

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54650; File No. SR-NASD-2004-130)

October 25, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Relating to Amendments to Rule 2320(g) (Three Quote Rule) and Corresponding Recordkeeping Requirements under Rule 3110(b)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 27, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On May 8, 2006, NASD filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On October 19, 2006, NASD filed Amendment No. 2 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend Rule 2320(g) (“Three Quote Rule”) and the corresponding recordkeeping requirements under Rule 3110(b) to exclude from the Three Quote Rule’s coverage transactions in foreign securities of a foreign issuer that are part of the FTSE All-World Index.

Below is the text of the proposed rule change. Proposed new language is underlined:

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 replaced and superceded in its entirety the text of the original filing.

<sup>4</sup> Amendment No. 2 replaced and superceded in its entirety the text of the original filing, as amended.

proposed deletions are in brackets.

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## **2320. Best Execution and Interpositioning**

(a) through (f) No Change.

(g) (1) Except as provided in subparagraph (3) below, [Unless two or more priced quotations for a non-exchange-listed security (as defined in the Rule 6600 Series) are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis,] in any transaction for or with a customer pertaining to the execution of an order in a non-exchange-listed security (as defined in the Rule 6600 Series), a member or person associated with a member shall contact and obtain quotations from three dealers (or all dealers if three or less) to determine the best inter-dealer market for the subject security.

(2) No Change.

(3) The requirements described in subparagraph (1) above shall not apply:

(A) when two or more priced quotations for a non-exchange-listed security are displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis; or

(B) to any transaction pertaining to the execution of an order in a non-exchange-listed security of a foreign issuer that is part of the FTSE All-World Index if such transaction is executed during the regular business hours of the foreign market for the foreign security and no trading halt or other similar trading or quoting restriction is in effect in any foreign market on which such foreign security is listed.

(4) Definitions

For purposes of this paragraph (g): [,]

(A) T[t]he term “inter-dealer quotation system” means any system of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers.

(B) [(4) For purposes of this paragraph,] T[t]he term “quotation medium” means any inter-dealer quotation system or any publication or electronic communications network or other device that is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.

(5) No Change.

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**3110. Books and Records**

(a) No Change.

**(b) Marking of Customer Order Tickets**

A person associated with a member shall indicate on the memorandum for each transaction in a non-exchange-listed security, as that term is defined in the Rule 6600 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market; however, the requirements of this subparagraph shall not apply if the member can establish and has documented that:

(1) two or more priced quotations for the security are displayed in an inter-dealer quotation system, as defined in Rule 2320(g), that permits quotation updates on a real-

time basis for which NASD [Regulation] has access to historical quotation information;  
or

(2) the transaction is effected in compliance with Rule 2320(g)(3)(B).

(c) through (j) No Change.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Rule Filing History

On August 27, 2004, NASD filed with the Commission proposed rule change SR-NASD-2004-130, proposing amendments to Rule 2320(g) and Rule 3110(b) to exclude from the Three Quote Rule's coverage transactions in foreign securities of a foreign issuer that are part of the FTSE World Index. On May 8, 2006, NASD filed Amendment No. 1 to change the proposed exclusion from the Three Quote Rule's coverage transactions in foreign securities of a foreign issuer that are part of the FTSE All-World Index, rather than the FTSE World Index.<sup>5</sup>

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<sup>5</sup> The FTSE World Index is a sub-set of the FTSE All-World Index. The list of securities that comprise the FTSE All-World Index are substantially similar to the list of securities that comprise the FTSE World Index. The key difference is that the FTSE All-World Index is comprised of securities from Developed, Advanced Emerging and Secondary

On June 30, 2006, the Commission approved SR-NASD-2005-087, which amended certain NASD rules to reflect the separation of Nasdaq from NASD upon the operation of the Nasdaq Exchange as a national securities exchange.<sup>6</sup> Among other amendments, SR-NASD-2005-087 amended Rules 2320(g) and 3110(b) to replace the term “non-Nasdaq securities” with “non-exchange-listed securities.” SR-NASD-2005-087 became effective on August 1, 2006, the date upon which Nasdaq began operation as an exchange for Nasdaq-listed securities.

Given the Commission’s approval of SR-NASD-2005-087, NASD filed Amendment No. 2. Amendment No. 2, which replaces and supersedes the prior filings in their entirety, amends the proposed rule text and description to reflect Nasdaq’s operation as an exchange, among other clarifying changes.

#### Proposal

The Three Quote Rule originally was adopted on May 2, 1988,<sup>7</sup> as an amendment to NASD’s best execution interpretation and generally requires that members that execute transactions in non-exchange-listed securities<sup>8</sup> on behalf of customers contact a minimum of

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Emerging markets, whereas the FTSE World Index is comprised of securities from Developed and Advanced Emerging market segments only. The FTSE World Index, however, is no longer offered other than to existing FTSE subscribers. Given that the FTSE World Index would not be widely accessible, NASD amended its filing accordingly. See Exhibit 2 to Amendment No. 2 for additional details, available on the NASD’s Web site at [www.nasd.com](http://www.nasd.com).

The information in this proposed rule change, as amended, and in Exhibit 2 thereto relating to the FTSE All-World Index is based on information published on FTSE’s Web site at [www.ftse.com](http://www.ftse.com), as well as from conversations between NASD staff and FTSE staff.

<sup>6</sup> See Securities Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006).

<sup>7</sup> See Securities Exchange Act Release No. 25637 (May 2, 1988), 53 FR 16488 (May 9, 1988).

<sup>8</sup> The Three Quote Rule applies to transactions in all non-exchange-listed securities. A non-exchange-listed security is defined in NASD Rule 6610 as “any equity security that is not traded on any national securities exchange . . . .” Therefore, the rule by its terms

three dealers (or all dealers if three or less) and obtain quotations, if there are fewer than two quotations displayed on an inter-dealer quotation system that permits quotation updates on a real-time basis. The Three Quote Rule further defined a member's best execution obligation to customers by setting forth additional requirements for transactions in non-exchange-listed securities, particularly transactions involving relatively illiquid securities with non-transparent prices. The Three Quote Rule is a minimum standard, and compliance with the rule, in and of itself, does not mean a member has met its best execution obligations.

Since the adoption of the Three Quote Rule, the market for non-exchange-listed securities has changed significantly. NASD has found that under certain circumstances, the Three Quote Rule often can hinder, rather than further, best execution by causing significant delays in obtaining executions of customer orders. For example, in 2000, NASD amended the Three Quote Rule to eliminate the requirement to contact three market makers when there are at least two priced quotations displayed in an inter-dealer quotation system that permits quotation updates on a real-time basis.<sup>9</sup> NASD concluded that, where there were two transparent, firm quotes, the costs associated with delayed executions resulting from compliance with the Three Quote Rule were not outweighed by the benefits of obtaining three telephone quotes.

Similar concerns have been raised with respect to the Three Quote Rule's application in the area of orders in foreign securities of foreign issuers. Certain members and other interested parties had raised concerns that the Three Quote Rule was unnecessary and potentially harmful

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applies to transactions effected on any foreign exchange. The term "national securities exchange" is not defined in NASD rules, but the requirements to qualify are set forth in Sections 6(a) and 19(a) of the Act. See 15 U.S.C. 78f(a) and 78s(a). See also Securities Exchange Act Release No. 39266 (October 22, 1997), 62 FR 56217 (October 29, 1997).

<sup>9</sup> See Securities Exchange Act Release No. 43319 (September 21, 2000), 65 FR 58589 (September 29, 2000). This rule change also alleviated the corresponding recordkeeping requirements under Rule 3110(b) where NASD could validate and confirm compliance with applicable requirements directly through its internal historical data.

to the customer's best interests when a member, using reasonable diligence, has determined that the best market for a foreign security is a foreign market where the securities trade with sufficient liquidity and transparency.

NASD staff agreed that the protections of the Three Quote Rule may not be necessary with respect to all orders in foreign securities. In fact, according to the NASD, the Commission, in its approval order granting NASD exemptive authority with respect to the Three Quote Rule, specifically indicated that exemptive relief may be appropriate for transactions executed on a foreign exchange.<sup>10</sup> The NASD noted that the Commission stated that exemptive relief may be appropriate in such circumstances because the foreign exchange may constitute the best market for securities that are listed on that market and the time delay involved in contacting three dealers may, therefore, hinder a member from obtaining best execution for the customers.<sup>11</sup>

Accordingly, NASD is proposing amendments that would exclude from the Three Quote Rule's coverage transactions effected in foreign securities of foreign issuers that are part of the FTSE All-World Index.<sup>12</sup> Therefore, under the proposed rule change, a member would not be required to obtain three quotes in connection with transactions in foreign securities that are part of the FTSE All-World Index. The proposed rule change would not require that the transaction be executed on a foreign market so as not to limit the member's ability to determine, in fulfilling its best execution obligations, that a better execution would be obtained off the foreign market. However, to qualify for the exemption, the transaction must be executed during regular business

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<sup>10</sup> See Securities Exchange Act Release No. 39266 (October 22, 1997), 62 FR 56217 (October 29, 1997).

<sup>11</sup> Id.

<sup>12</sup> NASD states that the Financial Times and the London Stock Exchange operate the FTSE All-World Index. The FTSE All-World Index includes 48 different countries and approximately 3,000 stocks. See Exhibit 2 to Amendment No. 2 for a detailed description of the criteria used to determine the FTSE All-World Index.

hours of the foreign market for the security and no trading halt or other similar trading or quotation restriction may be in effect in any foreign market on which for such foreign security is listed.<sup>13</sup>

NASD has selected the FTSE All-World Index in part because, according to the NASD, Commission staff has deemed the foreign securities that are listed on the FTSE World Index, a subset of the FTSE All-World Index, as having a “ready market” and therefore eligible to receive comparable favorable treatment to U.S. equity securities under the securities haircut<sup>14</sup> provisions of the SEC’s net capital rule.<sup>15</sup> In addition, the Federal Reserve Board recognizes the FTSE World Index for determining whether stocks are eligible for margin treatment. NASD believes that the criteria used in determining the composition of the FTSE World Index, which are substantially the same for the FTSE All-World Index, helps to ensure that the securities trade with a high degree of liquidity, consistency, and price transparency.<sup>16</sup>

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<sup>13</sup> Contingent upon approval of the proposed rule change, NASD staff plans to withdraw all existing exemptions it has granted to the Three Quote Rule that relate to foreign securities. NASD staff has granted seven exemptions for customer transactions in Canadian securities executed on a Canadian exchange on an agency or riskless principal basis. See, e.g., Letter to Mr. Kenneth W. Perlman, General Counsel, Mayer & Schweitzer, Inc., from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, Inc., on May 29, 1998.

<sup>14</sup> NASD notes that the Commission’s net capital rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions, commonly referred to as “haircuts.” Haircuts are calculated under paragraphs (c)(2)(vi), (c)(2)(vii), and applicable appendices of the standard net capital rule, SEC Rule 15c3-1. 17 CFR 240.15c3-1.

<sup>15</sup> See 1993 SEC No-Act LEXIS 967 (August 13, 1993) (regarding foreign equity issues listed on the FT-Actuaries World Index as having a ready market with respect to the ready market and haircut provisions of the SEC’s net capital rule). NASD states that the calculation of the FT/S&P Actuaries World Index was taken over by FTSE in November 1999 and renamed the FTSE World Index, which is a subset of the FTSE All-World Index.

<sup>16</sup> The FTSE All-World Index is based on a set of rules that govern the construction and maintenance of the index. Stocks comprising the FTSE All-World Index are screened to,

Importantly, while the proposed rule change would not require a member to obtain three quotes in connection with transactions in foreign securities that are part of the FTSE All-World Index, members would continue to be required to comply with their best execution obligations under Rule 2320, and to the extent applicable, their suitability obligations under Rule 2310.

The proposed rule change also would provide a corresponding exclusion to the recordkeeping requirements set forth in Rule 3110(b) relating to the Three Quote Rule if the member can establish and document its reliance on this exclusion. Rule 3110(b) requires that members indicate on the order ticket for each transaction in a non-exchange-listed security the name of each dealer contacted and the quotations received to determine the best inter-dealer market as required by the Three Quote Rule.

In addition, NASD no longer refers to its subsidiary, NASD Regulation, Inc., using its full corporate name, “NASD Regulation” or “NASD Regulation, Inc.” Instead, NASD uses “NASD” unless otherwise appropriate for corporate or regulatory reasons. Accordingly, the proposed rule change replaces one reference to “NASD Regulation” in the text of the proposed rule change with “NASD.”

Finally, NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

## 2. Statutory Basis

NASD believes that the proposed rule change, as amended, is consistent with the

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among other things, ensure there is sufficient liquidity and the availability of accurate and timely data. Factors in determining liquidity include the level of trading volume relative to shares outstanding. See Exhibit 2 to Amendment No. 2 for further information.

provisions of Section 15A of the Act<sup>17</sup> in general, and with Section 15A(b)(6) of the Act<sup>18</sup> in particular, in that it is 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. NASD believes that the proposed rule change will reduce the time and effort necessary in contacting three dealers in orders for foreign securities of certain foreign issuers where it has been demonstrated that such securities are trading with sufficient liquidity and price transparency.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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<sup>17</sup> 15 U.S.C. 78o-3.

<sup>18</sup> 15 U.S.C. 78o-3(b)(6).

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act.

Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-130 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2004-130. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to

make available publicly. All submissions should refer to File Number SR-NASD-2004-130 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

Nancy M. Morris  
Secretary

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<sup>19</sup> 17 CFR 200.30-3(a)(12).