

PLANNING MEMORANDUM

TO: Lori Richards

FROM: John McCarthy
Eric Swanson
Matt Daugherty

RE: Inspection of Self Regulatory Organizations and Market Makers with Respect to Trading in the Nasdaq 100 Exchange Traded Index Fund in the Nasdaq Intermarket During Periods of Abnormal Market Conditions.

DATE: March 3, 2003

I. INTRODUCTION

Staff from the Office of Compliance Inspections and Examinations (“Staff”) will conduct inspections of certain Self Regulatory Organizations (“SROs”) and Market Makers. These will include the Chicago Stock Exchange (“CHX”), the American Stock Exchange (“AMEX”), Knight Securities, L.P., (“Knight”), Bernard L. Madoff Investment Securities LLC, (“Madoff”) and the Boston Stock Exchange (“BSE”). The purpose of these inspections is to examine the aforementioned regarding policies and procedures with respect to order handling and execution in the Nasdaq 100 Index Exchange Traded Fund, or “QQQ”, during periods of abnormal market conditions, *i.e.*, when the market is locked or crossed. The Staff is concerned that when the market is locked or crossed, Market Makers and Exchange Specialists may be handling customer orders in violation of their fiduciary best execution obligations. The staff selected the QQQ security for this review because it is the most actively traded security and is frequently locked or crossed.

II. INSPECTION SCOPE

This inspection will examine the following aspects of Exchange and Market Maker operations:

- Order executions in the QQQ during periods of locked or crossed markets.
- Exchange and Market Maker procedures for order handling and execution when the market is locked or crossed.
- The status, use, and procedures for Exchange and Market Maker automatic execution systems, specifically at times when the market is locked or crossed.
- Exchange and Market Maker internal controls and compliance procedures relating to best execution obligations.
- Exchange and Market Maker internal controls and compliance procedures relating to the display of limit orders that would lock or cross the market.

III. BACKGROUND

A. Best Execution

The duty of best execution requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances.¹ In addition to price, other terms are also relevant to best execution, and must be taken into consideration by the broker-dealer. These include order size, the trading characteristics of the security, execution speed, clearing costs, and the cost and difficulty of executing an order in a particular market.² The Staff is concerned that a combination of factors including: abnormal market conditions; common industry practices such as internalization of order flow;³ and the automatic execution of customer orders – coupled with potentially inadequate order handling systems and guidelines for Market Makers and Exchanges – is causing best execution violations.

B. Locked/Crossed Markets

A locked market occurs when a market participant's bid equals the lowest offer of another market participant. A crossed market occurs when a market participant's bid exceeds the lowest offer of another market participant. Market Makers and Exchanges consider instances when the market is locked or crossed as “non-normal” or “abnormal” market conditions. During these times, Market Makers and Exchanges often deviate from their routine order handling procedures. As explained below, Market Makers and Exchanges will “turn off” their automatic execution systems during these periods.

IV. INSPECTION ISSUES

¹ Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971).

² Payment for Order Flow, Exchange Act Release No. 33,026, 58 Fed Reg. 52934 (Oct. 13, 1993).

³ As stated in the Staff's recent Study on Payment for Order Flow in the Options Markets:

“Internalization is the practice whereby a dealer exclusively interacts as the counter-party with customer order flow without the ability for other market participants to compete in order to trade against those same customer orders. The practice of internalization is prevalent in the Nasdaq market where Nasdaq market makers, who often pay for order flow or are sent order flow by an affiliate, trade proprietarily against incoming customer orders. NASD rules do not require Nasdaq dealers to expose their internalized orders to competitors. However, Nasdaq members are subject to rules that require them to use reasonable diligence to execute their incoming customer orders at the best price possible under prevailing market conditions. Typically, firms that internalize customer equity orders automatically execute customer orders at the national best bid or offer irrespective of their own quotations. This practice is referred to as price matching.”

Special Study: Payment for Order Flow and Internalization in the Options Markets Office of Compliance Inspections and Examinations, Office of Economic Analysis December 2000.

As noted above, many Market Makers and Exchanges have agreements with customers, order entry firms, or members whereby they will automatically execute certain orders at the current National Best Bid and Offer, or "NBBO".⁴ These orders by agreement are not exposed to the market, rather, they are internalized in the case of a Market Maker, or in the case of an Exchange, sent directly for execution through a dedicated terminal or line.⁵

Market Makers and Exchanges, however, will not automatically execute orders during periods they term non-normal market conditions.⁶ While an execution at the NBBO during a crossed market would obviously benefit the investor, Market Makers and Exchanges would lose against the spread on such transactions. Recent data gathered by the Office of Economic Analysis reveals that during the week of January 6-10, 2003, 54% of all trades were executed when the NBBO for QQQ was locked or crossed.⁷ The QQQ is the most liquid security traded on the U.S. markets.

The Staff is concerned that Market Makers and Exchange Specialists may not be honoring their quoted market during a locked or crossed market, and may not be fulfilling fiduciary obligations to obtain best execution for customer orders. Further, retail customers and order entry firms may not be aware that a majority of the trades in the most frequently traded security will not be automatically executed at the current NBBO as per their agreements, but instead manually handled and possibly executed outside the current NBBO on a delayed basis by the Market Maker or Specialist.

⁴ Knight provides information concerning its order execution procedures in the Frequently Asked Questions ("FAQ") portion of its web site:

"6. How does the firm determine the execution price of an order under normal market conditions?

During normal market conditions, our execution procedures and post-execution quality control procedures, whether carried out by our system or manually, generally utilize a stock's best consolidated inside quote (NBBO) as the price benchmark."

⁵ In the case of AMEX, members can route orders to the Exchange's trading floor through the Common Message Switch. These orders are routed to the AMEX's order file, which can direct the orders to the Automatic Execution system, which provides instantaneous automatic execution.

⁶ Regarding automatic executions, Knight states the following on its web site:

"14. How does the firm determine when market conditions are non-normal?

Automatic Execution is not available during non-normal market conditions.

Knight Capital Markets reserves the right, at the sole discretion of its Principals, to determine if and when market conditions are normal. Principals of Knight Capital Markets (including, but not limited to, Team Captains, Trading Room Managers and Executive Officers) determine when and if market conditions are considered normal. Non-normal market conditions include, but are not limited to:

a. Locked or crossed markets []."

⁷ The data show that 20.5% of the trades during that period were executed when the market was locked, and 33.5% were executed during a crossed market.