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January 10, 2003

R. Cromwell Coulson
Chairman and CEO
Pink Sheets LLC
304 Hudson Street
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New York, NY 10013

Re: Application of NASD and SEC Rules to Plink Messages

Dear Mr. Coulson:

You have asked us to provide guidance consistent with your recent correspondence with the NASD regarding the applicability of certain NASD and SEC rules to an electronic messaging service ("Plink," as more fully described below) that you plan to provide to subscribers. As a summary, we believe the following is true regarding the answers to your questions:

- 1) Generally, it is well established that the applicability of NASD and SEC rules governing the conduct of trading does not depend on the medium of communication. For example, the trading rules apply equally to communication between firms transmitted via Plink or orally via telephone.
- 2) Under NASD rules, a market maker should respond immediately to any order presented to it electronically (or telephonically) for which it is liable under NASD rule 3320.
- 3) NASD rules allow a market maker to decline an electronic order via Plink for which the market maker is subject to liability only if either (1) the market maker has already revised its quoted price or quoted size prior to the receipt of the Plink message order, or (2) the market maker can take advantage of the trade ahead exception. If either case is true and the market maker is no longer liable, the market maker should immediately decline the Plink order.
- 4) The information explicitly required to be retained by SEC rule 17a-3(a)(7) (transaction price and, to the extent feasible, execution time) already is retained by broker-dealers whether or not Plink is used by a broker-dealer. Also, SEC rule 17a-4 may require broker-dealers to

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record and preserve all the information contained in Plink messages. Under NASD and SEC rules, Pink Sheets LLC (“Pink Sheets”) is permitted to, and you have informed us that you intend to, preserve the information contained in Plink messages as a service to broker-dealers.

Below, please find a more detailed analysis and discussion of these issues.

Facts

As we understand the facts, Pink Sheets is introducing Plink, an electronic messaging service, to allow NASD member firms to electronically communicate in what has been traditionally a telephonic process.^{1/} Plink is an electronic-based instant messaging capability between NASD-registered broker-dealers on the Electronic Quotation Service (“EQS”). Plink will offer NASD members the option to automate the telephonic process of communicating with market makers, augmenting the verbal contact between trading desks. Plink will allow subscribers to direct messages to other specified subscribers. Plink also will identify incoming and outgoing messages and will allow traders to see subsequent messages and responses.

Plink is a common carrier of information for NASD-registered broker-dealers. Plink will not control the interaction of orders or the execution of trades. It will not be an agent, a participant or a beneficiary in any transaction. As with the EQS, Plink does not create content or liquidity, but rather makes transparent the already existing broker-dealer indications of interest and quotations in the OTC market. Plink will simply provide more efficient and transparent communication links between broker-dealers in the OTC market by allowing broker-dealers to

^{1/} Plink messages will help firms avoid the difficulties of telephonic communications sometimes associated with answering all calls during high volume periods of time. In the past, the NASD has warned member firms that they must ensure that they have sufficient staff to answer all phone calls. See NASD Head Trader Alert #2000-09, Obligation of Members to Comply with Conduct & Marketplace Rules (discussing obligations of member firms to answer phones during market hours) (“HTA #2000-09”).

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transmit any of the of pre-formatted, fixed protocol Plink messages permitted on the system.

The implementation of Plink will allow broker-dealers to send electronically buy or sell order messages to market makers publishing quotations in the EQS. Market makers will be able to respond to such messages with execution reports, counter offers or decline the order messages. Plink will indicate to the sender and the receiver whether the order is at a price for which the market maker is publishing a firm quotation in the EQS, and the number of live order messages to the market maker at that price, at the time the Plink receives such order message.

Plink will display different identifiers to indicate whether a message has been sent, canceled or responded to, as well as whether a message is in transit to the Plink server or has been received by the other party's software. Plink will be available via the OTC Dealer software application and offer an FIX Protocol API for firms to interface with their own in-house or third party service bureau message and/or record keeping systems. All messages will be time stamped and retained in the Pink Sheets historical database.

Pink Sheets has been asked by its subscribers for clarification of NASD members' responsibilities under NASD and SEC rules regarding the use of Plink to communicate with other NASD members. In a letter to the NASD dated March 19, 2002, you requested interpretive guidance concerning the application of NASD rules to communications made through Plink. More specifically, you asked:

- 1) Whether NASD members' responsibilities under NASD rules will be the same as they currently are for oral communications via the telephone when using Plink to send messages to and receive messages from other subscribers. More specifically, you asked about an OTC market maker's responsibilities under NASD rules if the market maker has chosen to participate in Plink and receives an electronic order message from another member via Plink.
- 2) Specifically how, and in what timeframe, an OTC market maker should respond to an electronic order message from another broker/dealer via Plink, at a price for which the market maker is publishing a firm quotation and liable under NASD rule 3320.

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- 3) How an OTC market maker should respond to electronic order messages via Plink for which the market maker is no longer liable because it has executed a prior order at the quoted price and size and is in the process of immediately updating the quotation. You ask further whether the market maker should decline the electronic order message under the stated circumstances and in what time frame the market maker should respond.

The NASD responded to you in a letter dated December 11, 2002 (“NASD Letter”). We seek to assist in the regulatory interpretation of the letter consistent with our understanding^{2/} under existing federal securities laws and rules, and NASD rules.

I. Plink Instant Messages as Oral Communications

Question: Under NASD rules, are NASD members’ responsibilities the same for messages between member firm subscribers sent or received electronically via Plink as for those for oral communications exchanged via telephone?

With respect to NASD and SEC rules governing the conduct of trading, it is well established that the application of the trading rules does not depend on the medium of communication between NASD member firms (ex., whether transmitted electronically via Plink or orally via the telephone).

As noted in the NASD Letter, “[i]t is not the medium through which events transpire that controls the applicability of these rules; rather these rules apply and are triggered by the occasion of the facts and circumstances that give rise to the obligations specified in these rules.”

Consistent with this guidance, we turn to your more detailed questions regarding NASD member firms’ obligations regarding Plink messages. As you will see, NASD members obligations regarding the conduct of their trading activities do not change based upon the medium of communication; however, the record-

^{2/} The questions we answer have been modified slightly from their original version as submitted to the NASD.

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keeping rules do change somewhat depending on whether communication is conducted via Plink or orally via telephone.

II. Response to Plink Order Messages

Question: How, and in what time frame, should an OTC market maker respond to an electronic order message from another broker-dealer received via Plink, at a price for which the market maker is publishing a firm quotation and liable under NASD rule 3320.

Market makers should respond immediately to any order presented to it electronically (or telephonically) for which it is liable under NASD rule 3320.

Although the NASD rules do not contain an explicit firm quote rule, NASD rules 2110, 3310, and 3320 together form a clear firm quote obligation. NASD rule 2110 requires a member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade. NASD rule 3310 generally prohibits a member from publishing or circulating any report of a securities transaction or any quotation for a security unless the member believes it is bona fide and that nominal quotations, if used, are identified as such.^{3/} NASD rule 3320 provides that “no member shall make an offer to buy from or sell to any person any security at a stated price unless such member is prepared to purchase or sell, as the case may be, at such price and under such conditions as are stated at the time of such offer to buy or sell.”^{4/} If a market maker identifies a quote as firm, the market maker usually must honor the quote.^{5/} As stated in IM-3320:

^{3/} See HTA #2000-09.

^{4/} NASD rule 3320.

^{5/} As stated in NASD IM-3320, “under normal circumstances where the member is making a “firm trading market” in any security, it is expected at least to buy or sell a normal unit of trading in the quoted stock at its then prevailing quotations unless clearly designated as not firm or firm for less than a normal unit of trading when supplied by the member. It should be realized, however, that at times contemporaneous transactions or substantial changes in inventory might well

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“In order to insure the integrity of quotations, every member has an obligation to correctly identify the nature of its quotations when they are supplied to others. In addition, each member furnishing quotations must insure that it is adequately staffed to respond to inquiries during the normal business hours of such member. It shall be deemed conduct inconsistent with high standards of commercial honor and just and equitable principles of trade if a member fails to fulfill its obligations as outlined above.”

We believe these NASD rules together impose a firm quote obligation.

In an e-mail dated February 10, 1999, you asked the staff of the NASD how much time a trader is permitted before updating his/her price when the trader's market changes? The NASD staff responded in a letter to you dated April 28, 1999 (“1999 NASD Letter”).^{6/} In the 1999 NASD Letter, the NASD staff stated:

“Although the SEC firm quote rule, Rule 11AC1-1(c), does not apply to transactions in OTC eligible securities, its provisions and exceptions should be considered in providing guidance and responding to this question. SEC Rule 11Ac1-1(c) provides that a market maker must execute an order “presented” to it at a price at least as favorable as its published quotation up to its published quotation size. Exceptions to Rule 11Ac1-1 exist only if: (1) the market maker revises its quoted price or size prior to the order being presented; or (2) the market maker has effected or is in the process of effecting a transaction at the time an order is presented and immediately upon completion of that transaction

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require dealers to quote a “subject market” temporarily.” IM-3320 specifically references its applicability to “the National Quotation Bureau sheets.”

^{6/} Letter from Mary N. Revell, Associate General Counsel, NASD Regulation, Inc., to Cromwell Coulson, Pink Sheets, LLC, dated April 28, 1999.

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communicates a revised quotation (the trade ahead exception). A trade-ahead exception for trades that are reported after the presentment of an order will not be permitted if a market maker executes a trade and changes its quote absent proof, such as the time of order entry, that the market maker was in the process of executing the order prior to presentment of the order and the market maker immediately updated its quote subsequent to the execution. These same concepts also apply to members' responsibilities under Rule 3320 with respect to quotes and transactions in OTC equity securities."

As seen in the 1999 NASD Letter, the NASD staff believes that, although not explicit, the firm quote rule does apply to OTC eligible securities. Under NASD rule 3320, it is the opinion of the NASD staff that any priced order to purchase or sell a security is a firm quote and the member is expected to execute that order at its published quotation size, unless designated as a non-firm quotation by the broker-dealer or by the rules of the quotation system.^{7/}

It is clear that an NASD member publishing a firm quotation in the Pink Sheets who receives a Plink message must honor the quotation for the full displayed size^{8/} unless the market maker either has already revised its quotation prior to receiving the Plink message or the market maker is eligible for the trade ahead exception. To not honor a quote would constitute backing-away and may be considered a violation of NASD rules 2210 and 3320.^{9/} Further, the response

^{7/} 1999 NASD Letter.

^{8/} It should be noted that NASD rule 6750 requires OTC equity market makers functioning on an inter-dealer quotation system that permits quotation updates on a real-time basis (such as the Pink Sheets), to honor those quotations for the minimum size specified in the rule for the particular price level of the market maker's firm quote.

^{9/} See IM-3320 (stating that in some instances a dealer's quotations, purportedly firm, are, in fact, so qualified upon further inquiry as to constitute "backing away" by the quoting dealer. Further, dealers who place quotations in the sheets have been found to be unwilling to make firm bids or offers upon inquiry in such a way

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must be as soon as possible, and in no case more than 30 seconds after receipt of the message.

III. Market Maker's Response when Not Liable

Question: How should an OTC market maker respond to electronic order messages via Plink for which the market maker is no longer liable because it has executed a prior order at the quoted price and size and is in the process of immediately updating the quotation? Should the market maker decline the electronic order message under the stated circumstances? In what time frame should the market maker respond?

As discussed above, NASD rules require that market makers only decline an electronic order via Plink if either the market maker has already revised its quoted price or size prior to the receipt of the Plink message order or if the market maker can take advantage of the trade ahead exception. If either case is true and the market maker is no longer liable, the market maker should immediately decline the Plink order.

You have represented that Plink identifies orders for which a market maker may be responsible for a quote under NASD rules and also identifies to the sender the number of orders to that market maker at that price (*i.e.*, the first order received by a market maker is identified as order 1, the second as order 2, etc.). If Plink accurately reflects the first person to send a Plink message to buy or sell at the market maker's quotation, the market maker must accept quickly the first person's order unless they have effected a trade ahead as discussed in the 1999 NASD Letter. If the market maker wishes to revise its quotation after completing the transaction with the first person, but before responding to the second or later messages, it must do so immediately upon completion of that transaction.

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as to pose a question as to the validity of the quotations originally inserted. Such "backing away" from quotations disrupts the normal operation of the over-the-counter market.)

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Refusal to respond to a Plink message would likely be considered a violation of just and equitable principles of trade. Market makers should immediately decline all orders that they are not required, nor intend, to execute in accordance with their firm quote obligations as stated above.

IV. Books and Records (SEC rules 17a-3 and 17a-4, and NASD rule 3010)

Question: Footnote 1 of the NASD Letter states that “[W]hile members are generally not required to record the contents of oral communications via the telephone, NASD rule 3010 and SEC rules 17a-3 and 17a-4 would likely require recording and preservation of Plink messages.” You have asked us to analyze whether, and if so to what extent, these rules apply to Plink messages.

Whether NASD rule 3010 and SEC rules 17a-3 and 17a-4 require the preservation of Plink messages is not completely clear. Although NASD rule 3010 may not require NASD members to keep records of all Plink messages sent and received, SEC rule 17a-3 requires records of the price and time of all transactions (including those that would be conducted through the use of Plink), and rule 17a-4 may require the retention of Plink messages in their entirety.

NASD rule 3010(d) covers the review and retention of transactions and correspondence (both electronic and non-electronic) relating to a member’s investment banking or securities business.^{10/} For purposes of NASD rule 3010, Plink messages do not fit the definition of correspondence (as they are not communications with customers, only other broker-dealers). Therefore, it is

^{10/} NASD rule 3010(d)(3) requires NASD members to “retain *correspondence* of registered representatives *relating to its investment banking or securities business...*” NASD rule 2210, Communications with the Public, defines the term “correspondence” for purposes of rule 2210 and any interpretation of that rule, as “any written or electronic communication prepared for delivery to a single current or prospective customer, and not for dissemination to multiple customers or the general public.” NASD rule 2210 specifically cross-references the rule 3010(d) for the requirements to review and endorse correspondence.

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questionable whether this Rule applies despite the statement in footnote 1 of the NASD Letter.^{11/}

SEC Rules 17a-3 and 17a-4

SEC rules 17a-3 and 17a-4 may require broker-dealers to keep records of the information contained in Plink messages. In 2001, the SEC adopted amendments to rules 17a-3 and 17a-4 that are effective May 2, 2003.^{12/} The following discussion of these rules discusses both the current and amended versions of these rules and notes any relevant differences.

17a-3(a)

Current and amended SEC rule 17a-3(a)(7)^{13/} requires NASD members to keep “a memorandum of each purchase and sale for the account of the member, broker, or

^{11/} NASD 3010(d)(1) and (2) require NASD members to have procedures for the review of “correspondence of . . . registered representatives with the public.” However, rule 3010(d)(3), regarding the retention of correspondence, drops the phrase “with the public” that is contained in 3010(d) (1) and (2), making it unclear whether the NASD intended to have 3010(d)(3) apply to correspondence beyond that with the public. The absence of this phrase, coupled with the unclear definition of “correspondence” makes it unclear whether NASD rule 3310 requires the retention of Plink messages. Any ambiguity is irrelevant, however, because as discussed below, the SEC’s rules already require broker-dealers to retain price and, to the extent feasible, time of all trades, whether using Plink or otherwise, and may require the retention of all the information in Plink messages.

^{12/} See Release No. 34-44992, 66 F.R. 55818 (Nov. 2, 2001).

^{13/} Current SEC rule 17a-3(a)(7) requires the retention of:

“A memorandum of each purchase and sale for the account of such member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt,

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dealer showing the price and, to the extent feasible, the time of execution.” This means broker-dealers are required to keep a record of all transactions for their own accounts including transactions between broker-dealers consummated through Plink communications. Broker-dealers are already required to comply with this rule, and the fact that firms may be using Plink rather than more

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the terms and conditions of the order, and the account in which it was entered.”

Amended SEC rule 17a-3(a)(7) requires the retention of:

“A memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order *and of any modification thereof*; the account for which it was entered; *the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum need not show the identity of any person other than the associated person responsible for the account who may have entered the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person: in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order with a customer other than a member, broker or dealer entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated.*” (Italics represents new text.)

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traditional forms of communication does not change this requirement. Because broker-dealers already have to retain records of the price and time of all such transactions, we do not foresee any needed changes to firms' internal systems or processes. However, on behalf of its customers, Pink Sheets is permitted to, and intends to offer to, keep such information as a service to its customers.^{14/}

Current and amended SEC rule 17a-3(a)(7) does impose additional record-keeping requirements where a purchase or sale is made on behalf of a customer other than a broker-dealer. However, because Pink Sheets only permits access to broker-dealers and all purchases and sales are between broker-dealers, these additional requirements do not apply to the Pink Sheets.

If a broker-dealer acting as agent sends via Plink a brokerage order for the account of a customer and not on a principal basis, then SEC rule 17a-3(a)(6) regarding customer brokerage order tickets will also apply. As we understand your system, this currently is not the case.

As a last note regarding SEC rule 17a-3, all records required to be made under SEC rule 17a-3(a) (6) and (7) must be preserved for at least three years, the first two years in an accessible place.^{15/}

17a-4(b)

Under current and amended SEC rule 17a-4(b)(4), each NASD member also must preserve all "communications ... relating to its business as such."^{16/} It is unclear

^{14/} See discussion of 17a-4(i), below, regarding the maintenance and preparation of required records by an outside entity (such as Pink Sheets).

^{15/} SEC rule 17a-4(b)(1).

^{16/} Currently, SEC rule 17a-4(b)(4) applies to:

"Originals of all communications received and copies of all communications sent by such member, broker or dealer (including inter-office memoranda and communications) relating to his business as such."

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whether this rule applies to Plink messages. This rule is very broad and ambiguous (in fact, 'communication' is not defined by the SEC), and the SEC may interpret the rule to apply to Plink messages. As discussed below, Pink Sheets is permitted, and intends, to preserve these messages on behalf of broker-dealers in accordance with SEC rule 17a-4(f).

17a-4(f) and 17a-4(i)

Rule 17a-4(f) permits the records required to be maintained and preserved pursuant to SEC rules 17a-3 and 17a-4 to be saved on "micrographic media" or by means of "electronic storage media" that meet the conditions of rule 17a-4(f).^{17/} Third parties such as Pink Sheets are permitted to save these records provided certain requirements are followed.

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As amended effective May 2, 2003, SEC rule 17a-4(b)(4) requires NASD members to preserve for at least three years, the first two years in an accessible place:

"Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public. As used in this paragraph, the term communications includes sales scripts."
(Italics represents new text.)

^{17/} "Micrographic media" means microfilm or microfiche, or any similar medium that meets the applicable conditions set forth in rule 17a-4(f). See SEC rule 17a-4(f)(1)(i). "Electronic storage media" means any digital storage medium or system that meets the applicable conditions set forth in rule 17a-4(f). See SEC rule 17a-4(f)(1)(ii).

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Under 17a-4(f)(3)(vii), the Pink Sheets shall be required to file specific undertakings with a broker-dealer's designated examining authority ("DEA") with respect to such broker-dealer's records that will be stored by Pink Sheets exclusively using electronic storage media. Under SEC rule 17a-4(f)(2)(i), broker-dealers who intend to use electronic storage media shall also notify their DEA prior to use of the electronic storage media. The broker-dealer also shall provide a representation (either directly by the broker-dealer or one from the storage medium vendor or other third party with appropriate expertise) that the selected storage media meets SEC mandated conditions.^{18/}

SEC rule 17a-4(i) requires that if the records required to be maintained and preserved by rules 17a-3 and 17a-4 are prepared or maintained by an outside entity (such as Pink Sheets), such outside entity shall file with the SEC a written undertaking that such records are the property of the member, broker or dealer required to maintain and preserve such records and will be surrendered promptly on request of the member, broker or dealer.

We would be glad to give you further guidance with respect to the specifics of compliance with the filing requirements of SEC rules 17a-4(f) and 17a-4(i) if you so desire.

Conclusion

I hope this letter satisfies your questions. If you would like to discuss our answers or if you have any further questions, please do not hesitate to ask.

Very truly yours,

Neal E. Sullivan

^{18/} See SEC rule 17a-4(f)(2)(ii).