

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51229; File No. SR-NASD-2004-026)

February 18, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto to Amend NASD Rule 2320(a) Governing Best Execution

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on February 12, 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 11, 2004, NASD amended the proposed rule change.³ On February 14, 2005, NASD amended the proposed rule change a second time.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.⁵

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Amendment No. 1 to SR-NASD-2004-026 filed on May 11, 2004. See infra discussion accompanying notes 6-7.

⁴ See Amendment No. 2 to SR-NASD-2004-026 filed on February 14, 2005. See infra discussion accompanying note 7.

⁵ NASD notes that related to amending NASD Rule 2320(a) it has also filed SR-NASD-2004-045, a proposed rule change that would require market order protection by prohibiting members from trading ahead of a customer market order. See Securities Exchange Act Release No. 51230 (February 18, 2005)(SR-NASD-2004-045). NASD has also filed SR-NASD-2004-089, a proposed rule change that would require limit order protection by requiring members to provide price improvement under certain circumstances. See Securities Exchange Act Release No. 51231 (February 18, 2005)(SR-NASD-2004-089).

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

NASD is proposing to amend Rule 2320(a) (“Best Execution Rule”). Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

2300. TRANSACTIONS WITH CUSTOMERS

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market center for the subject security and buy or sell in such market center so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

(1) [T]he character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

(2) the size and type of transaction;

(3) the number of [primary] market[s] centers checked;

(4) accessibility of the quotation [location and accessibility to the customer’s broker/dealer of primary markets and quotations sources.]; and

(5) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

(b) through (g) 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

Background

The Best Execution Rule currently requires a member, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. NASD has received a number of questions regarding the application of the term "customer," in the context of best execution. NASD Rule 0120(g) defines "customer" to exclude a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order from a customer ("originating broker-dealer") routes the order to a member firm ("recipient member") and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could argue that it has not violated the Best Execution Rule because the transaction was not "for or with a customer," but rather for or with a broker-dealer.

NASD believes that not applying the Best Execution Rule to recipient members is

contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker-dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to NASD Notice to Members 02-40.⁶ The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker-dealer.

On February 11, 2004, NASD filed the instant proposed rule change, proposing that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. The proposal also sought to clarify that the recipient member was not required to enter into any such written agreements with the originating broker-dealer, and that the originating broker-dealer (to the extent it is was a member) would remain obligated to comply with the Best Execution Rule, irrespective of whether such an agreement existed.

⁶ See letter from Dan Jamieson dated July 18, 2002; letter from Seidel & Shaw, LLC dated July 29, 2002; letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; letter from Security Traders Association dated Aug. 22, 2002; letter from The Island ECN, Inc. dated Aug. 22, 2002; letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and letter from the Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

On May 11, 2004, NASD filed Amendment No. 1 to SR-NASD-2004-026. Amendment No. 1 continued to require that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. In addition, Amendment No. 1 added a new reasonable diligence factor to the text of the Best Execution Rule that required consideration of the existence of a written agreement or written representations when a customer order is routed to another broker-dealer. Also, the amendment modified the text of new proposed paragraph (a)(2) of the Best Execution Rule. Lastly, the amendment provided proposed interpretive guidance concerning Rule 2320, as amended.

Proposal

With Amendment No. 2, NASD proposes to amend the Best Execution Rule to require that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer. Specifically, NASD is proposing to amend the Best Execution Rule to state that the rule governs "any transaction for or with a customer or a customer of another broker-dealer." NASD believes this proposed rule change will better ensure customer orders receive the equivalent best execution protections. This will occur without regard to whether a customer order is executed by the originating broker-dealer or routed to another broker-dealer.⁷ Moreover, best execution protection will apply whether the originating or recipient member executes the order as principal or routes it as

⁷ NASD believes that this approach is preferable to that specified in the original rule proposal and Amendment No. 1 because customer orders will receive best execution protections without regard to whether there is a written agreement or written representations from a recipient member.

agent to another market center. The recipient firm's duty under the rule is owed only to orders accepted by the recipient firm. The proposed rule change should enhance NASD's regulatory program and create a more uniform and consistent standard of best execution than currently exists.⁸

Furthermore, NASD proposes amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule currently requires a member to ascertain the best "inter-dealer" market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. As a result of changes in market structure, NASD is proposing to delete the term "inter-dealer" from NASD Rule 2320(a). This modification will clarify that member requirements to ascertain the best market for a security are not limited to "inter-dealer" markets, but may include all "market centers" in which a security is traded. NASD also proposes amending the reasonable diligence factors to reflect current market structure and to delete terms that are outdated. Specifically, NASD is recommending that the reference to the "number of primary markets checked" be updated to instead refer to "the number of market centers checked" and that the reference to the "location and accessibility to the customer's broker-dealer of primary markets and quotation sources"

⁸ NASD notes that by extending the scope of the Best Execution Rule to customer orders of another broker-dealer, the proposed rule change does not alter the obligation of an originating broker-dealer member to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. See Notice to Members 01-22 (April 2001), which reiterates the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and that also provides guidance to members concerning a broker-dealer's obligation, as articulated on numerous occasions by the SEC, to examine regularly and rigorously execution quality likely to be obtained from the different markets or market makers trading a security.

be updated to emphasize the importance of “accessibility of the quotation.” Lastly, NASD proposes adding a new factor that examines the “terms and conditions of the order” in determining whether a member has used due diligence. This will allow NASD staff to consider the communication of a customer’s instructions to assess whether a member and persons associated with a member have used “reasonable diligence.”

Should the Commission approve the proposed rule change, 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. Also in this Notice to Members, NASD will issue interpretive guidance consistent with the interpretive positions specified in this rule filing. The implementation date of the proposed changes will be 30 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,⁹ in general, and with Section 15A(b)(6) of the Act,¹⁰ in particular, which requires that NASD rules be 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. The obligation of a member firm to provide best execution to its customers has long been an important investor protection rule, characteristic of fair and orderly markets and a central focus of NASD’s examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will expand customer protection under the Best Execution

⁹ 15 U.S.C. 78o-3.

¹⁰ 15 U.S.C. 78o-3(b)(6).

Rule, provide better clarity to members, and enhance NASD's ability to pursue actions for failure to provide best execution.

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, as amended.

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

As discussed in the Section 2A above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another broker-dealer. A copy of the Notice to Members 02-40 and copies of the comment letters received in response to the Notice to Members 02-40 are on file with the Commission.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) limited to customer orders where there is an agreement or arrangement between the two broker-dealers that the recipient broker-dealer would comply with the duty of best execution; (2) limited to customer orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker-dealer agrees to provide automated executions to a routing broker-dealer's customer orders or there is another arrangement between the two broker-dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker-dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker-

dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited comment on whether the Best Execution Rule should distinguish, if at all, between customer orders received by a member from a foreign affiliate or foreign broker-dealer (as opposed to customer orders received by a member from a domestic affiliate or domestic broker-dealer that is subject to SEC, NASD, or other legal obligations concerning best execution).

NASD received eleven comments in response to the Notice to Members 02-40.¹¹ Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker-dealer.¹² Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker-dealer as customer orders. Lastly, two commenters articulated that the receiving broker-dealer should only have a duty of best execution under NASD Rule 2320 when the receiving broker-dealer has explicitly agreed to handle orders received from the originating broker-dealer as customer orders.

¹¹ See footnote 6, supra.

¹² See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

Four commenters asserted that the Best Execution Rule should not be amended at all.¹³ In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests. After considering the comments received in response to the Notice to Members 02-40, NASD proposed amending the Best Execution Rule. On February 11, 2004, NASD filed SR-NASD-2004-026. On May 11, 2004, NASD filed Amendment No. 1 to SR-NASD-2004-026.

In a letter dated August 17, 2004, the Securities Industry Association ("SIA") through its Ad Hoc Best Execution Committee ("SIA Committee") submitted comments to NASD in response to NASD's filing of Amendment No. 1.¹⁴ In this letter, the SIA Committee asserted that the proposal pending at the SEC is unnecessary in light of the effective safeguards already in place as a result of interplay between the current regulatory framework imposed on originating broker-dealers and competitive forces requiring recipient members to provide high-quality executions to orders routed to them. NASD staff did not agree with the SIA Committee's position that the current regulatory framework sufficiently addresses best execution obligations of recipient members. In

¹³ See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

¹⁴ Letter from Amal Aly and Ann Vlcek, on behalf of the Ad Hoc Best Execution Committee of the Securities Industry Association, to Barbara Z. Sweeney, NASD, dated Aug. 17, 2004.

addition, the SIA Committee urged NASD, to the extent that NASD is determined to amend the Best Execution Rule, to consider an alternative approach that would focus on extending the scope of the Rule to include transactions for or with a “customer of another broker-dealer.” NASD believes the SIA Committee’s alternative approach is consistent with the approach NASD proposed in Amendment No. 2.

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.

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. Please include File Number SR-NASD-2004-026 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-026. 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 the 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-2004-026 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.¹⁵

Margaret H. McFarland
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).