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January 4, 2001

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-00-42 -- Recording and Reporting Requirements for Certain
Quotation Data; Response to Comments and Amendment No. 1

Dear Ms. England:

NASD Regulation, Inc. ("NASD Regulation") hereby responds to the comment letter received by the Securities and Exchange Commission ("Commission" or "SEC") in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-00-42, regarding proposed recording and reporting requirements for certain quotation data.¹ In addition, NASD Regulation hereby submits Amendment No. 1 to the rule filing. The attached proposed rule language replaces the proposed rule language filed with the Commission on June 30, 2000 and incorporates the amendments described herein.

The Commission received one comment letter in response to the *Federal Register* publication of SR-NASD-00-42. The comment letter was submitted by R. Cromwell Coulson, Pink Sheets LLC (the "Pink Sheets") and is summarized by issue below. As an initial matter, however, NASD Regulation would like to clarify that the proposed rules do not impose any requirements on the Pink Sheets. The proposed quotation recording and reporting requirements apply only to NASD members. To the extent that a member and the Pink Sheets enter into an agreement whereby the Pink Sheets agrees to act as the member's reporting agent and fulfill the obligations of the member under the proposed rules, the Pink Sheets, as with any other third-party provider, would be obligated to record and report information only pursuant to its agreement with the member. The member, however, remains ultimately

¹ Securities Exchange Act Release No. 43367 (September 27, 2000), 65 Fed. Reg. 59482 (October 5, 2000). The public comment period announced in the *Federal Register* expired on October 26, 2000.

responsible for compliance with the proposed requirements, notwithstanding the existence of an agreement with the Pink Sheets to have it report on the member's behalf.

Privately Negotiated Contract

As an alternative to applying the proposed recording and reporting requirements to NASD members, the Pink Sheets recommends a privately negotiated contract between NASD Regulation and the operator of the inter-dealer quotation system. In this regard, the comment letter states that the Pink Sheets has offered to make the required information available on a contractual basis and, historically, has been extremely cooperative by providing information for investigatory purposes to the NASD upon its request. In addition, the Pink Sheets states that both the SEC and The Nasdaq Stock Market have contracted with the Pink Sheets to obtain access to similar types of information and any breach of contract by the Pink Sheets would be legally enforceable. The Pink Sheets contends that NASD Regulation is attempting to access quotation data through a proposed rule change, rather than negotiate a private contract like all other users of the data. As a result, the Pink Sheets claims that NASD Regulation is engaged in one-sided rulemaking to take Pink Sheets' valuable data and place unreasonable obligations on Pink Sheets for maintaining system standards.

As stated in the original rule filing, NASD Regulation does not have the authority or jurisdiction to require the operator of an inter-dealer quotation system that is not an NASD member to provide quotation data. In such cases where NASD Regulation does not have jurisdiction over the system operator, NASD Regulation cannot rely on a private contract to obtain the required quotation data, because the system operator could at any time refuse to provide the data to NASD Regulation. Although NASD Regulation may have a contractual basis to pursue legal action against the system operator, NASD Regulation would be at risk of not having access to quotation data during that time period, and, as a result, it would be unable to surveil effectively and monitor for compliance with applicable rules and regulations.

Proposed Requirements are Overly Burdensome

The Pink Sheets states that it is overly burdensome to place the sole responsibility on the member to determine whether NASD Regulation has received the information required by the proposed rule change. Alternatively, the Pink Sheets suggests a provision or obligation that NASD Regulation notify the member or the reporting agent if NASD Regulation believes or has reason to believe that it is not receiving the required data from the reporting agent.

NASD Regulation believes that compliance with the proposed rule change is the member's responsibility and that the member must have procedures in place to determine whether information is

being reported properly (either by the member or by its reporting agent). As with other regulatory requirements, however, to the extent NASD Regulation may reasonably assist firms in ensuring compliance with the proposed requirements, it will do so. For example, if a member or reporting agent were to inquire on the status of quotation data submitted pursuant to the proposed rule change, NASD Regulation would be willing, upon request, to confirm receipt (or non-receipt) of the information.

Proposed Requirements are Too Subjective

The Pink Sheets states that the proposed rule change lacks objective standards for the form or means of delivery of the data to NASD Regulation. NASD Regulation, however, has specified in the proposed rule change the quotation data and related information that must be recorded and reported. It will prescribe the form in which this data will be required to be transmitted to NASD Regulation in a *Notice to Members*. In this regard, NASD Regulation staff has met with a representative from the Pink Sheets to discuss data transmission alternatives. NASD Regulation intends to work with its members, the Pink Sheets, and other reporting agents, to determine the most appropriate means to report the required information. To mandate a specific transmission method at this time would not provide NASD Regulation the ability, if necessary, to address varying systems transmission capabilities.

Private Property Rights of the System's Owner

The Pink Sheets states that NASD Regulation must acknowledge the system owner's private property rights to the data submitted in furtherance of this proposed rule change. The Pink Sheets claims that through the proposed rule change, NASD Regulation indirectly will regulate the content of the market data created on the Electronic Quotation Service ("EQS") and other similar automated quotation systems. In this regard, the Pink Sheets has requested assurances that the data provided to NASD Regulation will be not be redistributed in competition with the Pink Sheets, such as for use on the OTC Bulletin Board ("OTCBB") or in any other commercial manner. The Pink Sheets claims that such a use by NASD Regulation would violate the Pink Sheets' intellectual property rights and the Pink Sheets would be required to seek all appropriate legal means to protect these rights.

As stated above and in the original rule filing, the proposed quotation recording and reporting requirements apply only to NASD members. NASD Regulation requires access to this quotation data for regulatory purposes and intends to use the data for only this purpose. NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act"), which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Withdrawal of Quotations due to System Problems

The Pink Sheets opposes as unnecessarily strict the requirement that members that use a reporting agent immediately withdraw their proprietary quotations if quotation data is not being recorded and reported. The Pink Sheets notes that system problems may occur, as they do in other markets, and it would “cause disarray” if market makers were required to withdraw their quotes and potentially lose their piggyback status pursuant to Rule 15c2-11 under the Exchange Act. The Pink Sheets contends that the goal of the proposed rule would be achieved if proposed Rule 6740(e)(4) were revised to allow members to maintain name only, indications of interest until the recording and reporting requirements could be fulfilled. In this way, members would not lose their Rule 15c2-11 piggyback status.

NASD Regulation, however, believes that if quotation information, including unpriced indications of interest, is not being properly recorded, then NASD Regulation will be unable to ensure that members are in compliance with applicable rules. Therefore, NASD Regulation continues to believe it is appropriate to require those members that use a reporting agent to record and report such information to withdraw their quotations or unpriced indications of interest until such time that the member has assurances that the quotation information is being properly recorded. It is important to note, however, that if the reporting agent is unable to record or report on the member’s behalf, the member can record and report the quotation information on its own behalf, and, would not be required to withdraw its quotations.

NASD Regulation recognizes that reporting agents may be subject to system problems that may restrict temporarily the reporting agent’s ability to record and report the quotation information required under the proposed rule. If a reporting agent is unable to record or report due to a temporary system problem, the member would not be required to withdraw its quotations or unpriced indications of interest, if the temporary system problem does not extend beyond one trading day. If the system problem extends beyond one trading day, the proposed rule would require that the member withdraw its quotations or unpriced indications of interest, if the member is unable to use an alternative means to comply with the proposed rule. Similarly, if the reporting agent were to have temporary system problems on a frequent basis, the proposed rule change would require the member to use an alternative means to comply with the proposed rule.

NASD Regulation further believes that the proposed requirement that members withdraw their quotations or unpriced indications of interest if quotation information is either not being properly recorded or not properly reported should not be limited to those members that use a reporting agent. Therefore, NASD Regulation is amending the proposed rule change to require that members withdraw their quotations or unpriced indications of interest if they know or have reason to believe that their

quotation information is not being properly recorded and/or reported, regardless of whether they record or report on their own behalf or through a reporting agent.

To incorporate these amendments, NASD Regulation is amending proposed Rule 6630(e)(4) and adding a new paragraph (f) of proposed Rule 6630 as follows (additions are underlined; deletions are bracketed):

* * *

(e)(4) Each member remains responsible for compliance with the requirements of this Rule, notwithstanding the existence of an agreement described in this paragraph.

(f) Withdrawal of Quotations or Unpriced Indications of Interest

If a member knows or has reason to believe that it or its Reporting Agent is not complying with the requirements of this Rule, the member must [immediately] withdraw its quotations or unpriced indications of interest until such time that the member is satisfied that its [the] quotation data is being properly [maintained] recorded and reported.

* * *

Proposed Requirements are Anti-competitive

The Pink Sheets states that the proposed rule is anti-competitive because it specifically exempts systems that are sponsored and regulated by a registered securities association or national securities exchange. The Pink Sheets argues that there is no rule that members must remove their quotations from any of the exempted systems if the member believes or has reason to believe that the data is not being properly maintained by the exempted system. This would include the OTCBB, which is sponsored and regulated by the NASD. The Pink Sheets also argues that since no other such automated quotation systems currently exist besides EQS, the proposed rule is unfairly targeted at EQS and its users.

As stated previously, because NASD Regulation does not have jurisdiction over the system operator to obtain the quotation data directly, NASD Regulation must rely on members to record and report such data. Where the system operator is an NASD member, NASD Regulation has jurisdiction over the system and can obtain the quotation data directly from the system operator. Similarly, where the system is sponsored and regulated by a registered securities association or national securities exchange, the appropriate regulatory body will have access to the system's quotation data and will be in

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a position to regulate the activity on that system. Therefore, it is not necessary for the NASD to require its members to record and report quotations displayed on these systems. To the extent that other systems currently or in the future fall within the scope of the proposed rule, the proposed requirements would apply uniformly to such other systems.

Application of Proposed Requirements to Other Markets

The Pink Sheets questions why NASD Regulation is applying the proposed requirements only to electronic equity quotation services and not to electronic bond quotation services and electronic order routing and negotiation services. The Pink Sheets believes that all quote information, order data and inter-dealer negotiations should be available to regulators to provide them with the best possible investigative tools.

The current rule proposal addresses quotation information that is necessary for NASD Regulation to adequately regulate activities in the over-the-counter equity market. To the extent an electronic order routing and negotiation service is considered an inter-dealer quotation system and the information displayed is quotation information, the proposed rule would apply. With respect to the application of the proposed rule to electronic bond quotations, NASD Regulation currently does not require historical quotation information for regulation of the over-the-counter component of the bond market. NASD Regulation, however, will continue to monitor activities in that area to determine if quotation reporting and recording requirements similar to this proposal are necessary.

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If you have any questions, please feel free to contact Stephanie Dumont, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Very truly yours,

Jeffrey S. Holik

Attachment

Attachment A
Proposed Rule Language, as amended by
Amendment No. 1 to SR-NASD-00-42

Proposed new language is underlined; proposed deletions are in brackets.

6600. [REPORTING TRANSACTIONS IN] OVER-THE-COUNTER EQUITY SECURITIES

This Rule 6600 Series sets forth recording and reporting requirements for certain quotations and unpriced indications of interest displayed on inter-dealer quotation systems and the trade reporting requirements applicable to members' transactions in equity securities for which real-time trade reporting is not otherwise required (hereinafter referred to as "OTC Equity Securities"). Members shall utilize the Automated Confirmation Transaction Service (ACT) for trade reporting in OTC Equity Securities.

Rules 6610 and 6620 No Change.

Rule 6630. Recording of Quotation Information

(a) Quotation Recording Requirements

(1) Subject to the terms and conditions contained herein, each OTC Market Maker that displays priced quotations (bid and/or offer) or unpriced indications of interest in OTC Equity Securities in an inter-dealer quotation system that permits quotation updates on a real-time basis shall record each item of information described in paragraph (b) of this Rule. This quote activity record must reflect all changes in an OTC Market Maker's priced quotation or quotation size displayed or unpriced indication of interest, and the time any such change was effected.

(2) Members shall record each item of information required to be recorded under this Rule in such form as is prescribed by the Association from time to time.

(3) Maintaining and Preserving Records

(A) Each member shall maintain and preserve records of the information required to be recorded under this Rule for the period of time and accessibility specified in SEC Rule 17a-4(a).

(B) The records required to be maintained and preserved under this Rule may be immediately produced or reproduced on "micrographic media" as defined in SEC Rule 17a-4(f)(1)(i) or by means of "electronic storage media" as defined in SEC Rule 17a-4(f)(1)(ii) that meet the conditions set forth in SEC Rule 17a-4(f) and may be maintained and preserved for the required time in that form.

(b) Information to be Recorded

The quotation activity record required pursuant to paragraph (a) of this Rule shall contain, at a minimum, the following information for every priced quotation (bid and/or offer) or unpriced indication of interest displayed by the member during the trading day:

- (1) Submitting firm;
- (2) Inter-dealer quotation system or medium;
- (3) Trade date;
- (4) Time quotation displayed (expressed in hours, minutes and seconds);
- (5) Security name and symbol;
- (6) Bid and bid quotation size (if applicable);
- (7) Offer and offer quotation size (if applicable);
- (8) Prevailing Inside Bid; and
- (9) Prevailing Inside Offer

If no updates were entered to an OTC Market Maker's quotation or quotation size for any given trading day, the member must record the information in subparagraphs (b)(1) through (7).

(c) Quotations Not Required To Be Recorded

The recording requirements contained in paragraphs (a) and (b) of this Rule shall not apply to quotations of OTC Equity Securities that are displayed on an inter-dealer quotation system that is:

- (1) qualified pursuant to Section 17B of the Act; or
- (2) operated by a member of the Association.

(d) Reporting Requirements

- (1) General Requirement

Members shall report information required to be recorded under this Rule to the Association upon its request.

- (2) Method of Transmitting Data

Members shall transmit this information in such form prescribed by the Association.

(e) Reporting Agent Agreements

(1) "Reporting Agent" shall mean a third party that enters into any agreement with a member pursuant to which such third party agrees to fulfill such member's obligations under this Rule.

(2) Any member may enter into an agreement with a Reporting Agent pursuant to which the Reporting Agent agrees to fulfill the obligations of such member under this Rule. Any such agreement shall be evidenced in writing, which shall specify the respective functions and responsibilities of each party to the agreement that are required to effect full compliance with the requirements of this Rule.

(3) All written documents evidencing an agreement described in paragraph (e)(2) shall be maintained by each party to the agreement.

(4) Each member remains responsible for compliance with the requirements of this Rule, notwithstanding the existence of an agreement described in this paragraph.

(f) Withdrawal of Quotations or Unpriced Indications of Interest

If a member knows or has reason to believe that it or its Reporting Agent is not complying with the requirements of this Rule, the member must withdraw its quotations or unpriced indications of interest until such time that the member is satisfied that its quotation data is being properly recorded and reported.

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