

# Compliance Risk and Best Execution

## ISI Compliance Note 2, 1998

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This Note discusses a recent case study (NASD vs. SEC) of the impact of compliance and legal risk on financial organizations. Legal issues and corrective procedural actions are summarized.

## Background

On August 9, 1996, the NASD settled charges with the SEC regarding collusion and improper execution. In the settlement, NASD, agreed to almost double its enforcement budget and spend \$100 million over the next five years to improve market surveillance, and to embark on a series of compliance reforms.

According to the Wall Street Journal (25 November 1998):

...the SEC and the Justice Department alleged that market participants kept stock price spreads – the difference between the stock's bid price and ask price – unfairly wide. The Justice Department's suit was brought against several dozen market makers while the SEC brought administrative actions against the NASD.

On November 10, 1998, the Justice Department approved a record \$1.03 billion settlement of a class-action lawsuit by investors who accused 37 brokerages of overcharging them for Nasdaq-listed stocks in a price-rigging conspiracy that resulted in a government crackdown.

The government had alleged that Nasdaq dealers engaged in a widespread practice of quoting stocks for customers to the nearest quarter of a dollar rather than the nearest eighth, thus giving themselves extra profits.

## Compliance with NASD and SEC Rules of Best Execution Obligations of the Market Maker

The NASD settled charges with the SEC regarding collusion and improper execution: execution that is clearly not "best" from the customer's perspective.

According to the Nasdaq Trader Manual [<http://www.nasdaqtrader.com/> p. 12-3]:

The duty of "best execution" arises from the common law duty of loyalty owed by a broker to its retail customers. The Securities and Exchange Commission (SEC) has stated that "when an agent acts on behalf of a customer in a transaction, the agent is under a duty to exercise reasonable care to obtain the most advantageous terms for the customer." ... The SEC has stated that, as a general matter, the duty of best execution refers to your duty to seek to execute your customer's order in the best available market.

This is further amplified by **NASD Rule 2110** (the Conduct Rule):

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

and **NASD Rule 2320** (the Best Execution Rule):

In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such a market so that the resultant price to the customer is as favorable as possible to the customer under prevailing market conditions.

According to the Nasdaq Trader Manual in its discussion of NASD Conduct Rule 2320, there is no rigorous definition of “reasonable diligence,” but factors mentioned in connection with it include

1. “Character” of the market price, volatility, liquidity
2. Size and type of transaction
3. Number, location, and accessibility of primary markets checked
4. Pressure on available communications

The issue of “reasonable diligence” is also connected with the best execution and handling of limit orders: the so-called SEC “Manning Rules” (see the following discussion below on the SEC Order Execution Rules). The following interpretation of Rule 2110 was approved by NASD [Adopted by SR-NASD-93-58 eff. July 7, 1994; amended by SR-NASD-94-62 eff. June 21, 1995.]:

A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer’s limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that, until September 1, 1995, customer limit orders in excess of 1,000 shares received from another member firm shall be protected from the market maker’s executions at prices that are superior but not equal to that of the limit order, and provided further, that a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an “institutional account” as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than \$100,000 in value. Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, the Association wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. The Association believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer’s order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm’s market making capacity does not occur. For purposes of this interpretation, a member that controls or is controlled by another member shall be considered a single entity so that if a customer’s limit order is accepted by one affiliate and forwarded to another affiliate for execution, the firms are considered a single entity and the market making unit may not trade ahead of that customer’s limit order.

The Association also wishes to emphasize that all members accepting customer limit orders owe those customers duties of “best execution” regardless of whether the orders are executed through the member’s market making capacity or sent to another member for execution. As set out above, the Best Execution Rule requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. The Association emphasizes that order entry firms should continue to routinely monitor the handling of their customers’ limit orders regarding the quality of the execution received.

This rule is directly related to the settlement and the current market maker efforts to help assess best execution performance.

## The Settlement: New NASD Rules and Compliance Procedures

These procedures can be used to assess compliance with the best execution obligations. **NASD Rules 6950 through 6957** (approved by the SEC on 6 March 1998). The actual rules are on the site [www.nasdr.com](http://www.nasdr.com), under the Special Notice to NASD Members. According to the Memo of 11 March 1998 from J.M. Cangiano [see OATS Reporting Technical Specifications, NASD, 30 June 1998, p. i]:

The rules require member firms that handle or execute orders in Nasdaq equity securities to capture and report to NASD Regulation, Inc., specific data elements related to those orders and to record order information in hours, minutes, and seconds. This data will be used [by NASD Regulation] to recreate events in the life cycle of an order and more completely monitor the trading practices of member firms.

The Order Audit Trail System (OATS) is the compliance system developed by NASD in response to the August 1996 legal settlement with the SEC: OATS will be used by NASD to perform surveillance of the Nasdaq market. Under NASD Rules 6590 through 6957, "NASD member firms are required to develop a means for electronically capturing and reporting to OATS."

Other details and interpretations of the rules are contained in the NASD OATS Reporting Technical Specification of 30 June 1998. Cangiano continues:

*...To further clarify and expand upon the requirements of NASD Rules 6950 through 6957...the OATS Specification is being provided. This document will detail; the operational and technical requirements for submitting order reports to OATS. ...Although this document will not tell you how to develop the system, it will tell you what the system must deliver.*

Note that these NASD rules are special cases of the **SEC Rule 17 CFR Parts 240 and 249** related to Recordkeeping and Reporting Requirements for Trading Systems Operated by Brokers and Dealers:

The Securities and Exchange Commission is adopting **Rule 17a-23** ("Rule") and Form **17A-23** under the Securities Exchange Act of 1934 to establish recordkeeping and reporting requirements for brokers and dealers that operate automated trading systems. Under the Rule, registered broker-dealers that sponsor these systems would be required to maintain participant, volume, and transaction records, and to report system activity to the Commission and, in certain circumstances, to an appropriate self-regulatory organization.

## New SEC Rules Specifying Best Execution Order Obligations

After the settlement, the SEC adopted new rules that clarifies "best execution." The **SEC Order Execution Obligations** are contained in the 216 pages of **Rules 11Ac1-4 and 11Ac1-1** [TEXT REVISED 9-6-96]; Release No. 34-37619A; File No. S7-30-95. The summary of is as follows:

The Securities and Exchange Commission ("Commission") is adopting a new rule requiring the display of customer limit orders and amending a current rule governing publication of quotations to enhance the quality of published quotations for securities and to enhance competition and pricing efficiency in our markets. These rules have been designed to address growing concerns about the handling of customer orders for securities.

Specifically, the Commission is adopting new Rule 11Ac1-4 ("Display Rule") under the Securities Exchange Act of 1934 ("Exchange Act") to require the display of customer limit orders priced better than a specialist's or over-the-counter ("OTC") market maker's quote or that add to the size associated with such quote. The Commission also is adopting amendments to Rule 11Ac1-1 ("Quote Rule") under the Exchange Act to require a market maker to publish quotations for any listed security when it is responsible for more than 1% of the aggregate trading volume for that security and to make publicly available any superior prices that a market maker privately quotes through certain electronic communications networks ("ECNs") ("ECN amendment"). Finally, the Commission is deferring action on proposed Rule 11Ac1-5 ("Price Improvement Rule").

The rationale for this new rule as far as Nasdaq is concerned, is that (p. 14):

The Commission recently reported that, among other things: (i) Nasdaq market makers widely followed a pricing convention concerning the increments they used to adjust their displayed quotes; (ii) adherence to the pricing convention was not the result of natural economic forces, often impacted the fairness and accuracy of public quotation information and interfered with the economically efficient execution of customer transactions; (iii) the pricing convention 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; (iv) numerous market makers collaborated in ways that misled and disadvantaged their customers and other market participants and frequently failed to honor their price quotations; and (v) many market makers have not consistently reported their trades on time or appropriately designated them as late as required by NASD rules [See the 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").]

The Commission has taken specific regulatory and enforcement actions to address these problems. The Display Rule and Quote Rule amendments adopted today should bring about other, significant changes in the operation of Nasdaq, by ensuring the disclosure of customer and market maker buying and selling interest that heretofore has been hidden from many market participants. At the same time, the new rules will benefit investors in the exchange markets by increasing transparency in those markets and improving opportunities for the best execution of customer orders.

The Commission firmly believes that the actions it is taking today are consistent with the regulatory framework for a national market system established by Congress in the 1975 Amendments. Congress envisioned a national market system supported by accurate and reliable public quotation and transaction information, and fair competition among market centers. Congress also believed that linking all markets for qualified securities through communication and data processing facilities would foster efficiency, enhance competition, increase information available to market participants and contribute to the best execution of customer orders[See Exchange Act Section 11A(a)(1)(D), 15 U.S.C. 78k-1(a)(1)(D).]

The Commission recognizes that investors will lose confidence in the fairness of the markets unless market structures and practices treat all investors fairly. The regulatory initiatives adopted today address current market practices that hinder competition among markets and affect the prices at which customer orders are executed. The Display Rule and Quote Rule amendments enhance transparency and facilitate best execution of customer orders in a manner that preserves maximum flexibility for the markets to design and implement trading and communication systems that are consistent with the objectives of the national market system. These rules contribute to the achievement of the full potential of the national market system as envisioned by Congress. They represent one more step to facilitate the development of an efficient, competitive and transparent national market system in which all market participants can achieve best execution of their orders.

In summary, OATS reporting is mandated by NASD Rules 6950-6957 (OATS Reporting) and 2110 (Conduct Rule). It is related to SEC Rule 17a-23 (Reporting for Trading Systems).

The best execution obligations of market makers are mandated by NASD Rules 2110 (Conduct Rule) and 2320 (Best Execution Rule). These obligations are also mandated by SEC Rules 11Ac1-4 and 11Ac1-1 (Order Execution Obligations).

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## References

Rules and their interpretations issued by the Securities Exchange Commission (SEC) are available at [www.sec.org](http://www.sec.org).

Rules and their interpretations issued by the National Association of Securities Dealers (NASD) is available at [www.nasdr.com](http://www.nasdr.com).