SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54799; File No. SR-NASD-2003-141)

November 21, 2006

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing of Amendment Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities

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 October 11, 2005, November 22, 2005, and October 31, 2006, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") Amendment Nos. 3, 4, and 5 to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. NASD submitted the original proposed rule change to the Commission on September 17, 2003 and filed amendments on June 29, 2004, and February 17, 2005.[3] The Commission published the proposed rule change, as amended by Amendment Nos. 1 and 2, for comment in the Federal Register on March 15, 2005.[4] The Commission received six comments on the

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Amendment No. 1 to SR-NASD-2003-141 made technical changes to the original rule filing. Amendment No. 2 to SR-NASD-2003-141 superseded in its entirety the original rule filing, as amended by Amendment No. 1.

4 See Securities Exchange Act Release No. 51338 (March 9, 2005), 70 FR 12764 (March 15, 2005) (NASD-2003-141).

proposal.[5] NASD submitted a response to these comments on October 4, 2005, and filed Amendment Nos. 3, 4, and 5 to further address the comments and propose responsive amendments.[6] Amendment No. 5 replaces in their entirety the original rule filing and Amendment Nos. 1 through 4 thereto. 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 adopt NASD IM-2440-2 to NASD Rule 2440 to provide additional mark-up policy for transactions in debt securities, except municipal securities. Below is the amended text of the proposed rule change. Proposed new language is underlined.

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IM-2440-1. Mark-Up Policy

Remainder of IM-2440-1 No change.

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5 The Commission received comments from Mr. Paul Scheurer, Banc of America Securities LLC, The Bond Market Association, CitiGroup Global Markets Inc., The Asset Managers Forum, and the American Securitization Forum. Two comments were submitted during the comment period which closed on April 5, 2005, and four additional comment letters were submitted after the comment period closed.

6 Both Amendment Nos. 3 and 4 to SR-NASD-2003-141 made technical changes to the rule filing as amended by Amendment No. 2.

IM-2440-2. Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities[1]

(a) Scope

(1) IM-2440-1 applies to debt securities transactions, and this IM-2440-2 supplements the guidance provided in IM-2440-1.

(b) Prevailing Market Price

(1) A dealer that is acting in a principal capacity in a transaction with a customer and is charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price. Presumptively for purposes of this IM-2440-2, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with NASD pricing rules. (See, e.g., Rule 2320).

(2) When the dealer is **selling** the security to a customer, countervailing evidence of the prevailing market price may be considered only where the dealer made no **contemporaneous purchases** in the security or can show that in the particular circumstances the dealer's **contemporaneous cost** is not indicative of the prevailing market price. When the dealer is **buying** the security from a customer, countervailing evidence of the prevailing market price may be considered only where the dealer made no **contemporaneous sales** in the security or can show that in the particular circumstances the dealer's **contemporaneous proceeds** are not indicative of the prevailing market price.

(3) A dealer's cost is considered contemporaneous if the transaction

occurs close enough in time to the subject transaction that it would reasonably be expected to reflect the current market price for the security. (Where a mark-down is being calculated, a dealer's proceeds would be considered contemporaneous if the transaction from which the proceeds result occurs close enough in time to the subject transaction that such proceeds would reasonably be expected to reflect the current market price for the security.)

(4) A dealer that effects a transaction in debt securities with a customer and identifies the prevailing market price using a measure other than the dealer's own contemporaneous cost (or, in a mark-down, the dealer's own proceeds) must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or, the dealer's proceeds) provides the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost is (or proceeds are) not indicative of prevailing market price, and thus overcome the presumption, in instances where (i) interest rates changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in debt securities pricing; (ii) the credit quality of the debt security changed significantly after the dealer's contemporaneous transaction; or (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.

(5) In instances where the dealer has established that the dealer's cost is (or, in a mark-down, proceeds are) no longer contemporaneous, or where the

dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or proceeds) provides the best measure of the prevailing market price, such as those instances described in (b)(4)(i), (ii) and (iii), a member must consider, in the order listed, the following types of pricing information to determine prevailing market price:

(A) Prices of any contemporaneous inter-dealer transactions in the security in question;

(B) In the absence of transactions described in (A), prices of contemporaneous dealer purchases (sales) in the security in question from (to) institutional accounts with which any dealer regularly effects transactions in the same security; or

(C) In the absence of transactions described in (A) and (B), for actively traded securities, contemporaneous bid (offer) quotations for the security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations.

(A member may consider a succeeding category of pricing information only when the prior category does not generate relevant pricing information (e.g., a member may consider pricing information under (B) only after the member has determined, after applying (A), that there are no contemporaneous inter-dealer transactions in the same security).) In reviewing the pricing information available within each category, the relative weight, for purposes of identifying prevailing market price, of such information (i.e., either a particular transaction price, or, in

(C) above, a particular quotation) depends on the facts and circumstances of the comparison transaction or quotation (i.e., such as whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction and timeliness of the information).

(6) In the event that, in particular circumstances, the above factors are not available, other factors that may be taken into consideration for the purpose of establishing the price from which a customer mark-up (mark-down) may be calculated, include but are not limited to:

- Prices of contemporaneous inter-dealer transactions in a "similar" security, as defined below, or prices of contemporaneous dealer purchase (sale) transactions in a "similar" security with institutional accounts with which any dealer regularly effects transactions in the "similar" security with respect to customer mark-ups (mark-downs);
- Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
- Yields calculated from prices of contemporaneous dealer purchase (sale) transactions with institutional accounts with which any dealer regularly effects transactions in "similar" securities with respect to customer mark-ups (mark-downs); and
- Yields calculated from validated contemporaneous inter-dealer bid (offer) quotations in "similar" securities for customer mark-ups (mark-downs).

The relative weight, for purposes of identifying prevailing market price, of the pricing information obtained from the factors set forth above depends on the facts and circumstances surrounding the comparison transaction (i.e., whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, timeliness of the information, and, with respect to the final factor listed above, the relative spread of the quotations in the similar security to the quotations in the subject security).

(7) Finally, if information concerning the prevailing market price of the subject security cannot be obtained by applying any of the above factors, NASD or its members may consider as a factor in assessing the prevailing market price of a debt security the prices or yields derived from economic models (e.g., discounted cash flow models) that take into account measures such as credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded options, coupon rate, and face value; and consider all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods). Such models currently may be in use by bond dealers or may be specifically developed by regulators for surveillance purposes.

(8) Because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price. For example, in considering yields of "similar" securities, except in extraordinary circumstances, members may not rely exclusively on isolated transactions or a limited number of

transactions that are not fairly representative of the yields of transactions in "similar" securities taken as a whole.

(9) "Customer," for purposes of Rule 2440, IM-2440-1 and this IM-2440-2, shall not include a qualified institutional buyer ("QIB") as defined in Rule 144A under the Securities Act of 1933 that is purchasing or selling a non-investment grade debt security when the dealer has determined, after considering the factors set forth in IM-2310-3, that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction. For purposes of Rule 2440, IM-2440-1 and this IM-2440-2, "non-investment grade debt security" means a debt security that: (i) if rated by only one nationally recognized statistical rating organization ("NRSRO"), is rated lower than one of the four highest generic rating categories; (ii) if rated by more than one NRSRO, is rated lower than one of the four highest generic rating categories by any of the NRSROs; or (iii) if unrated, either was analyzed as a non-investment grade debt security by the dealer and the dealer retains credit evaluation documentation and demonstrates to NASD (using credit evaluation or other demonstrable criteria) that the credit quality of the security is, in fact, equivalent to a non-investment grade debt security, or was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act of 1933.

(c) "Similar" Securities

(1) A "similar" security should be sufficiently similar to the subject

security that it would serve as a reasonable alternative investment to the investor. At a minimum, the security or securities should be sufficiently similar that a market yield for the subject security can be fairly estimated from the yields of the "similar" security or securities. Where a security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security.

(2) The degree to which a security is "similar," as that term is used in this IM-2440-2, to the subject security may be determined by factors that include but are not limited to the following:

(A) Credit quality considerations, such as whether the security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly strong guarantee or collateral as the subject security (to the extent securities of other issuers are designated as "similar" securities, significant recent information of either issuer that is not yet incorporated in credit ratings should be considered (e.g., changes to ratings outlooks));

(B) The extent to which the spread (i.e., the spread over U.S. Treasury securities of a similar duration) at which the "similar" security trades is comparable to the spread at which the subject security trades;

(C) General structural characteristics and provisions of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the security will be called,

tendered or exchanged, and other embedded options, as compared with the characteristics of the subject security; and

(D) Technical factors such as the size of the issue, the float and recent turnover of the issue, and legal restrictions on transferability as compared with the subject security.

(3) When a debt security's value and pricing is based substantially on, and is highly dependent on, the particular circumstances of the issuer, including creditworthiness and the ability and willingness of the issuer to meet the specific obligations of the security, in most cases other securities will not be sufficiently similar, and therefore, other securities may not be used to establish the prevailing market price.

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1. The Interpretation does not apply to transactions in municipal securities. Single terms in parentheses within sentences, such as the terms "(sale)" and "(to)" in the phrase, "contemporaneous dealer purchase (sale) transactions with institutional accounts," refer to scenarios where a member is charging a customer a mark-down.

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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 and Introduction

Under NASD Rule 2440, "Fair Prices and Commissions," members are required to sell securities to a customer at a fair price.[7] When a member acts in a principal capacity and sells a security to a customer, a dealer generally "marks up" the security, increasing the total price the customer pays. Conversely, when buying a security from a customer, a dealer that is a principal generally "marks down" the security, reducing the total proceeds the customer receives. NASD IM-2440, "Mark-Up Policy," provides

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[7] Rule 2440 specifically provides that a member is required to buy or sell a security at a fair price to customers, "taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit . . . ." Rule 2320, "Best Execution and Interpositioning," also addresses a member's obligation in pricing customer transactions. In any transaction for or with a customer or a customer of another broker-dealer, NASD Rule 2320, as amended effective November 8, 2006, requires a member to "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." See Securities Exchange Act Release No. 54339 (August 21, 2006), 71 FR 50959 (August 28, 2006) (order approving proposed rule change and Amendment Nos. 1 through 5; File No. SR-NASD-2004-026); NASD Notice to Members 06-58 (October 2006). Together, Rule 2440 and Rule 2320 impose broad responsibilities on broker-dealers to price customer transactions fairly. Cf. "Review of Dealer Pricing Responsibilities," MSRB Notice 2004 – 3 (January 26, 2004) (discussing MSRB Rules requiring municipal securities dealers to "exercise diligence in establishing the market value of [a] security and the reasonableness of the compensation received on [a] transaction").

additional guidance on mark-ups and fair pricing of securities transactions with customers.[8] Both Rule 2440 and IM-2440 apply to transactions in debt securities, and IM-2440 provides that mark-ups for transactions in common stock are customarily higher than those for bond transactions of the same size.[9]

Under Rule 2440 and IM-2440, when a customer buys a security from a dealer, the customer's total purchase price, and the mark-up included in the price, must be fair and reasonable. Similarly, when a customer sells a security to a dealer, the customer's total proceeds from the sale, which were reduced by the mark-down, and the mark-down, must be fair and reasonable. A key step in determining whether a mark-up (mark-down) is fair and reasonable is correctly identifying the prevailing market price of the security, which is the basis from which the mark-up (mark-down) is calculated.[10]

The Proposed Interpretation, "IM-2440-2, Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities" ("Proposed Interpretation"), provides additional guidance on mark-ups (mark-downs) in debt

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8 The terms "mark-up" and "mark-down" are not found in Rule 2440, but are used in IM-2440. Statements regarding mark-ups also apply generally to mark-downs unless mark-downs are discussed specifically in a separate statement.

9 NASD IM-2440(b)(1).

10 IM-2440 states: "It shall be deemed a violation of Rule 2110 and Rule 2440 for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable."

securities transactions, except municipal securities transactions.[11] The Proposed Interpretation addresses two fundamental issues in debt securities transactions: (1) how does a dealer correctly identify the prevailing market price of a debt security; and (2) what is a "similar" security and when may it be considered in determining the prevailing market price. As part of the discussion of prevailing market price, the Proposed Interpretation provides guidance on the meaning of "contemporaneous."[12] In addition, NASD proposes a significant exclusion from Rule 2440, IM-2440-1[13] and the Proposed Interpretation for broker-dealers engaging in non-investment grade debt securities transactions with certain institutional accounts.[14]

Prevailing Market Price

The Proposed Interpretation provides that when a dealer calculates a mark-up (or a mark-down), the best measure of the prevailing market price of the security is

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[11] MSRB rule G-30, "Prices and Commissions," applies to transactions in municipal securities, and requires that a municipal securities dealer engaging in a transaction as a principal with a customer must buy or sell securities at an aggregate price that is "fair and reasonable."

[12] See Proposed IM-2440-2(b)(3).

[13] If the Commission adopts the Proposed Interpretation, current IM-2440 will be re-numbered as IM-2440-1. IM-2440 is referred to hereinafter as IM-2440-1.

[14] See Proposed IM-2440-2(b)(9).

presumptively the dealer's contemporaneous cost (proceeds).[15] Further, the dealer may look to countervailing evidence of the prevailing market price only where the dealer, when selling a security, made no contemporaneous purchases in the security or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price.[16] When buying a security from a customer, the dealer may look to countervailing evidence of the prevailing market price only where the dealer made no contemporaneous sales in the security or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.[17]

The presumption that contemporaneous cost is the best evidence of prevailing market price is found in many cases and NASD decisions, and its specific applicability to debt securities transactions was addressed by the SEC as early as 1992 in F.B. Horner &

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15 See Proposed IM-2440-2(b)(1). Of course, if a dealer violates NASD Rule 2320, the dealer's contemporaneous cost (proceeds) in such transactions would not be a reliable indicator of the prevailing market price for the purpose of determining a mark-up or mark-down. If a dealer violates Rule 2320 because the dealer fails to exercise diligence, fails to negotiate at arms length in the market, or engages in fraudulent transactions, including those entered into in collusion with other dealers or brokers, including inter-dealer brokers, the price that the dealer obtains is not a price reflecting market forces, and, therefore, is not a valid indicator of the prevailing market price and should not be used to calculate a mark-up (mark-down). In addition, if a dealer that is not a party to a transaction engages in conduct to improperly influence the pricing of such transaction, the dealer could not properly use the execution price as the basis from which to compute a mark-up (mark-down) because the execution price does not represent the prevailing market price of the security.

16 See Proposed IM-2440-2(b)(2).

17 See id.

Associates, Inc.[18] ("F.B. Horner"), a debt mark-up case. In F. B. Horner, the SEC stated: "We have consistently held that where, as in the present case, a dealer is not a market maker, the best evidence of the current market, absent countervailing evidence, is the dealer's contemporaneous cost."[19] The basis for the standard was also restated by the Commission. "That standard, which has received judicial approval, reflects the fact that the prices paid for a security by a dealer in transactions closely related in time to his retail sales are normally a highly reliable indication of the prevailing market."[20]

The Proposed Interpretation recognizes that in some circumstances a dealer may seek to overcome the presumption that the dealer's own contemporaneous cost is (or proceeds are) the prevailing market price of the subject security for determining a mark-up (mark-down), and sets forth a process for identifying a value other than the dealer's own contemporaneous cost (proceeds).[21]

Cases Where the Presumption May Be Overcome

A dealer may seek to overcome the presumption that its contemporaneous cost or proceeds are not indicative of the prevailing market price in any of three instances: (i) interest rates changed after the dealer's contemporaneous transaction to a degree that

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18 50 S.E.C. 1063 (1992), aff'd, 994 F.2d 61 (2d Cir. 1993).

19 F.B. Horner, 50 S.E.C. at 1065-66. The term "market maker" is defined in Section 3(a)(38) of the Act, 15 U.S.C. 78c(a)(38), and a dealer in debt securities must meet the legal requirements of Section 3(a)(38) to be considered a market maker.

20 F.B. Horner, 50 S.E.C. at 1066 (citations omitted).

21 See Proposed IM-2440-2(b)(4).

such change would reasonably cause a change in debt securities pricing; (ii) the credit quality of the debt security changed significantly after the dealer's contemporaneous transaction; or (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.[22]

Interest Rates

The Proposed Interpretation provides that a dealer may seek to overcome the presumption that its contemporaneous cost or proceeds are not indicative of the prevailing market price where interest rates changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in debt securities pricing.[23] Changes in interest rates generally affect almost all debt securities pricing; when interest rates change, the price of a debt security is adjusted up or down so that the yield of the debt security remains comparable to other debt securities with the same or equivalent attributes, structures and characteristics (e.g., equivalent credit quality and ratings, equivalent call or put features, etc.).

Credit Quality

The Proposed Interpretation also provides that a dealer may be able to show that its contemporaneous cost is not indicative of prevailing market price where the credit quality of the debt security changed significantly after the dealer's contemporaneous

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[22] See id.

[23] See id.

transaction.[24] Although an announcement by a nationally recognized statistical rating organization ("NRSRO") that it has reviewed the issuer's credit and has changed the issuer's credit rating is an easily identifiable incidence of a change of credit quality, the category is not limited to such announcements. It may be possible for a dealer to establish that the issuer's credit quality changed in the absence of such an announcement; conversely, NASD may determine that the issuer's credit quality had changed and such change was known to the market and factored into the price of the debt security before the dealer's transaction (the transaction used to measure the dealer's contemporaneous cost) occurred.

News

NASD proposes that a dealer may be able to show that its contemporaneous cost is (or proceeds are) not indicative of prevailing market price where news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.[25] In such cases the dealer would be permitted to look at factors, as set out in the proposal, other than the dealer's own contemporaneous cost to establish prevailing market price. NASD proposes to include this provision in response to comments filed regarding the Proposed Interpretation. NASD agrees with commenters that certain news affecting an issuer, such as news of legislation, may affect either a particular issuer or a group or sector of issuer

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[24] See id.

[25] See id.

and may not clearly fit within the two previously identified categories – interest rate changes and credit quality changes. Such news may cause price shifts in a debt security, invalidating the dealer's own "contemporaneous cost" as a reliable and accurate measure of prevailing market price.[26]

Determining What is Contemporaneous

A broker-dealer must determine whether a transaction is contemporaneous to apply the guidance in the Proposed Interpretation, and, particularly, to identify the prevailing market price of a debt security. Although what is considered contemporaneous for purposes of determining a mark-up (mark-down) in a particular transaction is a facts-and-circumstances test, in response to the requests of commenters, NASD proposes to include in the Proposed Interpretation the following guidance:

> A dealer's cost is considered contemporaneous if the transaction occurs close enough in time to the subject transaction that it would reasonably be expected to reflect the current market price for the security. (Where a mark-down is being calculated, a dealer's proceeds would be considered contemporaneous if the transaction from which the proceeds result occurs close enough

[26] "News" referred to in paragraph (b)(4) of the Proposed Interpretation that may not be included in either of the other two categories referred to in paragraph (b)(4) may affect specific issuers, a group of issuers or an industry sector and includes news such as pending or contemplated legislative developments (e.g., relating to asbestos claims); the announcement of a judicial decision; the announcement of new pension regulation or a new interpretation; and the announcement of a natural disaster, an attack or a war.

in time to the subject transaction that such proceeds would reasonably be expected to reflect the current market price for the security.)[27]

Identifying Prevailing Market Price If Other Than Contemporaneous Cost or Proceeds

When calculating a mark-up, where the dealer has established that the dealer's cost is (or in a mark-down, proceeds are) no longer contemporaneous,[28] or where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost provides (or proceeds provide) the best measure of the prevailing market price, such as when there are interest rate changes, credit quality changes, or news events or announcements as described above and set forth in paragraph (b)(4) of the Proposed Interpretation, the dealer must follow a process for determining prevailing market price, considering certain factors in the appropriate order, as set forth in the Proposed Interpretation. Initially, a dealer must look to three factors or measures in the order they are presented (the "Hierarchy") to determine prevailing market price. The most important and first factor in the Hierarchy is the pricing of any contemporaneous inter-dealer transactions in the same security.[29] The second most important factor in the Hierarchy recognizes the role of certain large institutions in the

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27 See Proposed IM-2440-2(b)(3).

28 A dealer that has not engaged in trading in the subject security for an extended period can evidence that it has no contemporaneous cost (proceeds) to refer to as a basis for computing a mark-up (mark-down).

29 See Proposed IM-2440-2(b)(5)(A).

fixed income securities markets. In the absence of inter-dealer transactions, the second factor a dealer must consider is the prices of contemporaneous dealer purchases in the security in question from institutional accounts with which any dealer regularly effects transactions in the same security.[30] If contemporaneous inter-dealer trades or dealer-institutional trades in the same security are not available, a dealer must look to the third factor in the Hierarchy, which may be applied only to actively traded securities. For actively traded securities, a dealer is required to look to contemporaneous bid (offer) quotations for the security in question for proof of the prevailing market price if such quotations are made through an inter-dealer mechanism through which transactions generally occur at the displayed quotations.[31]

Additional Factors That May Be Considered

If none of the three factors in the Hierarchy is available, the dealer then may take into consideration the non-exclusive list of four factors in the Proposed Interpretation in trying to establish prevailing market price using a measure other than the dealer's contemporaneous cost (proceeds). In contrast to the Hierarchy of three factors discussed above, a dealer is not required to consider the four factors below in a particular order.

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30 See Proposed IM-2440-2(b)(5)(B). Contemporaneous dealer sales with such institutional accounts would be used to calculate a mark-down. If a dealer has overcome the presumption by establishing, for example, that the credit quality of the security changed significantly after the dealer's trade, any inter-dealer or dealer-institutional trades in the same security that occurred prior to the change in credit quality would not be valid measures of the prevailing market price as such transactions would be subject to the same defect.

31 See Proposed IM-2440-2(b)(5)(C).

The four factors reflect the particular nature of the debt markets and the trading and valuation of debt securities. They are:

- Prices of contemporaneous inter-dealer transactions in a "similar" security, as defined below, or prices of contemporaneous dealer purchase (sale) transactions in a "similar" security with institutional accounts with which any dealer regularly effects transactions in the "similar" security with respect to customer mark-ups (mark-downs);
- Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;
- Yields calculated from prices of contemporaneous purchase (sale) transactions with institutional accounts with which any dealer regularly effects transactions in "similar" securities with respect to customer mark-ups (mark-downs); and
- Yields calculated from validated contemporaneous inter-dealer bid (offer) quotations in "similar" securities for customer mark-ups (mark-downs).

When applying one or more of the four factors, a dealer must consider that the ultimate evidentiary issue is whether the prevailing market price of the security will be correctly identified. As stated in the Proposed Interpretation, the relative weight of the pricing information obtained from the factors depends on the facts and circumstances surrounding the comparison transaction (i.e., whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, timeliness of the information, and, with respect to the final factor listed above, the relative spread of the quotations in the "similar" security to the quotations in the subject

security).[32]

Finally, if information concerning the prevailing market price of the subject security cannot be obtained by applying any of the above factors, a member may consider as a factor in determining the prevailing market price the prices or yields derived from economic models that take into account measures such as credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded options, coupon rate, and face value; and consider all applicable pricing terms and conventions (e.g., coupon frequency and accrual methods).[33] However, dealers may not use any economic model to establish the prevailing market price for mark-up (mark-down) purposes, except in limited instances where none of the three factors in the Hierarchy and none of the four factors in proposed paragraph (b)(6) apply. For example, application of the Hierarchy and the four factors in proposed paragraph (b)(6) may not yield pricing information when the subject security is infrequently traded, and the security is of such low credit quality (e.g., a distressed debt security) that a dealer cannot identify a "similar" security.[34]

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32 See Proposed IM-2440-2(b)(6).

33 See Proposed IM-2440-2(b)(7).

34 When a dealer seeks to identify prevailing market price using other than the dealer's contemporaneous cost or contemporaneous proceeds, the dealer must be prepared to provide evidence that will establish the dealer's basis for not using contemporaneous cost (proceeds), and information about the other values reviewed (e.g., the specific prices and/or yields of securities that were identified as similar securities) in order to determine the prevailing market price of the subject security. If a firm relies upon pricing information from a model the firm uses or has developed, the firm must be able to provide information that was used on the day of the transaction to develop the pricing information (i.e., the data that was input and the data that the model generated and the firm used to arrive at prevailing market price).

The final principle in the Proposed Interpretation regarding prevailing market price addresses the use of pricing information from isolated transactions or quotations. The Proposed Interpretation provides that "isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price. For example, in considering yields of 'similar' securities, except in extraordinary circumstances, members may not rely exclusively on isolated transactions or a limited number of transactions that are not fairly representative of the yields of transactions in 'similar' securities taken as a whole."[35]

Certain Institutions Not Treated As Customers in Transactions in Non-Investment Grade Debt Securities

Commenters expressed concerns about the application of the original proposed rule change, as amended, to transactions between broker-dealers and large, knowledgeable institutions involving generally thinly traded, risky, and often volatile non-investment grade debt securities. In Amendment No. 5, NASD addresses these concerns and proposes, for purposes of Rule 2440, IM-2440-1 and the Proposed Interpretation, that in transactions in non-investment grade debt securities (including certain unrated securities), the term "customer" shall not include a qualified institutional buyer ("QIB"), as defined in Rule 144A under the Securities Act of 1933 ("Securities Act") provided other conditions are met. Specifically, the Proposed Interpretation provides that, for purposes of Rule 2440, IM-2440-1 and the Proposed Interpretation, the term "customer" shall not include:

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[35] See Proposed IM-2440-2(b)(8).

> a qualified institutional buyer ("QIB") as defined in Rule 144A under the Securities Act of 1933 that is purchasing or selling a non-investment grade debt security, when the member has determined, after considering the factors set forth in IM-2310-3, that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction.[36]

In NASD IM-2310-3, NASD sets forth a non-exclusive list of factors (or considerations) that a member may include in assessing and determining an institutional customer's capability to evaluate investment risk independently. These factors allow a member to examine the institutional customer's capability to make its own investment decisions, including examining the resources available to the institutional customer to make informed decisions, and include:

- the use of one or more consultants, investment advisers or bank trust departments;
- the general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;
- the customer's ability to understand the economic features of the security involved;

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[36] See Proposed IM-2440-2(b)(9).

- the customer's ability to independently evaluate how market developments would affect the security; and
- the complexity of the security or securities involved.

In addition, IM-2310-3 contains a non-exclusive list of factors (or considerations) for a member to use in determining if an institutional customer is making an independent investment decision. These factors probe the nature of the relationship that exists between the member and institutional customer and include:

- any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;
- the presence or absence of a pattern of acceptance of the member's recommendations;
- the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and
- the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

In addition, NASD proposes to define the term "non-investment grade debt security" broadly for purposes of NASD Rule 2440, IM-2440-1 and the Proposed Interpretation. Specifically, "non-investment grade debt security" shall mean a debt

security that (i) if rated by only one NRSRO, is rated lower than one of the four highest generic rating categories; (ii) if rated by more than one NRSRO, is rated lower than one of the four highest generic rating categories by any of the NRSROs; or (iii) if unrated, either was analyzed as a non-investment grade debt security by the member and the member retains credit evaluation documentation and demonstrates to NASD (using credit evaluation or other demonstrable criteria) that the credit quality of the security is, in fact, equivalent to a non-investment grade debt security, or was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act.[37]

The Proposed Interpretation recognizes and broadly addresses the most significant concerns of the comments received regarding the original proposed rule change, as amended. Many large institutional investors have sufficient knowledge of the market or certain sectors of the market to trade debt securities with broker-dealers at prices negotiated at arms length, reducing the need for such customers to be protected with respect to every transaction under Rule 2440, IM-2440-1 and the Proposed Interpretation. Further, the application of the Proposed Interpretation to generally illiquid market sectors, such as non-investment grade debt securities and bespoke or unique structured products that are sold pursuant to an exemption from registration under the Securities Act, and thereafter continue to be resold in private transactions rather than in the public markets, often may yield little or no pricing information that a dealer may use with

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[37] See Proposed IM-2440-2(b)(9).

confidence to determine the prevailing market price and a fair mark-up or mark-down for such debt securities transactions. It should be noted that even with respect to transactions with institutions that do not qualify for the exemption under proposed paragraph (b)(9), it would still be possible for a dealer to identify prevailing market price using information other than the dealer's contemporaneous cost (or proceeds), if done in accordance with the other provisions of the Proposed Interpretation.

Previously Proposed Concepts About Prevailing Market Price That Are Withdrawn

Specified Institutional Trade

In Amendment No. 1, NASD proposed that a dealer could seek to overcome the presumption that its contemporaneous cost or proceeds are indicative of the prevailing market price where the dealer establishes that the dealer's contemporaneous trade was a "Specified Institutional Trade"— a trade with an institutional account with which the dealer regularly effected transactions in the same or a similar security under certain

conditions ("SIT").[38] NASD subsequently withdrew the concept of SIT and substituted the size proposal set forth below.

Size Proposal

In Amendment Nos. 3 and 4, NASD proposed, instead of Specified Institutional Trades, the size proposal ("Size proposal"). As NASD stated in its Statement of Purpose for Amendment No. 3, "a large or a small transaction executed at a price away from the prevailing market price of the security, as evidenced by certain contemporaneous transactions, is an instance where it may be appropriate for the dealer to show that its contemporaneous cost (proceeds) is not indicative of prevailing market price." The proposed change was intended to provide dealers greater flexibility to identify prevailing

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[38] A "Specified Institutional Trade" was defined as a dealer's contemporaneous trade with an institutional account with which the dealer regularly effects transactions in the same or a "similar" security, as defined in the Proposed Interpretation, and in the case of a sale to such an account, the trade was executed at a price higher than the then prevailing market price, or in the case of a purchase from such an account, the trade was executed at a price lower than the then prevailing market price, and the execution price was away from the prevailing market price because of the size and risk of the transaction. In instances when the dealer would have established that the dealer's contemporaneous trade was an SIT, to overcome the presumption that the dealer's contemporaneous cost was (or proceeds were) the best measure of the prevailing market price, the dealer would have been required to provide evidence of prevailing market price by referring exclusively to inter-dealer trades in the same security executed contemporaneously with the dealer's SIT.

market price using a non-contemporaneous cost value than provided by the SIT provision proposed in Amendment No. 1.[39]

NASD also withdraws the Size proposal. Instead, NASD is proposing that, for purposes of Rule 2440, IM-2440-1 and the Proposed Interpretation, broker-dealers would not be required to treat QIBs engaging in transactions in non-investment grade debt securities as customers, if the broker-dealer determines, "after considering the factors set forth in IM-2310-3, that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction." The proposed amendment recognizes and addresses the concerns of commenters more clearly and more broadly than either the withdrawn SIT or Size proposals.

"Similar" Securities

The definition of "similar" security, and the uses and limitations of "similar" securities are the second part of the Proposed Interpretation. Several of the factors referenced above to which a dealer may refer when determining the prevailing market price as a value that is other than the dealer's contemporaneous cost (proceeds) require a dealer to identify one or more "similar" securities.

The Proposed Interpretation provides that a "similar" security should be

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[39] The SIT proposal was proposed in Amendment No. 1. In Amendment No. 3, NASD deleted the SIT proposal and replaced it with the Size proposal. Also in Amendment No. 3, references to size of trade as a consideration or a factor in pricing were added in other provisions. In Amendment No. 4, NASD submitted clarifications regarding the Size proposal. In Amendment No. 5, such references to size were deleted.

sufficiently similar to the subject security that it would serve as a reasonable alternative investment. In addition, at a minimum, a dealer must be able to fairly estimate the market yield for the subject security from the yields of "similar" securities.[40] Finally, to aid members in identifying "similar" securities when appropriate, the Proposed Interpretation sets forth a list of non-exclusive factors to determine the similarity between the subject security and one or more other securities. The non-exclusive list of factors that can be used to assess similarity includes the following:

(a) Credit quality considerations, such as whether the security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly strong guarantee or collateral as the subject security (to the extent securities of other issuers are designated as "similar" securities, significant recent information of either issuer that is not yet incorporated in credit ratings should be considered (e.g., changes in ratings outlooks));[41]

(b) The extent to which the spread (i.e., the spread over U.S. Treasury securities of a similar duration) at which the "similar" security trades is comparable to the spread at which the subject security trades;[42]

(c) General structural characteristics and provisions of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the security will be called, tendered or exchanged, and other

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40 See Proposed IM-2440-2(c)(1).

41 See Proposed IM-2440-2(c)(2)(A).

42 See Proposed IM-2440-2(c)(2)(B).

embedded options, as compared with the characteristics of the subject security;[43] and

(d) Technical factors, such as the size of the issue, the float and recent turnover of the issue, and legal restrictions on transferability as compared with the subject security.[44]

The provisions regarding "similar" securities, if adopted, would affirm explicitly, for the first time, that it may be appropriate under specified circumstances to refer to "similar" securities to determine prevailing market price. In addition, the Proposed Interpretation provides guidance as to the degree of similarity that is required. Also, the Proposed Interpretation recognizes an additional source of pricing information, i.e., certain economic models, that a dealer may consider in determining prevailing market price when all other factors, including those employing "similar" securities, do not render relevant pricing information because transactions and quotes (that have been validated by

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43 See Proposed IM-2440-2(c)(2)(C).

44 See Proposed IM-2440-2(c)(2)(D).

The Proposed Interpretation also states that, for certain securities, there are no "similar" securities. Specifically, when a debt security's value and pricing is based substantially on, and is highly dependent on, the particular circumstances of the issuer, including creditworthiness and the ability and willingness of the issuer to meet the specific obligations of the security, in most cases other securities will not be sufficiently similar, and therefore, other securities may not be used to establish prevailing market price of the subject security. See Proposed IM-2440-2(c)(3). As noted above, NASD may consider a dealer's pricing information obtained from an economic model to establish prevailing market price, when "similar" securities do not exist and facts and circumstances have combined to create a price information void in the subject security. In addition, as provided in the Proposed Interpretation, NASD also may look to economic models other than the dealer's to make determinations as to the prevailing market price of a security.

active trading) have not occurred in the subject security and there are no "similar" securities. Thus, when all other factors have been considered but are irrelevant, such as when a very distressed, very illiquid security is traded, the Proposed Interpretation provides the flexibility to determine prevailing market price and an appropriate mark-up (mark-down).

Conclusion

NASD believes that the Proposed Interpretation recognizes the special characteristics of debt instruments, reflects the particular nature of trading in the debt markets, and provides important guidance to all members engaged in debt securities transactions. The guidance sets forth clearly a basic principle in NASD's rules: a dealer's contemporaneous cost (or, when calculating a mark-down, a dealer's contemporaneous proceeds) is presumptively the prevailing market price in debt securities transactions. In addition, the Proposed Interpretation provides guidance on when this principle may not be applicable, and, in those cases, guidance on the dealer's obligation to provide evidence of the prevailing market price using the factors set forth above, and, as applicable, in the priority set forth above, and any other relevant evidence of prevailing market price. NASD also proposes to recognize, in limited circumstances, that a dealer may refer to an economic model to provide evidence of the prevailing market price of a security when the security is sufficiently illiquid that the debt market does not provide evidence of the prevailing market price, and the security does not meet other criteria and therefore cannot be compared with a "similar" security.

The Proposed Interpretation now includes an exemption from Rule 2440, IM-

2440-1 and the Proposed Interpretation for certain transactions in non-investment grade debt securities between broker-dealers and certain QIB customers. NASD believes that many of the concerns and objections raised by commenters regarding the regulation of mark-ups (mark-downs) in debt securities transactions between broker-dealers and institutional customers are addressed by the inclusion of the proposed exemption.

Finally, the Proposed Interpretation announces explicitly that a dealer is permitted to use "similar" securities in some cases where the dealer is identifying the prevailing market price of a security using a measure other than the dealer's contemporaneous cost (or contemporaneous proceeds). NASD's recognition of the limited but appropriate use of a "similar" security includes guidance on which securities may be considered "similar" securities. NASD believes that the Proposed Interpretation is an important first step in developing additional mark-up guidance for members engaged in debt securities transactions with customers on a principal basis.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[45] which requires, among other things, that NASD rules must 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. NASD believes that clarifying the standard for correctly identifying the prevailing market price of a debt security for purposes of calculating a mark-up (mark-down), clarifying the additional obligations of a member when it seeks to use a measure

[45] 15 U.S.C. 78o-3(b)(6).

other than the member's own contemporaneous cost (proceeds) as the prevailing market price, and confirming that similar securities may be used in certain instances to determine the prevailing market price are measures designed to prevent fraudulent practices, promote just and equitable principles of trade, and protect investors and the public interest. Further, the inclusion of an exemption from Rule 2440, IM-2440-1 and the Proposed Interpretation for transactions in non-investment grade debt securities between broker-dealers and certain QIBs provides such parties flexibility and will not impair or burden the markets or the parties trading in non-investment grade debt securities.

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

NASD has responded previously to industry and SEC comments regarding this rule change. See NASD Response to Comments, filed on October 4, 2005.

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 is consistent with the Act.[46] 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-2003-141 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-2003-141. 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

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[46] The Commission will consider the comments we previously received. Commenters may reiterate or cross-reference previously submitted comments.

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-2003-141 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.[47]

Nancy M. Morris
Secretary

[47] 17 CFR 200.30-3(a)(12).