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NASD OFFICE OF HEARING OFFICERS

MARKET REGULATION DEPARTMENT	:	
	:	Disciplinary Proceeding
Complainant,	:	No. CMS030181
	:	
v.	:	Hearing Officer – DMF
	:	
RESPONDENT	:	**HEARING PANEL DECISION**
	:	
	:	April 2, 2004
	:	
	:	
Respondent.	:	
	:	

Complainant failed to establish that respondent harassed, coerced, intimidated, or otherwise attempted improperly to influence another member or person associated with a member in violation of Rule 2110 and IM-2110-5, as charged. Complaint dismissed.

Appearances

M. Catherine Cottam, Esq. and Jeffrey K. Stith, Esq., Rockville, MD, for Complainant.

SC, Esq., New York, NY, and LP, Esq., Washington, DC, for Respondent.

DECISION

1. Procedural History

The Market Regulation Department filed a Complaint on August 8, 2003, charging that Respondent "harassed, coerced, intimidated, or otherwise attempted improperly to influence another member or person associated with a member in violation of NASD Conduct Rule 2110 and IM-2110-5." Respondent filed an Answer in which he contested the charge and requested a hearing. Market Regulation and Respondent subsequently filed cross-motions for summary disposition, pursuant to Rule 9264, both

motions relying upon Joint Stipulations ("JS") agreed to by the parties. The Hearing Panel, which included the Hearing Officer, a member of the District 9 Committee and a member of the District 10 Committee, heard oral argument on the motions on March 3, 2004. For the reasons set forth below, Respondent's motion for summary disposition is granted, Market Regulation's motion is denied, and the Complaint is dismissed.

2. Facts

From October 1999 through March 2003, Respondent was associated with NASD member WCA, LLC ("WCAI") as a General Securities Representative and a General Securities Principal. From February 2000 through March 2003, he was also registered with WCAI as an Equity Trader. He is currently associated with another NASD member in all those capacities. (Compl. ¶ 1; Ans. ¶ 1.)

The Complaint concerns Respondent' actions as a WCAI trader on three dates in 2001 when WCAI was a market maker in Cisco Systems, Inc. ("CSCO") and Applied Materials, Inc. ("AMAT"), and Respondent was WCAI's trader responsible for those securities. At the relevant times, both CSCO and AMAT were traded on the Nasdaq. Both stocks had dozens of market makers, were highly liquid and traded in large volumes. (JS ¶¶ 2-4.)

On January 16, 2001, between 10:29:15 a.m. and 10:29:59 a.m. (a 44 second period), WCAI received 44 sell orders for CSCO through SelectNet[1] from ONLI, Inc. ("ONLI"), which was a day trading firm, not a market maker. A firm placing an order through SelectNet could either "broadcast" the order to the market or "preference" the

[1] SelectNet was "an electronic screen-based order routing system that allows market participants to negotiate securities transactions in Nasdaq securities through computer communications, rather than relying on the telephone." Notice to Members 00-30 (May 2000). Since the period relevant to this proceeding, SelectNet has been subsumed into Nasdaq's SuperMontage trading platform. See Exch. Act Rel. No. 43863 (Jan. 19, 2001).

order to only a specific market maker chosen by the order entry firm. In this case, ONLI preferenced all 44 orders to WCAI.

Of the 44 ONLI orders, 42 were at prices away from WCAI's published market; the other two were at WCAI's market. ONLI canceled 42 of the 44 orders, including the two orders that were at WCAI's market, within seconds. Respondent believed that these orders were a form of harassment of WCAI.[2] In response to this perceived harassment, Respondent purchased one share of two 100-share orders, with the intention of discouraging the persons responsible for placing the orders from sending WCAI SelectNet orders that were away from WCAI's published quotes.[3] After Respondent executed the two one-share purchases, ONLI canceled the remaining 99 shares of the orders. (JS ¶¶ 1, 5, 7, 9.)

On April 23, 2001, between 10:11:01 a.m. and 10:13:22 a.m. (a two minute and 21 second period), WCAI received 16 preferenced buy or sell orders for AMAT, through SelectNet, from NASD member The Island ECN ("ISLD"), an electronics communication network that does not trade for its own account. Of the 16 orders, 10 were at prices away from WCAI's published market for AMAT. Respondent, once again believing that WCAI was being harassed, partially executed eight of the orders, in each case buying one share of a 300-share sell order. He intended the partial executions to discourage the persons responsible for placing the orders from sending WCAI SelectNet orders that were away from WCAI's published quotes. ISLD canceled each of the other

[2] Respondent' counsel suggested that the persons placing the orders "were trying to catch him with orders away from his bid" – i.e., they were hoping that Respondent would unintentionally execute one or more of the orders, even though the orders were priced away from the market (Tr. 36.)

[3] The one-share executions might be expected to have this effect because they left the seller with 99-share odd lots.

orders, including the six orders that had been placed at WCAI's market, prior to execution, and also canceled the remaining 299 shares of the eight orders that Respondent partially executed.[4] (JS ¶¶ 1, 5, 7, 10; Tr. 19-21)

On June 6, 2001, between 3:07:49 p.m. and 3:09:00 p.m. (a one minute and 11 second period), WCAI received 48 preferenced orders from ONLI, through SelectNet, to purchase CSCO. Of the 48 orders, 45 were at prices away from WCAI's published market for CSCO. Respondent, believing WCAI was being harassed, partially executed one share of a 100-share order, intending to discourage the persons responsible for placing the orders from sending WCAI SelectNet orders that were away from WCAI's published quotes. ONLI canceled each of the other orders, including those placed at WCAI's market, before they were executed, and also canceled the remaining 99 shares of the order that Respondent partially executed. (JS ¶¶ 5, 7, 12; Tr. 22-23.)

The parties stipulated that one-share transactions are not disseminated to the marketplace. They also stipulated that when Respondent executed the one-share transactions, he knew or should have known that he had no obligation to respond to any SelectNet order that was away from his published market.

Neither Respondent nor WCAI lodged a complaint with NASD regarding any of the SelectNet messages referred to above, and NASD's Market Regulation Department is not aware of any complaint from any other market participant. Respondent' trades came to the attention of Market Regulation as a result of its surveillance of market activity. Market Regulation did not conduct any investigation to learn the identity of the persons

[4] For unexplained reasons, the Complaint cites only five of the eight one-share executions in support of the charges.

who placed the orders through ONLI or ISLD, or to determine whether the orders were bona fide or intended as harassment of WCAI.[5] (JS ¶¶ 16-17.)

3. Discussion

The parties do not disagree about the relevant facts, but do dispute whether Respondent' actions violated IM-2110-5, which was issued by NASD effective July 1997 "to codify a longstanding policy." IM-2110-5 provides that it is inconsistent with just and equitable principles of trade for any member or associated person to, among other things, "engage directly or indirectly in any conduct that … retaliates or discourages the competitive activities of another market maker or market participant." The interpretation also states, however, that it should not be "deemed to limit, constrain, or otherwise inhibit the freedom of a member or person associated with a member to … take any unilateral action or make any unilateral decision regarding the market makers with which it will trade and the terms on which it will trade . . . ."

IM-2110-5 was adopted by NASD in compliance with certain NASD undertakings incorporated in the SEC's 1996 consent order in National Ass'n of Securities Dealers, Inc., 52 S.E.C. 875 (Aug. 8, 1996). That proceeding grew out of the SEC's investigation of competition among Nasdaq market makers. As a result of that investigation, the SEC concluded that "Nasdaq market makers have engaged in conduct which has resulted in artificially inflexible spreads between dealer price quotations for many Nasdaq securities and unduly disadvantageous prices to investors trading in those securities. A number of Nasdaq market makers have also taken action to discourage competition." The SEC also concluded that NASD "did not comply with certain of its

[5] As noted above, neither ONLI nor ISLD was a market maker. ONLI was a day-trading firm, so it is likely that the orders were placed by one or more of its day-trading customers. ISLD is an ECN that does not trade for its own account.

rules or satisfy its obligations under the Exchange Act to enforce its rules and the federal securities laws."

Without admitting or denying these conclusions, NASD consented to entry of an order that committed NASD to, among other things, propose a rule or rule interpretation for SEC approval that would "prohibit[] retribution or retaliatory conduct for competitive actions of another market maker or other market participant." NASD also agreed to take action "to discipline market makers who harass other market makers for … engaging in competitive conduct." 52 S.E.C. at 881.

In keeping with these undertakings, NASD proposed IM-2110-5. When it approved NASD's proposal, the SEC explained that "the interpretation relates to conduct … intended to influence a member … to refrain from legitimate market activity. However, … 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)." Exch. Act Rel. No. 38845, 1997 SEC LEXIS 1497, at *6 (July 17, 1997).

It is clear, therefore, that IM-2110-5 was intended to proscribe anticompetitive conduct, but was not intended to restrict a member firm's right to make unilateral decisions regarding with whom to trade, so long as those decisions are not anticompetitive. Accordingly, in applying IM-2110-5 to the stipulated and undisputed facts of this case, the issue is whether Respondent' actions amounted to anticompetitive behavior "intended to influence a member … to refrain from legitimate market activity."

The parties' stipulations and the undisputed facts preclude such a finding. The parties agree that Respondent "believed that WCAI was being harassed and therefore

responded by executing only one share of each order [at issue]. He intended the one share execution to discourage the persons responsible for the preferenced SelectNet messages from sending WCAI SelectNet messages to buy or sell securities at prices that were away from WCAI's published quotes for the securities." Plainly, harassment is not "legitimate market activity."

The undisputed facts support Respondent' belief. In each instance, WCAI received a large number of orders during a very short time period. The orders concerned CSCO and AMAT, which were among the most heavily traded and most liquid stocks on the Nasdaq, and there were many market makers for each. The orders, however, were specifically preferenced to WCAI. A preferenced SelectNet order was not disseminated to the market. Such an order, if away from the recipient's posted quotes, represented an attempt by the person placing the order to open private negotiations with the recipient that might, or might not, lead to a purchase or sale at some negotiated price. As the parties stipulated, the recipient was under no obligation to respond. If, however, the recipient responded and the parties succeeded in negotiating a transaction, the transaction, but not the negotiations that led to it, was reported to the market.

On January 16, 2001, of the 44 orders that ONLI preferenced to WCAI during a 44 second period, 41 were 100-share orders to sell CSCO at $39.9375. During this period, the inside market for CSCO was $38.125 bid, $38.1875 ask – that is, the inside spread was only 7½ cents. ONLI, however, was offering to sell CSCO at a price that was $1.8125 above the inside bid (which was also WCAI's bid), and $1.75 above the inside ask.[6] On their face, these offers were not bona fide attempts to negotiate a sale to WCAI;

[6] See Soderlund Declaration, filed in support of Complainant's Motion for Summary Disposition, Exhibit B (SelectNet Activity Report for trade date January 16, 2001).

as a result, the orders did not contribute to the market and, therefore, were not "competitive activities." Furthermore, ONLI canceled each of these orders within a few seconds, except the last two, which ONLI canceled after Respondent purchased just one share. The Hearing Panel finds that under these circumstances, Respondent' belief that the orders were a form of harassment, rather than legitimate market activity, was reasonable.

The record does not include such detailed information regarding the orders WCAI received from ISLD concerning AMAT on April 23, 2001, or the orders it received from ONLI concerning CSCO on June 15, 2001, but the parties agreed that many of the same conditions were present. The orders were preferenced to WCAI, not broadcast to the market; the orders were away from the market; and the order entry firm canceled all of the orders, including the orders that were at WCAI's market, before they were executed.[7] In both cases, the parties have stipulated that Respondent believed that WCAI was being harassed.[8]

Market Regulation points out that Respondent admits that by executing the one-share transactions he intended to discourage the persons who were responsible for the perceived harassment from placing additional orders with WCAI at prices that were away

[7] Market Regulation represented that the five April 23 orders cited in the Complaint "range from 10 to 20 cents away from Respondent's quoted prices," and that the June 15 orders that were not at WCAI's quoted prices "were to buy Cisco at about 79 cents below Respondent's ask." (Tr. 7.) The record does not, however, contain the inside market quotes at the relevant times.

[8] Market Regulation argues that the AMAT orders may be distinguished from the CSCO orders because they were fewer and were placed over a slightly longer time period. The Panel, however, finds the number and timing of the orders less significant than the undisputed facts that 10 of the 16 orders were outside the market and that all the orders, including those placed at WCAI's market, were canceled. In any event, Market Regulation has stipulated that Respondent' partial executions of the AMAT orders, like his partial executions of the CSCO orders, were a response to perceived harassment, not an effort to deter competition.

from WCAI's published quotes.[9] Market Regulation argues that this was improper because those persons were "entitled to submit orders at whatever price [they felt] appropriate."[10] (Tr. 24.) As explained above, however, IM-2110-5 is intended to protect competitive conduct, not harassment, and both NASD and the SEC have made it plain that a market maker remains free to decide unilaterally with whom to trade, so long as such decisions are not intended to impede competition.[11]

The Hearing Panel, therefore, concludes that Respondent did not violate IM-2110-5. His actions were not intended to retaliate against or discourage competitive activities on the part of any market participant, and there is no evidence that they had or could have had any such effect.[12] For the same reasons, the Panel concludes that Respondent did not violate Rule 2110, as charged.

The Panel wishes to emphasize that this conclusion is based on the specific stipulated and undisputed circumstances of this case, including the following: (1) the

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[9] The stipulation does not suggest that Respondent intended to discourage those persons from placing orders with WCAI at its published quotes, and Market Regulation did not allege or argue that Respondent ever backed away from his quoted market.

[10] By the same token Respondent was "entitled" to execute just one share of the orders. The issue, however, is whether the orders amounted to competitive conduct, and whether Respondent' responses represented an attempt to suppress such conduct.

[11] Market Regulation also points out that in approving IM-2110-5, the SEC specifically referred to "trading in odd lots" as an example of conduct that may be utilized "to influence another member in a manner that interferes with or impedes the forces of competition . . . ." 1997 SEC LEXIS 1497, at *6. The Panel agrees that odd lot executions may be utilized for such an improper purpose, but in this case, Market Regulation stipulated that Respondent used that technique in an effort to deter what he perceived to be harassment, not to discourage legitimate market activity.

[12] As a general matter, in highly efficient, highly competitive markets, such as the markets for CSCO and AMAT, unilateral action by a single market participant that lacks market power is unlikely to have any adverse impact on competition, particularly if it is not communicated to other market participants. In this case, neither the preferenced orders nor the one-share partial executions were communicated to the market. Thus, even if Respondent successfully discouraged the persons who he believed were attempting to harass WCAI from submitting any additional orders to WCAI that were away from its quotes, those persons could have submitted such orders to any or all of the dozens of other market makers for CSCO and AMAT, and those market makers would have been unaware of either the orders those persons had previously submitted to WCAI or of Respondent' partial executions in response to those orders.

orders were preferenced to WCAI, not broadcast to the market; (2) the orders were outside the market and involved highly liquid securities; (3) there was no evidence that Respondent backed away from WCAI's published quotes or that he was responding to or attempting to discourage competitive pressure on WCAI's markets – on the contrary, Market Regulation stipulated that he was responding to what he believed was harassment; and (4) Respondent' actions were unilateral – there was no allegation or evidence that Respondent was influenced by or attempted to influence any other market maker, or even communicated his actions to other market makers. Similar actions by a market maker under other circumstances might well violate IM-2110-5.

Further, the Hearing Panel is not holding that Respondent' actions were justified, appropriate or benign, but simply that they were not anticompetitive, in violation of Rule 2110 and IM-2110-5.[13] In that regard, the Panel notes that, because Market Regulation charged, briefed and argued the case on the theory that Respondent' actions amounted to anticompetitive harassment in violation of Rule 2110 and IM-2110-5, the Hearing Panel had no occasion to consider whether Respondent' actions could have been charged as violations of Rule 2110's broad requirement that members and associated persons "observe high standards of commercial honor and just and equitable principles of trade" under some other theory not articulated in the Complaint.

[13] Respondent also argued that the Panel could not find a violation of IM-2110-5 because Market Regulation could not establish that the persons who placed the orders through ONLI and ISLD were NASD members or persons associated with members. Market Regulation, on the other hand, argued that IM-2110-5 should be construed to prohibit anticompetitive harassment of any market participant, regardless whether it is a member or an associated person. Because the Panel is dismissing the Complaint on other grounds, it is unnecessary to address those arguments.

4. Conclusion

Therefore, the Complaint is dismissed.[14]

HEARING PANEL

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By: David M. FitzGerald
Hearing Officer

[14] The Hearing Panel has considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.