



Securities Industry Association

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May 4, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Disclosure and Consent Requirements When Trading on a Net Basis with a Customer (File No. SR-NASD-2004-135)

Dear Mr. Katz:

The Self-Regulation and Supervisory Practices and Trading Committees ("Committees") of the Securities Industry Association¹ ("SIA") welcome the opportunity to provide comments on NASD's above-referenced proposed rule to require disclosure and consent when trading on a net basis with customers ("Proposed Rule").² NASD states that this proposal is designed to codify prior interpretive guidance regarding a member's obligations when trading "net" with institutional customers, and to address for the first time a member's obligations when trading "net" with non-institutional customers.³

¹ The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated \$227.5 billion in domestic revenue and \$305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

² Exchange Act Release No. 51457 (March 31, 2005), 70 FR 17489 (April 6, 2005). As defined in the Proposed Rule, a "net" transaction is "a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price." In "net" transactions, a component of a broker-dealer's compensation is the spread between the price at which it purchases the security and the price at which it sells the security.

³ *Id.* See also, Exchange Act Release No. 43103 (July 31, 2000), 65 FR 48774 (August 9, 2000) and NASD Notice to Members 00-79 (November 2000).

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The Committees fully support NASD's goal of ensuring adequate disclosure and requiring consent when necessary to protect investors' interests. The Committees, however, believe that the many changes in our markets over the past decade and the resulting changes in the way broker-dealers charge for services may render the Proposed Rule either unnecessary or in need of further fine-tuning. If NASD decides to move forward with this Proposed Rule, we respectfully request that the Proposed Rule be revised for both institutional and non-institutional customers as set forth below.

In brief, with respect to institutional customers, the Committees respectfully request that the Proposed Rule be revised to provide firms with the option when trading "net" of using negative consent letters or of obtaining verbal consent on an order-by-order basis and to permit such consent to be evidenced on the customer order ticket. In addition, the Committees believe that mandatory written pre-trade disclosure concerning "net" trading is unnecessary, as firms and their customers generally agree on terms at the time the order is placed.

In brief, with respect to non-institutional customers, the Committees request that NASD review and clarify the form of disclosure and consent required when trading "net." As with institutional customers, the Committees recommend that the Proposed Rule be revised to provide firms with the option when trading "net" of using negative consent letters or of obtaining verbal consent on an order-by-order basis and to permit such consent to be evidenced on the customer order ticket. In addition, for firms choosing to obtain verbal consent on an order-by-order basis, the Committees recommend that pre-trade disclosure be required in the form of a one-time comprehensive disclosure statement. Finally, the Committees request that, for fiduciaries of non-institutional customers granted trading discretion who on their own qualify as an "institutional account" under the Proposed Rule, members be permitted to obtain the consent of such fiduciaries in the same manner as permitted for their institutional customers.

The Committees further request that NASD confirm that member firms and other registered broker-dealers are exempt from the requirements of the Proposed Rule, as they are neither institutional nor non-institutional customers.

Finally, the Committees request that NASD confirm an executing broker-dealer handling an order marked "net" routed to it from an originating broker-dealer has no consent and disclosure obligation to the customer of the originating broker-dealer for whom it is handling the order.⁴

⁴ On this point, the Committees wish to incorporate by reference SIA's comments on NASD's recent best execution rule proposal, SR-NASD-2004-026 (Exchange Act Release No. 51229 (February 18, 2005), 70 FR 9416 (February 25, 2005)). Among other things, SIA opined that because recipient [executing] broker-dealers have no knowledge of the originating broker-dealer's customer, the recipient broker-dealer should be deemed to have satisfied its best execution obligation if it executes the order in accordance with the terms and conditions of the order as communicated by the originating broker-dealer. See letters from the Ad Hoc Best Execution Committee (which includes members of the SIA Trading and Self-Regulation and Supervisory Practices Committees) of SIA to the SEC, dated March 18, 2005 and from the Ad Hoc Best Execution Committee of SIA to NASD, dated August 17, 2004.

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I. Background

It is our understanding that the interpretive guidance the NASD proposes to codify was necessary for the short period of time between March 1999 when NASD amended its trade reporting rules relating to riskless principal transactions ('Amendments')⁵ and the advent of decimal pricing in 2000.⁶

On March 24, 1999 and July 8, 1999, the SEC approved the NASD's rule proposals to require market makers to report qualifying riskless principal transactions⁷ in a single trade report, as opposed to separate reports for each leg of the transaction as had been required. To advance the NASD's regulatory interest in having a single trade report for riskless principal transactions, NASD subsequently provided that a member "working an order" for an institutional account (*i.e.*, "not held order") would be presumed to be handling the worked order on a qualifying riskless principal basis with the order matched off on each side at the same price (exclusive of any mark-up or mark-down, commission equivalent or other fee), unless the customer has specifically requested that the order be traded on a "net" basis at a different price.⁸

Because, at the time, institutional broker-dealers generally traded not held orders on a net basis as expected by their customers, many such broker-dealers were concerned that the presumption placed them in a difficult position of having to rebut it on nearly every institutional trade. Accordingly, firms requested guidance on how to document this understanding and asked for permission to use negative consent letters, citing difficulties with obtaining affirmative consents. Nasdaq subsequently provided interpretive guidance

⁵ Exchange Act Release No. 41208 (March 24, 1999), 64 FR 15386 (March 31, 1999) and Exchange Act Release No. 41606 (July 8, 1999), 64 FR 38226 (July 15, 1999).

⁶ On January 28, 2000 and June 8, 2000, the SEC issued orders directing the exchanges and NASD to submit a plan to implement decimal pricing. See Exchange Act Release No. 42360 (January 28, 2000), 65 FR 5003 (February 2, 2000) and Exchange Act Release No. 42914 (June 8, 2000), 65 FR 38010 (June 19, 2000).

⁷ A qualifying riskless principal transaction is a transaction in which a member, after having received a customer order, executes an offsetting transaction as principal with another customer or broker-dealer to fill the customer's order, and both transactions are executed at the same price. See Exchange Act Release No. 51457 (March 31, 2005), 70 FR 17489 (April 6, 2005); Exchange Act Release No. 43103 (July 31, 2000), 65 FR 48774 (August 9, 2000); and NASD Notices to Members 00-79 (November 2000) and 01-85 (December 2001).

⁸ Exchange Act Release No. 51457 (March 31, 2005), 70 FR 17489 (April 6, 2005); Exchange Act Release No. 43103 (July 31, 2000), 65 FR 48774 (August 9, 2000); and NASD Notice to Members 00-79 (November 2000).

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that members may use negative consent letters so long as the letter clearly discloses the terms and conditions for handling the customer's orders and the customer is provided a meaningful opportunity to object to any statements in the letter.⁹ This made perfect sense at the time given the riskless principal presumption and the high volume of "net" trading.

With the advent of decimal pricing in 2000, however, broker-dealers handling institutional customer orders moved away from "net" trading and now generally charge a commission or commission-equivalent for their services.

II. Institutional Customers - SIA Recommendations

For institutional customers, the Committees respectfully request that NASD revise its Proposed Rule to provide firms with the option when trading "net" of using negative consent letters or of obtaining verbal consent on an order-by-order basis and to permit consent to be evidenced on the customer order ticket.¹⁰ While "net" trading was once the norm in trading with institutional customers, it is now a rarity for customers to request to trade on a net basis. Many firms therefore believe that negative consent letters are no longer warranted in light of the decline in "net" trading resulting from the advent of decimal pricing, and that the costs and burden of sending, receiving and tracking negative consent letters are excessive in light of the fact that institutional customers would receive the requisite level of protection, if not greater, by providing verbal consent on an order-by-order basis. A small number of firms, however, may find it still useful to use negative consent letters, and therefore wish to retain the option of doing so.

Additionally, the Committees believe that it is unnecessary to require broker-dealers to provide written disclosure to institutional clients of the "terms and conditions" for handling "net" orders as such orders are generally initiated by the client who is a sophisticated investor that understands the implications of trading "net." At the time of the request to trade "net," the broker-dealer and client generally negotiate the broker-dealer's compensation and, if so compelled, the institutional customer has the opportunity to inquire about any additional terms and conditions. If, however, NASD believes that mandatory written disclosure of the terms and conditions of trading "net" remains warranted, the Committees respectfully request that pre-trade disclosure be permitted in the form of a one-time disclosure statement. The disclosure statement would provide

⁹ Written disclosure of the terms and conditions for handling customer orders when trading "net" and customer consent were not required prior to adoption of the Amendments.

¹⁰ One firm suggested that the specifics that could be documented on an order ticket is the agreed-upon compensation that the dealer would be making on the trade, which would reflect the fact that a conversation as to how much the dealer would get paid actually occurred with the client.

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the terms and conditions for handling "net" orders and inform clients that consent to trade "net" would be required on an order-by-order basis and that such consent would be evidenced on the order ticket. While firms should have flexibility to determine how best to comply with the Proposed Rule, it is expected that firms would send the disclosure to existing clients and include the disclosure on account opening documents for new clients.

III. Non-Institutional Customers - SIA Recommendations

NASD addresses for the first time in the Proposed Rule a member's obligations when trading "net" with non-institutional customers. The Proposed Rule would require members to obtain a customer's written consent to trade "net" on an order-by-order basis prior to executing the transaction, and the consent must evidence the customer's understanding of the terms and conditions of the order.

For non-institutional customers, the Committees request that the Proposed Rule clarify what form of consent and disclosure would be required to evidence agreement to "net" trading. While the Committees support the notion that non-institutional customers must knowingly consent to trade on a "net" basis, we are concerned with the requirement for a knowing, written consent on an order-by-order basis. The Committees believe that this requirement is impractical where most orders are not taken in writing, and there is no opportunity to obtain a written pre-trade consent on an order-by-order basis. We believe that no purpose is served by imposing onerous and impractical requirements on customers who do wish to consent to such trading. The Committees therefore recommend that the Proposed Rule be revised to provide firms with the option when trading "net" of using negative consent letters or of obtaining verbal consent to trade "net" on an order-by-order basis and to permit consent to be evidenced on the customer order ticket.

In addition, the Committees recommend that firms who choose to obtain verbal consent be required to provide pre-trade written disclosure in the form of a one-time comprehensive disclosure document.

The Committees also request that members be permitted to obtain the consent of fiduciaries of non-institutional customers granted trading discretion, who on their own qualify as an "institutional account" under the Proposed Rule, in the same manner as permitted for institutional customers.

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We appreciate the opportunity to provide you with these comments, and believe the above recommendations respond to the Committees' and the NASD's goals of protecting investors' interests while also addressing the realities of the marketplace. We welcome the opportunity to continue this dialogue with the NASD or SEC staff. If you have any questions, you may contact the undersigned at 212-608-1500 or 202-216-2000.

Very truly yours,

Amal Aly
Vice President and
Associate General Counsel

Ann Vlcek
Vice President and
Associate General Counsel

cc: Chairman William H. Donaldson

Commissioner Paul S. Atkins

Commissioner Roel C. Campos

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