



THE CHAIRMAN

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

December 23, 1994

The Honorable Alphonse M. D'Amato  
United States Senate  
Washington, D.C. 20510-3202

Dear Senator D'Amato:

In your letter to me dated October 25, 1994 you raised concerns about reports of potentially improper and anticompetitive trading activities by market makers in the Nasdaq stock market. Your concerns raise questions regarding the fundamental structure and regulation of the over-the-counter securities market.

The Commission is giving serious consideration to these reports. Customer protection and confidence are vital to the continued growth of the U.S. securities markets and are the fundamental principles underlying the federal securities laws. Therefore, I urged the National Association of Securities Dealers, Inc. ("NASD") to establish a special, high-level committee charged to conduct a review of the Nasdaq market and the governance of the NASD. Separately, the Commission's staff is conducting a special review of this matter and is cooperating fully with the Department of Justice in its inquiry regarding possible antitrust violations. Among other matters, the Commission's staff intends to examine the issues raised in your letter.

The Commission will report to you the findings of the staff's review when it is completed, and will make sure that the special committee's findings are made available to you. Since I obviously cannot predict the results of our review, I must defer any detailed response to your letter. However, the enclosed memorandum to me from the

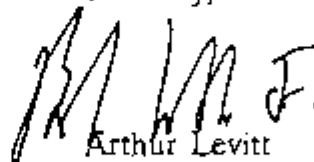
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Commission's Division of Market Regulation does respond to some of the concerns raised in your letter.

If you or any member of your staff would like a briefing concerning the details of the Commission's review, please let me know and I will instruct our staff to seek necessary Commission authorization and, once authorized, to arrange a confidential briefing for the Committee staff. As you know, Commission authorization would be necessary because members and employees of the Commission may not divulge nonpublic information without such authorization.

If you have any additional questions, please do not hesitate to contact me at 202-272-0100, or Brandon Becker, Director, Division of Market Regulation at 202/942-0090.

Sincerely,



Arthur Levitt

Enclosure

## MEMORANDUM

TO: Arthur Levitt, Chairman

FROM: Brandon Becker, Director <sup>BB</sup>  
Division of Market Regulation ("Division")

RE: Letter from Senator D'Amato regarding Nasdaq

DATE: December 23, 1994

This memorandum responds to concerns raised in Senator D'Amato's letter of October 25, 1994 about improper and anticompetitive practices by Nasdaq market makers and the implications of that conduct for individual investors. Senator D'Amato's letter is in response to a series of reports, including several articles published by the *Los Angeles Times*, that criticized the Nasdaq stock market. Senator D'Amato also raised several questions about the structure of the Nasdaq market and whether more can be done to protect investors. The Nasdaq market is operated and overseen by the National Association of Securities Dealers, Inc. ("NASD") which is the self-regulatory organization responsible for regulating the over-the-counter market. The NASD is a national securities association registered with the Commission under Section 15A of the Securities Exchange Act of 1934 ("Exchange Act"). Its membership includes virtually all broker-dealer firms doing business with the public. The reports have called into question the integrity of both the Nasdaq system and the NASD's oversight of Nasdaq and broker-dealer activities.

The reports generally raise three areas of potentially improper conduct by Nasdaq market makers - failure to report trades in a timely manner, failure to honor quotes, and "tacit collusion" in establishing quote spreads. In response to these concerns, the Divisions of Enforcement and Market Regulation are conducting a special review with respect to these issues.

The Division also will continue to pursue regulatory initiatives, including those discussed in the Division's *Market 2000 Report*. *Market 2000* recognized the dramatic growth of Nasdaq and its role as the second largest market for actively traded securities. Many of the report's recommendations called on the NASD to provide increased investor protection and improved market quality, including decreased spreads, in the Nasdaq market. For example, *Market 2000* advocated the NASD's doing more to protect public customers and to change the limit order handling practices of Nasdaq market makers. Another significant recommendation involved Commission rulemaking on payment for order flow, the practice whereby market makers or exchange specialists compensate brokerage firms for directing customer orders to them for execution.

The Commission and the NASD have initiated action on several of the *Market 2000* recommendations that relate to the Nasdaq market. The Commission adopted rules requiring enhanced disclosure of broker-dealer payment for order flow practices. The Commission also requested comment on the need for additional disclosure of order routing and payment for order flow arrangements. The Commission also approved an NASD proposal that prohibited trading ahead of member-customer limit orders.

The Commission proposed for comment a rule that would prohibit Nasdaq market makers from trading at the same or better price than customer limit orders they are holding, including limit orders of other firms' customers that have been sent to the market maker for execution -- so called "member-to-member" trades. The NASD recently filed a proposed

rule change to protect the customer of a firm that sends a limit order to another member for execution. The proposal would phase in protection in two steps. The proposal would be effective July 1, 1995, until which time member-to-member customer limit orders greater than 1,000 shares would be protected at prices that are superior but not equal to the limit order price. The Commission recently published this proposal for comment and expects to act on the proposal within the next month.

The NASD also is proposing to revise its small order execution system in order to provide a better opportunity for price improvement of small customer orders. The new system, termed "N-PROVE," would replace "SOES," the NASD's current small-order, automatic execution system. The N-PROVE proposal would create an order routing and execution facility where retail orders could obtain price improvement within the bid-ask spread. The NASD's revisions would allow interaction of customers' orders, execute market orders that match limit orders (unless the market maker improves the price), and end the prohibition on short selling through N-PROVE. In this regard, the NASD recently filed a proposed rule change that would extend for four months limitations on SOES orders ("interim rules") the NASD adopted last year. Both proposals have been published for comment and the Division expects that the Commission will act on the proposals before the interim rules expire.

Many issues raised in Senator D'Amato's letter are the subject of current review by the Commission staff. The Division at this time cannot reply to specific questions regarding this review. The Division, however, has discussed below specific concerns raised in Senator D'Amato's letter as they relate to the overall structure and regulation of the Nasdaq market and the NASD's oversight of this market.

- *Have market makers in the Nasdaq stock market colluded to maintain wide spreads in certain high volume Nasdaq stocks?*

The Commission staff is conducting a special review of the Nasdaq market concerning possible collusion by Nasdaq market makers and is cooperating fully with the Department of Justice in its inquiry regarding possible antitrust violations.

- *Do Nasdaq market makers typically trade with each other at prices that are between their published bids and offers while executing investor orders at published prices? If so, what percentage of Nasdaq trades are between the spreads? Of these trades between the spreads, what percent are between market makers and investors?*

Because a dealer/quote-driven market requires much more dealer intermediation than an auction/order-driven market, market makers commonly trade at a "wholesale" price with each other that may be at or between their published price. Unlike the auction market, in the competing dealer market there is no central location where customer orders can be collected, matched, and executed. Thus, the wholesale dealer, or market maker, plays a key role in a quote-driven market. It "makes a market" by advertising its willingness to buy or sell securities for its own account with the expectation of buying at its bid and selling at its offer. Inherent in the competing dealer market is the dealer's willingness to negotiate at prices between the spread to lay-off excess risk to other market makers or to provide a more favorable price to customers to attract business.

*Once the SEC's proposed rule on Nasdaq limit orders is in place, will it be possible for market makers to fill customer orders at prices inferior to the prices at which market makers are trading?*

The Commission recently proposed a rule that would set standards for market makers in handling customer limit orders in Nasdaq National Market securities. In connection with the Commission's proposal, the Division is considering an NASD proposed rule change to expand the scope of limit order protection which contains the safeguards the Commission proposed in its own rulemaking proposal. The Commission will be evaluating the NASD's proposal further during the comment period. Under these proposals, market makers would be prohibited from trading ahead of all customer orders, including member-to-member orders, at the same or better price. In certain circumstances, particularly for institutional-sized orders, terms and conditions may govern the handling of a limit order if fully disclosed by the market maker on a trade by trade basis. The obligation to fill the customer's order is triggered whenever the market maker in possession of the limit order trades for its own account at the limit order price or better. Thus if a market maker trades for its own account at the limit price or better, it will be required to fill all customers' limit orders it is holding at the limit order price or better. However, the proposals will not require market makers to better the limit order price or cross customer limit orders.

*Is the SEC considering prohibiting or further restricting the ability of market makers to have a two tier trading system where market makers trade among themselves at better prices and narrower margins than they trade for investors? If so, please describe.*

The extent to which Nasdaq market makers trade among themselves is one of the hotly debated issues confronting the NASD and its oversight of the Nasdaq market. Similar to other wholesale professionals, market makers' bids and offers represent wholesale prices in a particular security at which the broker-dealer stands ready to buy from and sell to other broker-dealers. The Nasdaq competing dealer market also provides the opportunity for price improvement through negotiation. The NASD has developed automated systems, such as the SelectNet system, to enhance the opportunity for price improvement of principal and customer trades through on-line negotiation.

The Division believes that such systems should provide opportunities for all market participants. Thus, the Division's *Market 2000* report provided several recommendations to ensure that the securities markets remain fair to all market participants including individual investors. Reform of Nasdaq limit order handling practices would play a fundamental role in achieving this goal. As discussed above, the Commission and the NASD are working to protect customer limit orders by prohibiting market makers from trading ahead of customer orders that they are holding at the same or better price including member-to-member trades.

To further respond to allegations of wide spreads and unfair treatment of investors, the Commission may require that customer limit orders and limit orders entered into SelectNet be displayed as part of the Nasdaq best bid and offer ("BBO"). This would provide a valuable opportunity for non-market makers (individuals and institutions) to improve the quote and receive better prices, and would address many of the concerns raised in Senator D'Amato's letter. Accordingly the Division is developing a rule proposal to require that if a customer submits an order to SelectNet, that order be displayed in the BBO unless the customer otherwise requests.

- *Do Nasdaq market makers delay reporting their trading within the ninety second period required? If so, has this delayed reporting become routine?*

The Commission staff is conducting a special review of the Nasdaq market and possible delayed transaction reporting by Nasdaq market makers.

- *In its recently completed "Market 2000" study, did the Commission staff review the spreads in the Nasdaq market and compare them to the spreads on stock exchanges? Does the Commission have plans to study this in the future?*

Market 2000 recognized the distinct characteristics of each market including the Nasdaq's competing dealer market. Thus Market 2000 reviewed each market independently and did not compare the spreads of one market to that of another. Market 2000, however, recognized the dramatic growth of Nasdaq and its role as the second largest market for actively traded securities. Many of the recommendations urged the NASD to increase investor protection and encouraged improved market quality, including decreased spreads, in the Nasdaq market. For example, Market 2000 called on the NASD to do more to protect public customers and to change the limit order handling practices of Nasdaq market makers.

- *Is the NASD's regulatory oversight of Nasdaq adequate, in the Commission's view, to detect and prevent practices which are unfair to investors and inconsistent with the objective of fair and free competition in the securities market?*

The Commission staff is conducting a special review of the Nasdaq market and the adequacy of the NASD's regulatory oversight of this market. The NASD's regulatory oversight also is under review by a special, high-level committee chaired by former Senator Warren Rudman.