

File 705-3

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

489 SEVENTEENTH STREET N. W. WASHINGTON, D. C. 20006

July 6, 1970

HAND DELIVERED

Mr. Irving M. Pollack, Director  
Division of Trading & Markets  
Securities and Exchange Commission  
500 North Capitol Street  
Washington, D. C. 20549

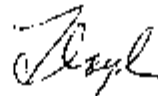
Re: NASDAQ  
Response to Department of Justice Inquiry

*Im*  
Dear Mr. Pollack:

Enclosed is a copy of a proposed response to the inquiry referred to above.

It is our intention to file this response as promptly as possible. We are, of course, quite interested in your comments and would appreciate receiving them as soon as practicable.

Very truly yours,



Lloyd J. Derrickson  
Vice President and General Counsel

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Samuel Z. Gordon, Esq.  
Assistant Chief, Special Trial Section  
Antitrust Division  
United States Department of Justice  
Washington, D. C. 20530Re: File 60-211-0

Dear Sam:

This responds to questions in your letter dated June 4, 1970 addressed to the National Association of Securities Dealers, Inc. ("NASD"). These queries cover, and grow from, NASD's "contract with Bunker-Ramo Corporation whereby the latter will build and operate an Automated Quotations System (NASDAQ) for over-the-counter securities."

I

WHAT IS NASDAQ?  
(Your Question #6)

A brochure prepared by NASD, and distributed May 27, 1968 (Doc. # NASD-1) summed up NASDAQ:

**NASDAQ SUMMARY****WHAT IS NASDAQ?**

NASDAQ stands for NASD Automated Quotations system. It is a system of computers, communications and terminal devices designed primarily to accept and distribute quotations for OTC securities.

NASDAQ is a system designed by the NASD for the needs and requirements of broker-dealers and their employees who are traders or registered representatives.

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**HOW WILL NASDAQ BE USED?**

In the NASDAQ Level 1 service, registered representatives may view a representative quotation for any NASDAQ security on terminals now used for listed stock quotation services. Traders may view the current bid and ask prices entered by all market makers for any NASDAQ security on NASDAQ Level 2 terminals. Market making traders may enter and change quotations for securities in which their firm has been authorized by NASD as a market-maker, and they may view the current bid and ask prices entered by all market makers for any NASDAQ security on NASDAQ Level 3 terminals. Responses to all queries and entries will occur within a

few seconds. NASDAQ will also prepare and distribute quotation and volume information to newspapers.

**WHAT IS A NASDAQ SECURITY?**

A NASDAQ security is one approved by the NASD for quoting in NASDAQ. It is expected that initially this system will include the NASD National List and as soon as possible include regionally quoted securities.

**HOW WILL NASDAQ CHANGE THE TRADING PROCESS?**

NASDAQ should virtually eliminate the need for routine calling of market makers to obtain quotations for information purposes only. However, the present process of negotiated trading will be unchanged.

\* \* \*

**OBJECTIVES OF****NASDAQ**

**A Nationwide  
Automated  
Quotations System  
for the Over-the-  
Counter Market**

After more than three years of intensive study, the NASD has developed the basic specifications for an automated quotations system designed to assist market makers, retail order traders, registered representatives and investors in the over-the-counter market.

• Market makers—will be relieved of answering inquiries for quotations intended for informational purposes only. (The most frequent estimate made by market makers is that they answer 10 quote requests for each call that results in a trade.)

• Retail order traders—will be relieved of making several calls seeking the best market each time a routine order of 100 shares or less must be executed and of having to call market makers to fill requests for information quotations.

• Registered representatives — will have for the first time at their fingertips instantaneous access to current representative bid and asks on a large number of over-the-counter securities, eliminating delays in turning up securities in need of quotation information.

\* \* \*

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## LEVEL 1 SERVICE: FOR REGISTERED REPRESENTATIVES

The Level 1 service will make available to the registered representative a current "representative bid and ask" for each security handled by NASDAQ. It is anticipated that the Level 1 service will be distributed by the present stock quotation services: Bunker-Ramo Corporation, Scanlon Electronics, Inc. and Ultronic Systems, so that the same terminal will be used by the RR to obtain quotation information on both listed and over-the-counter securities. The representative bid-and-ask quotation is determined by NASDAQ on a

moment-to-moment basis by selecting the middle of the range (the median) of the bid prices entered into the system by the registered MMT's for that security, and calculating an ask price based on the representative (median) spread for that security. Each time a MMT changes his quote for a security in the system (using the Level 3 service described below), the NASDAQ computer will re-compute the representative bid-and-ask quotation for that security within five seconds.

\* \* \*

## LEVEL 2 SERVICE: FOR RETAIL TRADERS

The Level 2 service is designed for the RT with an order to execute. Upon request, the Level 2 device will show the RT the current quotes of all the MMT's making a market in the security, obviating the necessity of calling three or more firms for quotes. The RT will then call the MMT of his choice to negotiate the trade using communications facilities of his choice.

The Level 2 service will be provided through desk-top inquiry devices connected directly to the NASDAQ computer. These units will be especially designed for the purpose, and will be provided and serviced by the NASDAQ operator. The service will be approximately as follows:

The subscriber depresses keys for the four-letter security abbreviation. He then depresses either a "bid" or "ask" key, depending on whether he wishes to sell or buy. The inquiry

unit then presents a display of the following form:

ABCO	17 $\frac{1}{4}$ -18 $\frac{1}{4}$
B MLPFS	17 $\frac{3}{8}$ -18 $\frac{3}{8}$
NYHAN	17 $\frac{1}{8}$ -18 $\frac{1}{4}$
JBMAG	17 $\frac{3}{4}$ -18 $\frac{1}{4}$
TRSN	17 $\frac{3}{4}$ -18 $\frac{1}{8}$
GREGO	17 $\frac{3}{4}$ -18 $\frac{1}{4}$ M

The first line shows the representative bid-and-ask quotation currently being distributed by the Level 1 service. The symbol "B" at the beginning of the second line means "bid", showing the trader depressed the "bid" key, causing the highest bid quotes to be ranked in descending order. If the trader had depressed the "ask" key, the lowest offer quotes would be ranked in ascending order. (When several market makers have entered the same bid, the quotes will be shown in the order received, with the first highest. The sec-

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and through the sixth lines show the MMT's quotes, each consisting of five letters identifying the firm, followed by its current quotation (bid and ask). The numbers of markets shown on the device may be fewer or more than five, depending on the capability of the particular device used by the system operator and the number of markets in the computer.

If more than five market makers have entered quotes for this security, the symbol "M" ("more") is displayed at the end of the sixth line. The inquiry device has a key labeled "more". If the trader depresses a "more" key, the

next five (or fewer) markets will be shown, still in order of descending bid or ascending ask, as originally requested, and the process may be repeated until all of the markets are shown.

The Level 2 service should virtually eliminate burdensome, routine quote request calls from RT's to MMT's, making quotes easier and much faster to obtain than at present. Most calls between RT's and MMT's should then be made to negotiate a trade

\* \* \*

### LEVEL 3 SERVICE: FOR MARKET MARKETING TRADERS

The Level 3 service is designed for the MMT. It provides for entering the MMT's own quotes into the system in addition to providing the same displays as the Level 2 service. Because market making firms differ widely in size and method of operation, the Level 3 service will be offered in several forms, but each will give the same information services.

The Level 3 service inquiry devices offered will be the same as for Level 2: a television type desktop unit, or a teletypewriter at lower cost, but markets may be entered on the keyboard of either device. To enter a market, the MMT (or his assistant) will depress keys to identify the security and enter bid and ask prices. The system will automatically provide the firm's name abbreviation because it knows which device sent the message and will update his quotes within three seconds. "Short cut" keys will facilitate

changing a market already in the system, without the necessity of re-entering all the information.

If a market making firm with a number of traders chooses to enter all its markets and quote changes from a central point, a suitable device will be provided. It may take the form of a reader for cards that show the security identifier and bid and ask prices by pencil marks; these cards might be very like those now used to send markets to the "pink sheets". If cards are pre-prepared by security, the process of marking the new price and inserting the card in the reader is rapid and simple. It is anticipated that the system operator and NASD will consult with individual market making firms to develop optional devices both for entering markets and for displaying information in convenient and economical form.

\* \* \*

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## II

THE "BACKGROUND" FOR NASDAQ "AND THE NEEDS  
AND PURPOSES IT IS DESIGNED TO SERVE"

(Your Question #1)

1. NASDAQ may be gauged only in the context of the NASD's history and regulatory function. The NASD is a "national securities association" established and "registered" some three decades ago pursuant to the Maloney Act (which added section 15A to the Securities Exchange Act, 15 U.S.C.A. § 78o-3 (1963 and Supp. 1968)) in order "[t]o provide ... a mechanism of regulation among over-the-counter brokers and dealers ... [and] to prevent acts and practices inconsistent with just and equitable principles of trade...." 52 Stat. 1070. NASD's "membership" today "includes virtually all broker-dealers engaged in a general securities business...." REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, at 603 (1963) [hereafter called SEC Special Study].

Thus today, as since its founding, NASD "is ... primarily engaged in regulatory activities" with primary responsibility [that] relates to the over-the-counter markets." Id. at 603. Congress's continuing preference for this self-regulating scheme was made clear in a Report of the Senate Banking and Currency Committee (S. REP. NO. 379, 88th Cong., 1st Sess. 42 (1963)):

"A significant part of the regulation of the securities markets provided in the Securities Exchange Act is based upon the concept of self-regulation by industry organizations, under the supervision of the Commission. This philosophy was notably reaffirmed in 1938, when Congress enacted section 15A of the act. This extensive reliance on self-regulation rests on two principal premises: first, it provides an alternative to a much more pervasive direct regulation by the Government, which would be expensive to the taxpayers and burdensome to the industry, and it also provides a more sensitive and effective device for regulation in the area of unethical as distinct from illegal conduct. The Report of the Special Study has recommended that the responsibilities of self-regulatory agencies be substantially expanded and that their self-regulation be made more vigorous and effective. These recommendations thus contemplate an even greater degree of reliance upon self-regulation, although under somewhat more intensive Commission supervision...."

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2. Against this background of NASD's regulatory responsibility, in 1963 the SEC Special Study (pt. 2 at 656) heralded the entry of automation, then in "primary use ... in regard to listed securities," into over-the-counter markets, too. With automation, market makers "could enter quotations ... into a central computer for indexing under the appropriate security," while broker-dealers interested in trading "could interrogate the computer to determine the highest bid and lowest offer, selected by the computer." Id., pt. 2 at 657. Other advantages could stem from automation, too, such as the "compilation of complete data relating to quotations and transactions." Id., pt. 2 at 658.

And the SEC Special Study concluded (pt. 2 at p. 678):

"... Any such automated system would clearly be affected with a public interest and should be under regulatory supervision. The NASD is the natural source of leadership and initiative in dealing with matters of automation in respect of over-the-counter markets. It should actively carry forward the very limited study of automation possibilities applicable to over-the-counter markets that the Special Study has been able to undertake and should report to the Commission from time to time as to the progress and programs of the industry in this area. The Commission and the NASD should jointly consider possibilities for developing and coordinating automation programs in such manner as to fulfill their respective regulatory needs, as well as operational needs of the markets, with maximum effectiveness and minimum duplication and expense."

3. Following the SEC's Special Study, Congress acted to "clarify the authority" of NASD "and further impose on ... [it] a responsibility to act." Report of the Senate Banking and Currency Committee (S. REP. NO. 379, 88th Cong., 1st Sess. 42 (1963)). The Securities Acts Amendments of 1964 added section 15A(b)(12) to the Exchange Act, specifying that NASD may not remain "registered as a national securities association unless it appears to the Commission that ..."

"the rules of the association include provisions governing the form and content of the quotations relating to securities sold otherwise than on a national securities exchange.... Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations." (Emphasis supplied.)

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4. Soon after, the NASD formed a special Committee on Automated Quotations (the "Committee"), composed of representatives from a broad cross section of firms-- wire houses, professional trading firms, and smaller firms involved in both market making and retailing of OTC securities. In the words of its July 20, 1965 press release, the Committee was formed "to study the possibility of automated quotations in the OTC market."

"NASD President, Robert W. Haack, who is also a member of the committee, stated that it was the goal of the Association to develop criteria for a quotations system that would help in the dissemination of information for both investors and dealers, and, at the same time, improve the mechanics of the over-the-counter market."

A. From the very inception of the Committee, the Securities and Exchange Commission played an active role in its deliberations. Though NASD's files appear far from complete on this score, they do reflect, for example, a meeting with the Commission staff on December 9, 1965 where "Mr. Pollack stressed that the SEC staff was most interested in seeing an automated quotations system established and stood ready to help in the development of such a system wherever possible." See Docs. # NASD-2-4, particularly # 3, at p. 4. These contacts by the Committee, as well as various NASD officials, remained constant and involved pervasive consideration of, and comment upon, principal facets of NASDAQ's projected operations by the Commission. See, e.g., Docs. # NASD-2 ~ NASD-73. The upshot is that the NASDAQ system, as it has finally emerged, appears to contain no significant feature to which the Commission, following discussion and consideration, has persisted in objection.

B. The Committee also maintained contact with major electronic equipment manufacturers, feeling that it "would learn more from several exchanges of correspondence with the suppliers than we would if we sat back until we thought we had all the possibilities exhausted."\*

\* Memorandum, dated March 30, 1966, from Marc A. White (an NASD staff Official) to Committee Members, Messrs. Allan C. Fustis, Jr., Robert M. Gardiner, and Robert W. Haack, entitled "Meeting with representatives of Scantlin Electronics." Doc. # NASD-75.



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Seeking to take advantage of potential suppliers' expertise in order to develop the best system, the Committee consulted with representatives of six equipment manufacturers--Ultronic Systems Corp., Scantlin Electronics, Inc., The Bunker-Ramo Corporation, Data Network Corporation, OTC Trading Corp., and The Western Union Telegraph Co., each of which demonstrated its automated quotations system. Later, on April 13, 1966, the Committee met "to draft a specification letter to be sent to all interested vendors. This letter [was] purposely broad in scope in order to allow the vendors sufficient flexibility to develop a system to meet [the NASD's] needs."\*

C. At the same time, the Committee recognized the importance of securing disinterested advice, advice from other than a potential supplier. Thus representatives of the Committee approached both Booz, Allen & Hamilton, Inc. and Arthur D. Little, Inc. to obtain their preliminary views on such an undertaking. Proposals for advice were sought from both (See Docs. # NASD-76 - 77), and evaluated. See Doc. # NASD-78. Following this analysis, in July 1967 NASD retained Arthur D. Little, Inc. "to undertake a study to determine the technical and economic feasibility of establishing a nationwide automated quotations system for the over-the-counter securities market."\*\*

The study was conducted in two phases, as follows:

"In Phase I we [Arthur D. Little] developed an initial system concept for an automated quotations service, ascertained the rough costs of providing the service, and determined that the proposed system was technically feasible. Our initial system design was based on our analysis of information contained in earlier proposals for over-the-counter quotations systems, interviews of selected securities firms, and other existing data about the

\* Doc. # NASD-74, Memorandum, dated April 14, 1966, from Paul F. Murray (of NASD's staff) to Robert W. Haack, then NASD's President, entitled "Notes on the Automation Committee Meeting held on April 13, 1966" at p. 1.

\*\*Doc. # NASD-56, Affidavit of Arthur D. Little's Mr. Thorpe Wright, sworn to January 21, 1969, at p. 1.

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operation of the over-the-counter market. We considered a number of alternative systems and selected the most likely one for further testing in Phase II. We next determined that the system we had chosen was technically feasible. We then developed rough cost estimates for providing the service, to which we added an amount for profit to determine estimated rates for the service.

"In Phase II we tested our initial set of system services and rates on a representative set of NASD member firms. We carefully selected 34 firms representative of various types of businesses in the over-the-counter market and representative geographically. Interviews with these firms were conducted in depth. In general, we covered the following major areas: general company information (information about the type business done by the firm), key operating statistics (such as number of markets made and volume of trades), present communications and data processing services, and the firm's reactions to the proposed NASD system services and costs, and the firm's reactions to specific problem areas of interest (principally the firm's reactions to proposed rules to support the system).

"We concluded in November 1967, upon completion of the study, that an automated system for the over-the-counter market was feasible and we so advised NASD."\*

III

THE PROCESS FOR SELECTION OF THE NASDAQ OPERATOR  
(Your Question #2)

In view of A. D. Little's conclusion that an automated quotation system was feasible, NASD's Board of Governors, upon the recommendation of the Automation

\* Doc. # NASD-56, Affidavit of Arthur D. Little's Mr. Thorpe Wright, sworn to January 23, 1969, at p. 1.

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Committee, proceeded to solicit bids on what was to become NASDAQ. And Arthur D. Little was asked to prepare a request for proposal ("RFP") for presentation to potential system operators.

As a first step, a preliminary draft RFP was circulated for comment to all electronics systems companies which had expressed any interest in the project. By the time of the February 19th meeting of the Committee, it was clear that the response was not happy:

"With regard to pretest results, it was stated that the general reaction to the RFP draft was discouraging. Specifically Data Network seemed to be interested, but it was not apparent that they could handle the system. Scantlin gave the impression that the approach was too structured for them. They were generally hostile and felt that the RFP was slanted to a common carrier. It was not clear that they could or would want to handle the system. Western Union was at first negative but, after discussions of certain compromises, seemed very interested. Bunker-Ramo also was initially negative but seemed very interested after discussing certain compromises. Both Bunker-Ramo and Western Union looked to be able to handle the system. Telemart looks 'out of it.'" Doc. # NASD-27, at p. 1.

Thereafter, NASD modified the RFP. See Doc. # NASD-35. While maintaining its position "that the system operator alone will be responsible for the establishment and operation of the NASDAQ system,"\* the RFP, as finalized, provided:

"Specifically ... that service must be provided under reasonable, uniform and non-discriminatory charges regardless of size of firm and of geographic location within the continental United States, that the initial charges should be based upon anticipated third year operations and at a level which would allow the system operator an opportunity to earn a fair profit commensurate with the risks involved, that the charges would be subject to review annually by NASD after two years of operation, and that the charges after

\* Doc. # NASD-79, RFP, at p. 4.

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such review would ultimately be determined by NASD (subject to SEC disapproval). Further, the operator was to be obliged to keep accounts specified by NASD in order to assure that the periodic reviews of the charges would be effective.\*\*

Equally important, the RFP itself specified (at p. 35):

"NASDAQ subscriber terminals (Levels 2 and 3), those interfacing directly with the NASDAQ central processor complex, shall be designed if necessary, furnished, installed and maintained by the NASDAQ system operator." Similarly, see, pp. 19-21.

In this form the "RFP was publicly distributed in February 1968 to all companies which NASD could determine might be interested in studying the proposal and submitting bids."\*\* And, on February 19, 1968, NASD's request for bids was carried in The Wall Street Journal:

## *NASD Will Accept Bids From Suppliers to Make Automatic Quote System*

From WALL STREET JOURNAL Staff Report

WASHINGTON The National Association of Securities Dealers formally announced it will accept bids from potential suppliers for an automated quotation system for over-the-counter securities.

It had recently been disclosed by industry sources that the NASD, which polices the over-the-counter market, had found such a system technically and economically feasible after a one-year study.

\* Doc. # NASD-55, Affidavit of Richard B. Walbert, President, NASD, sworn to January 22, 1969, at p. 1.

\*\*Id.

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Using present desk-top interrogation devices, the system would provide brokers, dealers and the public with market data on some 1,500 to 2,000 actively traded over-the-counter stocks. Eventually, it's expected that the system will be enlarged to include more of the 20,000 regularly traded unlisted issues.

Once the RFP had been distributed, the NASD scheduled a conference for April 8 with all organizations interested in submitting proposals to provide them an opportunity to ask questions about the RFP. Several concerns wrote back immediately, saying they planned to attend the conference, some appended detailed questions on the RFP showing apparent close interest in it, others made no response at all. In the end, 48 people attended the conference, representing 36 companies. See, e.g., Doc. # NASD-35.

During the period between the proposal invitation and the bidders' conference

"[NASD] answered many questions posed by the potential bidders. These questions taken with those submitted at the conference demonstrated that most potential bidders would have been more interested in designing and operating a system which would be either under contract directly to NASD with little financial risk or completely free of NASD regulation. The approach decided upon, regulation of a non-affiliated private enterprise by a private association assigned regular duties by statute and subject to SEC regulation, is a new dimension in our society and apparently many firms did not find it palatable."\*

Any firm desiring to submit a proposal was permitted to do so. Doc. # NASD-80, at p. 1. Interested companies were initially given until June 3 to submit proposals in response to the RFP. During the period between the bidders' conference and the proposal submission date

\* Doc. # NASD-51, Proposed final draft of Report Prepared by Arthur D. Little for NASD, December 1968, at p. 2.

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"[NASD] briefed several firms on the results of our market projections and explained other data contained in the RFP, including our rate estimates and development estimates, as directed by the Automation Committee.\*"

However, extension of the bidding deadline was to prove of little avail:

"In the week before the new June 17 deadline, it became clear that the field was narrowing down to two bidders, ITT and Bunker-Ramo. Nearly all of the others we had been in contact with dropped out. These included Philco-Ford, Computer Sciences Corporation, GE, Auerbach, Bonner-Moore and SBC (Service Bureau Corporation, a wholly owned subsidiary of IBM). However, on Thursday, June 13, two working days before the proposals were due, SBC formally requested a two-week postponement in order to submit a proposal (they had gotten involved late in the proceedings). NASD, ADL and John Miller agreed to grant a one-week extension (we were anxious to receive a proposal from them), making the new deadline June 24. By the following Monday, (June 17), SBC realized they would not be able to submit a proposal after all and dropped out. Having just announced the one-week delay to the others, we did not feel we were in a position to request that proposals come in before the new deadline. The net of this was to lose a week when it hurt most and, I might add, for no good reason.\*\*"

## IV

BUNKER-RAMO: THE SOLE RESPONSIVE BIDDER  
(Your Questions #3, 4, and 5)

All-in-all, only two companies submitted any proposal that might by any stretch be deemed a "bid"--The

\* Doc. # NASD-52, Proposed final draft of Report Prepared by Arthur D. Little for NASD, dated December 1968, at p. 2.

\*\* Doc. # NASD-81, Chronology of Events Concerning the Submission and Evaluation of NASDAQ Proposals, dated June 28, 1968, at p. 2.

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Bunker-Ramo Corporation\* and ITT Data Service.\*\* See Doc. # NASD-52, at p. 1 and NASD-81, at p. 2. But ITT's "proposal" was hardly responsive to the RFP. In A. D. Little's words, that "proposal indicated that at least a portion of the NASDAQ system start-up costs should be borne by NASD, but no specific plan for sharing these costs was advanced. This was not in accordance with the intent of the RFP which stated

'The system operator will assume all financial liabilities arising from establishment ... of the NASDAQ system....' Doc. # NASD-52, at p. 4.

In any event, ITT made no firm offer: ITT took pains to point out that

"... notwithstanding anything herein or in the RFP to the contrary, this submission is not a firm offer by ITT Data Services...." Doc. # NASD-82, covering letter. (Emphasis added.)

It was against this background that A. D. Little advised, and NASD concluded,

"... that the B-R proposal was superior in business arrangement, technical approach and company qualifications...." Doc. # NASD-52, at p. 3.

The Bunker-Ramo proposal is submitted herewith, marked Docs. # NASD-83 and 83A. And a copy of "the contract entered into by NASD and Bunker-Ramo," as your Question 5 requests, is submitted, marked Doc. # NASD-84.

V

WHY IS BUNKER-RAMO "TO BE THE EXCLUSIVE SUPPLIER  
OF LEVELS 2 AND 3 SERVICE AND  
ASSOCIATED DESK TOP TERMINALS...."?  
(Your Question #7)

1. In point at the outset, just what does the NASD-Bunker contract provide on this score?

\* Business and Industrial Division, 445 Fairfield Avenue, Stamford, Connecticut, 06904.

\*\*A Division of International Telephone & Telegraph Corp., P. O. Box 402, Route 17 and Garden State Parkway, Paramus, N. J. 07652.

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A. Bunker-Ramo's obligations: Bunker-Ramo is obliged to

"Undertake with due diligence, and at its own expense, to design, organize, furnish, install, test, make operational, operate and maintain Phase I of the NASDAQ system ... [and] to use its best efforts to place such system in operation on or before January 1, 1971...."\*

Most important, Bunker-Ramo must

"Assume all the costs, expenses and financial commitments arising from the establishment and operation of the NASDAQ system (other than those costs heretofore or hereafter voluntarily incurred by NASD) including, but not limited to, purchases, leases, salaries, fees, taxes, and uncollectables." Doc. # NASD-84, at p. 8.

Specifically with regard to Level 2, Appendix A to the Operating Agreement makes clear that "This service shall be made available through CRT terminals furnished by Operator ...." Doc. # NASD-84, Appendix A, at p. 3. Similarly for Level 3, such service is to "be made available to approved subscribers through terminals furnished by Operator ...." Doc. # NASD-84, Appendix A, at p. 6. Finally, Bunker-Ramo is required to "Provide Level 2 and 3 services to approved subscribers in areas of the 48 contiguous states of the United States covered by charges

\* Doc. # NASD-84, at p. 5. Beyond Phase I, Bunker-Ramo is required to "Undertake with due diligence, and at its own expense, to study and discuss with representatives of NASD the feasibility of undertaking the other developments of the NASDAQ system specified in Section 9 of Appendix A ... and, upon NASD's written request, undertake to design, organize, install, operate and maintain each such subsequent development unless Operator can demonstrate to NASD's satisfaction that the requested system development is not economically feasible, in which event Operator shall not be obliged to undertake the expansion unless NASD provides the means to make it feasible, where appropriate, a return equal to that allowed for rate review purposes under paragraph 5 of Article V." Id.



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published by NASD who are approved by NASD to receive such service." Doc. # NASD-84, at p. 6.\*

B. As far as NASD is concerned, the Operating Agreement makes clear that "NASDAQ" is a trademark, tradename and service mark of NASD. Doc. # NASD-84, at p. 3. However, Bunker-Ramo is granted an exclusive right to use such trademark within the United States, and for the duration of the Operating Agreement.\*\* Finally, NASD obliged itself to "Refrain from sponsoring any other automated quotations system offering service to NASD's general membership during the primary term of this Agreement, or any extension thereof pursuant to the terms of paragraph 1 of Article VI below." Doc. # NASD-84, at p. 14.

C. As for the Operating Agreement's duration, the contract has "a primary term extending from the date first set out above through December 31, 1975, or five years after the date on which NASDAQ services commence, whichever is later ...." Doc. # NASD-84, at p. 27. In the event of termination, Bunker-Ramo would be required to

"convey, transfer, assign and license to NASD all NASDAQ facilities including terminals, and technology, designated by NASD as required for continued operation of the NASDAQ system. In the event the central processing complex units are owned by Operator on the termination date, such units shall remain the property of Operator. Upon completion of these measures, NASD shall pay Operator an amount equal to Operator's undepreciated investment in the NASDAQ system as of the termination date, excluding the central processing complex units and profits on company-produced equipment, as shown in the accounts kept by Operator pursuant to subparagraph 1(i) of Article II above, plus the reasonable actual cost to Operator of transferring such data and the system to NASD or its designee." Doc. # NASD-84, at p. 28.

\* As a corollary, Bunker-Ramo must "Refrain from using the NASDAQ system for any purpose not specifically authorized by NASD in writing and, if so authorized, provide such service subject to NASD's regulation as provided herein." Doc. # NASD-84, at p. 9.

\*\*License Agreement at pp. 1 and 3, annexed to Doc. # NASD-84.

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2. Most significant in determining both the RFP and the resultant Bunker-Ramo contract were difficulties NASDAQ apparently faced in getting off the ground and, in light of such difficulties, the reluctance of any supplier to commit itself.

A. Difficulties NASDAQ apparently faced:

"Unlike the markets which are made on the organized securities exchanges, the over-the-counter (OTC) market is widely disbursed geographically. This fact has led to the growth of a complex, unplanned communications network among brokers and dealers in OTC securities, through which information is obtained and business is conducted ... Also, the absence of a central point through which information flows has made it difficult, if not impossible, to obtain an accurate picture of the prices and volumes of trading of the securities handled in the OTC market." Doc. # NASD-77, at p. 1.

In its Special Study, the SEC found that:

"In general, over-the-counter trading tends to be governed by informal codes of conduct and practices evolving out of the workings of the markets themselves--in contrast with the major exchange markets where trading is carried on in a marketplace during fixed trading hours by members subject to detailed trading rules." SEC Special Study, pt. 2 at p. 552.

"Because there is no central location where public orders can be collected, matched and executed, the wholesale dealer is the key firm in the over-the-counter markets." Id., at p. 554.

What was the attitude of the broker-dealer, in 1968, toward the establishment of an automated quotation system for the OTC market? At best the broker-dealer was indifferent and at worst hostile: "people are reluctant to cooperate in the development of any program of automation when they are in fear of losing their jobs." Doc. # NASD-3, at p. 1. Indeed, as late as July 29, 1969,

"ten representatives of some of the major trading firms in Wall Street met to discuss the proposed NASDAQ system ... The objective of this group or association of major market makers, would be to urge people that are concerned about

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this system not to subscribe at this juncture....\*\*  
 Doc. # NASD-87. See also Docs. # NASD-85 and 86.

Apart from broker-dealer reluctance, no current statistics on the potential for an automated quotations system were available. To aid prospective proposers in making an intelligent evaluation, NASD commissioned Arthur D. Little to survey six categories of firms participating in the OTC market. In-depth interviews were held during the late summer of 1967; however, the formal results of the survey were not published until May 10, 1968--more than a month after the bidders' conference was held. Even then, the survey did not give much comfort to the prospective bidder.

"Not all firms in the market making field are particularly anxious to have market maker's quotes displayed for traders in retail houses and for other market makers. Opposition to Levels 2 and 3 tended to be strongest among the wirehouses ... Some people fear that Level 2 and 3 displays will lead to a dangerous narrowing of spreads, but there appears to be no definite evidence one way or the other in this regard--and there is a body of opinion that says that spreads will temporarily narrow and then stabilize again ... while, of course, there is another body of opinion that feels that Levels 2 and 3 will definitely lead to a heavy degree of attrition among market makers. 'Quote competition' resulting from the 'nakedness' of the market maker's quotes on Levels 2 and 3 has also been brought up as possible danger by a number of market makers ...." Doc. # NASD-88, at p. 63.

Notwithstanding the plethora of uncertainties facing the prospective system operator, the only aid NASD was willing to offer was to agree that it "will not sponsor another NASDAQ system providing service to NASD's general membership." Doc. # NASD-79, at p. 3. Yet, as pointed out in the RFP:

\* Any revolt of major market makers would likely spell disaster due to the "high concentration of over-the-counter business within a few large firms. Fifty-six broker-dealers, or less than 2 percent of the total number, accounted for half the dollar volume of over-the-counter sales ... in 1961." SEC Special Study, pt. 2 at p. 548.

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"The service provided by NASDAQ shall be considered to be an NASD service rather than a service of the selected firm (the system operator), as is suggested by the name of the service (NASDAQ). Further, the responsibility for all policy matters concerning the service, as well as ownership of the information contained within the system, will be retained by NASD." Id.

And, as we have seen, the system operator was required to bear the entire financial burden of setting up the system even though NASD retained the right to set the monthly charges to its members for the service as well as fix the rate of return for the system operator--all under a contract with a term limited to but five years.

B. The Reluctance of Potential Suppliers:  
As the Wall Street Journal reported, on February 6, 1968:

"Industry sources say some suppliers familiar with the system's specifications have shown reservations both about this arrangement and the fact that the NASD doesn't plan to offer any financial support. Sources say some potential suppliers believe that the NASD in effect is requiring the ultimate operator to lose money in the operation's early years and then cede the rate-making responsibility to the NASD, which would then oversee the operation as if it were a public utility.

"It's expected that some potential suppliers, therefore, will ask the NASD for a promise of financial support and, as a means of gaining more security, seek a longer contract to operate the system."

Anticipated difficulties became real problems. The comments of Clarence Armenaki of Computer Sciences Corporation were typical:

"He said that in general they felt there was not enough profit potential in the system, based on the seven-year contract. They were also quite concerned about the possibility of losing the system at the end of seven years. He showed us their cost and revenue presentations which indicated at one point a cumulative

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cash flow deficit of \$3.8 million and also indicated a positive cumulative cash flow of only \$2.3 million at the end of seven years. He indicated that they had conversations with Ultronic [sic], Scantlin and Bunker Ramo [sic] and that Ultronic [sic] and Scantlin were very negative and were not going to bid." Doc. # NASD-89, at p. 1.

The upshot was that, only Bunker-Ramo submitted a proposal responsive to the RFP. In light of the obvious problems and serious risks involved in the establishment of NASDAQ, all concerned agreed that the system operator is entitled "to exclusivity and fair and equitable compensation." Doc. # NASD-90, at p. 2. This seemed reasonable in light of the market conditions against which the system operator was expected to bid, the risks he must bear, and the pressing public need to implement the system as soon as possible.

## VI

NASDAQ, "THE SECURITIES ACTS" AND  
THE SEC'S ROLE  
(Your Question #8)

1. Initially, NASDAQ is the vehicle for providing, as the Congress specified, "orderly procedures for collecting and publishing quotations." Exchange Act, § 15A(b)(12). But NASDAQ is more than a simple response to that statutory demand: it fits the broader regulatory framework put together by Congress and the Commission. For example, the largest group of securities to be qualified for the System are those required to be registered under section 12(b)(1) of the 1934 Act. Since each of these is held by 500 or more persons, Congress thought they had a sufficient public trading interest to be put "on the same regulatory level as listed securities so far as the registration, reporting, proxy and insider-trading provisions ... (the disclosure oriented provisions) are concerned." V. L. LOSS, SECURITIES REGULATION 2712 (Supp. 1969). And NASD's gathering and dissemination of current data on trading done via NASDAQ should dovetail with federally required disclosure provisions to help promote a fair and informed over-the-counter market. Even now the NASD is working with the Commission to devise regulations appropriate for SEC adoption to require issuers of

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will be the operator of the NASDAQ System." Id. The method of selecting the systems operator and indeed the RFP itself had been discussed with the SEC staff, for example during January 1968.

Yet, the Rule--focusing on problems of limitation of access to the system--left undisturbed the terms on which the NASD had chosen Bunker-Ramo to serve as the system operator. In material part, the Rule requires that:

"[NASD's] rules shall also provide a fair and orderly procedure with respect to the determination of whether any customer or issuer or broker or dealer may be excluded or limited in respect of requested access to such system (of securities quotations) . . . ." (Emphasis supplied.)

Approval by the SEC of each key NASDAQ step was deemed important not only by NASD but also to potential system operators:

"The attitude of the SEC with regard to the functional specifications of NASDAQ is also of vital concern to the organizations that are now considering whether they should submit a bid to the Association to operate the system. Bidders will be offering to commit an estimated eight to ten million dollar investment into the system. Their willingness to risk this capital will be based on the NASD's projections in the RFP as well as their own assessment of the number of firms that will subscribe. Most of the potential bidders, as well as the NASD, are well aware that the threat of a change in any one of the key specifications . . . can drastically change the marketability of the system." Doc. # NASD-30, at p. 3.

3. Beyond informal consultation, the SEC has formally considered and passed upon key NASD strictures that bear on NASDAQ. The Securities Acts Amendments of 1964 specified, bear in mind, that NASD may not remain "registered as a national securities association unless it appears to the Commission that" NASD has designed rules "to promote orderly procedures for collecting and publishing quotations." In compliance with this statutory mandate, NASD promulgated Article XVI to its By-Laws, and Schedule D specifying NASDAQ's governing rules.

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Procedurally, section 15A(j) of the 1934 Act requires that NASD

"shall file with the Commission . . . any changes in or additions to the rules of the association . . . . Any change in or addition to the rules . . . shall take effect upon the thirtieth day after the filing of a copy thereof with the Commission . . . unless the Commission shall enter an order disapproving such change or addition; and the Commission shall enter such an order unless such change or addition appears to the Commission to be consistent with the requirements of . . . [the registration provisions]."

In accordance with these provisions, and following consultations with the Commission, NASD filed its By-Law Article XVI and Schedule D and requested acceleration of effectiveness to cut down the thirty-day period. By letter of January 8, 1969 addressed to Mr. Richard B. Walbert, NASD President, Irving M. Pollack, Director of the SEC's Division of Trading and Markets, advised that:

"This is with reference to the various amendments to the by-laws of the Association and new Schedule D, adoption of which has been authorized by the NASD Board of Governors upon effectiveness of the by-law amendments and adoption of Rule 15Aj-2 under the Exchange Act, which have been filed by the Association with the Commission pursuant to SECTION 15A(j) of the Act.

"The Commission considered the proposed by-law amendments and Schedule D on December 16, 1968 and found them to be consistent with applicable requirements of the Act and authorized acceleration of their effective date in accordance with your request. The Commission has also determined that these rule changes would be consistent with the requirements of Rule 15Aj-2 previously adopted on December 16, 1968."

Similarly, separate amendments to Article XVI and Schedule D were filed on April 4 and October 3, 1969 and NASD was advised that the amendments were considered by the Commission on April 14 and October 15, respectively, that they were found consistent with the Act, and that their effectiveness was accelerated as requested. (Another amendment was filed June 5, 1970; as of this writing, no notice has yet been received as to Commission action.)

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4. All these factors bear on application here of the Exchange Act's section 15(a)(n)--the so-called Maloney Act under which the NASD functions:

"If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provision of this section shall prevail."

VII

OTHER DOCUMENTS

Finally, in response to your Question #9, enclosed are Docs. # NASD- through , which together with other documents previously referred to, should comprise papers called for from NASD.

Very sincerely,



NARA-CP

RG 266 UD-UP Entry 1

Subj, Files 34-81

Box 71 "Folder "National Association of Securities Dealers v. 16"