside over disciplinary proceedings. This measure should enhance the dispassionate application of the rules and fairness in the disciplinary process. Since representatives of NASD member firms will no longer preside over the hearings, any negative implications of business persons sitting in judgment on their competitors should be alleviated. Since industry representatives will continue to constitute a majority of each hearing panel, they will continue to have a central role in bringing their market expertise to bear on the disciplinary process.

The NASD has undertaken to provide for the autonomy and independence of its staff with respect to disciplinary and regulatory matters where the commercial interests of the NASD's members, or any particular segment of its members, could be inappropriately inserted. Staff autonomy and independence are vital to the future effectiveness of the NASD if it is to comply with its statutory mandate. The NASD staff must have an environment in which they can bring to bear the objectivity, professionalism, and concern for investor protection that an SRO must always display.

---

[112] These changes will build upon structural reforms recommended by the Rudman Committee. In terms of structural change, the Rudman Committee generally called for substantially greater public participation in the governance of the NASD and a separation of the NASD's regulatory function and the Nasdaq market into separate corporate subsidiaries. The NASD has adopted in large measure the recommendations of the Rudman Committee. The Commission is requiring additional refinements of the NASD's governance structure because of the nature and scope of the Commission's findings.

The NASD has undertaken to promulgate and consistently apply uniform guidelines for regulatory and other access issues, such as membership applications and conditions of admission.[113] The NASD will also institute safeguards to ensure fair and evenhanded access to all services and facilities of the NASD. These measures should bring greater consistency and fairness to the membership application process, and other regulatory activities, and deter arbitrariness or the insertion of inappropriate considerations into these processes.

The NASD has undertaken to ensure the existence of a substantial independent internal audit staff. The Commission's findings in its investigation demonstrate the need for an effective internal audit staff with a direct line of reporting to the NASD's Board of Governors. The internal audit staff should address complaints received from members and other NASD constituencies, maintain a program of regular audits of the NASD's activities, and independently initiate inquiries with respect to possible anticompetitive practices and violations of law or the NASD's rules that otherwise come to their attention. This measure should ensure that the NASD engages in a process of comprehensive ongoing self-evaluation.

The NASD has undertaken to design and implement an audit trail sufficient to reconstruct the markets promptly and effectively surveil them and enforce its rules. The new audit trail will include, subject to the Commission's approval, among other things, an accurate time-sequenced record of orders and transactions, beginning with the receipt of an order and documenting the life of the order through the process of execution. Such an audit trail will significantly enhance the ability of the NASD to surveil the market to enforce investor protection rules, such as the prohibitions against trading ahead of limit orders, and other rules such as the firm quote rule and trade reporting rules. Vigorous enforcement of these rules will enhance investor confidence. Improved surveillance is essential to the integrity of the Nasdaq market and the NASD.

The NASD has undertaken to improve substantially the surveillance and examination of order handling. Improved regulatory oversight in this area is warranted in light of the problems uncovered by the Commission's investigation.

The NASD has undertaken to upgrade substantially its capability to enforce the firm quote rule by (a) implementing a process for backing away complaints to be addressed as they are made during the trading day so that valid complaints may be satisfied with a contemporaneous trade execution and (b) taking other appropriate actions. The firm quote rule is a primary means of ensuring that the market makers provide liquidity. The frequency of backing away uncovered in the investigation requires prompt and strict enforcement of the firm quote rule.

The NASD has undertaken to propose a rule or rule interpretation for Commission approval that will make explicit that coordination by or among market makers of their quotations, trades and trade reports, and actions taken as retribution or retaliation for competitive

---

[113] Such guidelines, and guidelines for disciplinary sanctions, should be filed with the Commission pursuant to Section 19(b) of the Exchange Act. 15 U.S.C. § 78s(b) (1994).

actions of another market maker or other market participant, are unlawful under the NASD's rules. The coordinated activities of market makers described herein sap the competitive vigor of the market. Such a rule or rule interpretation is necessary to ensure that a culture of competition exists in the Nasdaq market.

The NASD has undertaken to enforce Article III, Section 1 of the NASD Rules of Fair Practice, with a view to enhancing market maker competitiveness by eliminating anticompetitive or unlawfully enforced or maintained industry pricing conventions, disciplining market makers who harass other market makers in retaliation for competitive conduct, eliminating coordination of quotations, trades, and trade reports, and acting to protect order entry firms and non-market maker firms from concerted discrimination and concerted refusals to deal by market makers. Such conduct is antithetical to the goal of free and open markets and the NASD must use its enforcement authority to investigate and sanction members who engage in it.

The NASD has undertaken to improve substantially the reliability of trade reporting, through, among other things, enhancement of surveillance, examination, and enforcement. Reliable trade reporting is one of the foundations of investor confidence. The NASD has agreed that a substantial increase in enforcement resources to enforce trade reporting requirements is warranted to impress upon market makers the importance of making timely and accurate trade reports.

The NASD has undertaken to redefine the excess spread rule to eliminate any disincentive to close the spread in market maker quotations, or to repeal the rule. The Commission is concerned that the excess spread rule as presently formulated interferes with the pricing mechanism of the market. It may have also created disincentives to narrowing dealer spreads and incentives for market makers to restrain other market makers from narrowing their dealer spreads. Regulations which are not serving their intended purpose or are creating undesirable consequences should be modified or repealed, and the NASD has agreed to address the problems created by the excess spread rule.

B. Commission Rule Proposals

The evidence gathered during the Commission's investigation underscores the need to enhance competition among Nasdaq participants and to heighten the standards for the handling of customer orders. The Commission believes that the internal governance and market reforms that the NASD is undertaking, including its organizational restructuring, represent significant advances in this regard. Comprehensive and lasting relief, however, also requires certain reforms to the operation of the Nasdaq market. Out of concern for certain practices that have developed in both the OTC and exchange markets, the Commission recently proposed a series of requirements for specialists and market makers concerning order handling and execution practices on exchanges and the OTC markets that may help to inject competition into the Nasdaq market.[114] The proposal would enhance transparency and diminish fragmentation by providing for prices that more fully reflect overall supply and demand in the market and, thereby, increase competition.

The Commission's proposed amendment to the Quote Rule would require market makers who submit priced orders to certain electronic communications networks to make those orders publicly available. As noted earlier in this Report, market makers are currently able to avoid quoting odd-eighths in Nasdaq because of the availability of systems such as Instinet and SelectNet, which allow market makers to attract trading interest at prices inside the spread without adjusting their Nasdaq quotes. By ensuring that the public quotes for a security reflect the best prices at which market makers are willing to trade, the proposed amendment would limit the ability of market makers to avoid quoting in odd-eighths on Nasdaq, without limiting the usefulness of these systems as efficient alternative mechanisms for negotiating transactions.

In addition, the Commission's proposal would require market makers to display immediately customer limit orders that improve their quote. This proposal would improve competition among market participants by providing investors enhanced access to the market and, consistent with the statutory directive of achieving a national market system, would provide greater opportunities for investors' orders to interact with one another. Further, transparency of customer limit orders would significantly improve price discovery and significantly undermine the ability of market makers to coordinate quotations.

Finally, the proposed rules would require specialists and OTC market makers to provide their customer market orders with an opportunity for price improvement. Providing customer orders with an opportunity for price improvement would allow those orders to compete with market maker quotations and, thus, impose competitive pressure on market maker quotations.

These rules were published for comment in September 1995 and Commission staff are currently studying the proposals and reviewing the approximately 175 comment letters received. The Commission anticipates receiving a final recommendation from the staff on the proposed rules in the near future.

C. Summation

The paramount goals for the NASD are to ensure the free flow of competition to the Nasdaq market and to attain the impartiality, objectivity, and public-interest orientation statutorily required of an SRO. The long term interests of the Nasdaq market are to provide investors with a free and open market where execution costs are set through dynamic

[114] Although the Commission's rule proposal addresses certain concerns independent of those detailed in this Report, the proposed rules, by stressing the importance of transparency and customer order interaction, are expected to enhance competition among Nasdaq market participants and provide a structural response to some of the anticompetitive behavior discussed in this Report.

competition. To move forward as an effective SRO, the NASD must transform its attitudes and conduct and renew its commitment to the interests of investors and the public. The confidence of the public and investors in the Nasdaq market and in the NASD requires nothing less, and investors and the public deserve nothing less.

* * * * *