

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38845; File No. SR-NASD-97-37]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to an Interpretation of NASD Conduct Rule 2110 Regarding Anti-Intimidation/Coordination Activities of Member Firms and Persons Associated With Member Firms

July 17, 1997.

On May 7, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act").¹ The proposed rule change was published for comment in Securities Exchange Act Release No. 38715 (June 4, 1997), 62 FR 31854 (June 11, 1997) ("Notice of Proposed Rule Change"). No comments were received on the proposal. For the reasons discussed below, the Commission is approving the proposed rule change.

I. Background

On August 8, 1996, the Commission used an Order pursuant to Section 19(h)(1) of the Exchange Act ("SEC Order"), making certain findings about the NASD and conduct on the Nasdaq Market, and imposing remedial sanctions.² Among other findings, the Commission determined that certain activities of Nasdaq market makers had directly and indirectly impeded price competition on the Nasdaq market. In addition, the Commission determined that a number of Nasdaq market makers had coordinated quotations, trades and trade reports with other Nasdaq market makers for the purpose of advancing or protecting the market maker's proprietary trading interests. Based on the Commission's specific findings of certain anti-competitive behavior of Nasdaq market makers in the Nasdaq Stock Market, the NASD agreed to certain undertakings. In particular, Undertaking 11 requires the NASD "[t]o propose a rule or rule interpretation for

Commission approval which expressly makes unlawful the coordination by or among market makers of their quotes, trade and trade reports, and which prohibits retribution or retaliatory conduct for competitive actions of another market maker or other market participant." Undertaking 12 requires the NASD "[t]o enforce Article III, Section 1 of the NASD Rules of Fair Practice (currently NASD Conduct Rule 2110), with a view to enhancing market maker competitiveness by: (a) acting to eliminate anti-competitive or unlawful enforced or maintained industry pricing conventions, and to discipline market makers who harass other market makers for narrowing the display quotations in the Nasdaq market, trading not more than the quantities of securities they are required to trade under the NASD's rules, or otherwise engaging in competitive conduct; (b) acting to eliminate coordination between or among market makers or quotes, trades and trade reports; and (c) acting to eliminate concert discrimination and concerted refusals to deal by market makers."

To comply with both Undertaking 11 and 12, the NASD proposed a rule interpretation of NASD Conduct Rule 2110 (formerly Article III, Section 1 of the NASD's Rules of Fair Practice). The NASD noted that the conduct described in the interpretation is fundamentally inconsistent with the obligations of member firms to their customers and is inimical to the public interest in fair and efficient securities markets. The NASD, therefore, believes that the conduct described in the interpretation is already prohibited by NASD Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade. The NASD, however, proposed the interpretation to address specifically certain of the findings contained in the SEC Order and to emphasize the importance placed by the NASD on the enforcement of the prohibition.

II. Description

This rule interpretation defines as conduct inconsistent with just and equitable principles of trade certain conduct by and among members firms, and sets forth specific exclusions (numbered 1 through 7) which identify bona fide commercial activities by and among member firms. The conduct excluded, however, must otherwise be in compliance with all other applicable law. The interpretation identifies three general areas of conduct that are prohibited. The first part of the interpretation prohibits coordinating activities by member firms involving

quotations, prices, trades and trade reporting. Conduct covered by this prohibition would include, but not be limited to, agreements to report trades late or inaccurately, or to agree to maintain certain minimum spreads or quote sizes above the legal minimums. In addition, the interpretation does not prohibit a market maker from contacting another market maker in a locked or crossed market situation to attempt to unlock or uncross the market. Moreover, the overall prohibited behavior outlined in the interpretation applies to primary market as well as secondary trading activities.

The second part of the interpretation prohibits "directing or requesting" another member to alter prices or quotations. This would include, among other things, situations in which a market maker requests another market maker to move or adjust its displayed quotations to accommodate the requesting market maker. This prohibition does not extend to activity, identified in exclusion number 7, that permits a member to route customer orders to market makers for handling or a correspondent firm of the member to ask a market maker to represent an order in the market maker's quote.

The third part of the interpretation relates to conduct that threatens, harasses, coerces, intimidates or otherwise attempts improperly to influence another member in a manner that interferes with or impedes the forces of competition among member firms in the Nasdaq Stock Market. This part of the prohibition is intended to reach conduct that goes beyond legitimate bargaining among member firms. This conduct may include, among other things, refusals to trade, improper systems messages, trading in odd lots, and other conduct intended to influence a member to engage in improper market activity or refrain from legitimate market activity. However, as identified in exclusion number 6, this language would not prohibit a member from taking unilateral action in selecting with whom to trade and under what terms, based on legitimate market and commercial criteria (e.g., credit exposure).

III. Discussion

The Exchange Act contemplates that the U.S. securities markets shall be "free and open"³ with safeguards "to protect investors and the public interest."⁴ The Commission stated in the 21(a) Report that vigorous price competition is a hallmark of a free and open market and

³ 15 U.S.C. 78f(b)(5).

⁴ 15 U.S.C. 78o-3(b)(6).

¹ 15 U.S.C. 78s(b)(1).

² See Securities Exchange Act Release No. 37538 (August 8, 1996), SEC's Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions. See also Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD, the Nasdaq Market and Nasdaq Market Makers, Securities Exchange Act Release No. 37542 (August 8, 1996) ("21(a) Report"), and Appendix thereto.

is critically important to the efficient functioning and regulation of a dispersed dealer market and any significant hindrance to price competition impedes the free and open market prescribed by the Exchange Act.

The Commission believes that the NASD's proposed interpretation expressly reaffirms that anti-competitive and intimidation and harassment of other members is prohibited. The Commission noted in the 21(a) Report, and the NASD's interpretation reiterates, that such conduct is inconsistent with just and equitable principles of trade. The Interpretation clearly delineates the type of behavior that is antithetical to a free and open market while preserving the ability of members to engage in legitimate market activity. Although the behavior prohibited under the interpretation has continually been violative of NASD Rule 2110 and the federal securities laws, the Commission believes that the interpretation will clearly highlight for members that such conduct is a serious violation of NASD Rules.

The Commission believes that the proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder applicable to the NASD, in particular, Sections 15A(b)(6) and 15 A(b)(11).⁵ The Commission finds that the proposed interpretation specifically prohibiting anti-competitive conduct of member broker/dealers and persons associated with member broker/dealers is in furtherance of the requirements of Section 15A(b)(6) that the Association's rules be designed to promote just and equitable principles of trade, prevent fraudulent and manipulative acts and practices, and to protect investors and the public interest. In addition, the Commission finds that the proposed rule change is consistent with Section 15A(b)(11) in that the interpretation is designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder applicable to the NASD and, in particular, Sections 15A(b)(6) and 15A(b)(11).⁶

⁵ 15 U.S.C. 78o-3.

⁶ In approving this rule proposal, the Commission notes that it has also considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

It Is Therefore Ordered, pursuant to section 19(b)(2) of the Exchange Act,⁷ that the proposed rule change (SR-NASD-97-37) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38851; File No. SR-NASD-97-49]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval to Proposed Rule Change Relating to an Extension of the NASD's Rule Permitting Market Makers To Display Their Actual Quotation Size

July 18, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on July 11, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposal on an accelerated basis.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD proposes to extend the effectiveness of NASD Rule 4613(a)(1)(C) until December 31, 1997. NASD Rule 4613(a)(1)(C) provides that market makers in the first fifty Nasdaq stocks subject to the Commission's Limit Order Display Rule are allowed to quote their actual quote size ("Actual Size Rule").¹ The text of the proposed

⁷ 15 U.S.C. 78s(b)(2).

⁸ 17 CFR 200.30-3(a)(12).

¹ The NASD has concurrently requested that the pilot for the Actual Size Rule be expanded to apply to 100 additional Nasdaq securities and extended until March 27, 1998. See Letter from Robert E. Aber, Vice President and General Counsel, The Nasdaq Stock Market, Inc., to Katherine England, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated July 10, 1997.

rule change is as follows. (Additions are italicized; deletions are bracketed.)

* * * * *

NASD Rule 4613 Character of Quotations

(a) Two-Sided Quotations.

(1) No change.

(A)-(B) No change.

(C) As part of a pilot program implemented by The Nasdaq Stock Market, during the period January 20, 1997 through at least [July 18] *December 31, 1997*,² a registered market maker in a security listed on The Nasdaq Stock Market that became subject to mandatory compliance with SEC Rule 11Ac1-4 on January 20, 1997 must display a quotation size for at least one normal unit of trading (or a larger multiple thereof) when it is not displaying a limit order in compliance with SEC Rule 11Ac1-4, provided, however, that a registered market maker may augment its displayed quotation size to display limit orders priced at the market maker's quotation.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

On August 29, 1996, the Commission promulgated a new rule and adopted amendments to other SEC rules that are designed to enhance the quality of published quotations for securities and promote competition and pricing efficiency in U.S. securities markets (these rules are collectively referred to hereinafter as the "Order Handling

² The NASD filed an amendment ("Amendment No. 1") to extend the pilot to December 31, 1997, rather than September 26, 1997. See Letter from Robert E. Aber, Vice President and General Counsel, The Nasdaq Stock Market, Inc., to Katherine England, Assistant Director, Office of Market Supervision, Division of Market Regulation, Commission, dated July 17, 1997.